Energy Interdependencies between the EU and Russia: Anything but Institutions?

Sesso scientifico-disciplinare: STORIA DELLE RELAZIONI INTERNAZIONALI (SI/06)

DOTTORANDO (PHD CANDIDATE): MORENA SCALAMERA

COORDINATORE DEL COLLEGIO DEI DOCENTI (COORDINATOR OF THE DOCTORAL PROGRAM): CHIARIMO PROF. LUIGI PELIZZONI

UNIVERSITÀ DI TRIESTE

FIRMA:

RELATORE (Tesi Supervisor): CHIARIMO PROF. GIORGIO COTL

UNIVERSITÀ DI TRIESTE

FIRMA:

CORRELATORE (Tesi Co-Supervisor): CHIARIMO PROF. RAHI ABDELAL

HARVARD UNIVERSITY

FIRMA:

ANNO ACCADEMICO 2011 / 2012
Dedication

To my grandparents and their unconditional love. I miss you.
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Acknowledgements

I wish to express my sincere gratitude to all those who have helped me to complete this dissertation. First of all, I would like to thank my supervisors; professors Giorgio Osti (University of Trieste) and Rawi Abdelal (Harvard University), whose support and guidance provided an invaluable motivation to pursue this project. I wish to express my sincere appreciation both for their willingness to read through drafts of this work, and for the quality of their analyses on how to best ground my work and strengthen the arguments presented. This dissertation would not have been possible without the support of the International University Institute for European Studies (IUIES) and the encouragement of the University of Trieste. Similarly, I am particularly grateful to the Davis Center for Russian and Eurasian Studies, where the core research for this dissertation was conducted. My greatest debt of gratitude is owed to Robyn Angley who assiduously helped me throughout all the bureaucratic and organizational issues and whose collaboration has been much appreciated. I am very grateful to the Fung Library’s librarian Hugh Truslow for his courtesy and support. I also wish to extend my gratitude to the entire faculty, the scholars-in-residence, and other graduate students at Harvard University whose contributions were vital to the completion of my analysis. Many people at Harvard provided valuable advice, thoughtful criticism and help with the revisions. In that sense, above all thanks are due once again to the Davis Center and the Harvard Ukrainian Research Institute (HURI), which provided the academic homes during my residence at Harvard. I am particularly grateful to Meghan O’Sullivan for her consistent and structured advice, Leonardo Maugeri who provided great insights into the business perspective of the key issues, and again to Joseph Nye, Karl Kaiser and John Ruggie for their time and brilliant advice. Special note of gratitude goes to Nadiya Kravets, Jonas Meckling and Boris Barkanov who read and commented on early drafts of this work and Margarita Balmaceda who reminded me to follow one core research question and provided invaluable insights on how to clearly ground my argument. Thanks to Margarita, this dissertation benefited greatly from the input of the German scholars during my short stay at the Forschungsstelle Osteuropa in Bremen and at the SWP in Berlin in May 2012. A special thanks to Heiko Pleines and Kirsten Westphal for granting me the opportunity to visit their research centers and make use of the vast libraries, but especially thanks of their expert insights on aspects of this work. Once again, I wish to thank all the interviewers who found time in their busy schedules to be interviewed and those experts who freely shared their knowledge with me: Coby van der Linde (CIEP), Albert Bressand (Columbia University), Tatiana Mitrova (Skolkovo Centre), Andrey Belyi, Leonid Grigoriev, Catherine Locatelli, Christof Van Agt (CIEP), Heiko Pleines, Andreas Heinlich, Karen Smith Stegen (Jacobs University), Giacomo Luciani. This dissertation and fieldwork would not have been possible without the financial support of the IUIES and the University of Trieste, hence I am enormously grateful for all the great opportunities they gave me. I would also like to thank my colleagues at the IUIES for their help with this research. Finally, I would not have been able to complete this project without the continued support, love and warmth of my family and the constant encouragement of my friends. Thank you for helping me to see what really matters.
Preface

This dissertation offers a thorough analysis of European-Russian energy cooperation. It sheds light on the question: why is there a lack of binding institutionalization of the EU-Russia energy relationship despite the high degree of interdependence between the two sides? It is primarily focused on identifying the main actors on both sides of the relationship. This allows us to understand whether there are causal implications between the interest formation and the lobbying power of the crucial actors on the one hand, and the lack of binding governance structures in the EU-Russia energy cooperation on the other. It speaks to the body of literature examining the failure to cooperate in situations of high economic interdependence. Questions such as do multilateral agreements really matter to the main actors on both sides of the EU-Russian energy relationship form the core of this dissertation. My study differs from dominant liberal and constructivist interpretations in that it links in a comprehensive way the influence of the main actors (i.e. the big gas companies) and the lack of binding governance structures regulating the relationship. Hence, unlike other analyses it finds that the central influence of the industrial gas lobby on decision-making processes is the direct cause of the lack of binding governance structures. It is therefore an alternative to studies that either conceptualize the institutional deadlock as a consequence of structural deficiencies on both sides, or as an outcome of a normative clash. In contrast, I point to the primacy of the private sector and I argue that the influence and the behavior of strategic corporate actors is key to understanding the deadlock. A crucial focus lies on the current paradigm changes in the European gas pricing systems, which widen the already high interest gap between the two blocs. Although being theoretically grounded in the realist tradition, in focusing on the large potential of cross-border cooperation this dissertation employs an innovative and complementary perspective. I investigate various angles on different levels of the complex interdependent relationship, such as the sub-regional level. Yet, the most distinctive feature of this work is the emphasis on the dynamic causal pathways between the influence of the strategic corporate actors and the weakness of governance patterns in the EU-Russia energy relationship. I show how the corporate sector's pressures on both sides of the relationship ultimately shape and predetermine the configuration of EU-Russia energy governance structures. While evidence about the centrality of the corporate sector strengthens the conclusions of a growing body of research, this study provides an original causal explanation that links the interests of the big energy firms and their reluctance to be locked-into binding governance structures, with the energy governance deadlock. My propositions are tested empirically through an array of qualitative methods (interviews, case studies, analysis of legal and policy documents). I believe that my findings will contribute to the debate on energy relations between the EU and Russia, and help improve our understanding of the role of the corporate sector in relation to weak governance structures.

April 2013
Trieste, Italy

Morena Skalamera
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<tr>
<td>BASREC</td>
<td>Baltic Sea Region Energy Cooperation</td>
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<td>BITs</td>
<td>bilateral investment treaties</td>
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<tr>
<td>BP</td>
<td>British Petroleum</td>
</tr>
<tr>
<td>BRICs</td>
<td>Brazil, Russia, India, China</td>
</tr>
<tr>
<td>BTC</td>
<td>Baku-Tbilisi-Ceyhan oil pipeline</td>
</tr>
<tr>
<td>BTE</td>
<td>Baku-Tbilisi-Erzurum gas pipeline</td>
</tr>
<tr>
<td>BAU</td>
<td>business-as-usual</td>
</tr>
<tr>
<td>CAC</td>
<td>Central-Asia-Centre Pipeline</td>
</tr>
<tr>
<td>CBC</td>
<td>Cross-border Cooperation</td>
</tr>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
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<tr>
<td>CEO</td>
<td>chief executive officer</td>
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<tr>
<td>CERA</td>
<td>Cambridge Energy Research Associates</td>
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<td>CIEP</td>
<td>Clingendael International Energy Programme</td>
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<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>CNPC</td>
<td>Chinese National Petroleum Company</td>
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<tr>
<td>CO₂</td>
<td>Carbon Dioxide</td>
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<tr>
<td>CFSP</td>
<td>Common Foreign and Security Policy</td>
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<td>CSTO</td>
<td>Collective Security Treaty Organization</td>
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<tr>
<td>DEPA</td>
<td>Public Gas Corporation of Greece</td>
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<td>DESFA</td>
<td>Hellenic Gas Transmission System Operator</td>
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<tr>
<td>EAI</td>
<td>Energy Affinity Index</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EC</td>
<td>European Commission</td>
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<td>ECT</td>
<td>Energy Charter Treaty</td>
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<tr>
<td>EDF</td>
<td>Electricité de France</td>
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<td>EEAS</td>
<td>European Union External Action Service</td>
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<td>EIA</td>
<td>Energy Information Administration</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<tr>
<td>ENEL</td>
<td>Ente Nazionale per l’Energia Elettrica</td>
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<tr>
<td>ENI</td>
<td>Ente Nazionale Idrocarburi</td>
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<tr>
<td>ENP</td>
<td>European Neighborhood Policy</td>
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<td>EP</td>
<td>European Parliament</td>
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<tr>
<td>ESDP</td>
<td>Common Security and Defense Policy</td>
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<td>ESPO</td>
<td>East Siberian Pacific Ocean Pipeline</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FSU</td>
<td>Former Soviet Union</td>
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<tr>
<td>FTA</td>
<td>Free Trade Agreement</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GDF</td>
<td>Gaz de France (Suez)</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GECF</td>
<td>Gas Exporting Countries Forum</td>
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<td>GHG</td>
<td>greenhouse gases</td>
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IEA International Energy Agency
IGA intergovernmental agreement
IMF International Monetary Fund
INO GATE Interstate Oil and Gas Transport to Europe
IOC International Oil Companies
IPE international political economy
IR international relations (discipline)
ITGI Interconnector Greece Italy gas pipeline
LNG liquefied natural gas
LTSCs long-term supply contracts
MOL Magyar Olaj és Gázipari Részvénytársaság
MoU Memorandum of understanding
NATO North Atlantic Treaty Organization
NGO non-governmental organization
NIMBY Not In My Back Yard
NOC National Oil Companies
OECD Organization for Economic Cooperation and Development
OMV Österreichische Mineralölvorverwaltung
OPEC Organization of the Petroleum Exporting Countries
OSCE Organization for Security and Cooperation in Europe
PCA Partnership and Cooperation Agreement
PM prime minister
PSV Punto di Scambio Virtuale
R&D Research and development
RWE Rheinisch-Westfälisches Elektrizitätswerk
SCO Shanghai Cooperation Association
SCP South Caucasus Pipeline
SEE South-Eastern Europe
SERI Socioeconomic Energy Risk Index
SNAM Società Nazionale Metanodotti
SOCAR State Oil Company of the Azerbaijan Republic
Statoil Norske Stats Oljeselskap AS
TACIS Technical Aid to the Commonwealth of Independent States
TAP Trans-Adriatic Pipeline
TCP Trans-Caspian Pipeline
TEN-E Trans-European Network
TPA Third-Party Access
UG Unconventional Gas
UK United Kingdom
UN United Nations
US United States (of America)
USSR Union of Soviet Socialist Republics
WE O World Energy Outlook
WIEH Wintershall Erdgas Handelshaus GmbH
WTO World Trade Organization

Units of Measurement

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<th>Symbol</th>
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<th>Units</th>
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<tr>
<td>bcm</td>
<td>billion cubic meters</td>
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<tr>
<td>bcm/y</td>
<td>billion cubic meters per year</td>
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<tr>
<td>km</td>
<td>kilometer</td>
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</tr>
<tr>
<td>mmbtu</td>
<td>million British Thermal Units</td>
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<tr>
<td>tcm</td>
<td>thousand cubic meters</td>
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PART I
Research Design and Methods
1. Introduction - The Puzzle

Wider scholarship seems to agree that the only solution to the EU and Russian energy relationship lies in interdependence. The literature on interdependence theory has centered on the idea that with the increasing of economic interdependence, in which coalitions are formed transnationally and transgovernmentally, the potential role of international institutions is greatly enhanced. Confronted with complex interdependence and the efforts of states to manage it, liberal political scientists such as Nye and Koehane (1977) began to redefine the study of international institutions, broadening it to encompass what they called "international regimes" – i.e. structures of rules and norms that could be more or less informal. The underlying assumption was that in a world becoming more and more economically interdependent, international institutions had an important function in reducing the so-called “transaction costs,” alongside reinforcing practices of reciprocity and helping states to achieve the collective gains of globalization. In the 1980s, research on international regimes moved further from attempts to describe the phenomena of interdependence and international regimes to closer analysis of the conditions under which countries cooperate. The most prominent contribution is perhaps Keohane’s (1984), epitomized in the following statement: “in order to achieve what they want, most states will find that they will have to cooperate. It is important to note that cooperation does not imply harmony. On the contrary cooperation arises out of discord, along with the shared belief that mutual adjustment is necessary – albeit often painful.” Cooperation typically takes the form of bilateral and multilateral treaties and delegation to intergovernmental institutions. According to liberal scholars economic interdependence and its regulation have altered notions of sovereignty, which is now recognized as a relative concept. Noteworthy is Robert Keohane’s distinction between “formal sovereignty” and “operational sovereignty”: “Formally sovereign states often limit their operational sovereignty by accepting constraints on their own actions, as they do when they enter into agreements establishing international regimes and organizations.” Keohane goes on to argue that states often find it in their interest to limit their own operational sovereignty in order to enjoy the cooperative benefits with other states. From the standpoint of political liberalism, both the last decade’s reaffirmation of sovereignties in a number of rising powers and the failure of the EU and Russia to ‘regulate’ institutionally their otherwise high level of interdependence, are puzzling. What is more, the EU-Russian high level of balanced interdependence and hence a low degree of asymmetry – not only failed to become a source of fruitful cooperation, but has rather proven as a source of conflict. Hence, could it be that in some cases, instead of cooperation arising from discord – discord arises from interdependence? According to the broadly defined liberal research discourse, in order to be successful “international regimes” should rest on shared conceptual frameworks encompassing rules and norms, structures for information sharing and reciprocity. In the case of Russian and European energy cooperation the two main “ingredients” of information sharing and reciprocity are at the least ‘problematic’ concepts. However, considering the high degree of complex interdependence, since the EU needs Russian gas as much as Russia needs Europe’s hard currency, the question is why this ever-increasing energy interdependence did not point to the significance of institutions that could facilitate their energy relationship by reducing

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1. John Ruggie introduced the concept of international regimes into international politics literature in 1975, and he defined a regime as “a set of mutual expectations, rules and regulations, plans, organizational energies, and financial commitments, which have been accepted by a group of states.” (p. 570).
uncertainty, lowering the transaction costs of the cooperation, and setting commonly accepted rules and standards (Keohane 1984, Ikenberry, 2008)? This question seems unanswerable if high degrees of interdependence are seen as prerequisites for peace and institutional cooperation. Yet as it will be argued here, high interdependence can under certain circumstances become a source of friction and of an increasing feeling of insecurity. In fact, several energy specialists point out that the nature of the European and Russian energy relationship has been interdependent but at the same time confrontational. Generally speaking the liberal theories failed to predict why economic cooperation has not been conducive to a peaceful relationship exempt from the realist—style “security dilemma.” The basic idea that when states begin to cooperate they become aware of mutually beneficial strategies of institution-building, thereby fostering further “institutional” cooperation, for the maintenance of their agreements and in the final analysis for securing peace, holds negative evidence in the case of the EU’s and Russian energy cooperation. The two blocs are willing to be highly economically interdependent but the economic interdependence per se does not foster a commitment to a common umbrella of legally binding agreements. In the last analysis, one could argue that it is rather peace that fosters interdependence, and not interdependence that fosters peace. For example, some realist argue that the high degree of interdependence between the United States and China, does not in itself guarantee that the rise of China will not eventually result in an open conflict between the two countries. The constructivist school of thought has taken another perspective to explain why the EU-Russian energy interdependence is not conducive to commonly agreed energy governance frameworks. The proponents of this strand of thought tend to emphasize the normative clash between the EU and Russia. For example, Russia and the EU are very different from the standpoint of operationalizing sovereignty and on their views on reciprocity and other norms influencing their energy relationship, which results in an almost unbearable “normative gap” between the two blocs. While the EU has became the most advanced world’s bloc in pooling sovereignty, Russia has had a historical determination regarding borders, sovereignty and self-determination, incorporated during the Soviet Union in the conceptions on the Brezhnev Doctrine. This conception of sovereignty has somewhat reemerged in the present day Russia, which is one of the reasons making it is difficult to find common ground between the EU’s and Russian guiding paradigms and to bridge the normative gaps dividing the two blocs. The classic realist school of thought favors the lens of the energy security dilemma to look at the problem; indeed geopolitical realism leads to a tendency to see international relations in zero-sum terms, thus any increase in Europe’s energy security unavoidably leads to a decrease of Russia’s energy security and vice versa. According to Realists, in a setting dominated by anarchy and power insecurities states should not even bother to delegate their power to international institutions.

1.1 Research Question

With this in mind, I seek to answer the key puzzle of this study: why interdependence does not work in the EU-Russia natural gas relationship? In other words, the research question guiding this dissertation is why, given the high degree of mutual dependency, to date, not a single binding institution regulating the EU-Russia energy trade has been put in place? In order to shed light on this larger question, it is very useful to look at the more concrete questions of:

a) Who are the relevant actors in the EU-Russia energy relationship?

b) What are the main incentives shaping their behavior?

c) And why they are taking a particular course of action?
Moreover I will address the question of which are the relevant events that have prompted the two blocs to re-think their energy relationship? I propose to show how some exogenous events, such as technological breakthroughs, have profoundly affected the relationship. These include the revolution of so-called shale gas in the USA that mixed with the global economic recession, have reduced the demand for Russian gas in its main market, the EU and put pressure on the long-established oil-indexation system.

1.2 Hypothesis

I will seek to demonstrate that the reason for the EU-Russian failure to establish commonly agreed institutions of energy governance stems from the fact that the crucial actors in the Russia – EU energy cooperation have not enough shared interests favoring institutional cooperative endeavors, which would thus outweigh the cost of being tied-up in international regulatory frameworks with a legal value. In that sense, this study argues that under some conditions interdependence can facilitate cooperation, but it is neither a necessary nor a sufficient condition for it. As recent events have shown, the earnings of the main actors’ depend on a gas market that is volatile and subject to big changes. The fact that the gas markets are still regional, gives Russia an exceptional position of arbitrage between the two largest importing blocs – the EU and Asia. Moreover, this thesis attempts to show that Russia refused to ratify the Energy Charter Treaty simply on the grounds of a cost-benefit analysis, i.e. because it did not reflect its sheer interests. The EU-Russia Energy dialogue has proceeded mainly on minor, day-to-day issues. From the EU perspective likewise, the main drivers of the EU’s unity and disunity have been the corporate actors, who, as my findings demonstrate, have no interest in obeying to binding governance arrangements. Moreover, the sense of urgency and optimism that brought the ECT into being in 1994 and that put in place the Energy Dialogue in 2000 has for the most part vanished today. I draw upon realist and liberal IR theories on the role of power, interest and interdependence to explain why the most interdependent dimension of EU-Russian relations is characterized by discord and apprehension, rivalry and tension. I will take a rational-choice approach to studying the behavior of the crucial actors on both sides of the interdependence spectrum. Therefore, I will assume that actors behave in a way consistent with egoistic and rational self-interest. This research breaks with the institutional liberalism in the view that interdependence is conducive to institutional cooperative ties between states or blocs and well with the idealism associated with the claim that interdependence is conducive to peace. Although my argument is based within the realist tradition, it employs a broader approach, which allows for a simultaneous engagement of different interpretative perspectives, such the constructivist tradition. Moreover, in order to adequately account for the wide ranging relationships at the interregional level of the EU’s and Russia’s energy policies, this study identifies a number of frames that bolster previous research, such as Aalto’s et al. (2008) remarkable analysis of the different dimensions of energy politics within which the related actors operate and pursue their interests. Aalto’s analytical model provides an excellent theoretical platform to account for all the energy interrelationships that are already in place, for the leading actors within the particular domains and the outcomes of their activities. Aalto’s et al. research however, does not help us answer the fundamental question guiding this inquiry: why the extensive interdependencies between the EU and Russia did not lead to mutually acceptable regional institutions and/or encouraged the creation of global institutions of energy governance? Other insightful studies stress the need for global governance structures to cope with the rapidly changing and increasingly interdependent global energy markets (Goldthau 2010; Bressand 2010; Van der Linde, 2008) but they do not provide strong explanatory factors on why this has not already occurred in the EU’s and Russian case. This research project seeks to answer the puzzle by looking at the energy interaction between the EU and Russia at the institutional level. The study focuses on the regional energy governance, in the sense that
only the EU, Russia and the relevant regions in between are examined. Temporally, the period between 2000 and 2010 is essential to empirically map the two actors’ intensive interaction and to derive the relevant theoretical conclusions.

1.2.1 The traditional view and an Alternative Hypothesis

Evidence has already accrued that indicates that extreme interdependence, whether symmetrical or asymmetrical, has the greatest potential for increasing the likelihood of conflict (Barbieri 1996; Yafimava, 2012). Barbieri (1996) for example, highlights the need to consider both the nature and context of economic linkages in assessing whether such ties are more likely to dampen or amplify interstate conflict. Yet, to date no study has systematically investigated why the two blocs under scrutiny, the EU and Russia, have failed to successfully institutionalize their relationship and in doing so to cooperate in mutually beneficial ways by reducing the uncertainty and the related “transaction costs” of their economic interdependence. No study to date has empirically mapped the interdependence between the two blocs and determined which are the dominant actors that determine the outcomes of the present day relationship. Some reputable scholars have considered instances of cooperative business practices between individual private actors in the EU-Russian gas relationship, even when conditions at the more general political level between the EU-Russian would suggest otherwise (Abdelal, 2012; Bressand, 2011). However, prior studies do not link the importance of the corporate sector to explanations of the institutional failure in situations of high economic interdependence. Most studies focus on the need to recognize that in the final analysis all actors in the energy domain have shared interests, or in other words the consumers’ quest for supply security is met by the producers’ quest for demand security (Goldthau, 2010). While this study agrees with the fundamental reality that generally speaking, interests of all actors in the energy domain overlap -in the more specific case of Russia and the EU, interdependence is an important disciplining force but at the same time its impact should not be overstated. Instead, the fundamentally different interests of Russia as a producer and the EU as a consumer bloc in capturing the economic rents in their part of the value chain and an inability to include both interests in a fitting market design have become a factor yielding to increasingly conflicting patterns. This dissertation starts with several fundamental theoretical questions that I have attempted to answer through an empirical observation of the relationship between the two actors in the last ten years (2000-2010).

1. Assuming the high degree of intertwined economic and energy interests between the EU and Russia, why transnational agreements and binding energy governance agreements did not spring from this relationship?
2. Who are the main actors that have influenced such a relationship and what are their interests and motives?
3. What are the key events and developments in the energy relationship that influence the configuration of the main actors’ priorities?
4. Is the cooperation on a regional level better suited to exploit the advantages of a bottom-up, less confrontational approach?

To answer the last question, an investigation of the South-Eastern Europe (SEE) contact-region will be conducted. To date, this area has been under-researched, but is of strategic importance to the developments in the Southern Gas Corridor and is the region where, due to a unique presence of member states of the EU, non EU states and signatories of the EnCT, according to some scholars (i.e. Yafimava, 2012), the ECT might obtain a second chance as a workable mechanism for transit dispute prevention and resolution. In fact, no study to date examines regional energy security policies in the South-East European area through a cross-border cooperative perspective that emphasizes the benefits of cross-border
institutional bottom-up arrangements between the EU, the transit countries (that are still not part of the EU but signatories of the EnCT), and countries that are not part of the EU governance structures altogether (such as Turkey) and Russia. This study reveals that cross-border regional cooperation in this area helps to create partnerships and to promote a bottom-up dialogue in the region. The two patterns of cooperation that I observed suggest that at a macro-level energy interdependence does not represent a path toward interregional peace, but a means for securing power. When demands change due to changes in the terms of trade, trade ties can easily be jeopardized or even broken. In no way does trade preclude the use of alternative strategies to further the national interest, including the use of force. At the sub-regional level however, once the advantages of cooperation in the “contact zones” have been recognized, the interests and identities of the actors at the cross-border level tend to coalesce in a more stable way, in an attempt to enhance their voice and power at the micro-level and consequently influence the macro-level. Consequently, the examination of the South East European dimension, while bolstering some prior research on the North European regional level (Romanova; 2007) adds novel attention on how best practices set at a regional level can partly remedy for the stalled developments at the strategic level.

1.3 Organization of the Dissertation

To test my hypotheses, this introductory chapter continues with a definitional section where I outline the key terms of the dissertation such as interdependence (balanced and asymmetrical), ‘gas security,’ ‘security of demand,’ security of supply’ and several others. At the end, the Chapter provides a figure stating the research question of the study and a ‘chapter outline’ as an overview of the organization of the study in parts. This dissertation is organized in five parts; the first three parts contain two chapters per part, the south part containing the case studies contains four case studies and therefore four chapters, and the fifth part is constituted by the conclusions. The focus on my central question, while unpacking the role of key actors, institutions, agencies and interests, will inform and crosscut all the chapters of this study.

Chapter 2 constructs a theoretical framework for studying the EU-Russian energy relationship and the reasons for a deadlock in their institutional cooperation. The framework conceptualizes the relevant dynamics between the EU and Russia from the three main approaches of IR scholarship and places the key actors according to different perspectives that might inform their policy choices. The framework also stresses the importance of two generally omitted variables when analyzing the deadlock in the EU-Russian institutional energy cooperation: the interests of the dominant actors and the influence of the external changes in a globalized energy market, in which gas is not a yet a fungible commodity such as oil, but where changes in one region have inevitably ripercussions elsewhere. Then, also is Chapter 2, I justify the selection of the case studies, describe my methodology and field work. Thereafter, we turn to the empirical chapters of this dissertation.

Chapter 3 will provide a historical overview of the EU-Russia gas trade. The worsening relations of the EU and Russia during the 2000s, against a background of an increasing Europe’s dependence on Russian gas, heightened concerns over the reliability of Russia as a gas supplier. In order to account whether these concerns are well grounded, a historical overview of the gas trade between the two blocs necessary.

Chapter 4 looks at the institutional dimension of EU-Russia energy relations. As previously mentioned, to date the EU and Russia lack legally binding instruments ruling their energy relationship. Currently, the institutional dimension of their energy relationship includes three main elements, which are:
1. The Partnership and Cooperation Agreement of 1994 between the EU and Russia,
2. The Energy Charter Treaty and the Russian proposal to substitute it, and
3. The EU-Russia Energy Dialogue.

In this Chapter the relevant Russian and EU legislation and their impact on one another will be analyzed. The purpose of the chapter is to draw a comprehensive picture of the past and current institutionalized exchange between Russia and the European Union. This chapter maps empirically the history of the Russian and EU energy institutionalization to date, based on factual publicly available evidence alongside with the use of interviews with anonymous energy experts, officials and representatives of the business community. Chapter 4 examines all the relevant arrangements along two dimensions: bilateral vs. multilateral, and business-to-business vs. government-to-government.

Chapter 5 reviews the existing approaches to understanding why Interdependence does not lead to institutionalized cooperation in the case of Russia and the EU, and situates my alternative explanation within the literature on IR. This chapter analyzes the priorities of the various actors from the standpoint of the three traditional approaches to the issue, as described in my analytical approach (Chapter 2). The aim is to examine the EU’s and Russian common and diverging interests looking at the issues from the realist, liberal and constructivist lenses. In each domain of the multilayered EU-Russian energy relationship, there is a mixed dynamic of interests and norms at play that ultimately drive the decisions of the actors. While in various decisions values and interests blend together and become mutually reinforcing, it is useful to pull over all the components that typically involve power, values and law and try to determine which is the leading force in a given moment. A rigorous analytical assessment is conducted from the perspective of the three main schools of thought and it is explained why they are not providing a satisfactory answer to my research question. Then I provide a parsimonious alternative hypothesis, which has its roots in (but also challenges) existing explanations within the Realist theory.

Chapter 6 identifies the relevant actors in the EU-Russian energy cooperation. In that sense, the chapter looks at the two sides – the main actors on the European side of the relationship and the main players amongst the Russian actors. After having identified the crucial actors, this chapter examines the causalititylinkages between the main actors’ interests and the deadlock in the energy governance between the EU and Russia. The next four chapters (Chapter 7, 8, 9 and 10) are devoted to the case studies and to test the hypotheses advanced in my alternative explanation (see Chapter 5).

Chapter 7 discusses the reasons for Russia’s joining of the Kyoto protocol, which remains puzzling in light of certain explanations holding that an assertive Russia simply rejects any form of multilateralism. Chapter 7 by contrast, shows that Russia embraces multilateral institution when that is in the interest of the dominant actors. Hence, Russia has not inherently opposed multilateralism, but the latter is embraced if it is in line with the rational calculations of the dominant actors.

Chapter 8 maps the energy interdependence between Italy - Russia and Slovenia - Russia in their own right, and then compares them. On the European side Italy and Slovenia are chosen because they both are major consumers of Russian gas. Yet, there is a high degree of variation between the two countries. Italy is a case of an “old” and big member state with a high degree of dependence on Russia but with a gas supply that is fairly diversified. Slovenia belongs to the new member states that joined the EU with the enlargement of 2004. Besides being a small economy and poorly diversified in its gas supply, the country is highly dependent on Russia. Moreover, Italy and Slovenia are adjacent geographically and both involved in the Southern Gas Corridor competing gas projects. Here, engaging in a country-by-country analysis the dissertation tries to answer some of the key questions hinted at the outset. What is the nature of interdependence in the Italian-Russian energy cooperation?
Who are the main actors? What are their crucial interests and how do they pursue their objectives? The same is done in the case of the Russian-Slovene energy cooperation. Chapter 8 will seek to determine whether the relevant actors from both sides have acted in accordance with the logic of interests detailed at length in Chapter 5. Also, this chapter examines whether cooperation on a regional level is better suited to exploit the advantages of a bottom-up, less confrontational approach.

Having established the importance of exogenous events, Chapter 9 is devoted to the big structural changes that have been occurring on the business side of the EU-Russian relationship, and which are putting in question the old contractual structures and pricing mechanisms in Europe. This takes into account how the sequence and combination of events can be central to the explanation of structural change (Aalto, 2012). The events that have been driving changes in regional energy governance arrangements are: first, the structural increase in the production of unconventional gas in the US that as a result, has made available great amounts of gas previously destined for the US market, which returned to Europe in the form of LNG. Second, an unprecedented economic recession that has frozen the demand for gas in Europe and third, the advancement of the EU’s Third Energy Package that in itself put under re-examination some of the clauses of the long-term contracts deemed incompatible with the flexibility needed for the operation of a single natural gas market.

Chapter 10 analyses the competing gas pipeline projects designed to feed the states of South-East Europe. In this chapter the main actors’ conceptions of their interests are analyzed in light of the implications for the Southern Corridor pipeline “race.” A parsimonious way of conceptualizing these diverse pipeline projects is by critically assessing the prospects of the different competing pipelines to get built while discussing the underlying geopolitical and economic rationale of each project. That in turn, will help us to better understand for instance, the repercussions for the nature of the EU-Russian energy cooperation if a smaller and scalable pipeline from Central Asia gets built? What if instead Russia cements its dominance in Europe with South Stream? The underlying assumption is that energy is a crosscutting policy field; hence it is contrary to both approaches portraying the Southern Corridor pipeline projects as a classical geopolitical competition with an energy twist, and market proponents picturing a mere straightforward economic competition for profits to be gained from privileged access to the southeastern quarter of the European energy market. Energy is more and less than that; it is a multilayered, variegated policy field. Tracing the dominant alliances will help to understand why the business interests of some dominant actors within the EU have downgraded Nabucco; was the abandonment of Nabucco motivated by profit considerations or rather by concerns to prove loyal to Gazprom’s interests, considering its importance as a gas supplier to Europe? Most of these situations will be ‘mixed-motive games,’ characterized by a combination of conflicting and complementary interests. However, the chapter will try to ‘unpack’ which have been the prevailing interests that have outweighed concerns about the solidarity on a European level and the common interests of a potential EU energy policy. This chapter also makes some cautious predictions about the outcomes of the Southern Corridor battle of the pipelines.

In conclusion, Chapter 11 brings together some of the core insights of the previous chapters. It also discusses the policy significance of the study and suggests some directions for further research.
1.4 Key Concepts

The main aim of this section is to define in detail the major concepts of the dissertation – Interdependence (Balanced and Asymmetrical), Institutions, Cooperation, Energy Security, Security of Demand, Security of Supply, Gas Security and Gas Transit Security, Diversification and Geopolitics of Gas. These concepts form the core thematic focus of the study.

1.4.1 Interdependence, Complex and Asymmetrical

1.4.1.1 Definition

Interdependence has been an elusive concept for statesmen, economists and analysts of world politics and international political economy (IPE). The primary difficulty derives from establishing what interdependence really means. Interdependence most simply defined means mutual dependence. Interdependence in world politics refers to situations characterized by reciprocal effects among countries or among actors in different countries. However, some authors point to the distinction between ‘economic interdependence’ and ‘political interdependence.’ For economists, ‘macroeconomic interdependence’ derives from trade and financial integration that generally increases the transmission of business cycle fluctuations among countries. Floating exchange rates give countries some insulation against each other’s fluctuations (Frankel, 2000). When capital markets are highly integrated, floating rates do not give complete insulation, as the 2007-2009 financial crisis and the Euro-zone crisis among major industrialized economies have both shown. In the eyes of IR scholars this definition is broadened to include – flows of money, goods but also people and messages across international boundaries. In that sense interdependence resembles interconnectedness. Yet, as Nye and Keohane (1977 p.8) warn, interconnectedness is not the same as interdependence. The effects of transactions on interdependence will depend on the constraints, or costs, associated with them. Keohane and Nye propose two conceptually distinct, but related, definitions of interdependence. The first defines interdependence as mutual sensitivity: i.e., the extent to which change in one state affects change in others. This definition is appropriate at the process level, since it assumes the existence of a structure of relations within which actors are sensitive to others to a variety of degrees. At the structural level one might argue that the relative dependency of EU and Russia is not that high, given the fact that the two blocs do not share many binding governance structures. However, it is the second definition of interdependence that plays a bigger role in the EU-Russian energy relationship. The other definition of interdependence rests on relative vulnerability: i.e., on the relative cost of alternatives for the parties, the less dependent state is the one that possesses relatively lower costs from the termination or drastic alteration of the relationship. Relative vulnerability is what best illustrates the nature of the relationship between the EU and Russia. Russian dependence on Europe is unquestionable. The EU is the first trading partner of Russia. According to the Permanent Mission of the Russian Federation in the EU, in 2010 the EU member-states accounted for about 50 per cent of Russia’s export of goods and 55 per cent of its merchandise imports. In such numerical terms, the significance of Russia for Europe is relatively small. Russia is certainly important as a supplier of oil and gas to Europe, but its role is nevertheless confined to these two commodities. Overall, in 2010, the country accounted for only about 7.5 percent of EU overall imports and consumed a little more than 5 percent of EU exports. Although in terms of overall trade volumes, Russia is clearly much more dependent on Europe than vice versa, it is the quality of the

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4http://www.russianmission.eu/en/trade
5ECB; 2012 (http://www.ecb.int/mopo/eaec/trade/html/index.en.html)
dependency that makes Russia equally important to Europe. Oil and gas are commodities of the highest strategic importance, and Europe at present cannot do without Russian supplies. According to Eurostat, in 2010 ‘mineral fuels’ accounted for 75% of the total value of EU-27 imports from Russia. A hypothetical stop of Russian oil deliveries would hurt Europe less than a disruption of gas supplies, simply because all of the gas that Europe imports from Russia arrives through pipelines and there are currently growing albeit still limited alternative sources. Such a situation could be termed as “complex interdependence” and according to Keohane and Nye (1977) three rationales may be offered to explain the behavior of utility-maximizing egoists under complex interdependence. First, the relevance of the threat of the use of force among states linked by complex interdependence becomes unlikely. This boils down to the maxim that in a complex, interdependent, but often-unfriendly world, offending foreigners may be costly in the long run. Applying it to our case, given the very strong mutual dependencies between Russia and Europe, it is at present hard to imagine that either side would see a benefit in applying sanctions against the other. Second, state policy goals are not arranged in stable hierarchies, but subject to trade-offs and third, the existence of multiple channels of contact among societies expands the range of policy instruments, thus limiting governments’ control over foreign relations. While I agree that in a highly interdependent relationship military force becomes unlikely, I will question the assumptions underpinning the second and the third characteristics of ‘complex interdependence’; in other words the assumption positing that if dependencies between states are symmetrical it is more likely that the relationship will be characterized by cooperation and peace. Structural liberals such as Keohane and Nye emphasized the linkage between interdependence and transnationalism, in which the role of domestic factors is expected to be slipping more and more out of focus, particularly as the concept of international regimes should come to the fore. In my dissertation I find no evidence that economic interdependence fosters peace and institutional cooperation between the linked blocs and I try to demonstrate in an analytical and sophisticated manner that the strength of the corporate sector “should be brought in” the explanations for institutional failure between Russia and the EU. This brings me to another working concept of this dissertation – the term asymmetrical interdependence. In some instances less vulnerable states will try to use asymmetrical interdependence as a source of power. Simply put, when an actor in the relationship is more vulnerable than the other, the asymmetry of the relationship can be used as an important source of power. Since the EU is not a unitary actor, the relative vulnerabilities of member states differ across countries. While Germany and Russia have a degree of balance in interdependence that does not help the newer and smaller member states of Central and Eastern Europe, and the states in the so-called Russian Neighborhood, where Russia’s effort to gain power by structuring market asymmetries in the area of natural gas is more obvious.

1.4.1.2 Operationalization of the term

The second difficulty derives from operationalizing interdependence, which in turn stems from the absence of a clear consensus about what the phenomenon entails and how it should be measured. The inconsistencies that occur in empirical research are due to different conceptions and operationalizations of ‘interdependence’ as a concept. There are major differences between one on one side, a measurement of interdependence that only includes as variables the volume of the financial flows (i.e. the trade balance), or an operationalization that includes the quality of the goods traded and the relative asymmetries in dependence derived from the strategic value of certain goods as compared to others. The many and different operationalizations of trade dependence have different impacts on empirical findings. For example in her study Barbieri (1996) measures two dimensions of dyadic interdependence: the salience and the symmetry of dependence. In order to calculate the two

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variables Barbieri employs the share of trade each state maintains with each partner. That helps her to assess the relative importance of any given relationship compared to others. Trade share measures the proportion of dyadic trade over total trade; both import and export flows, for each state with its trading partners. Despite the undeniable value of such a study, the share of trade in the case of the EU and Russia gives us only a partial picture of the relationship, as we have seen previously. A better-suited quantitative measurement of ‘energy interdependence’ is developed in Quemada et al. (2012) where the interdependence in the energy flows of two countries (or two blocs for that matter) is determined by the degree of complementarity between the latter ones. The interests of countries ‘i’ and ‘j’ are considered to be complementary depending on both the importance of country ‘i’ as a consumer of energy imports from country ‘i’ and the importance of country ‘i’ as energy supplier of country ‘j’.” The Energy Complementarity Index is defined therefore as the product of the relative weight of country “i” among the buyers of energy from country “i” times the relative weight of the country “i” among the relative suppliers to country “i” over the same period:

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ECL_i = \frac{X_j^i}{\sum X_i} \times \frac{X_i^j}{\sum X_j}
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In Quemada et al. the Complementarity Index jointly with the Energy Competition Index determines the Energy Affinity Index (EAI). On a scale from 0 to 100, the Russian Federation represents an affinity of 97.44 with the EU energy interests. The Energy Affinity Index does not include however the geopolitical dimension of energy security. For example, issues such as commercial and political alliances can decisively influence energy flows for geostrategic reasons. Companies’ and transit states’ behavior is another dimension that might complement the study of energy affinity. Given the fact that this dissertation aims at a systematic research of energy relations between a limited set of actors – the EU and Russia with the relevant actors gravitating around them, such an index might play only an auxiliary role for comparative purposes. Instead, this study employs in-depth historical analysis to understand the complex energy relationships between the EU and Russia, and to take into account the multidimensional nature of the relationship characterized by various degrees of asymmetry. In sum, given the difficulties in measuring “interdependence,” and considering that quantitative measurements employing trade shares are ill-suited to assess the differences in interdependence across issues and over time, the qualitative method of historical analysis is preferred here to place the countries in a given context, provide the relevant events and locate individual countries on a continuum between: relative insensitivity to each other, a balanced interdependence and an asymmetrical interdependence. By looking at the two blocs’ economic and political structures, we will discern who are the dominant actors generating decisions in the EU-Russian energy relationship and attempt to explain why the relationships have evolved in a certain way.

1.4.2 Institutions

According to Douglass North Institutions are “the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (Douglass North, 1991). Lin and Nugent (1995) argue that Institutions are “a set of humanly devised behavioral rules that govern and shape the interactions of human beings, in part by helping them to form expectations of what other people will
Institutions can be formal (laws, regulations) or informal (patterns of behavior, conventions, moral codes) and usually embrace some form of enforcement mechanism. This thesis will examine the lack of formal institutions between the EU and Russia. On the question why do institutions exist, in our case, the EU side favors “demand-side explanations”: institutions are created by those who stand to benefit from them (Keohane and Nye, 1977, Ikenberry, 2012). Within these benign theories it is believed that trade and capital flows increase demand for “good” institutions (Cooper, 1985). There is another line of thought on the question where do institutions come from, which emphasizes the “supply side:” institutions are the imposition by foreign powers (i.e. the EU) and the adoption of imported legal norms and rules. To a certain extent, Russia favors this explanation. In this thesis, a third feature of the development of institutions is added: namely, the institutional lock-in. Different societies choose different laws or social practices that reflect their needs and concerns. In a globalized world, it is challenging to come up with deep transnational governance structures that respond to the needs and concerns of all the players included, because in general actors do not want to be locked-in binding structures unless they reflect their own priorities. Furthermore, like-minded Western countries are progressively losing their ability to set the essential rules and maintain them for the entire system, due to the current process of global power rebalancing and a ‘rise of the rest.’

1.4.3 Cooperation

To investigate the features of the EU-Russian relationship I will borrow from Axelrod’s (1984) classical theory of cooperation and I will further build on Keohane’s (1984) study on “cooperation after hegemony.” The central question of under what conditions and why independent states decide to cooperate has intrigued many students of world politics for a long time. According to Axelrod who has written extensively on the topic in terms of the famous ‘Prisoner’s Dilemma’ game, the importance of the next encounter between the same two individuals must be great enough to make defection an unprofitable strategy. It requires that the players have a large enough chance of meeting again and that they do not discount the significance of their next meeting too greatly. Cooperation theory implies that the foundation of cooperation is not really trust, but the durability of the relationship. When the conditions are right, the players can come to cooperate with each other through trial-and-error learning about possibilities for mutual rewards, through imitation of other successful players, or even through a blind process of selection of the more successful strategies with a weeding out of the less successful ones. In 1984 R. Axelrod writes:” Once the US and the USSR know that they will be dealing with each other indefinitely, the necessary preconditions for cooperation will exist. The leaders may not like each other, but neither did the soldiers in World War I who learned to live and let live.” According to Axelrod, in order for cooperation to get started in the first place, one more condition is required. The problem is that in a world of unconditional defection, a single individual who offers cooperation cannot prosper unless there are other individuals around willing to reciprocate. Indeed, Axelrod’s experiments have shown that partners in prisoners’ dilemma and public goods games can develop cooperation in repeated play over extended periods of time. Around the same time, R. Keohane writes that to achieve what they want, most states will find that they have to cooperate. Moreover, he says, “Cooperation should not be viewed as the absence of conflict, but rather as a reaction to conflict or potential conflict. Without the specter of conflict, there is no need to cooperate.” Robert Keohane argues that it is possible to design international institutions to solve problems of coordination in world politics, even from the standpoint of restrictive Realism and game theory. Egoistic governments can rationally seek to form international or regional regimes on the basis of

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shared interests, as the example of the European Union best illustrates. The EU also provides a case in point of the institutionalist type of cooperation, or the claim that successful cooperation will “spill over” onto others (Haas, 1958). According to the literature on “spillover” in bargaining, expectations that an integration agreement can be expanded to new issue-areas permit the broadening of potential side payments.

This dissertation will test the propositions advanced by cooperation theory by applying them on the EU-Russia energy interdependence case—i.e. the proposition that in a world of growing economic interdependence the costs of not following multilateral rules and forging cooperative ties inevitably rises. This thesis finds that high levels of interdependence do not necessarily spur the creation of new international regimes to solve coordination problems, because the dominant actors’ prosperity on both sides of the interdependent relationship might be larger without clearly defined rules, therefore the key players might want to ensure their self-interest by preventing the emergence of binding institutions.

1.4.4 Energy Security

Although the term ‘energy security’ is frequently used in both scientific and political arenas, its definition is rather fuzzy. In fact, energy security means different things to different countries based on their geographical situation, their political system and their economic disposition. Each country is likely to push its own interests and to date there is no unanimity here. For example, in a country like the United States, for many leaders and observers, energy security has come to be synonymous with “energy independence.” Although energy experts warn that there is one fungible global market for oil and that the idea of energy independence is neither desirable nor affordable, the idea on energy independence has dominated the rhetoric of U.S energy politics for 35 years. While the so-called environmental security has become an important element in our energy security today, the more “classic” aspects of the term include the energy-related relationships that exist among states and involve the so-called ‘security of demand’ and ‘security of supply.’ While energy importers want security of supply and low prices, energy exporters seek security of demand – the assurance that their production will be purchased at a fair price over the long term, so that national budgets can anticipate a steady and predictable revenue flow. The most fundamental relationship is the one between energy suppliers and consumers, but important relationships also take shape between and among competing consumer countries. In other words, the EU is highly reliant on imported gas, making Russia an important supplier and an important factor in the EU’s energy policies. However, this reliance is also raising tensions between different consumer countries, particularly between Germany and the central European states.

Traditional definitions of energy security have included availability, reliability and affordability. Daniel’s Yergin commonly adopted definition says: “The objective of energy security is to assure adequate, reliable supplies of energy at reasonable prices and in ways that do not jeopardize major national values and objectives.” A similar definition was offered by Haghighi (2007, p. 15) “energy security is the adequacy of energy supply at a reasonable price.” Clearly, a contemporary understanding of energy security must also include the environmental sustainability dimension. Anyhow, the literature is divided between those who interpret energy security from an economic perspective and those who stress its political and strategic side. Further, the literature is divided between those who see security of supply as exclusively related to energy and those who like to couple it with the environmental dimension. Although there is no common interpretation, it is fundamental to add the temporal dimension to our analysis, i.e. what does the concept ‘energy security’ consist of in a given moment. For example, environmental sustainability that in the past was not included in definitions of energy security is now an

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integral part of the energy security indices. For instance, in the United States the Chamber of Commerce releases every year an “Energy Security Index.” They take indicators related to energy and security and combine them to create a master index of the energy security risk. Interestingly enough, “environmental security” now accounts for 20% of the general index. Obviously each of the diverse indexes has its shortcomings and ultimately they are the outcome of subjective evaluations made by the researchers on what indicators to ‘put in.’ The temporal dimension allows us to comparedifferent operationalizations of energy security and assess whether the economic or the strategic side of energy security takes precedence in a certain period. In Western Europe for more than four decades energy security was regarded mainly through economic lenses, which included two predominant features - physical availability and price. After the gas disruptions caused by the Russo-Ukraine gas disputes, energy security started to be perceived in a more strategic way with the EU commissioner at the time, Andris Piebalgs, calling for “a clear and more collective policy on the security of our energy supply.” Over the next couple of years energy security became “reliable access to energy at affordable prices without having to formulate your entire policy strategy around it.” And since energy security was perceived as an existential threat, emergency measures and actions outside the normal politics were deployed and perceived as needed. That view led to a considerable deterioration in the relations with Russia, with an increasing “securitization” and politicization of the natural gas issue. If previously, the EU’s energy security rested on the principles of availability and affordability, now new elements completed the picture. Diversification of supply, “security margins” given by enhanced storage capacity, interconnectors at the EU level and high-quality information became imperatives for the EU, while at the same time natural gas remained a heated subject of contention and suspicion in the dealings with Russia. The concept of securitization as defined by the Buzan and Weaver and more generally by the Copenhagen school, best captures what happened in the EU-Russian energy relations since 2006. According to Buzan and Weaver securitization in the energy issues ought to be portrayed negatively because it is almost never successful. Because it is carried out at the international level it usually results only in politicization (Buzan B., Weaver O., Wilde J. 1998. p.71). Securitization is seen as a failure to deal with issues as normal politics, therefore desecuritization should be a preferred option when it comes to energy and the environment (energy security itself can be seen as a part of what Buzan et al. call the environmental sector within their relatively new concept of wider understanding of security, see f. e. Buzan, Waever, Wilde 1998: 71 – 94). In this sense, desecuritization refers to the shifting of the issue out of the existential mode back into the normal political sphere. However increased diversification of supply for the EU with the goal of “more independence from Russia” triggered decreased ‘security of demand’ for the latter, that requires demand in order to monetize its natural endowment. At the heart of this is a ‘security dilemma’ between the EU and Russia, where ‘the actions of one [the EU], in trying to increase its security, causes a reaction in the second [Russia], which in the end, decreases the security of the first.’ Therefore we ought to conclude that countries’ definition of energy security has much to do with their own particular situation and how they subjectively perceive their vulnerabilities to energy supply disruptions. If energy security remains in the eyes of the beholder, there still remains the question of how the two blocs can most effectively manage their delicate energy interdependence. In short, in the case of Russia and the EU, informing the dialogue “by ghosts and unfounded fears” (Guillet; 2011) is to no one’s benefit.

1.4.5 Gas Security and Gas Transit Security

In the European Union energy security almost became synonymous with security of gas supply. Gas came to play a major role in the European energy mix just after the ‘oil shocks’ in the 1970s as a strategy to diversify away from oil. In the aftermath of the oil crises, the EU

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10 http://www.energyxxi.org/energy-security-risk-index
Gas imports from Russia began to increase and replaced much of the oil imports from the Persian Gulf, which was at the time considered a sound diversification of supply (Van der Linde, 2007). However, the reliance of gas supply on fixed networks of transportation (primarily pipeline networks) made it more rigid vis-à-vis oil and coal which are unaffected by such transportation constraints. In fact, dependence on a handful of suppliers turns the pipeline into an umbilical cord, raising concerns about potential disruptions of the gas flow due to technical problems or deliberate cut-offs from suppliers on the other side of the pipeline, due to their temptation to use the “energy weapon.” As discussed later, these fears are largely unfounded because the costs of a damaged reputation by using ‘gas weapon’ outweigh any possible benefit that such tactics might entail. The specificity, and drawback, of the ‘energy weapon’ lies in the fact it immediately backfires on those who wield it (Garbe & Hett & Lindner, 2011, p.202). However, because gas is very costly to transport, and because new infrastructure connections take years to construct, gas supply security is assured in the short term only by having diverse routes for supply to final users. There is another important component of ‘gas security’ considering the nature of the trade via pipeline - security of transit. Since the break up of the Soviet Union in 1991, Ukraine, Belarus and Poland became transit countries for pipelines that in the Soviet era were built without regard to internal borders. The political instability of the countries across which gas flows and the complicated relationship between Moscow and the transit countries became a new source of concern in securing the gas stream to the EU. An undisrupted transit of gas is, therefore, carefully looked at in designing energy policies that aim to secure energy supply and this aspect of energy security will, therefore, be of great relevance to our discussion. Just as with the broader view on ‘energy security,’ there is no unique methodological definition of ‘gas security.’ Even more so, gas markets are still regional, which makes every region tackle different conditions in price and supply arrangements. As expected, these characteristics make ‘gas security’ hard to measure and difficult to conceptualize. From the European point of view, security of natural gas sources is defined as an “uninterrupted physical availability of natural gas on the market, at a price which is affordable for all consumers (private and industrial), while respecting environmental concerns and looking towards sustainable development.” This is roughly how the European Commission defines the concept of energy security and it is adapted here for natural gas. As we know, there is a clear trend towards declining domestic gas production and resource discovery vis-à-vis an increasing demand for gas in the EU. This growing dependence is associated with some risks, which are more political in nature than related to the physical availability of the hydrocarbon. In the EU, the main source of concern and debate is associated with the projected increase of gas imports from Russia and the political reliability of this country: the major concern relates to the nationalization and the politicization of energy resources in the Putin’s regime, given that Russia accounts for more than 30% of all natural gas imports. In this study I will utilize Stern’s (2002) “brief” definition of gas security: gas security deals with the threats of supply and price disruptions arising from risks associated with the (reliability of) sources of gas supplies, the transit of gas supplies and the facilities through which gas is delivered. There are two major dimensions of these risks:

- Short-term supply availability versus long-term adequacy of supply and the infrastructure for delivering this supply to markets;
- Operational security of gas markets, i.e. daily and seasonal stresses and strains of extreme weather and other operational problems versus strategic security, i.e. catastrophic failure of major supply sources and facilities.

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11 For an extensive discussion on gas transit issues see Yafimava, (2012).
1.4.6 Gas security as opposed to Oil Security

For the purposes of this study it is important to distinguish security of oil from the security of natural gas. These two fossil fuels have inherently different characteristics, which will not be elaborated here, but my emphasis is on how they also differ from the perspective of energy security. Oil is a completely fungible commodity, in other words oil prices are determined by global supply and demand and there is only one fungible global oil market. That means that oil is sold on an open global market, which also equilibrate its price. Natural gas is quite different. Gas is mainly sold on the basis of long-term bilateral contracts and shipped through dedicated pipelines that often cross several countries. The gas market is still regional. Admittedly, we are witnessing a rapid increase in global supplies of liquefied natural gas (LNG) that have resulted in a global ‘gas glut.’ As the share of LNG continues to increase in the regional markets, gas markets will become gradually more integrated. However, for the time being transportation infrastructure is rigid in nature and it requires a physical link between producers and consumers and therefore, by its sheer nature, gas business is much more politicized than oil business. As noted by Haghighi (2007), in gas supply the number of alternative routes to the consumer is limited. For example, a cargo of oil designated for one country can easily be switched and sent to another country: this is actually an everyday occurrence, whereas for gas this flexible switching does not happen. That is why in the case of natural gas, security of supply has a completely different meaning than for oil, due to the presence of rigid and costly infrastructure (the pipelines) that create an umbilical cord of interdependency between suppliers and consumers. From that perspective, we can define the security of gas sources in a two-fold way: as physical security or the ability of the supplier to provide the contracted amounts, and a political security, meaning an ensurance that politically motivated disruptions will not occur. Many scholars believe that political insecurity of natural gas rather than the physical scarcity could cause headaches in the future. Yet, as it will be discussed in detail in this study, “political” disruptions are very unlikely because the producer (i.e. Russia) cannot do easily without its dedicated market (i.e. the EU), and the buyer cannot do easily without its supplier. When there is a high degree of balance in interdependency such as in the EU-Russia case, politically based disruptions are highly unlikely. The only conceivable case where gas deliveries could be used as a weapon is in situations of highly asymmetrical relationships, and here the concept of vulnerability is crucial. Percebois for instance argues that reliance on imported energy per se is not a security problem because there could be high dependency without any supply risk. In other words he distinguishes energy vulnerability from energy dependency. The energy vulnerability of a country indicates that it has to make energy choices or bear high economic costs. Percebois (2006) underlines that “a country which imports the majority of its energy at a sustainable cost and which ensures the security of supply thanks to well-diversified sources will be dependent but not vulnerable.” In Europe such countries are the largest consumers of gas (Germany, Italy, and France) that are largely dependent on Russia but not vulnerable. The same cannot be said about countries in Eastern Europe, that are poorly diversified and thus their vulnerability is higher. In sum, security of transit, diversification of energy sources and security of facilities are considered as the most relevant elements to emphasize when designing a framework for energy security. This leads me to the definition of another fundamental concept in this dissertation: diversification (of supply and demand).

1.4.7 Diversification

As we have seen, energy security has a multi-faceted nature. In recent years another crucial component of ‘security of supply’ in Europe and in turn a key concept is “diversification.” The latter is another slippery term to define. Diversification just as ‘energy security’ means different things to different countries in the inter-regional gas trade. As noted by Haghighi (2007) the diversity of choices between different regions and different
countries producing energy is a component of energy security, since the ‘more diverse the supply source, the smaller the proportion of supply that could conceivably be interrupted.’ In other words, if Europe is dependent on only one country as its source of energy supply, a little disruption of supplies from that country could greatly jeopardize the economy. Therefore, the idea is to rely on various sources to be able to switch from one to another at times of difficulty. As argued by Victor, Jaffe and Hayes (2006), diversity of supply is an important protection from rent-seeking behavior of both gas exporters and transit countries and a long-term crucial security measure. Europe's dependence on Russian natural gas is unquestionable. But the situation varies greatly between Central and Eastern Europe that consume relatively little Russian gas (in absolute terms) but have no other, or very few other suppliers in contrast to Western Europe, where supply is nicely diversified. In general terms, in the EU as a whole Russia has the majority share (see fig. 17, Chapter 9) of the total gas imports, which are provided entirely through pipeline. That poses a transit risk as well. Therefore, for security of supply reasons Europe tries to decrease reliance on Russia, for example, through diversifying to other sources, such as countries in the Caspian or through other routes, mainly avoiding Ukraine, (as it was done with the Nord Stream project). For Europe diversification means 'spreading' dependence from Russia to the Middle East or Algeria, or to any other energy producing country. In other words, diversification for Europe means dependence on several countries instead of just one. So it does not free the Union from its dependence, it is just enlarging the horizon of dependence (Haghhighi, 2007). Today in Europe diversification also entails relying increasingly on renewables (i.e. Germany and its Energiewende) and potentially on indigenous unconventional gas sources. Yet, pipeline gas still has the lion share. As noted earlier, pipelines create ties that are hard to dissolve, which means that if the EU is dependent on Russia for supply, Russia is, even more, dependent on Europe for security of demand. Some scholars point out (Noël, 2008) that Russia is in fact very much dependent on its gas exports to European countries, while the EU relies on Russia only for 6.5% of its total primary energy (not just gas) consumption. Given the very strong ties that pipeline gas installs, the EU’s quest for diversification, from the Russia’s perspective raises questions about the EU’s reliability as a consumer. That is why in the last years Russia has embarked (yet still only “on the paper” for now) systematic efforts toward diversification of export markets, primarily to the Asian market, also in light of China’s exceptional economic growth. In that sense, Europe’s frantic drive toward diversification could backfire against it, as it increases Russia’s urgency in diversifying to the Asia-Pacific region. Therefore, if Europe’s only preoccupation is to diversify as soon as possible away from Russia, that won’t help to de-politicize the EU-Russia gas relationship, as the EU won’t be perceived as a reliable customer.

1.4.8 Geopolitics of gas

Finally the concept of ‘geopolitics of gas’ remains central to our discussion of the gas interdependence between the EU and Russia. Throughout this dissertation the broad Victor’s et al. (2006) definition of the concept ‘geopolitics of gas’ will be employed. Contrarily to the traditional view framing geopolitics in terms of competitive zero-sum games played by nation states in the pursuit of power and security, this dissertation employs a broader approach. Geopolitics is hence defined as the influence of geographic, cultural, demographic, economic and technological factors on the political discourse among international actors. In this definition relative gains matter, but so do joint gains from possible cooperation. In sum, geopolitics of gas does not mean an endless struggle for power positions, but also the political actions of governments, investors, and other key actors who decide which gas trade projects will be built, how the gains will be allocated, and how the risks of dependence on international gas trading will be managed. This thesis also highlights that geopolitics of gas is loosely connected with the concept of “scarcity.” The concept of scarcity has been out of fashion for several years now. In fact, there is little doubt that consumption of energy and in particular natural gas will rise rapidly over the coming decades. Experts do not agree,
however, on how long oil and gas reserves will last if supplies expand at the same rate. The oil price explosion of recent years was seen by many as a prelude to an ultimate oil crisis, in the course of which sooner or later “we would run out of oil.” Since the Shell geologist King Hubbard correctly predicted in the 1950s that US oil production would reach its peak in 1970 (peak oil) and then decrease, there has been disagreement over when the physically inevitable zenith of global production would be reached, marking the onset of a pronounced fall in production from this point on (Hirsch, 2005). However, it was suggested that the commonly used image of an imminent oil (or gas) peak was mistaken. Rather, the producer countries are tempted to “create scarcity” or delay the investments in infrastructure that would push prices up. The apocalyptic picture of fossil fuels running out is not any longer part of the political discourse, and all the concerns seem directed towards the soaring price of oil. As pointed out by Maugeri (2012) in a groundbreaking study, new technologies and developments in field exploitation will make oil and gas even more abundant in the future and the role of technology will be vital in facing some of the greatest challenges of the century including energy and climate issues. Obviously “easy” oil and gas are already exploited, but there won’t be a shortage in hydrocarbons any time soon. Thanks to the breakthroughs of horizontal drilling, fracking in tight rocks and many other new techniques, today the perceived shortage of reserves was defied. In gas, the new technologies related to the shale gas revolution, brought immense new quantities of gas on the market and brought the American price for gas down to an unprecedented level. In oil, the new techniques did discredit the theories of “peak oil” but they did not so far act on the price front, in other words new technologies did not yet develop techniques that could cheaply recover oil and thus push the price down. Oil price continued to rise in the last decade, although Maugeri’s (2012) study foresees an oil price collapse in the next decade. In any case, despite the rise of new big consumers such as China, India and Brazil, oil and gas resources are plentiful and, in Yergin’s words: “although energy companies will be prospecting in more difficult environments, the major obstacle to the development of new supplies is not geology but what happens above the ground: namely, international affairs, politics, decision-making by governments, and energy investment and new technological development” (Yergin, 2006, cited in Umbach, 2010). In sum, what happens above ground, namely geopolitics – has had a major impact on whether and when oil (and gas) has been discovered and developed. So according to Yergin13 the big challenges we are facing today such as politics, mismanagement of resources and wars are all “above ground” issues.

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13Yergin, D. *There Will Be Oil*, Wall Street Journal, September 17, 2011
**Figure 1: Research Question**

Research Question

Why, given the high degree of mutual dependency, to date, the EU and Russia lack legally binding instruments ruling their energy relationship?

**Figure 2: Chapter Outline**

- **Part I**
  - CH 1. Introduction - The Puzzle
  - CH 2. Analytical Approach + Methods

- **Part II**
  - CH 3. Historical and Institutional overview
  - CH 4. Existing Bilateral and Multilateral Frameworks

- **Part III**
  - CH 5. Literature review and Alternative Explanation
  - CH 6. Main Actors/Interlinkages with the Institutional deadlock

- **Part IV**
  - CH 7. Russia and the Kyoto Protocol
  - CH 8. The Regional Perspectives: Italy and Slovenia/CBC
  - CH 9. Paradigm Changes in the Gas Markets
  - CH 10. The Southern Gas Corridor

- **Part V**
  - CH 11. Conclusions: Significance of the Study and Policy Recommendations
2. My Analytical Approach and Contribution to the Literature

2.1 Existing Explanations of the deadlock in the EU – Russian Institutionalization of Interdependence

Recent scholarship has yielded a number of explanations for the inability or unwillingness of the EU and Russia to turn their energy interdependence into a legally binding governance structure ruling the relationship. Explanations have differed according to the lenses through which one has approached this thorny question; the differences are linked to the ways the three major traditions of thought in International Relations tackle broader issues of world politics. In the table below I will summarize these approaches.

Table 1: Outline of the existing explanations for my central question

<table>
<thead>
<tr>
<th>Schools of Thought</th>
<th>Actors</th>
<th>Main Concerns</th>
<th>Explanatory Factors of a Deadlock</th>
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<tr>
<td>Neo-Realism</td>
<td>1. EU Member States, Russia and their commanding heights</td>
<td>1. The “Security Dilemma” – self-interested effort to maximize the energy security of its own state relative to others</td>
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<td>2. Transit States and their Leaders</td>
<td>2. The balancing of each other’s sphere or influence in the shared neighborhood</td>
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<td></td>
<td>3. Leaders of the Involved Companies</td>
<td>3. The precedence of the national interests and the gains made by fdomestic companies</td>
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<td></td>
<td>4. The EU Commission</td>
<td></td>
<td>1. Energy cooperation is a zero-sum game where the interests of producers and consumers do not coincide and any gain of one results in a loss for the other.</td>
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<td></td>
<td>5. International Organizations and other Transnational actors</td>
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<td>2. General distrust in the utility of multilateral structures of governance – when it comes to issues of strategic importance the basic unit of world’s politics is the state.</td>
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<td>3. The EU does not speak with one voice in energy matters which weakens its leverage position vis-à-vis Russia – anomaly of the EU’s structure</td>
</tr>
<tr>
<td>Neo-Liberalism</td>
<td>1. EU Member States and Russia</td>
<td>1. The reluctance of the main Member states to transfer energy competencies to the EU Commission</td>
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<td></td>
<td>2. Transit States and their Leaders</td>
<td>2. The asymmetry of Interdependencies between the bigger and smaller EU member states</td>
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<td>3. Energy Companies</td>
<td>3. The reluctance of Russia to institutionalize the relationship legally with a new PCA and the ECT</td>
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<td></td>
<td>4. EU Commission and International Organizations, other transnational actors</td>
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<td>1. The identity dilemmas of the EU as such worsen the prospects of a shared identity between Russia and the EU</td>
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<td>2. Insufficient mobilization of the peripheries for a bottom-up, regional cross-border dimension of cooperation</td>
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<tr>
<td>Constructivism</td>
<td>1. EU Member States and Russia</td>
<td>1. Clash of Identities</td>
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<td></td>
<td>2. Transit States and their Leaders</td>
<td>2. Incompatible view on leading norms such as reciprocity, sovereignty and information sharing</td>
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<td>3. Energy Companies</td>
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<td>4. EU Commission and International Organizations, NGOs, regional organizations</td>
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<td>5. The civil society</td>
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<td>6. Regional organizations</td>
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As summarized above the existing explanations of the deadlock in the institutional cooperation between the EU and Russia fall into three broad perspectives, each focusing on different motivations for a deadlock in the EU-Russian binding institutionalization of the energy trade.

2.1.1 Realism and neo-realism

The first approach starts off with the problem of the “security dilemma” and frames it within a fairly pessimistic view of the human nature compounded with the notion that states are the basic units of world politics. In this view, there is a traditional and irreconcilable large difference in the political interests between energy producing and consuming countries. In that sense, states are the main actors in the political arena and rational national self-interest is what drives them. Security of energy supply and demand is included in the ‘high politics’ sphere, which pertains exclusively to the states. International institutions are regarded with suspicion and dismissed especially from domains of crucial national interest such as energy policy. Therefore, states are abandoned to self-help and to pursue their own goals they count on a relative “balance of power” achieved with bilateral alliances and “power politics.” The member states of the EU are reluctant to transfer their sovereignty in energy politics and more generally in foreign policy to the supranational EU. Indeed, the EU’s quest for more convergence and of a “Europeanization” of the national energy policies is viewed just as a means for the EU Commission to increase its powers. On the other end of the energy policy spectrum, Russia is using its energy abundance as an instrument of foreign policy, i.e. in order to achieve what it wants and secure itself a place among the great powers in the international arena. While national interests are permanent, alliances and agreements are limited in time and can change very quickly. Some scholars have underscored the cyclical nature of oil and gas markets distinguishing periods when we are in a sellers’ market (where demand is outpacing supply and prices are thus high) from the buyers markets’ (where supply is ample and prices are thus low). In a buyers’ market situation, consumers favor a liberalized system integrated through ‘markets and institutions’ while in times of the sellers’ market a ‘empires and regions’ scenario dominates, reflecting a fragmented global energy system dominated by power politics (Correlje and Van der Linde, 2006). Notwithstanding that these changes occur cyclically, since the first Ukrainian-Russian gas war a process of “securitization” of energy relations between Russia and the EU has started, which has been continued despite the current “gas glut” in the EU, in line with the neo-realist view. In recent years Moscow did use pipeline politics to expand its market share and its dominant position in the gas markets in Europe and more broadly in Eurasia, and the EU was widely predisposed towards the export of economic and regulatory norms, as its key means of foreign policy influence and as tools for the pursuit of its own material interests. According to the realists, the influential concept of “EU external governance” captures this notion of the EU seeking to transfer its own rules and legal norms to Russia, among other countries of the “Neighborhood” as a form of “external Europeanization.” Many critics increasingly condemned the EU’s espousal of democratic norms as a new form of geopolitical “imperialism.” In this neo-realist view the Neighborhood indeed remains a crucial terrain of geopolitical battle.

While the neo-realist view is right in capturing that “geopolitics” do indeed matter, faced with a multilayered policy agenda and a more variegated set of actors, such as the influential transnational gas companies, major realist observers have found great difficulty in maintaining a sustained, consistent understanding for the huge political influence of private actors in the EU-Russian energy relationship. In fact, realist theorists have traditionally relegated economic relations to low politics, arguing that the influence of economics and trade is subordinate to other considerations of “high politics.” And indeed when in the natural gas trade national companies work in a symbiotic relationship with their respective governments to advance the ‘national interest’ of the latter, that is consistent with the realist
theory. Yet, there are scholars actively discussing the fact that private companies, despite being bound to profitability concerns, retain a huge influence in the decision-making process involving the EU-Russian gas cooperation and in many cases they are the decision-makers actively shaping the process (Abdelal, 2011). Despite a limitation in not paying much attention to the functions performed by international institutions and private actors, the neo-realist approach is well suited to capture the weaknesses of international institutions and chiefly of the EU, when issues of strategic importance such as energy politics and the underlying paramount considerations of ‘national security’ are concerned.

2.1.2 Liberal Institutionalism

According to the proponents of this approach, the best way to govern the anarchy of the international system is through the creation of institutions and organizations conveying shared norms and principles. The underlying assumption is that peace comes from prosperity and transnational relations. Previous empirical studies of Interdependence have investigated the impact of increased economic ties on a myriad of multilateral relations. This literature emphasizes the transnationality of issues and the importance on focusing on the “common good.” The literature offers extensive explanations for the drawbacks of the EU-Russian cooperation, which pertain to both sides. From the EU side, the obstacles rise from the peculiar institutional nature of the EU, the disunity and selfishness of some member states that render the task of ‘speaking with one voice’ challenging in energy matters (Helén, 2010). On the Russian side, the assertiveness of Putin’s foreign policy, with energy policy becoming the projection of the Russian power in the world, neutralizes any attempt of multilateralization (Umbach, 2010). As a result, commercial and intellectual relationships with the West as a whole are less welcoming while at the same time attempts to play “divide and influence” policies with individual member states remain an important source of power.

Despite estimable descriptive contributions, this literature has confined its analysis on possible interpretations of why it has proven so difficult to multilateralize the EU-Russian energy relations, assuming that the presence of energy governance is indeed desirable and a necessary condition accompanying dense interdependence. Thus, this literature fails to question the desirability of such institutional arrangements and therefore does not answer the fundamental question: “is there even a broad desirability for the fostering of multilateral, institutional cooperation between the EU and Russia?” In this study, I seek to show that Institutionalism’s optimism about economic interdependence fostering the desirability for shared international regimes is indeed incorrect. This study argues that there is little reason to believe that economic interdependence is either a necessary or a sufficient condition for the emergence of regimes and the abiding by their rules.

2.1.3 Constructivism

Whereas realism and liberalism tend to focus on material factors such as power or conflict, constructivist approaches emphasize the impact of norms, identities and ideas. Instead of taking the state for granted, constructivists regard the interests and identities of states as a highly malleable product of specific historical processes. They pay close attention to the prevailing discourse(s) in society because discourse reflects and shapes beliefs and interests, and establishes accepted norms of behavior. Consequently, although power is not irrelevant, constructivism emphasizes how ideas and identities are created, how they evolve, and how they shape the way states understand and respond to their situation. Therefore, it matters whether Europeans define themselves primarily in national or continental terms in dealing with the Russians, it matters how Russians frame and understand leading norms such as sovereignty and reciprocity and in short, whether the Europeans and Russians fundamentally disagree on what are the important norms regulating their relationship. On a lower level of abstraction, this literature points to the fundamental identity clash between the EU and
Russia, to the different perception between two of the structuring relations among states – the different view on reciprocity, an asymmetry in information sharing (assuming that high degrees of information asymmetry are increasing the transaction costs of the relationship), the fundamental norm of sovereignty. Constructivism also points to the fact that identities and interests are interlinked and consequently, from this perspective, the EU and Russia should frame suitable policies in order to effectively respond to the concerns and objectives of both parties. Hence, the present status quo the EU-Russian institutional landscape is an outcome of the mutual “othering” between the two, leading to an intensification of political antagonism (Morozov, 2008). In that sense, their economic potential, which is quite substantial, remains hostage of the lack of understanding in the political domain.

Despite the validity of the constructivist perspective, what is not immediately clear from the constructivist reading is, for example, if a shared identity between Russia and the EU were to be created – would that lead to a deepening of multilateralism? Even at the EU level, where the degree of approximation in the mutual identities is immensely higher, we observe that the latter is not a sufficient condition for a unified voice in matters still perceived as pertaining to the ‘national interest,’ such as energy security. Therefore, this study seeks to demonstrate how the discourse on identities provides only a partial explanation for a deadlock in the EU-Russian energy cooperation. However, the constructivist emphasis on the need for more attention and detailed qualitative analysis of the bottom-up regional cooperative patterns observed in individual countries, provides more nuanced conclusions on the potential for cross-border cooperation. In that sense, this author will agree with studies pointing to the potential of cross-border cooperation in creating new alliances on the basis of new identities and fostering positive developments in the peripheries even at times of strained EU-Russian energy relations.

2.2 An alternative view

This dissertation offers an alternative understanding of the forces that have impeded the EU and Russia to agree on institutions of multilateral energy governance. As mentioned earlier the dissertation is based within the realist or neorealist tradition, which holds that a high degree of cooperation is unlikely even in conditions when states operate under high levels of interdependence. However, it constitutes both a critique and modification of Realism pointing out that the classic neo-realist tradition fails to recognize the growing role of actors “other” than states, such as multinational gas firms whose pursuit of interests and power can sometimes determine the foreign policy of their own states. Moreover, it fails to account for the impact of the sub-state dimension of energy cross-border cooperation, whose advantages will be emphasized in a detailed analysis deferred to Chapter 8. Therefore, within the literature on the EU-Russian energy governance, I also look at the other two schools to theoretically ground my explanation, suggest key variables, and devise testable hypotheses. Despite some contention in the neo-realist literature (Barbieri, 1996) and doubts whether it is peace that fosters interdependence or interdependence that fosters peace, the positive link between economic interdependence and peace between countries is widely accepted.

Generally, liberal approaches emphasize the broad societal and cultural exchanges associated with economic globalization, that lead to the emergence of international institutions governing globalization. This strand of scholars has widely discussed and debated on the question: given the interdependent nature of the EU-Russian relationship why did institutions of interregional governance fail to emerge? While this literature has been generous with suggestions explaining why such institutions should be promoted, it basically has not yet sorted out the major puzzle addressed by this study: namely, why institutions of energy governance in the EU-Russian case are not already there. A third strand of the literature on the EU-Russian relations, known as the constructivist school of thought, further suggests that, given the structural constraints constituted by a conflict in the “the moral
framing” of key norms in turn shaping the set of interests guiding the crucial actors, promoting sustained institutional cooperation requires institutions involving commonly acceptable and shared rules and social norms. According to Constructivists, there is a qualitative difference in how the EU and Russia perceive the structuring relations among them, which hampers the possibilities of further institutional cooperation. Curiously however, in the evidence that I have surveyed not much has been said whether there is a prevailing desirability among the key-actors from both sides to put in place regimes encompassing broadly shared norms. Therefore, this study will try analytically and in a sophisticated manner to get back to the roots of the problem by answering two fundamental central questions:

a) Who are the key actors in the EU-Russian multiscalar energy relationship?

b) On what basis are their interests, preferences, and capabilities formed, and which are the factors causing the institutional deadlock in the EU-Russian energy cooperation?

The realist “security dilemma” proposition provides one answer. The liberal theories emphasizing the context in which the EU and Russian operate provide another answer. The constructivist school pointing to the almost insurmountable “clash in paradigms” looks at the issue through a third pair of lenses. However, the empirical evidence for the deadlock in the EU-Russian institutional cooperation of the previous theories is weak, because they fail to question the need for regimes and test the general desirability of the institutions of global governance in the energy arena. This dissertation, by relaxing the key assumption that interdependence is conducive to shared international regimes, attempts to find answers in a comprehensive manner to questions such as: what are exactly the benefits for Russia from adopting the ECT or renewing the PCA? On the other end of the spectrum, what are the benefits for the EU’s main actors fromabiding to long-term agreements that Russia finds desirable, such as the long-term supply contracts (LTSCs), which have a great deal of inertia and rigidity and do not allow for example, a flexible renegotiation? In sum, in the EU-Russia particular situation, does the benefit of security of supply for consumers (the EU) and security of demand for suppliers (Russia) outweigh the cost of being locked-in long-term binding agreements? I will argue that in the rapidly evolving interregional gas markets, where there are still mainly three regional markets for gas with differentiated prices, both consumer and producer countries do not want to be locked-in by agreements that would limit their possibility to look for more attractive possibilities in the medium term. For example, Russia does not want to be locked in any agreement that would limit its pipeline monopoly and the possibility to lock up Central Asian gas and export it further to the European markets or in the future other Asian attractive markets. The EU countries do not want to be locked in long-term agreements that limit their capacity to buy gas on the “spot” market. In terms of interstate or multilateral agreements there is no need for trade agreement in the gas trade, because both parties have an interests in a smooth trade with no barriers such as quotas or tariffs. However, what is puzzling is the non-existence of an overarching structure regulating investment and one providing legal security for pipeline transit, which would encompass all actors along the pipeline stream. In that sense the idea of the ECT was an attempt to redress this neglect. However, the ECT was considered too disadvantageous for the producer countries and for that reason the bargaining process is still ongoing. The dominant actors, which I identify in the business elites, have simply no interest in being tied-up by a common governance system, for a number of reasons rooted in self-interest. If you are a Russian supplier and you are sitting on excessive supply of natural gas you need security of supply to develop expensive upstream projects, to achieve that goal you have no incentive to allow for “third party access” through your pipelines. The status quo allows for, besides keeping the traditional European market, a potential opening of the export to the Asian gas market that offers higher prices. If you are a EUconsumer you do not want to have a system obliging you to buy the more expensive Russian gas, when cheaper gas is available on the spot markets.
When it comes to investment protection, my findings corroborate that the companies themselves are the main actors in finding strategies to mitigate risk. Large investments in pipelines are no longer the result of state-to-state agreements, but increasingly rely on firm-to-firm contracts (sometimes backed by state to state agreements) and strategies to mitigate the risks of such international projects. Interestingly enough, I do find the presence of interstate BITs between Russian and the EU states along the pipeline routes, however the Lisbon Treaty brought investment policy within the sphere of policy areas developed at the European level, which means that the Commission will review the existing Member States’ BITs.\textsuperscript{14} If it finds clauses that are incompatible with EU law (e.g. transfer clauses that would hamper the implementation of EU financial restrictions against a certain third country), it would ask the Member State to renegotiate such clause. This could trigger some new debates about the diverging approaches of the EU and the EU’s member states’ policies vis-à-vis Russia.

In sum, I propose to show why a high degree of EU-Russian energy interdependence does not create a sufficient bond to spur into existence legally binding governance institutions, (and deter the two blocs from securitization in energy relations). I first identify the key actors on both sides of the relationship and I then investigate whether there are positive causal connections between their interests and the institutional deadlock. To do that, I resort to the data and the methods that will be described in methodology section.

2.3 Conclusion

This study provides little empirical support for the liberal proposition that economic interdependence paves the way for the flourishing of international regimes. Most crucially, my approach further differs from previous explanations, which focus overwhelmingly on the reasons for a deadlock in the institutional cooperation between the EU and Russia, rather than questioning whether the dominant actors consider such institutionalization desirable from the outset. My findings suggest a tension between the deepening of multipolarity between the EU and Russia and the interests of the key players on both sides of the energy relationship spectrum. Providing empirical evidence, I demonstrate that enforcing the multilateral governance aspect of the relationship is not within the priorities of the key decision-makers. The ‘gas wars’ between Ukraine and Russia provide good illustrative examples. As noted by Yafimava (2012), while in the aftermath of the 2006, the political mood in Europe regarding the reliability of Russian supplies was that of extreme nervousness on the part of the Old Member states, and an outright insecurity on the part of its new Member States, in contrast the prevalent attitude among major players of the European gas industry was calm and even optimistic. This is suggested by the fact that nearly all European gas buyers, including German E.ON Ruhrgas and Wingas, French EDF Austrian OMV and Italian ENI, renewed their long-term contracts with Gazprom between 2004 and 2006 for the subsequent 30 years. The fact that these LTSCs were renewed in the second half of 2006 (after the 2006 Ukraine crisis), indicates that these requests were made despite (or probably because) of the 2006 Ukraine crisis. These gas giants might have decided to extend their LTSCs with Gazprom before the potential limitation of the European Commission legislation initiatives to impose volume and regulatory limitations on Russian gas. Although today the situation is quite different (see Chapter 9), the decisive input for the change has come once again from the private sector. In the 2009 gas crisis, the decision to not resort to the ECT by all the contracting parties for preventing and resolving the crisis, but also further, the failure to even acknowledge that the ECT had been violated despite abundant available evidence has proven that in that specific case the economic imperatives

on all sides proved stronger than the still incomplete legal framework (Pirani, 2012). Moreover, for the EU the 2009 supply interruption highlighted the limits of the solidarity to which the EU aspires. The South Stream pipeline case study is also critical to my explanation. All actual signatories of the Nabucco project besides Romania have welcomed the alternative Russian project as a significant additional route that will enhance the EU energy security. This includes a number of states members of the Nabucco Consortium and that are already heavily dependent on Russian gas (such as Bulgaria, Slovenia and Turkey). It is important to note that both Hungary and Bulgaria made an impressive turn in their policy and backed South Stream in order to ensure supplies from Gazprom, although they initially fully supported the alternative Nabucco pipeline (the South Stream case will be analyzed in detail in Chapter 10). I focus on such key events, assuming that the context means a great deal, in testing the proposition that multilateral arrangements can be easily broken when states face different priorities in the pursuit of profit and the national interest in energy matters. In that sense energy cooperation between individual countries has to a certain extent revolved around the motto “there are not permanent allies, just permanent interests.” One way to reconcile the differences in the propositions advanced between different theoretical traditions and to add my proposed explanation to the existing body of literature is to consider the linkages among the arguments presented within each school of thought. Therefore, in the empirical chapters of the dissertation (chapters 4 through 10), I test the hypotheses generated by prior studies and my proposed explanation using multipledata on the EU and Russian multiscalar energy relationship and the related governance issues.

2.4 Hypotheses in the Literature

REALIST HYPOTHESES

H1

Under conditions of high mutual dependency that are perceived as alarming, the EU-Russian relationship is characterized by an energy security dilemma, whereby the Union’s suddenly desperate diversification drive (in response to largely unfounded concerns) forces Russia in response to these concerns to diversify away from the EU which appears to have become less dependable (Monaghan, 2006). The fear of both entities that one might diversify its imports/exports raises mutual mistrust and weakens the prospects of cooperative endeavors.

H2

The idea of energy interdependence is not in itself sufficient foundation for successful institutional cooperation, because the interests of producers and consumers largely differ. Specifically, viewed through the lens of energy security, reconciling the fundamentally different interests of producer and consumer countries becomes a challenging, if not an impossible task.

15The exact quote, “We have no permanent allies, we have no permanent enemies, we only have permanent interests.” –Attributed to Henry John Temple Viscount Lord Palmerston 1784-1865, Foreign Secretary and two-time Prime Minister under Queen Victoria. What he actually said was [concerning apparent British apathy regarding Polish struggles against Russian hegemony, which Palmerston did not believe that it met the threshold of justifiable war] “He concluded with the famous peroration that Britain had no eternal allies and no perpetual enemies, only interest that were eternal and perpetual . . .”–quoted in David Brown, Palmerston and the Politics of Foreign Policy, 1846-1855 (Manchester: Manchester University Press, 2002), pp. 82-83
H3
The overlap in the EU’s neighborhood policy and Russia’s ‘near abroad’ policy triggers an imperial-style competition between the EU and Russia, in order to influence the countries of the shared Neighborhood and to expand the respective security zones and spheres of influence at the expense of the other. The competition on the borders is most evident in the case of Ukraine, where Russia and the EU compete to further their own interests in influencing the country’s direction (Van der Linde, 2008).

LIBERAL HYPOTHESES

H1
The impossibility of the EU to ‘speak with one voice’ and even to define what ‘one voice’ means in energy matters is the most obvious drawback in the EU’s relations with Russia. Russia is able to exploit the EU’s inherent weaknesses and play 'divide et impera' tactics mostly because of the sui generis nature of the European experiment, where energy policy is still almost an exclusive competence of the member states. In the future, the possibility to reach a shared governance framework with Russia will depend on the extent and the durability of European solidarity and the willingness to cede sovereignty in energy matters from the national capitals to Brussels.

H2
The institutionalization of the EU-Russian energy governance has largely failed because of the power-political imperatives of the Russian foreign policy especially during the Putin years and Moscow’s general belief in the supremacy of states and a distrust of international organization and norms.

CONSTRUCTIVIST HYPOTHESES

H1
There is an almost insurmountable “clash in paradigms” in the two states cooperation, originating from a different framing of concepts such as ‘Interdependence’, ‘Reciprocity’, ‘Transparency’, ‘Sovereignty,’ that resulted in an epic battle over the interpretation of the rules that would underpin a shared energy governance order (Emerson, 2006).

H2
Europe, as much as Russia itself remains in search of a stable identity for the long term. Until those identities can fully coalesce, the nature of the relations between Russia and Europe will remain at once interdependent and confrontational (Mankoff, 2011).

H3
The EU and Russia should understand that the failure to articulate their relationship at the macro-level could be improved by enhanced ties at the regional level, through a bottom-up dialogue. The target should be an improvement of the investment climate and the strengthening of energy ties at the peripheral level, that would enhance the EU’s and Russia’s capacity to promote energy-related investments, especially when the strategic partnership is temporarily strained and in a situation when an enlarged EU finds it more difficult to reach consensus on its Russian foreign policy (Romanova, 2008).
2.5 My Hypotheses

H1

The key-actors on both sides of the energy relationship are the heads of the big gas firms with the political backing of their respective governments (already argued by Abdelal, 2011).

H2

Provided that the key-actors of the EU-Russian energy relationship are on both sides the heads of the big gas firms with their respective governments, these players have no inherent interest in being locked-in multilateral institutions. They often build a business discourse built on trust and they find different ways of mitigating the risk deriving from energy investments. Despite the obvious interdependence between the EU and Russia, the interests of the EU’s consumer countries diverge greatly even among themselves, and in turn their positions on Russia as a producer vary significantly. More broadly, taken as a whole the interests of the EU as a consumer bloc are not easily compatible with those of Russia as a supplier. Hence, finding common ground on these multiple levels is particularly challenging and as we will see later, there is little evidence that the dominant business interests even broadly desire it. In fact, the political disputes between the EU and Russia are not reflected at the general business level where pragmatic calculations and day-to-day arrangements are driving the relationships. In that sense the companies seek to maximize their interests with an ad hoc type of energy cooperation with very low levels of institutionalization, that allows for abrupt changes in preferences when the demands of profit and/or national interest change.

H3

The presence of the European Commission adds another actor on the table whose drive in promoting the necessity for more convergence in the energy policies of the member states, is also motivated by power considerations and the ambition to increase its own competences.

Conclusion

In the empirical chapters of the dissertation (chapters 4 through 10), I test the hypotheses generated by prior studies and my proposed explanation using data on energy cooperation between the EU and Russia.
Table 2: Summary of the Hypotheses to be tested

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td><strong>Realism</strong></td>
<td></td>
</tr>
<tr>
<td>H1</td>
<td>No cooperation: security dilemma</td>
</tr>
<tr>
<td>H2</td>
<td>Interdependence leads to discord and not cooperation</td>
</tr>
<tr>
<td>H3</td>
<td>Competition in the Neighborhood is not conducive to cooperation</td>
</tr>
<tr>
<td><strong>Liberalism</strong></td>
<td></td>
</tr>
<tr>
<td>H1</td>
<td>The efforts to put up common governance structures with Russia are hampered by the structural unsoundness of the EU</td>
</tr>
<tr>
<td>H2</td>
<td>The structural asymmetries between the EU and Russia have widened especially during the semi-authoritarian switch of the Putin’s second term in office and his distrust of multilateral organizations</td>
</tr>
<tr>
<td><strong>Constructivism</strong></td>
<td></td>
</tr>
<tr>
<td>H1</td>
<td>The ‘clash in paradigms’ impedes for commonly agreed governance structures</td>
</tr>
<tr>
<td>H2</td>
<td>The irreconcilability of the double Identity question prevents governance</td>
</tr>
<tr>
<td>H3</td>
<td>The normative gap could be improved though a more specific dialogue and partnerships at the regional level, in a gradual bottom-up approach.</td>
</tr>
<tr>
<td><strong>My Hypotheses</strong> (within the Realist School of Thought)</td>
<td></td>
</tr>
<tr>
<td>H1</td>
<td>The key-actors on both sides of the energy relationship are the heads of the big gas firms with the political backing of their respective governments</td>
</tr>
<tr>
<td>H2</td>
<td>These players have not an inherent interest in being locked-in multilateral institutions</td>
</tr>
<tr>
<td>H3</td>
<td>The presence of the European Commission adds another negotiating actor that is, among other things, motivated by power considerations</td>
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</tbody>
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2.6 Research Design, Methodology, and Fieldwork

This section is devoted to answering fundamental questions about the dissertation’s conceptualization and execution. To test the hypotheses enumerated in the previous section, the study will analyze a series of policies, which are considered of relevance. It will then undertake a closer examination of a number of case studies, which exhibit marked variation along the articulation of the dependent variable under investigation: namely, despite the high degrees of energy interdependence why there has been a ‘deficit’ in binding governance arrangements? My independent and dependent variables for this study are derived from the main proposition (H2), which I outlined in the previous section. The key independent variable is ‘the preferences of the business elites (which support a fragmented institutionalization of the EU-Russian energy relationship)’ and hypothesizing the possibility to isolate key structural features and the effect of the hypothesized causal factor – by holding the independent variable constant (*ceteris paribus*), the dependent variable will be “the ‘deficit’ in the EU-Russia’s binding energy governance.” My proposal leads to a direct causal relationship whereby the lack of institutionalization results from the preferences of the dominant actors to retain the current shallow governance configuration.
The theoretical framework presented above underpins the theoretical foundation of this dissertation. The dissertation employs inductive method, with a content analysis of the bulk of existing scholarly work, the documents and statistics available in the public domain, expert interviews alongside with the examination of specific case studies. Each case study employs in-depth historical analysis to assess the critical factors explaining the observed outcomes. The aim is to construct a strong explanatory model of the key players’ behavior, while illustrating and testing the existing hypotheses in the literature and adding my working hypotheses about the motivations of the key actors emphasizing the pursuit of profit. In that sense, the analytical focus of each case study is on identifying the key players and tracing the interests that drive their actions, as lens through which I assess the causal connections between these historical processes. The case studies tackle a number of questions—sketched in the table above, while also providing a historical context within which the events take place. The context and the temporal element will be of paramount importance in explaining the predominance of certain agendas. A comprehensive empirical analysis of the EU-Russian energy interdependence and the differing stances towards the potential developing of binding institutional realities requires a time frame of approximately 20 years to adequately grasp the “paradigm shifts” that have surrounded the EU-Russian energy cooperation. However, the period between 2000 and 2010 will be essential to understand why a high degree of interdependence has not led to ‘more institutions.’ Formal energy relations with Russia commenced in 2000, in a period of high-energy prices and peculiar political changes in Russia. Throughout the following ten years the relationship has been characterized by both a conflicting pattern at the EU-Russian level and fruitful bilateral dealings between Russia and single member states and companies. This dissertation focuses on three multilayered spatial levels. First, the interregional level, where the EU and Russian energy sales and relations come into play. Parties to these relationships are national states, gas industries, and the multilateral institutions. Second, the national level is examined where countries and gas companies develop national energy policies and strategies. In this case, bilateral frameworks and bilateral contractual arrangements dominate the scene. Third, a sub-regional level will be analyzed here with an emphasis on South-East Europe; this study argues that a detailed focus on the region of South-East Europe is particularly useful for several reasons: first, this is the area where the EU countries covered by the energy acquis, the Balkan countries members of the Energy Community Treaty (EnCT) and Russia come into regulatory, business and geographical contact. I contend that reinforcing and actively promoting cross-border, bottom-up energy cooperation in the area can soften the diversities of the region. Second, the stability of this region is crucial from the energy point of view because major gas (and oil) transit routes go through or close to South-East Europe. Third, major new energy
infrastructure projects are in a planning phase or under construction in this specific area of Europe, which enhances its strategic importance.

2.6.1 Selection of Cases

The selection of my case studies follows a three-step process. First, I identify the key cases that might have explanatory value by tracing the reasons leading to the current deadlock of the EU-Russian institutional cooperation. For example, the Southern Gas Corridor is the epitome of a failure of multilateralization, because if the Energy Charter Treaty was set in place, the race for the Southern Gas Corridor would not have been necessary, or at least the whole process would have been played out in a different way. It also illustrates the favoring of the self-interests and business gains instead of an overarching ‘common vision.' In-depth analysis of each case requires immense attention to detail in order to unravel complex pathways of cause and effect. Second, I seek to have a large range of variation in the observations. From the member states I have chosen Italy and Slovenia. These states have been chosen since they are both highly dependent on Russian gas and yet they represent an “old” fairly diversified member state and a “new” member, that has a higher level of asymmetry in its energy relations with Russia. Moreover, these two states are immediate neighbors and both involved in the Russian South Stream project besides participating in a handful of other competing projects from Central Asia, which makes them ideal candidates for cross-border cooperation (or competition). Each case study is analyzed in connection with the other three cases, and mutual influences are examined. Third, besides the synchronic comparison, I will observe the same cases over time (diachronically) to impart additional analytical leverage. Perhaps the most critical concern lays in determining which cases to investigate in order to ensure variation on the dependent variable.

2.6.2 Data sources and collection

The data come from the expert literature, news sources, documents, and most importantly, the expert interviews. I have collected primary texts from a broad variety of sources:

- Russian, EU and Member States’ and commercial firms' legislation and documents such as treaties, intergovernmental agreements, contracts (when available)
- EU Commission Decisions and Reports
- Statistics available in the public domain
- Web based resources

Secondary texts were chosen from the European, Russian and American academic literature on the EU-Russian energy interdependence. Many texts (articles and books) received from or recommended by interviewees have been used. During residence at the Davis Center for Russian and Eurasian Studies at Harvard University from October 2011 to March 2013 I have conducted research using the vast Harvard's computer networks and libraries. My interactions with faculty, scholars-in-residence, and other graduate students resulted in productive exchanges and collaborations that bolstered my dissertation by incorporating additional views and explanatory factors. Dissertation fieldwork took place in Italy from March to April 2012, Brussels from April to May 2012, and Slovenia from July to August 2012. The dissertation also draws on more than 50 in-depth interviews, lasting from 30 minutes to two hours with energy experts, gas executives, academics, EU and Russian officials involved in the EU-Russian institutional cooperation, as well as diplomats commenting the energy negotiations from outside. With the exception of interviews conducted with Italian representatives, all interviews were conducted in the English language. I conducted face-to-face as well as phone interviews. I used “snowball” sampling – personal references and introductions from respondents I met – to identify other potential
respondents. Public figures – including appointed and elected officials and well-known political observers who appear in the media – are identified by name, except in cases where they asked to remain anonymous. All other respondents, including energy industry insiders, remain anonymous and are described only by the nature of their expertise.

2.6.3 Conclusion: Limitations of the Study

The interest for this study rises from the awareness that we still don’t know what are the critical factors that caused the deadlock in the EU-Russian institutional cooperation. My case studies encompass an ideographic approach, as detailed qualitative information is collected about an individual case over an extended period of time. The explanations offered in my dissertation are thus limited to the particular content and context under observation. That means that my study does not provide a generalizing tool though which multilateral relationships in any other country/region can be observed as well. The subjective nature of the case studies limits the extent to which the theoretical result can be generalized and applied to the remainder of the (energy) interdependence cases, as the reported findings may not accurately represent the dynamics in a different case. Therefore, the study is limited to the empirical observation of the EU and Russian dynamics of energy governance and thus in itself does not “increase generality of knowledge about the social world” (Junisbai, 2009). However, there is one theoretical result that can be generalized and applied to any importing and exporting country where gas supply takes place through long-term bilateral contracts that are undergoing rapid changes toward an enhanced globalization: the limit of expanded institutional cooperation between gas importing and exporting countries lies in the fact that the major players are driven by profitability and the ‘national interest’ imperatives that do not allow for a deep institutionalization in the rapidly changing interregional gas markets.

A second limitation of a study as such is that the limited availability of data regarding contracts and intergovernmental agreements poses limitations to the selection of case studies. As one would expect, information concerning interstate trade is more readily available for EU states, leading to an inherent bias toward the exclusion of the Russian sources, and the over-representation of the consumers’ point of view in the study. Every effort was made to minimize this bias.

Third, how reliable are the findings and arguments presented here, and how different they are from alternative explanations on the desirability of institutional cooperation between the EU and Russia? My central aim in this dissertation is to identify the factors – beyond simply institutional and normative disparities – that explain why, despite high degrees of interdependence, to date there is no legally binding instruments ruling the EU-Russian energy relationship. During my research project, I surveyed the literature and scrutinized experts, with the aim of identifying original factors that could prove to be powerful explanations, in light of what has been already said in the literature.

A final worry has been not to incur subjectivity bias. In order to obviate such risk, I present my findings in as transparent a way as possible, providing the sources in support of my position, so that others may decide if such a subjective evaluation is too optimistic, too pessimistic, or wholly unrealistic. All my evaluations are verifiable and falsifiable (Popper, 1963). Despite the margins of error that every analysis of this kind may face, I hope that with this work I can give my (limited) contribution to the wide body of knowledge existing on energy interdependence and the relations between Russia and the EU.

With these limitations in mind, a multidimensional analysis of the EU and Russian energy interdependence is carried out in the following chapters.
PART II

Historical and Institutional background
3. Historical overview of the EU-Russia gas trade and institutional cooperation

3.1 Introduction

A comprehensive assessment of the EU-Russian political relations and gas flows since the beginnings of their energy trade relationship dating back to the Cold War will not be attempted here. Rather, crucial turning points will be outlined as well as the major paradigm shifts (Van der Linde, 2006) that have impacted the nature of the gas trade relationship.

In order to place the current debate on Russian-European energy relations in perspective, a review of the relationship dating back to the post-World War II period is useful. Since the Soviet era, Russia has been one of the largest world’s producers and exporters of natural gas. From the earliest years of the Khrushchev’s rule, the gas-rich Soviet Union (USSR) adopted an industrial strategy that mandated a shift to gas with pipelines and economic integration between the Soviet Union and the Soviet bloc of nations of the COMECON (Council for Mutual Economic Assistance) that extended gasification from the late 1960s through the 1970s. In Western Europe, Italy made the first moves towards the Soviets. As early as 1959 the Agip’s leader at the time, Enrico Mattei visited Moscow where he brokered the first oil import deal over heated protests from the NATO and the United States. Enrico Mattei was a former commander of the opposition partisans in the struggle against the fascists, which made him one of the most powerful political figures in Italy. Moreover, Italy at the time had the least Stalinist communist party in Europe, which was known for its polycentrism and pragmatism. Along with that, Mattei's lead of Agip and the foundation of ENI created good relationships with Egypt, Iran, Tunisia, Libya, Morocco and Nigeria. Also, due to the Italian limited and unfortunate colonial experience, Italy did not have to bear the post-colonial bitterness that prevented other European companies to move abroad. Nevertheless, at the time dealings with the Soviets were seen with suspicion. Especially the United States tended to see Italian engagement with the Soviet Union as subversive and dangerous. Just after the conclusion of the first deal between Italy and the Soviet Union in 1959, The New York Times reports: This deal almost certainly has a significant bearing on Italy’s position regarding the security of the Western World. It also raises some questions about the effectiveness of Italy’s contribution in the event of an international crisis.”

In 1962 Enrico Mattei dies in a doubtful plane accident. Nevertheless, ENI’s drive towards internalization and gasification began and would continue in his absence. In the 1960s the USSR reemerged on the world market as a significant exporter of oil and then, in the 1970s was working to explore the more remote but promising areas of West Siberia. Western Siberia soon became the new ‘oil and gas frontier,’ gradually replacing maturing oil fields in the European part. The development of Western Siberian oil boosted natural gas production as well. Exports to the satellite states and later to Western Europe rapidly followed. At that time, the first long-term contracts with West European countries were signed, marking the beginning of a long-term interdependency. The first supply contract for Russian natural gas with a West European company was signed with the ÖMV – Österreichische Mineralölverwaltung Aktiengesellschaft (today OMV) in 1968. In the same year, an agreement covering supplies of gas to East Germany was concluded. The first Russian gas flowed in the direction of West

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Germany on 1 May 1973. A year later, in 1974, Italy launched the first gas pipelines originating from the USSR. Since then, Russia has continuously supplied these markets, which alongside with France became its most lucrative markets for natural gas. The construction of transcontinental pipelines that prompted technological cooperation with Western Europe, at the time was regarded by many as an economic folly and an engineering hazard (Maugeri, 2011 p. 67). Yet, in the context of the oil shocks of the 1970s, the countries of the European Community viewed such cooperation positively despite the ideological and political divide. For the US, these exchanges were seen as “trading with the enemy” and caused considerable transatlantic frictions. The spectacular development of the Soviet oil and gas industry required colossal capital investment, which along with military expenses represented a considerable burden on the stagnating Soviet economy. In Daniel Yergin’s words (2011, p.23): “One of the lasting ironies of the Soviet Union was that while the communist system was almost synonymous with force-paced industrialization, its economy in the final decades was so heavily dependent on vast natural resources – oil and gas in particular.” By the end of the 1960s, the Soviet economy was showing signs of decay and incapacity to maintain economic growth. But as a significant oil exporter it received a huge push from the Arab oil embargo and the quadrupling of world prices. Nevertheless, a drop of international oil prices in the mid-1980s exposed the fallacies of the moribund Soviet economy, and in 1991 the USSR ceased to exist. The new government of the independent Russian Federation opted for radical market reforms based on price liberalization, privatization of state enterprises, severe budget constraints and free external trade. In the 1990s the EU itself, undertook a vast course of liberalization in its gas and electricity markets, as part of the Maastricht Treaty principles. The liberalization of the energy sector implied a choice favoring efficiency and short-term goals instead of longer-term energy-security planning. In these years, the main reasons for the failed attempts to forge a common energy policy and a common external stance towards Russia featured in the EU’s ‘market and institutions’ approach to energy policy. Basically the EU was hoping that with the promotion of market liberalization and the underlying norms and political values, it would create an institutional framework facilitating its energy imports. It was a period of abundance and low gas prices and under such circumstances and in the liberalizing spirit of the Maastricht Treaty - it was strongly believed that the market would provide Europe’s energy security by itself. That was to be achieved with a two-fold strategy: first, the EU sought to involve Russia in its institutional and regulatory web. Second, efforts were made to attract the country as quickly as possible to the liberalization mantra. On the regulatory front, after the break-up of the Soviet Union, the EU started a well intentioned, if misguided process (for reasons that we will discuss in more detail in Chapter 4) to create a special framework for energy projects that could facilitate collective long-term infrastructure investments, resulting in the Energy Charter Treaty signed in 1994. The importance of the ECT’s role was accentuated by the fact that it was, and it still is, the only forum open to all countries along the energy chain: producers, consumers and transit states, as well as industrialized, transition, and developing economies. In that sense, the ECT is aspirational in its attempt to create a multilateral and comprehensive context for investment (Myers Jaffe, Victor, 2006). However, Russia’s long awaited ratification did not materialize and that has been the single most salient feature of its weakness. In the dynamic 1990s another institutional instrument was set up to enhance the political dialogue between Russia and the European Union, the Partnership for Cooperation Agreement (PCA) ratified in 1997. In these optimistic years some even speculated about the prospects of Russia joining the EU. As noted by Van der Linde (2007) “In the 1990s, the EU’s oil imports from Russia began to increase and replaced much of the oil imports from the Persian Gulf, which was at the time considered a sound diversification of supply policy.” The proximity of Russia and the Caspian Sea region to the European market and the fact that the production facilities were already connected to the European market through the former Soviet Union oil and gas infrastructural system, justified the European comfort. Yet, Russia and the Caspian Sea countries increasingly began to develop their own designs on how to best exploit their energy resources, and these designs
have not always matched the European drive for liberalization. The problem was compounded by the fact that the EU was approaching Russia on unequal power basis, expecting that Russia would promptly adopt the European institutional framework. In reference to this, Keohane provides a compelling observation that such an Institutionalist stance: (1984, p.8) “runs the risk of being naïve about power and conflict. Too often its proponents incorporate in their theories excessively optimistic assumptions about the role of ideals in world politics, or about the ability of statesmen to learn what the theorist considers the “right lesson.” The EU’s behavior in the 1990s seems confirming Keohane’s proposition. The EU acted naïve in expecting that the transposition of the EU’s market governance and regulatory principles to Russia would be an easy undertaking and that it would in and of itself, be sufficient to guarantee its energy supply. The fundamental fact that both the EU and Russia did not have similar interests made those efforts challenging. One of Russia’s major preoccupations was how to restore its influence in the “Near Abroad” and regain control over the transit pipeline system. The disintegration of the USSR fractured a largely unified energy system, built irrespective or regional borders. Thousands of kilometers of pipelines, major oil terminals and a number of refineries were henceforth located in different independent states. The fragmentation of this network was hard to accept as it exposed Russia to the bargaining and nuisance power of transit countries. The existence of such perceptions made relations over natural gas a highly politicized foreign policy issue for Russia, and a top, almost obsessive priority became the reducing of its dependence on transit countries that stood ‘on the way’ to the European market. Throughout the whole decade of the 1990s Russia was weakened and only when oil prices began to increase after 1999 did its economy recover. By 2002 Russia became a top producer again and was back on the international scene. With the Putin presidency also political and institutional direction arrived, which restored stability after the chaos of the Yeltsin era. At first the EU and the United States, who were becoming tired of Russia’s controversial development under Yeltsin, accepted this new order with certain optimism. However, attracted by the context of growing demand and limited supply, in Putin’s Russia natural gas became not only the most important strategic commodity but also a powerful geopolitical tool. Energy was an instrument for Russia to restore its lost influence and to play an increasing role in the international theater. And indeed, although geopolitics of energy had already been an element in the relations between the West and Russia during the 1990s, it was only during Vladimir Putin’s presidency of Russia (2000–2008) that oil and gas became truly central. Many observers posited a direct linkage between the strengthening of the Kremlin’s political control over its natural gas reserves, and European growing worries over its dependency and its quest for diversification. At the same time, the European Union, finally realizing that Russia had become a power to be recognized, was frantically trying to institutionalize its relationship with the Kremlin by means of the Energy Charter Treaty and the PCA’s successor. The first PCA expired in 2007; negotiations over the follow-up began in July 2008, but were suspended one month later because of the war in Georgia. Most importantly, an instrument specifically set up for dialogue in the energy domain, the ‘EU-Russia Energy Dialogue’ adopted in 2000, aimed to compensate for the absence of progress within the ECT (and in the PCA, where energy is dealt only indirectly). The energy dialogue is however not legally binding, but it represents a platform for permanent coordination. The EU-Russia energy dialogue has also aimed at enhancing infrastructure connections. This cooperation was reinforced by the agreement in 2003 to reorganize the EU-Russia relations around four ‘common spaces.’ The PCA, signed in 1994 and entered into force in 1997, also created a series of multidimensional arenas for the EU and Russia to discuss their concerns, including semiannual summits at the head of state/government level, a permanent partnership council at the ministerial level and regular consultations between working groups covering a series of common concerns. The series of consultative bodies and the regular schedule of meetings occurring under their auspices make the EU-Russian relationship unique in its level of institutionalization. Yet, despite such an apparently dense relationship, to date the EU and Russia lack a more durable set of interlocking institutions cementing
their relationship. Before starting to unfold my arguments why that might be the case, let us briefly sketch out their main concerns from a standpoint of the EU as a consumer bloc and Russia as a producer country of natural gas.

3.2 Russia – the Producing country Perspective

In the 1990s the whole Russian economy was trapped in a debt spiral. The European Union, imbued in the ‘mantra’ of free market promptly transferred its policies\(^1\) and provided its reformers to apply the recipes on the so-called Washington Consensus in the post-Soviet space. The weakened Russian economy was put through a drastic liberalization of both the trade and the capital, as was the norm of the ultra-liberal economical doctrine at the time. These reforms have occurred in two phases: a radical change in the ownership of energy infrastructure assets and an attempt to reform the legal environment. Soviet-trained experts, public and private energy producers and the new political leadership engaged in decision-making within the context of a new, evolving constitutional and regulatory framework. However, the strengthening of the regulatory aspect of the financial markets and the institutions of the new state were no more than in an “embryonic” phase, which allowed for a diffusion of “baron capitalism” and the formation of an elite of business “oligarchs” who usurped state's functions. In 2000, when Putin came to power he met with his country's business leaders early on in his presidency and said he would back a proposal that those dubious privatizations that took place more than three years ago should be put out of reach of judicial investigation. But, in return he asked that these “oligarchs” stay out of politics. Further, since Putin took office it became clear that the expected liberalization of the gas sector in Russia will not take place and instead Putin re-emphasized state control over the strategic sectors of the economy, with the gas sector assuming critical importance. The 2000 Foreign Policy Concept, drafted under Putin’s supervision, already stated that ‘Russia must be prepared to utilize all its available economic levers and resources for upholding its national interests,’ with an obvious reference to the energy resources (Morales, 2008). In Putin's view, this was a field where Russia had a competitive advantage over other world powers; thus, preserving its role as Europe’s main supplier was set as the chief priority, while simultaneously developing energy ties also with China and other Asian countries. Under Putin, foreign investment was allowed, but it was limited only to a minority share. This strategy was consistent with Putin’s conviction that energy exports are one of the most useful resources at Russia’s disposal in its quest for great power status and therefore they should be used as a foreign policy instrument to advance Russia's interests in the world. In the gas investment sector, the privatization of the early 1990s had been reversed at the expense of private firms. Shell and BP were being forced to cede control over their Sakhalin II and Kovykta investments respectively, and Total had been offered a similar model of limited technical participation in the Shtokman gas field. The joint venture TNK-BP has been put in the government’s sights as well (Youngs, 2009). During Putin’s second term, the Kremlin dramatically stepped up the process of bringing gas production under the control of the national champion Gazprom. The consolidation of Putin’s power did not spare some domestic firms operating in Russia either. Oligarch-owned firms were swallowed up, such as Mikhail Khodorkovsky's Yukos, by Rosneft, and Roman Abramovich’s Sibneft, by Gazprom. Roman Abramovich moved to England, where he was said to be the second-richest person in the country, exceeded only by the Queen herself (Yergin, 2011 p. 32). In the meantime, the government actively supported Gazprom in its quest for ‘security of demand’ in Europe, where the company was cementing its control in the form of downstream acquisitions: purchases of storage facilities, stakes or complete ownership of utilities around Europe are prime examples of this strategy. Allowing Russian companies access to the European market was broadly in line with the EU’s desire to promote competition and market liberalization, yet disputes over how liberalization would

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be done in practice created significant obstacles. Like the energy monopolies in Germany, France, and elsewhere, Gazprom has resisted European Commission attempts to require that it “unbundles” its transportation and refining operations. Faced with opposition from Germany, France, and others, the Commission has been unable to force European utilities to completely unbundle their operations but continued to insist that non-EU companies – namely Gazprom, to do so. Moscow complained, not unreasonably, of the double standards in the European attempts to interfere in its internal affairs by dictating how the gas industry should be structured. In the face of the EU’s opposition to Gazprom’s purchasing transit infrastructure inside Europe, Moscow has found it preferable to deal with individual European countries and companies, signing bilateral deals in Romania, Bulgaria, Ukraine, Germany, Italy, Hungary, Austria, and Finland (Youngs, 2009). Such deals make it harder for the EU to coordinate its members’ energy policies. And understandably, as long as Brussels sought to impose this by the special ‘Gazprom clause’ rather than as part of a comprehensive package of energy market reform applying equally to EU utilities, it had little leverage in Moscow. However, with its ‘Third Energy Package’ the European Commission could be finally successful in pushing its unbundling and liberalization policy, especially in the gas market. The new EU law that came into force in March 2011 requires all energy companies active in the European market to run their supply, transport and sales businesses separately. This includes indistinctively Gazprom and the European energy monopolies. If the European Commission managed to truly overcome the opposition from the French, German and Italian energy monopolies and to impose across-the-board unbundling, this kind of approach might be the right one, rather than focusing on the “Gazprom clause” as a compromise position. Gazprom has been heavily complaining, as its interest is to secure long-term agreements with customers, guarantees for investments and access to the attractive European-end customer market. In face of a growing politicization of the EU’s relationship with Russia, the latter responded in kind, announcing a two fold policy based on a diversification of the product structure of exports by increasing the share of liquefied natural gas (LNG) and the diversification of export markets, primarily to the Asian market (Mitrova, 2010). Yet, despite Russian recent efforts to diversify its markets and export products, these objectives are hampered by a Soviet pipeline infrastructure built to feed essentially the Western markets, by Sino-Russian disputes over the price for gas and by a slowly developing LNG technology. In fact, despite its huge potential, Russia provides for only 5% of world LNG production (Hulbert, 2012). Given the difficulties of turning elsewhere, it is not surprising that Russia will do everything to withhold, and possibly increase its presence on the European markets. Russia takes great pains to remind Europe that it has never, even during the days of the Cold War, failed to meet contract commitments for deliveries of oil and gas. It knows that to sustain its economy and social programs it needs access to its lucrative European markets. As noted by Belova (2010): “For some decades, resources have been exported from Russia to countries within the EU. Such exports have been taking place based on commercial arrangements involving private businesses. This has been very successful, and even in the midst of the Cold War trade went on without interruptions.”

3.3 The EU – the Consuming Bloc Perspective

In the 1990s natural gas exports from Russia were sporadically cut off and the former Soviet republics (FSU) experienced severe shortages. The EU countries were gradually realizing that the sole ‘market governance’ approach was inadequate given the expanding role of Russian natural gas in the EU markets – a dominance that now required securing supplies originating in Russia and subsequently crossing transit countries where contracts were difficult to enforce, regulatory systems were immature, and investors had been wary in deploying capital. In such settings, it was feared, the benefits from gas trade could be difficult to realize and there was a rising conviction that gas should be also approached through the geopolitical

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18 For more detail on this controversial provision see Finon (2011) and Locatelli and Boussena (2011).
prism. Among the new “risky” transit countries there was a new protagonist that would play a pivotal role in the years to come – namely, Ukraine. In the 2000s, a growing assertiveness of Putin’s power raised concerns over Russian participation in the European energy markets, particularly worrisome were its purchases of equity in European utilities such as refineries and pipeline operators. The European fears were connected both to the nontransparent nature of most Russian energy companies and to worries that these companies were in fact proxies for the Kremlin and its foreign policy agenda (Baran, 2007). The EU looked on alarmed as the Putin administration rolled back civil liberties, took control over sections of the mass media, tightened its grip over the energy sector and made angry gestures towards its smaller neighbors. The controversy over the arrest of Mikhail Khodorkovsky in October 2003 and the murder of journalist Anna Politkovskaya of Novaya gazeta newspaper in October 2006, just added fuel to the fire (Youngs, 2009). In the context of a growing “regions and empire” approach to its relations with Russia, the EU Commission undertook the ambiguous dual role as: on one side the catalyst for competitive markets, and on the other, it became the promoter of Europe’s “pipeline politics” with an open backing of the Nabucco pipeline as a means to secure the EU’s energy security. After the Russian–Ukrainian gas conflict in January 2006, energy security had emerged in the European foreign policy agendas. The active diplomatic efforts of these years are documented in the European Green Paper “A European Strategy for Sustainable, Competitive and Secure Energy” in March 2006,19 the First Strategic Review (in 2007) “An Energy Policy for Europe” that gave a boost to the EU’s discourse for the common energy policy, and the Second Strategic Review in November 2008,20 where the EU was stressing the importance of: energy solidarity among member states, a reinforcing of energy efficiency and most importantly the adoption of a collective “crisis management” against possible disruption shocks. These objectives were to be achieved by a liberalized and “liquid” gas market and the possibility of pipelines to operate in “reverse flow,” more gas storage and increased cross-border gas trading within the EU. Despite these admirable goals, the path towards a common internal gas market has been full of obstacles. The measures to ensure “resilience” (Mitrova, 2010; Yergin 2012) were met with a lot of resistance from Russia and from within European big gas firms. The owners of the pipelines resist these measures since they might attract competition. In this context, it is understandable why the European Commission with its ‘Third Energy Package’ has to push for an unbundling of the ownership of production and transportation capacities. Indeed, at this writing perpetuating national regulatory approaches still inhibit the ability to insulate the countries that depend heavily on Russian supply from possible supply shocks. Potential disruptions crises require the possibility to move gas quickly and efficiently among the European states, which in turn requires, as already noted, interconnector pipelines and the possibility to reverse the flow in the West-East direction. Gazprom has already “conceded” on one of the major impediments, namely, the existence of restrictive ‘destination clauses’ in its delivery contracts, which in the past did not allow for the resale of its gas inside Europe. In the past, these clauses enabled producer states to prevent a buyer passing on surplus supplies to other states. Such provisions were vital for producers to protect the exclusivity of bilateral contracts; but the Commission insisted they were incompatible with the internal market rules. This issue, related to internal competition law marked a significant victory for the Commission and had an impact on energy security, because a more flexible switching of gas supplies between member states as their respective demands fluctuate, is in itself a contribution to better energy security. Yet in order for the gas to move freely, interconnecting pipelines should also be put in place. Establishing the European Network of Transmission System Operators for Gas (ENTSOG) and the Agency for the Cooperation of Energy Regulators (ACER) were two additional novel steps in the direction of dealing with gas supply threats, even though their roles still remain too vague. An equally vague blueprint for a potentially new European energy security and infrastructure instrument has been envisioned

which would be presented in the 2nd phase of the Energy Infrastructure Package. It remains to be seen who will pay for these ambitious and vague proposals. The public debate whether the pipeline owners or taxpayers’ money should pay for the installment of interconnectors is still open. Equally, a still open question remains whether ACER, the new ‘agency for the cooperation of energy regulators’ (ACER) in Slovenia ought to be given a strengthened mandate to establish gas market regulations, including the power to overrule national regulators on issues connected with security of supply and the operation of cross-border transmission systems. A common regulatory framework could in fact become the EU’s most potent negotiating tool, as it would allow coordination at the EU level and the creation of a more liquid market to enable gas supplies to be moved and swapped between member states. Convergence towards a common approach is not an easy task in Europe. Historically energy has been a sector of the highest national priority and different member states found different responses on how to manage their energy mixes. If there is no single EU energy mix model, convergence is difficult to assess: one might ask, convergence towards what? (Escribano, 2012) Moreover, for the past decade, several larger states that enjoy close relations with Moscow—Germany, France, and Italy in particular—have blocked steps toward real integration. In accordance with Noël (2008), this thesis considers worth noting that interdependence with Russia is not a worrisome thing in itself, since the EU is not so badly diversified as it is sometimes believed. However, a better-coordinated approach would certainly give member states greater political leverage over Russia. An interconnected internal market for natural gas would “Europeanize” bilateral relations with Russia as transmission operators, suppliers, and governments would have to take into account not only their own markets, but also that of the EU as a whole. Yet the lack of connecting infrastructure within Europe is still an impediment in the process or reaching an internal gas market, much more than the fact that individual countries compete against one another to seek favorable deals with Russia. In this sense, this thesis holds that a solution to EU energy security concerns does not lie in a common EU external energy policy and its pivotal policy of diversifying away from Russia, but rather in increasing gas solidarity domestically. That is not an easy task, considering the high variation in the energy mixes of the different European countries. In Europe, the Russian big clients are Germany, Italy and France, which together account for more than a half of Russian gas consumed in the EU (Noël, 2008). These countries have a long history of friendly ‘special relations’ with the Kremlin and their policies are centered on promoting the interests of their ‘national champions’ through bilateral relations with Russia, rather than promoting EU-wide long-term security of supply. These three large member states have traditionally relied on state control, or have delegated energy governance to the companies, like in the Italian case. Historically, these three countries have been characterized by national or regional monopolies, supported by the government. In the early 1980s, especially after the European Common Act (1986) in Europe the battle between governments and markets turned in favor of markets and privatizations. There has been an extensive international process of privatization, concentration and consolidation of the industry, to which the industry responded with a series of mergers and acquisitions. Thus, although in the 1990sstate companies were privatized due to pressure from the EU, after the privatization and initial liberalization of the EU market, the tasks of these utilities were enhanced to include expansion into other markets (i.e. East Europe). Hence, in Germany, Italy and France, market integrations were carried out by the big corporations and were not conceived in terms of rules-based development. On the other side of the spectrum, there are countries in the EU that do not depend on Russian gas at all, such as Spain, the UK, Portugal, Denmark and some others. The UK, with an almost totally liberalized energy industry and a developed ‘spot market’ pricing system, is still an exception in the European energy scene. While it is unquestionable that Russia, which supplies a quarter of total EU gas consumption, is and will remain the most important EU gas-trading partner, there are deep differences in the member states’ energy mixes that exacerbate the quest for a common energy policy. The three biggest Russian clients are still not convinced that a truly
common external European energy policy is in their interest. The UK, somewhat ironically, having already liberalized its own markets, is pushing for a fully integrated energy market (Youngs, 2009). On top of that, the new Central and East European countries are poorly diversified and rely heavily on Russia in their supplies. Among them, the ones adopting the toughest line towards Moscow were, until recently, those with the highest rates of gas dependency on Russia – this including Poland, the Baltic States and Slovakia. Poland in particular assumed the hardest stance in ‘demonizing’ Moscow, and was criticized from the other member states that strived for a more pragmatic approach toward Moscow. Hence, in the gas sector, the picture is complicated not only by the lack of an integrated market mechanism allowing gas to move economically between different regions of the continent, but also by the memberstates’ uneven dependence on Russia. As previously said, Central and Eastern Europe in particular rely heavily on Russia for their gas supplies.

Thus, fundamental differences still remain between different member states and the EU’s toughest challenge is hence to ensure greater solidarity between Eastern and Western Europe, and between countries that rely on Russian gas and those that do not. The energy specialists are divided between those who advocate a truly common European internal and external energy policy (Rosner, 2010) and those who rather believe that one step at the time should be taken; i.e. the EU should make the internal gas market integration a priority, and only when that is achieved an eventual external energy policy is a conceivable idea (Van der Linde, 2008). The current weakness of energy policy at the EU level stems from the fact that its essence consists of an internal market and competition policy, a nascent sustainable energy policy and a still empty security of supply policy. At the core of this problem is the “mandate” issue, that is the EU’s lack of legitimacy over its member states’ energy policies. The issue of sovereignty over energy policy has cropped up repeatedly in the history of European integration. The current financial crisis has dramatically exposed the dilemmas of such a Union. European Eurosceptics and European federalist alike feel vindicated in predicting that the monetary union would not work without a political and economic union.

The same dilemmas and divergences in opinion have been surrounding the EU’s ‘Energy policy.’ The Lisbon Treaty does provide the European Union with a mandate to establish a common energy policy based on ‘solidarity, sustainability, security of supply and economic efficiency.’ However, Member states tend to retain their sovereignty in security of supply issues as they are seen as critical for the national security and the economy. Thus, in the short term prospects for a Brussels-led common external energy policy remain weak, and as I seek to show later, maybe that is not a bad thing in itself. As with the energy mix, the geographical origins of energy sources vary widely across the EU countries due to geoeconomic circumstances. In fact, a more detailed qualitative analysis of the still incomplete changes observed in the EU’s internal gas market, provides more nuanced conclusions on the need to advance with the external energy policy (Chapter 5). One of my central arguments, drawing on the Realist tradition posits that as long as there is no integrated European market creating effective solidarity between gas consumers across national markets, the prerequisites for an “external” energy policy are not there yet. However, the slower the Member States implement such transition, the longer Russia will be able to exploit national variations and successfully continue to play its famous “divide and rule.”

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22 Poland has been the country with the toughest stance towards Moscow. Nevertheless, after the more pragmatic Donald Tusk succeeded Jarosław Kaczyński, we have witnessed a Polish-Russian rapprochement.

3.4 The Transit Issue

For an analytically rigorous assessment of the dynamics between the EU and Russia, we need to take into consideration the transit issue. In the context of transit, fruitful contributions in which the relationship between Russia and the transit countries (Balmaceda, 2008), Russia, the transit countries and the EU (Yafimava, 2012) have been the major object of analysis offer more detail. This section sketches the challenges that transit posits and the implications for the EU and Russia’s potential multilateralization of their relationship, but it explicitly abstains from going into detail in the assessment of the responsibility for the gas disruptions.

In the Soviet era, pipelines were built without regard to internal borders. Moscow controlled the entire Soviet Union, and even where pipeline planners knew of possible long-term political risks, internal borders were not factors to be considered in the planning process. Invariably, pipelines followed straight-line routes. Thus, the trunk-line that carries gas from the Caucasus north to Moscow links several cities on straight-line paths that carry the line a few miles inside Ukraine’s territory – an irrelevant fact in Soviet times and now a source of substantial transit revenues for Ukraine. In the 1990s Gazprom would have been delighted to bypass Ukraine if others paid for it (Victor and Victor, 2006 p. 156). But Western buyers did not worry that much about possible transit risks, hence projects conceived with the sole purpose to bypass Ukraine were not credible at the time given that the Ukrainian corridor is clearly the least-cost route between Russia and Europe. With the dissolution of the Soviet Union, the European part of the Soviet Union formally disintegrated in 1992 into seven states – Russia, Belarus, Ukraine, Moldova, and the three Baltic states. Thus, instantly transit countries (Belarus and mainly Ukraine) appeared on the routes of all the pipeline projects connecting Russia to Western Europe. At the time that the Soviet Union dissolved, about 90 per cent of Russia’s gas exports traveled through Ukraine. Moreover, significant storage facilities of natural gas that were previously under direct Moscow’s control were now in the states of the CIS (Commonwealth of Independent States), notably Ukraine. In the following years the transit countries of Belarus and Ukraine were often locked in disputes with Russia over the pipelinesownership and the pricing of gas. Ukraine presented the larger problem. The 1990s saw a constant simmering battle between Gazprom and Ukraine over the latter’s repayment of accumulated debts, demands for more favorable gas contracts and the former’s demands of uninterrupted gas flow through Ukraine. The effects of these battles were occasionally felt in Western nations when contracted gas supplies fell short. Accumulated debts and accusations of stealing the gas designated for the EU market became a source of growing tensions between Russia and Ukraine. The situation escalated in two occasions: in 2006 and in 2009 over past debts and gas prices for the following year. Especially the 2009 dispute cut gas deliveries to many European importers of Russian gas at a time of unusually cold weather and caused widespread shortages. For Eastern Europeans that crisis demonstrated that the region has remained hostage to the unpredictability of Russia-Ukraine relations, the instability of Ukrainian politics, and the possibility of deliberate supply manipulation by Russia. In particular the January 2009 cut-off evinced the energy vulnerability of the countries of Central and South-East Europe. In fact, the uneven distribution of vulnerability has still important foreign policy implications, insofar as it inhibits the development of an agreed strategy for dealing with Moscow. In Smith’s (2010) words: “Eastern Member states had little reason to be supportive of projects that increase their dependence on Russia.” Since 2009, the efforts to diversify away from Russian gas have gained momentum, especially among some of the Eastern member states, notably Poland. Hence, while Eastern Europe was meditating about diversification, at the same time, Gazpromwas painfully realizing that the gas disruptions, plus a number of corruption scandals, seriously tarnished its otherwise impeccable reputation as a gas supplier. Ever since the gas disputes, the efforts to develop alternative routes to the Ukrainian corridor have created a major fissure in the Gazprom leadership. As documented by a European industry insider: “Already by the mid-1990s theft and risk of gas interruption through Ukrainian transit had focused Russian minds.
on finding alternative routes. Indeed, delivering gas to Southern Europe via the Southern route had been under discussion in Russia as early as the 1990s, driven by the a keen, almost obsessive, attention of Gazprom (and the Russian government) to this route, even before Nabucco was ever mentioned.”

Indeed, the 2009 gas crisis has shown that Ukraine responded to the crisis by siphoning other countries’ gas from the Russian pipeline for its own use and made the EU aware that transit countries, rather than producer countries are those that tend to turn energy into a “weapon” (Bressand, 2010). In the 2000s Ukraine showed that it was able to affect the development of the cross-border gas trade and was also able to siphon gas from Russia’s westbound pipelines. It has thus proved to be an unreliable transit country. The case of Ukraine provides a stark example of the leverage that a transit country can impose where there are no viable alternative export options in the near-to-medium term (for a more detailed discussion see Yafimava, 2012). As the influential study from the Baker Institute (Victor, Jaffe and Hayes, 2006 p. 334) demonstrates, producer countries have no interest in using the “gas weapon” because all major markets for gas are fundamentally contestable over the long term by alternative suppliers or alternative sources. Curtailing gas shipments causes harm to suppliers’ reputation. Russia is no exception in this respect, it is aware that a damage to its reputation as a reliable supplier could lock it out of the lucrative European market for a generation or longer. The political uncertainty in Kiev and its siphoning of gas for its own use during the 2009 crisis, has exposed the problem of relying on Ukraine as a transit state and has strengthened the case for diversification. To some degree the EU’s decision to officially endorse Nord Stream as a European project and to not oppose South Stream, stems from these considerations. In fact, the Russian drive to (partly) avoid Ukraine was pursued with the aim of supplying Northern Europe through the Nord Stream project. The South Stream project is still under consideration, mainly due to the Russian deep recession that seriously diminished Gazprom revenues in 2009 and 2010. Nevertheless, the company seems determined to pursue the project unless Ukraine decides to sell its distribution network to Gazprom, which would then make the project superfluous. At present, Ukraine’s behavior is already tempered by the knowledge that Russia can advance alternative export routes, with a consequence of a long-term erosion of Ukraine’s transit fees. Indeed, Germany in 2011 inaugurated the new Nord Stream pipeline, which built an umbilical cord to Russia bypassing Ukraine, and Italy is potentially in the process of doing so with the South Stream project, whose only purpose is, to bypass Ukraine. Hence, this country is already constrained much more by the stick of becoming bypassed and by the carrot of the need for revenues in order to pay for its own gas and maintain the economy. But the transit issue has another, additional dimension. After the break-up of the Soviet Union, Moscow also lost the rich natural gas and oil reserves that it previously controlled in Central Asia. Suddenly Russia became the transit country for these countries’ gas (notably Turkmenistan’s) en route towards the Western markets. To date, many projects have been promoted to bypass Russian intermediation and bring the land-locked Central Asian gas to the European markets Russia-free. That has proven a difficult endeavor for many reasons; building new pipelines is expensive, the new routes would traverse potentially other risky countries in the region, and in addition Russia is already locking-up most of the resources from these states for its own consumption and export. Therefore, twenty years after their independence the Central Asian countries did little progress to reduce dependence on marketing their reserves through Russia and gain more general economic independence. On the contrary, in the 2000s the Russian hold on these countries seemed increased. Long terms gas contracts were signed between Gazprom and all Central Asian countries. These reserves are critical to Russia’s domination of the European gas market. Recently in fact, all the CIS countries, including rebellious Ukraine that might soon decide to sell its treasured pipelines, fell in the embrace of Russia and increased their dependence on the country.23

23 For a deeper analysis on the Russia – Ukraine relationship and the impacts of an increasing Russian hold on the neighborhood see “Contended Neighborhood – A case in point of the Neorealist narrative,” Section 5.2.5 (Chapter 5).
inaccessible; the EU depends not merely on Russia but also on a small number of pipeline channels moving oil and gas from East to West. Before the inauguration of the Nord Stream pipeline, nearly 80 percent of Russian gas sold to Europe passed through Ukraine; the remaining passed through either Belarus or Turkey (Ebel, 2009). Pipeline politics has also negative effects on the already tenuous unity of the European member states. The recently opened Nord Stream has been agreed by Germany and Russia with the means of bypassing the current transit states, but it also bypasses current EU member states such as Poland. At the time, that provoked heated reactions of the Polish officials that somewhat dramatically called it the new Molotov-Ribbentrop Pact, as it could allow the Russians to use energy as a lever against Poland and the Baltic States. Meanwhile, the Italian national champion ENI and Gazprom have agreed on the construction of the South Stream. With a projected volume of 30 bcm, South Stream would be an extremely expensive project, constructed by Gazprom and the Italian energy firm Eni, and will run from Russia’s terminal at Novorossiysk under the Black Sea to Bulgaria, where it will split into a southern branch, through Greece to Italy, and a northern branch, through Serbia, Hungary, and Slovenia to Austria. This project is in open opposition with Nabucco, a pipeline of the same capacity; also very expensive that is politically backed by the EU and the US to diversify EU supply away from Russia. Despite Russian and EU declarations that Nabucco and South Stream are not competing projects, they are designed to provide essentially gas to the same markets, which do not need more than one pipeline. At this writing to say that Nabucco is a “challenging” project is an understatement, but South Stream is also in a bad shape (the Southern Corridor will be examined in more detail in Chapter 10). In light of the “gas glut” in Europe many observers find the possibility of a smaller diversification pipeline from Central Asia more realistic, with recent analyses pointing to the much less ambitious Trans Adriatic Pipeline (TAP). The “battle of the pipelines” also somewhat strained transatlantic relations. Washington and its EU allies differ sharply about Russia’s role in European energy security. Many EU states are eager to get as much gas as they can from whatever source is available. This stance frequently puts them at odds with the United States, whose approach has focused on reducing Europe’s dependence on Russia as a supplier rather than overall supplies maximization (Mankoff, 2009). Washington’s strategy centers on establishing an east-west energy corridor from the Caspian to Europe, bypassing both Russia and Iran. The EU also backs what it calls the Southern Gas Corridor as one element in its campaign to diversify supplies. Yet, as it will be shown in Chapter 10, Nabucco is not practical in the near or medium term—it is too expensive and politically complex. Most importantly, no one has yet determined the source of the gas it is meant to supply. In face of these difficulties Richard Morningstar, the U.S. Special Envoy for Eurasian Energy, has recently stated that a “smaller, cheaper alternative to the EU-backed Nabucco pipeline could be the best choice to carry Caspian natural gas to Europe.”24The situation of a complex interplay between political and institutional forces on one side, and technological and economic interests on the other renders the “race for the Southern corridor” a multilayered issue that is unfolding very slowly in the current situation of gas oversupply in the European markets. The Southern Gas Corridor is also the epitome of “geopolitics;’ the fact that the state is clearly “back in” and that energy is not ‘just another commodity.’The race for the Southern Corridor where the European Union (as a whole) and Russia are clearly adversaries, while conflicting interests within Europe in new gas export projects, geography and politics have slowed the exit of the state, show that while there is a shift to a greater role for the European Commission the member states are injecting a good dose of state control back into energy market arrangements. Much of this pattern simply reflects the desire of governments to preserve control over such a variegated and multilayered policy field. By consequence prospects for further multilateralization of the EU and Russia’s energy relationship are not behind the horizon any time soon.

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24Euractiv, US urges Azerbaijan to choose 'smaller pipeline', November 17, 2011
3.5 Conclusions

In the last decade the relationship between the EU and Russia has gone through a period of mistrust rooted in a series of misunderstandings. In the energy domain the growing “securitization” of energy relations has resulted in a gradual political drifting apart of the two neighbors. In short, Russia has been considered a difficult neighbor and the European Union has been a hopelessly divided interlocutor. Between 2008 and 2009 the hostility between the EU and Russia was at the highest level. Hard power, the kind Moscow deployed against Georgia in August 2008 frozen the relationships and the 2009 gas disruption generated concerns that Moscow could decide to withhold contracted deliveries, a form of economic-political blackmail. Some even called increasingly for an “energy NATO,” siding unsurprisingly with Poland and the US supporting the NATO-line (Youngs, 2009). But a broad involvement of NATO in energy security issues would only have run the risk of straining the relations even more, rather than relaxing them. However, the general rhetoric towards Russia was fiercer, and mutual mistrust was growing. As Gazprom was purchasing downstream infrastructure in Europe, worries over transparency and the endemic corruption afflicting the Russian energy industry increased. On the Russian front, its deep recession in 2009 caused a decline in production and the Russian elite came to the realization that its economy needs diversification and modernization (Barysch, 2011). The EU became the strategic partner in helping to achieve these goals. The EU on its part froze its narrative about ‘common values’ and instead focused on a more pragmatic, goal oriented approach. In the subsequent two years (2010-2012) both Russia and Europe relaxed their rhetoric, however visible improvements in their institutional cooperation have not been achieved. Negotiations proceed on vague, superficial and declaratory basis, with a lack of real and genuine commitment to find workable solutions (Chapter 4).

There are still heavy concerns on both sides that impede progress; the EU fears the uncertainty of Russia’s long-term ability to produce enough oil and gas to meet contracted demand at home and abroad (Goldthau, 2008). Russian energy production remains imperiled by inefficiency, underinvestment, politicization, high taxes, and falling prices. These issues, combined with declining indigenous production in Europe, signal that in the coming decades Europe will have to come up with new solutions. Unexpectedly, a possible solution came from the United States. The US “shale gas revolution” marked a crucial turning point heavily impacting the supply and contracting structures in Europe, with probable further surprises in the future (see Chapter 9). The LNG supplies destined for the US market, were resent to the European “spot” markets, with Russia suddenly facing an increasing competition of liquefied natural gas (LNG), and a potential version of the “shale” revolution on the Old continent. It remains to be seen whether and how will Russia face this “perfect storm” of gas changes in Europe (Gustafson, 2011). At the same time, the European Union should come to terms with the fact that Russia remains its major natural gas supplier for the decades to come, even though that the latter will be losing market share in the medium term. The EU should also prove itself as a reliable customer. Indeed, asking more supplies from Russia and at the same time claiming that it wants to diversify away from Russia is a contradiction in terms (Henry 2010, Grigoriev 2011).

At the institutional level, the Partnership and Cooperation Agreement expired at the end of 2007. Without a new agreement, it has been renewed automatically. However, the intensification of trade underlined the need for a new framework, primarily in order to facilitate the Euro-Russia commerce. A new agreement has not yet been finalized, due to a lack of political will from both sides. The EU stopped its talks after the Russian invasion of Georgia in 2008, and Russia in any case considers the current PCA inappropriate for the new balance of powers and sees this document as contracted when it was “weak.” The same can be said about the Energy Charter Treaty, which Russia signed in 1994 but did not ratify. Russian objections stem from Gazprom’s unwillingness to accept the treaty’s “Transit
Protocol,” which would establish and define the principle of freedom of transit, threatening Gazprom’s revenues from its pipeline monopoly. Ever since the Treaty has been rejected, the EU struggles with finding a new approach vis-à-vis Russia that transcends its usual praxis of Europeanization through conditionality and a gradual convergence towards the EU’s model. A first attempt was tried with the European Neighborhood Policy (ENP) in 2003. It was designed to bring coherence to the series of PCAs existing between Brussels and the neighboring countries, by means of privileged relationships built ‘upon a mutual commitment to common values’ (mainly through bringing partner states’ legislation in line with the EU aquis communautaire). Russia rejected inclusion in the ENP because it saw the demand to coordinate its legislation with the principles contained in the aquis communautaire as interference in its internal affairs, because it objected to being given the same status as the smaller states covered by the ENP (Mankoff, 2011) and it refused being treated as a “junior partner” (Light, 2008). In the following chapters, both the failure to keep Russia as an active participant in the European Energy Charter (ECT) and the obstacles found to substitute the expired PCA, point to the fact that the incentives offered by the EU are clearly insufficient to alter Russia’s preferences and attract it the EU’s governance structures. Thus far Russia has resisted any European attempt towards the formal institutionalization of the energy relationship despite the EU’s efforts to persuade Russia to adhere to at least some of the ECT’s market-governance principles. The EU insists that the Energy Charter is of the highest priority because of its focus on the rule of law and the role of governments in providing robust frameworks for foreign investment. Russian officials continue to be resistant to EU efforts to ‘smuggle in’ ECT principles to a new PCA agreement (Youngs 2009; Noel 2008). The empirical evidence scrutinized in this study explicates that Russia would be much more prone to adhere to an amended Treaty, whose common guidelines would be established in a spirit of mutual recognition of both the producers’ (Russian) and the consumers’ (European) interests (Bressand, 2010; Van der Linde, 2008). Although important, the ECT should not be seen as a sort of oracle of the EU-Russia relationship and insistence on an instrument that is still in its bargaining process precisely because is regarded as too disadvantageous for the producers, does not send positive signals to Russia. However, it is worthwhile to keep the process going, especially given that oil and gas prices are now lower and the market is evolving so rapidly, that it could force a new agreement.

In summary, the presently contested institutions draw the attention on their necessary “modernization”: in the face of rapidly evolving interregional gas markets what kind of institutions should the EU and Russia conceptualize in the future and what should their distinctive features be? But these questions are beyond the scope of this dissertation, which is limited to exploring the current institutional framework, and in light of this analysis, attempting to understand the reasons for the institutional impasse between the EU and Russia. Having offered an overview of the complexities of the EU-Russian energy relationship, the next section will proceed to analyze how the current energy interdependence has been dealt with under the existing bilateral frameworks provided by bilateral intergovernmental agreements and private contracts, and by the formal and informal, multilateral institutional frameworks.
4. Existing Multilateral and Bilateral Frameworks for Managing EU-Russian Energy Trade and Investment

The institutional dimension of the EU-Russia energy relationship consists of multiple and multilayered agreements regulating the energy trade and investment.

1. The bilateral level can be split in:

a) The Member states’ – Russia’s relationship that covers state-to-state intergovernmental agreements and firm-to-firm commercial contracts. This is the domain where individual Member states and gas firms negotiate directly with Russia. In the ‘investment domain’ we find a dense interaction in the form of Bilateral Investment Treaties (BITs) between Russia and several Member States.

b) The EU-Russia bilateral agreements such as the Partnership and Cooperation Agreement (PCA) and the EU-Russia Energy Dialogue.

2. The multilateral frameworks are commonly understood as a set of formally and informally devised rules that shape the interaction of two or more actors. To date the EU and Russia’s relationship is governed by only one multilateral framework, the Energy Charter Treaty (ECT), with an overlapping membership of the EU, Member States, Russia, Western CIS countries, Central Asian CIS countries and a number of other countries. However, due to Russia’s refusal to ratify the ECT, the EU-Russian relationship lacks legally binding norms that can be enforced in a case of a dispute. This chapter analyses:

a) The Energy Charter Treaty

b) The Multilateral Cross-Border Frameworks in place in the sub-region of interest in this dissertation, namely South East Europe.

4.1. Bilateral Frameworks

Where natural gas trade is concerned, it is not puzzling to find many institutionalized frameworks, at least at a state level, within which the above-mentioned relationships operate. The reason is simple. Russia wants to sell as much as gas as possible to the EU’s markets and the EU has no reason to be protectionist in regard to energy supplies that it needs from Russia. Given the fact that energy markets are constantly evolving, the arrangements about the gas trade - the prices and volumes – are covered in the commercial contracts at the company level. The existing intergovernmental bilateral frameworks cover thus the infrastructure investment domain.

4.1.1 Russia and the Member States

4.1.1.1 The intergovernmental Agreements between Russia and the Member states

Since the creation of the European Union the Member states had consistently expressed a preference for intergovernmental over supranational policy-making in the energy field. The path towards the common internal energy policy is still incomplete and debates over the practicability and the desirability of a common external energy policy are ongoing. The
dilemma goes to the very heart of the long-standing, and fundamentally, the most basic underlying debate on the nature, the function and the future of the European Union between the federalists and the intergovernmentalists. As far as energy policy is concerned, the still predominantly intergovernmental nature of the EU decision-making in this policy area is undeniable. From the Russian perspective, in the gas contracts with Europe two-favored modus operandi prevailed. When trading with relatively politically vulnerable states, such as the western CIS countries, Russia had tried to supplement the commercial contracts by inter-governmental long-term agreements, which would guarantee necessary volumes of gas supply for the consuming country and a return of investments for the producing country in order to minimize the risks. On the contrary, the commercial contracts between the consumers in Western Europe and Gazprom were not underpinned by these political clauses. Thus, in Western Europe commercial contracts had been and still constitute the only bilateral commercial framework within which commercial terms and conditions of Russian supplies to the European markets can be agreed (Yafimava, 2012). That has been a commonly accepted practice between the countries of the EU and Gazprom ever since the times of the USSR. Yet, there were no transit problems at this stage as they obviously started to emerge only in the 1990s. Despite the novel ‘transit issue’ starting with the 1990s, commercial relations between the EU’s natural gas buyers and “Gazprom Export” have been stable enough to prevent the emerging of further institutions regulating gas trade. The investment sector is different. In this domain, in order to secure foreign direct investment in Russia, member states and Russia have been signing Intergovernmental Agreements and Bilateral Trade Agreements (BITs). That is hardly surprising considering that the upfront investment phase in energy projects may involve significant commitments in terms of time, effort, and money, even prior to the actual decision to fully commit capital is made. Once the investment is made, a conditio sine qua non for energy investors is a guaranty against unfair, discriminatory, or improper seizure of assets by governments, and assuring those investors that their rights to open procedures and the rule of law will be respected, including unfettered access to impartial judicial processes and effective and expeditious compensation. Experience in the application of BITs shows that cases of direct expropriation are normally not difficult to determine. More difficulty lies in determining when governmental action leads to "indirect" expropriation. A case in point is the situation that surrounded the Sakhalin II project, where Royal Dutch Shell was the majority partner until Gazprom gained a controlling share of the project as the result of a December 2006 deal. Gazprom purchased Shell’s shares in the field for far less than their real value. True, Shell decided not to complain about this partial expropriation. Further, in June 2007, TNK-BP was forced to sell a 62.9 percent stake in its Kovykta gas field to Gazprom (Youngs, 2009). Since Gazprom and Rosneft have radically strengthened their positions in Russia’s East, it has become a testing ground for the new state petroleum policy. According to Poussenkova (2008), “Russification” and “etatization” of the domestic oil and gas sector will probably continue. Global majors are delegated the role of minority investors and junior partners: indeed French Total and Norwegian Statoil have been offered a similar model of limited technical participation in the Shtokman gas field. The mounting rise of the so-called resource nationalism (Bremmer and Johnston, 2009) in Russia throughout the 2000s has empowered the state-owned companies (NOCs - Gazprom in particular) and put them at times in direct conflict with the Western IOCs. Indirect expropriation, often called "creeping" expropriation, took many forms, including disguised or opaque regulations and policies that have the effect of removing or depreciating the value of an investment (World Energy Council, 2012). That is precisely why numerous BITs are essential components of investment security; because they can be used for the purposes of non-discrimination, movement of capital, transparency and related issues. The BITs are the most direct remedy to foreign expropriation, and members of the European Union have sensibly developed this major legal instruments with Russia; 48 countries, including 21 EU-countries, have concluded 50 bilateral investment treaties with .

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Russia that have been ratified, allowing foreign claimants in those countries to sue the Russian government.

Table 3: Bilateral Investment Treaties (BITs) of the Russian Federation

<table>
<thead>
<tr>
<th>Country</th>
<th>Signature Date</th>
<th>Entry into Force Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Apr 11, 1995</td>
<td></td>
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<tr>
<td>Argentina</td>
<td>Jun 25, 1998</td>
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<tr>
<td>Armenia</td>
<td>Sep 15, 2001</td>
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<td>Austria</td>
<td>Feb 08, 1990</td>
<td>Sep 01, 1991</td>
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<tr>
<td>Bulgaria</td>
<td>Jun 08, 1993</td>
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<tr>
<td>Canada</td>
<td>Nov 20, 1989</td>
<td>Jun 27, 1991</td>
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<tr>
<td>China</td>
<td>Jul 21, 1990</td>
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<tr>
<td>Croatia</td>
<td>May 20, 1996</td>
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<tr>
<td>Cuba</td>
<td>Jul 07, 1993</td>
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<tr>
<td>Czech Republic</td>
<td>Apr 05, 1994</td>
<td>Jun 06, 1996</td>
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<tr>
<td>Denmark</td>
<td>Nov 04, 1993</td>
<td>Aug 26, 1996</td>
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<tr>
<td>Egypt, Arab Republic of</td>
<td>Sep 23, 1997</td>
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<tr>
<td>Finland</td>
<td>Feb 08, 1989</td>
<td>Aug 15, 1991</td>
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<td>France</td>
<td>Jul 04, 1989</td>
<td>Jul 18, 1991</td>
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<td>Hungary</td>
<td>Mar 06, 1995</td>
<td>May 29, 1996</td>
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<td>India</td>
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<td>Aug 05, 1996</td>
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<td>Japan</td>
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<td>Vietnam</td>
<td>Jun 16, 1994</td>
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Note: The data, which is not conclusive, is based on information provided to International Centre for Settlement of Investment Disputes (ICSID) by governments.

Source: ICSID Database of Bilateral Investment Treaties, accessed on September 5, 2012
Interestingly enough, all the transit countries along the Russian pipelines’ paths are covered by BITs. The agreements for the build-up of pipelines are the most prominent cases where the intergovernmental level still dominates. For example, in July 2009, the prime ministers of Austria, Bulgaria, Hungary, Romania and Turkey signed an intergovernmental agreement regarding the construction of Nabucco. Likewise, between 2008-2009 Russia obtained support in boosting intergovernmental cooperation for its alternative, the South Stream pipeline, for the supply of Southern Gas Corridor. Intergovernmental agreements were signed with Bulgaria, Hungary, Greece, Serbia, Slovenia, Croatia and Austria in order to construct pipeline sections in these respective countries. The political backing of transit also indicates that the Energy Charter Treaty (ECT), a multilateral framework of energy governance, has produced limited overall results in matters of trade and transit, but its investment provisions generally work well (Westphal, 2011). The treaty, which came into force in 1997, contains substantial clauses against confiscation. Although Russia has not yet ratified the treaty, it has committed itself to abide by it, and major suits are under way on this basis (Aslund, 2009). Thus, at the state-to-state level there are multiple instruments to deal with issues pertaining to investment. As part of these endeavors, the BITs merit most attention. In the years to come we could witness a dispute between member states and the EU’s Commission regarding the BITs. Indeed, after Lisbon, EU Member States have lost their power to conclude (both intra and extra-EU) BITs protecting their Foreign Direct Investment (FDI), as that now falls within the exclusive competence of the EU. In fact, the Lisbon Treaty brought investment policy within the sphere of policy areas developed at the European level, meaning that the Commission has the powers to review the existing Member States’ BITs. If it finds clauses that are incompatible with EU law (e.g. transfer clauses that would hamper the implementation of EU financial restrictions against a certain third country), it would ask the Member State to renegotiate such clause. How this would be done is however not clearly spelt out, and in the short term a “grandfathering solution” is likely to be adopted. This means that an exemption might be granted allowing the existing BITs to be kept in place until the adoption of EU investment agreements. It is uncertain which is the added value of a EU comprehensive investment policy, given that the BITs were functioning well and given that any additional bureaucracy raises the question of its desirability and the EU’s accountability. According to the EU Commission, it aims to “explore the desirability and feasibility of stand-alone investment agreements with countries which receive high proportion of EU investments, such as China and Russia.”

4.1.1.2 EU Member States Contractual Relations with Russia

Gazprom’s gas is sold to the EU on the basis of long-term supply contracts (LTSCs). In continental Europe the general pricing structure works in the following way: given the large up front investments required for gas pipeline infrastructure, Russia prefers to secure long-term contracts. As a result of long standing competition with other fuels, formulae for the price of gas in these long-term contracts are linked to fuel alternatives - primarily crude oil and/or petroleum products. The price paid by European consumers is called netback price. It indicates the transportation costs for shipping gas from the Russian border to for instance the German border and the price received by Gazprom net of (or after subtracting) the transportation costs. All these LTSCs are self-standing and are subject to international arbitration. Although, as noted before, these contracts constitute the only bilateral commercial framework within which commercial terms and conditions of Russian gas supplies to the European market can be agreed (Yafimava, 2012), they are often closed with the attendance of the political leaders of the countries in question. From the consumers’

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perspective, diplomatic efforts can be very helpful when contracts are being negotiated with state companies of producing countries, such as Gazprom and the Kremlin. In this environment a certain amount of governmental backing is indeed helpful for the companies (government-to-government to facilitate business-to-business). In fact, many large gas contracts between Gazprom and the European gas companies have been closed in the context of bilateral meetings between government leaders. Until the most recent paradigm changes, the LTSCs role was regarded as necessary in securing the flow of gas to Europe, which also guaranteed stable revenue to supplying countries. In the last few years this system has been crumbling, not due to its long-term nature but because of its oil-product indexation element, which ties the LTSCs to the prices of oil (see Chapter 9). In any case, in a longer perspective since the 1960s when the first long-term contracts were signed, these were seen as successful strategies to secure supply and manage the interdependence between Russia and its main European customers. These relationship have been marked by years of mutual trust and by a successful business record. Most of Gazprom’s LTSCs with its major European buyers were extended for a further 20-30 years between 2004 and 2006. Even more, several major energy companies prolonged their long-term supply contracts with Gazprom in the wake of the Russian–Ukrainian gas wars, meaning that the strained political relations between the EU and Russia did not impact significantly the business-to-business relationships, and not even the government-to-government relationships between Russia and some key customers (see Table 4).

Table 4: Gazprom’s European New, Extended and Renegotiated LTCSs

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>CONTRACTS</th>
<th>RENEWALS / NEW-LTCS/ RENEGOTIATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Russian natural gas is delivered to E.ON Ruhrgas AG for distribution in Germany and Switzerland</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 7 long-term contracts, 22 bcm/a</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 3 prime LTSCs have been concluded with WIEH and WINGAS for the delivery of 22.3 bcm/a in the plateau period, with another LTSC signed for the delivery of 5 bcm/a to Romania.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• In September 2003, Gazprom Export and WINGAS signed a LTSC on the sale of natural gas on the British market, which is valid till 2013. Delivery volumes reached around 5 bcm in 2008.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• In August 2006, E.ON has extended all its long-term supply contracts with Gazprom through to 2035</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Between 2020-2035 the volume of deliveries under the prolonged contracts reaching 19.8 bcm/a</td>
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<tr>
<td></td>
<td>• LLC Gazprom Export has signed an agreement with WIEH, WINGAS and WIEE extending these contracts till 2031.</td>
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</tr>
<tr>
<td></td>
<td>• Gazprom agreed in early July 2012 to renegotiate its contract with E.ON: Gazprom offered a price discount in return for E.ON continuing to accept the principle of a link between the prices of natural gas and oil. This compromise was reached outside arbitration, and the suit brought by E.ON against Gazprom was a form of pressure on the Russian monopoly (Negotiations between Germany’s E.ON and Gazprom result in lower gas prices).</td>
<td></td>
</tr>
</tbody>
</table>
### France
- Currently there are 3 LTSCs contracts between Gazprom Export and GDF Suez for the delivery of Russian gas to France
  - The first 2 contracts were both signed on September 3, 1975 and provided gas to the Slovakian-Austrian border
  - Within the frameworks of the “Gas for Pipes” project, the third contract was signed on October 28, 1983 for delivery of gas to the Czech-German border.
- On December 19, 2006 GDF extended its contract with Gazprom until 2030, and in exchange Gazprom received the right to sell 1.5 bcm/a directly to the end customers.
- On March 1, 2010 Gazprom Export and GDF Suez signed a MoU on additional supplies of Russian natural gas and the Nord Stream project. In accordance with it, the parties will explore the possibility of Gazprom Export supplying GDF Suez additional volumes of gas starting in 2015.

### Italy
- Gazprom Group supplies natural gas under 3 LTSCs with ENI.
- In 2006 Eni extended its supply contracts with Gazprom through to 2035. Gazprom supplies around one third of Italy’s gas consumption. In exchange, Gazprom received the right to use ENI’s pipeline network to sell directly to Italian customers.
- In March 2012 ENI receives a price cuts of 10% in a round of renegotiations that begun in early 2011 (Reuters;ENI Russian gas price cut worth $700 mln). In July 2012 ENI receives a further discount for its LTSCs.

### Austria
- Until September 2006, Russian gas deliveries to Austria were carried out with 4 LTSCS that stretched till 2012.
- Replaced with new contracts, which Gazprom Export signed with EconGas, GWH and Centrex for Russian natural gas deliveries to Austria (from November 1, 2006 to December 31, 2027).
- With the new contracts Gazprom Export was able to achieve its strategic goal of penetrating the Austrian end-user market.

### Czech Republic
- The main partner of Gazprom Group in the Czech Republic is RWE Transgas.
- The existing LTCSs signed in 1998 and 1999 respectively
- Extended to 2035 in 2006 with annual delivery volumes up to 9.0 bcm and transit volumes up to 30.5 bcm/a

Source: Gazprom Export (and Related News)

As noted by Yafimava, while in the aftermath of the 2006 Russia-Ukraine gas crisis, the political relations between the EU and Russia were touching one of its lowest points, in contrast the prevalent attitude among major players of the European gas industry was calm and even optimistic. This is suggested by the fact that nearly all major European gas buyers, including German E.ON Ruhrgas, WIEH and WINGAS, French EDF, Austrian OMV and Italian ENI renewed their LTSCs with Gazprom between 2004 and 2006. The fact that these LTSCs were prolonged well before their expiry date suggests that the renewals took place at the request of the European gas companies, probably precisely because of the 2006 Ukraine...
crisis, where the EU buyers wanted to prevent a potential Commission’s reaction against Gazprom’s activity in the European market (Yafimava, p.100). This situation has now changed to some extent. Starting from 2009 a number of Europe’s big gas companies demanded for a substantial revision of these LTSCs contracts, as a consequence of a deeply depressed European consumption, substantially weakened by the economic crisis. The pricing issue has become one of the most contentious topics in EU–Russia company-to-company relations. Gazprom has had to cede ground on its enforcement of take-or-pay contracts with European consumers in face of the ongoing arbitration about gas prices between Gazprom and a growing number of EU companies including German energy giants E.ON and RWE.27 In response to arbitration appeals by several European companies, Gazprom sought to reach an agreement with the great majority outside the arbitration proceedings. The gas giant agreed to introduce partial elements of spot pricing in contracts to prevent losing further market shares in the EU (see Chapter 9). Despite these large challenges in the European markets, Gazprom has well consolidated commercial relationships with its main European buyers, demonstrated by the resilient bilateral ties Gazprom keeps with the major EU companies and their readiness to jointly develop pipeline projects, invest in storage capabilities, and jointly build and operate gas-fired power plants (i.e. Gazprom and RWE’s joint venture).28 The continuation of these projects has proven that the recent price renegotiations and the EU Commission’s antitrust raids did not have a profound impact on the strategic partnerships and the joint ventures between Gazprom and many of the big European gas companies.29

4.1.2 EU-Russia bilateral relations

This section proceeds with the analysis of the existing frameworks employed by the EU and Russia to institutionalize their emerging energy cooperation. The plethora of mechanisms within the EU-Russia partnership encompasses joint structures (the permanent council, the working groups), bilateral agreements (PCA), the “Four Common Spaces,” and each party’s own instruments. A comment from one of the European Commission’s (EC) officials interviewed on the nature of the EU –Russian energy relationship: “We have regular consultations with the Russian partners at very different levels. We hold between 10 to 20 meetings per year. In 2011 we met more than 20 times” (EU official, DG Energy). Yet, paradoxically to date there are no legally binding instruments regulating the relationship and the major ‘ingredients’ to make a transition towards “binding institutions” possible lack for a number of reasons that will be examined later in this dissertation. The four existing bilateral frameworks are:

- The Partnership and Cooperation Agreement of 1994 between the EU and Russia
- The EU-Russia Energy Dialogue
- The Four Common Spaces
- The Partnership for Modernization

The next sub-section discusses the four existing instruments, aiming to give a descriptive overview of the current state of the relationship’s institutionalization, as a basis to start our discussion on why there is still no legally binding governance structure to regulate the partnership. This dissertation argues that the current lax institutional frameworks reflect the preferences of the key actors in the EU-Russia energy cooperation, namely the big gas firms.

28 Financial Times, “RWE extends joint venture talks with Gazprom”, October 6, 2011
29 For a recent discussion on this topic see: Riley, A. Commission v. Gazprom: The antitrust clash of the decade? CEPS Policy Brief, No. 285, 31 October 2012
4.1.2.1 The Partnership and Cooperation Agreement (PCA)

The PCA with Russia was signed in June 1994 but entered into force only in 1997. The PCA was set up to enhance the political dialogue between Russia and the European Union. The ambition was to promote democracy, trade and convergence; yet the first PCA is a child of the 1990s (Westphal, 2011) when for the EU ‘policy convergence with Russia’ essentially meant the convergence of Russia towards the EU’s preferences, institutions and policies. Policy transfer is the process that best describes the efforts led by the EU Commission to influence Russian preferences, institutions and policies to match its own agenda. Energy is dealt with in article 65, and indirectly in article 12 referring to the freedom of transit.30 The agreement covered a ten-year period that expired in 2007, but anticipated automatic extension until a new agreement has been concluded. Negotiations over the follow-up began in July 2008, but were suspended one month later because of the war in Georgia. They resumed in July 2008, and by the end of 2010, 12 full negotiating rounds took place.31 Both the EU and Russia have been disappointed with the slow progress of negotiations. The question of what type of agreement should replace the PCA and what would be the implications if it became an increasing source of contention. In fact, in the period from Putin’s rise to power in 2000 up to 2007 when the first PCA was set to expire there had been considerable change in the Russian state identity (Barkanov, 2011). The first PCA substantially reflects Europe’s optimism and the belief that Russia would rapidly adopt Western (or, more precisely, European) values regarding human rights, the rule of law, democracy and free markets. Many in Russia saw the PCA idea as conceived at a time when Russia was weak. In 2008 when Russian economy was booming (with energy prices at their highest peak at the time were the negotiations about the renewal were held) and when political stability had been restored, Russia wanted to establish a more “equal partnership.” These appeared to be Russia’s main objectives for negotiations on the replacement of the “old” PCA. The second set of concerns was linked to the evolution of Russia’s and EU mutual perceptions that took place after the EU enlargement, which left Russia frustrated. Moscow’s concerns on critical issues (Kaliningrad transit, the minority situation in Latvia and Estonia) were taken into account mostly “on paper” and Russia had to extend the Partnership and Cooperation Agreement to the new members without any real negotiations, while being put under pressure of losing the PCA altogether. Amid Russian complaints the EU responded curtly; “unless the PCA was applied to the EU-25 without pre-condition or distinction by 1 May 2004, Russian–EU relations would be seriously affected.”32 The Russians were offended – this response did not accord with the respect with which Russia, as a great power, should be treated. Non-tariff barriers and approximation of legislation became a critical point of contention in the new agreement. The PCA included provisions for a Russian adoption of the EU legislation in various sectors, but Russia appeared reluctant to accept such asymmetric adaptation in the new agreement. Perhaps realizing that regulatory convergence was not the most promising way forward, the EU in July 2006 suggested that it could open talks on a free trade agreement (FTA), as part of the negotiations on a post-PCA agreement. Thus far, however, Russia has not shown that much enthusiasm for this idea. Russia rightly suspected that the EU would link the offer of free trade to demands about turning the Russian energy sector more open and competitive. In fact, the EU was hoping that Russia would accept the incorporation of some of the principles from the Energy Charter Treaty in the post-PCA agreement, in return for a free trade agreement with the EU. However, Moscow has shown little interest in better EU market access: three-quarters of its exports to the EU consist of raw materials, which are hardly affected by trade rules anyway.

31 Currently the “old” PCA continues automatically because neither side took any steps
On a visible side, between 2007 and 2009 negotiations on extending or replacing the PCA have been held up by “normative” objections in both the EU and Russia. The EU was pressing for a relationship based on adherence to common values while the increasingly authoritarian Russia was struggling with a double objective: deepening the cooperation with the EU and simultaneously guaranteeing Russian sovereignty and freedom of action. This divergence resulted in the emergence of different ideas, ranging from a minimalist (i.e. Russian) approach to an ambitious (i.e. EU) vision of the new PCA. Moscow was pressing for a non-binding political declaration on a “strategic partnership,” essentially confirming Russia’s status as a Great Power on an equal plane with the EU, while limiting the EU to pressure Moscow over issues of democracy and human rights (Mankoff, 2011). The EU preference was for a series of more substantive and complex agreements that could be concluded from time to time for specific tasks (such as environmental protection). By contrast, many in Russia were leaning towards a “low-cost” variant that would not require a new ratification of the agreement, but that would provide more visible statements on global security (Ibid. 2011). In the last few years the EU Commission has slowly adjusted to the new rapport de forces in its approach to an update of the PCA. The EU’s previous focus on democracy and human rights no longer dominates the discussions about the new PCA. While this ‘de-ideologized’ approach suits Russia much better than the EU’s previous stress on common values and commitments, yet thus far it has not resulted in more fruitful EU-Russia ties (Barysch, 2011). There have been two still significant points of contention: trade and energy provisions. Russia talks about a “new basic agreement,” which means a broadly defined political strategic agreement followed by sectorspecific agreements. The EU envisions a more comprehensive agreement with the EU Commission committed to including energy provisions in the new agreement.33 On the other side, Moscow’s reluctance to include energy provisions in the new agreement has not changed. When it comes to trade provisions, Moscow is reluctant to go beyond a broad and vague “strategic partnership.” For a long time the ongoing WTO accession negotiations were the main focus of the EU-Russia relations. As these negotiations have been completed and Russia is now becoming a WTO member, the focus for the EU is shifting to bilateral negotiations, in particular strengthened bilateral trade relations by enshrining some key basic principles and objectives in the area of trade.34 In other words the EU insists the new agreement should contain substantial trade and investment related provisions. The EU has called for free trade to be included in the agreement, to be negotiated following Russia’s WTO accession. The two sides have, however, different ambitions and priorities when tariff-free trade is concerned, with Putin’s stated aim of prioritizing the customs union as a part of his proposed “Eurasian Union.” Currently, Putin’s top priority is to persuade as many countries as possible to join the customs union, but thus far only Belarus and Kazakhstan have done so. Instead of signing a ‘deep’ free trade agreement with the EU, Russia is pursuing its own version of economic integration in the post-Soviet space. Putin sees no rush in an agreement with the EU; EU tariffs towards Russian goods are already rather low and energy, which makes up the bulk of Russian sales to the EU, passes tariff-free. In June 2012 Putin added insult to injury by making it clear that his country cannot advance negotiations on a new basic treaty with the EU, unless Brussels formalizes relations with the so-called "Common Economic Space" - its Customs Union with Belarus and Kazakhstan.35 Putin insists that the EU deals with Russia, Belarus and Kazakhstan as a bloc. It is still uncertain how Russia intends to combine WTO membership with the customs union it is building with neighboring Belarus and Kazakhstan. In that context, it remains even more problematic that none of the two parties, has at present a draft of a concept for negotiating a regulatory system that would incorporate rules (and social norms) that are acceptable to both sides and that go beyond the negotiation

35 “Putin promotes Eurasian union at EU summit”, Euractiv, Published on June 5, 2012.
attempts currently blocked. Russia’s Customs Union with Belarus and Kazakhstan has already delayed Moscow’s accession to the World Trade Organization (WTO). It is unclear how Russia benefits from such tactics. Many European officials doubt whether Russia’s integration with its former Soviet neighbors can easily be combined with the EU-Russia free trade agreement that will probably be envisaged in the new PCA. Such FTA would entail the harmonization of many trade rules and product standards between Russia and the EU. At the same time, Russia would have to harmonize rules and standards with Kazakhstan and Belarus, if it is serious about making free trade between the three countries a reality. “Russia points out that it is a sovereign country with sovereign decisions. Yet, not everything is compatible with everything else. A deep and comprehensive free trade agreement is not easily compatible with the Customs Union”, says one Brussels official, adding “currently we are more than in a vague state of affairs.” However, as already mentioned energy, which makes up the bulk of Russian sales to the EU, passes tariff-free. For Russia, a deep and comprehensive FTA with the EU would presuppose legal and regulatory approximation with the EU’s acquis communautaire, something that Russia has no intention to accept. Largely because of this, Russia rejected the involvement in the ENP (i.e. the need to accept conditions laid down by the EU as the price for engagement). On the other hand, for Russia the gains of a deep FTA with the EU obviously do not outweigh the cost of changing its regulatory structure and being locked-in by a legally binding agreement that limits its “freedom of action.” In the light this evidence, it seems clear that the EU and Russia are faced with difficult and lengthy negotiations before a new comprehensive bilateral agreement to replace the current PCA can enter into force.

4.1.2.2 The EU-Russia Energy Dialogue

The Energy Dialogue was launched in the occasion of the 6th EU-Russia Summit (Paris, 30 October 30 2000). It was agreed to establish an Energy Dialogue in order to enable progress in the definition and arrangements for a EU-Russia energy partnership. The official objective of the EU-Russia Energy Dialogue is to provide reliability, security and predictability of energy relations and to increase confidence and transparency on both sides (European Commission, 2012). The cornerstone of this policy is to enhance the EU-Russian energy security by binding them into a closer relationship in which all issues of mutual concern in the energy sector can be addressed, while at the same time, ensuring that the policies of opening and integrating energy markets are pursued. In order to achieve this goal the meetings of the Dialogue bring together representatives from governments and the industry to discuss issues and opportunities, especially in the gas sector. The dialogue is organized as a multi-level attempt to manage energy by channeling the participants of the relevant political and economic realm into four thematic groups: namely the Energy Markets and Strategies Group, the Group on Electricity, the Energy Efficiency and Innovations Group and the Group on Nuclear Energy. The Dialogue has permitted a good and frank debate at different levels between the EU and Russia and has allowed broad participation and involvement of the various Russian governmental bodies, the European Commission, EU Member states and International Financial Institutions such as the European Bank for Reconstruction and Development (EBRD), as well as a wide variety of EU and Russian energy companies (Bahgat, 2010). However, the energy dialogue is, as the name implies, not legally binding but constitutes a permanent consultative mechanism. In its ten years of history the Energy Dialogue reflected the growing mistrust in the EU-Russian political relations (especially some of its new Member States). The beginning of the Dialogue was marked by political optimism, when in 2000 the Prodi Plan foresaw the negotiated doubling of Russian gas imports (Dickel and Westphal, 2012). According to this plan, the EU was supposed to support the exploitation of gas reserves using its political influence and technical assistance to canalize

36 Interview with the author on May 3, 2012
foreign investment into the Russian sector. In return, Russia guaranteed the EU a significant supply of energy for the next 20 years. The EU-Russia Dialogue aimed for an ever-closer common energy space. Yet, the EU’s optimism was not to be confirmed. Russian energy nationalism was growing in parallel with the soaring price of hydrocarbons in the second half of the 2000s and Russia was less prone to accept any formal integration. The EU on the other hand, has proven clearly unprepared to define a position towards this new dominant neighbor and offer incentives that go beyond the export of its own norms and rules. The Energy Dialogue was conceived as an instrument to guarantee timely upstream investment for Russia and a secured flow of energy for the EU. However, once again, the dialogue reflected two different approaches. Brussels assumed that the dialogue would essentially facilitate investment in the Russian energy sector and allow European companies unrestrained access to Russia’s pipeline network. Furthermore, the EU approach consisted in linking its energy security to climate and environmental protection. Russia on the other hand aimed at maintaining its dominant position in the European gas markets, Gazprom’s monopoly structure and the long-term oil indexed supply contracts. Both sides were disappointed. When gas prices increased Russia reintroduced a steady state-control over the oil and gas industries, and Gazprom’s monopoly of the pipelines remained unchanged, or even reinforced with a “law on the pipelines” in 2006. Russia was disappointed by the EU’s so-called Third Energy Directive, which requires all companies operating in Europe to unbundle their production, transit, and distribution operations. A significant victory for the EU within the Energy Dialogue was the success in abolishing the restrictive ‘destination clauses’ in Russian long-term contracts (Rosner, 2009). For Russia the main results were the agreements that no quantitative restrictions were to be placed on EU’s imports on fossil fuels. More recently, a significant point of contention regards the EU’s questioning of the long-term contracts with fixed volumes and prices linked to the international oil price. In the words of a EC’s official: “The fundamental changes in the global gas markets that put pressure on the indexation structures are among the most contentious issues disputed within the Energy Dialogue. The EU’s Decarbonization policy is another significant topic of the dialogue.”38Russia fears that the EU’s ambitious decarbonization policy could have a negative impact on its exports to the EU. Russia has shown a keen interest in working on that point within the EU-Russia Roadmap that has been agreed in February 2011 by the Commissioner for Energy Günther Oettinger and by the Russian Minister for Energy Sergey Shmatko. From the conclusions of the 4th Meeting of the EU-Russia Gas Advisory Council in July 2012, “decarbonization is not likely to have a substantial impact on Russian gas supplies to Europe; pricing will probably have a bigger impact.”39

The Gas Advisory Council is a consultative body consisting of representatives of the leading EU and Russian gas companies and of experts from the Russian and European academic research organizations. It assesses the development of the gas markets and provides recommendations for the long-term EU-Russia gas cooperation. The Advisory Council analyses different scenarios and their impact on EU-Russia energy relations, taking into account interests and concerns of both sides. In this context, the EU intends to reconcile the way in which it has managed relations with its main supplier, a strategy that revolved around attempting to impose a model based on competition, unbundling of network industries and privatization. The question as to whether the international standards generated by the EU are consistent with Russia’s institutional environment is a key one, but it still remains unanswered within the Advisory Council. In Locatelli’s (2012) words: “The Russian state’s growing role in the hydrocarbons industry, exerted through various state-controlled companies, through the imposition of tougher conditions of access to resources but also through the introduction of some form of competition, can be seen as an attempt to introduce an alternative organizational model more consistent with the country’s institutional environment.”40Whether and how these different views can be reconciled

38 Interview with the Author: May 2, 2012
40 Catherine Locatelli, Interview with the Author, September 2012.
is a key question to grapple with; the present EU-Russia Dialogue outlines different risks related to future "uncertainties" for Russia (investment) and the EU (policy and security of supply) but does not provide comprehensive or definitive answers on how to bridge the gap between two fundamentally different organizational models. In sum, the two main existing bilateral frameworks binding the EU and Russia (the PCA and Energy Dialogue) have proven insufficient today despite the very strong energy interdependence and a number of forums, including semiannual summits at the head of state/government level and a multitude of working groups covering issues of common concern. The EU has more high-level political dialogue with Russia than with any other third country except for the United States; in contrast, the depth of ‘network’ interlinkages and integration is less than elsewhere in the East, as Russia has shown increasing disinterest in adopting European norms and standards (Youngs, 2009).

4.1.2.3 The four ‘common spaces’ – economics and trade, internal security, foreign policy issues, science and culture

Given the slow progress of the PCA and the Russian refusal to take part in the ENP (because it objected having to coordinate its legislation with the ‘acquis communautaire’), Russia agreed to the creation of the so-called ‘Four Common Spaces’ at the May 2003, St. Petersburg Summit. Unlike the ENP action plans, the four common spaces make no mention of the incorporation of EU governance rules and standards. Despite that, in practice cooperation has proceeded slowly within these four spaces, fueled by the political tensions and the mounting mistrust after the Russia-Ukraine gas dispute in 2006. The discussions became politicized and energy “securitization” led to negative mutual perceptions. Although progress has been limited thus far, there have been some constructive discussions in the newly created expert groups. These discussions are themselves useful since they try to enhance mutual trust, build credible commitments and recognize the preferences of Russia as a supplier. In terms of achievements however, the ‘common projects’ in economics, energy, security and education made very little progress to date. The so-called ‘road maps’ were adopted at the EU-Russia summit in Moscow in May 2005. They contain few concrete project proposals and no deadlines. Against this background, low-profile technocratic rapprochement is slowly progressing under the Common Spaces.

4.1.2.3 The Partnership for Modernization

This is the latest project of the EU and the Russian Federation, agreed at a summit held on 31 May-1 June 2010 in Rostov-on-Don. This date marked the starting point of a new “rapprochement” between the two parties when they launched the EU-Russia Partnership for Modernization through the adoption of a Joint Declaration. This new modernization initiative serves as a flexible framework for promoting reform, enhancing growth and raising competitiveness, and builds on results achieved so far in the context of the Common Spaces, while complementing the partnerships between the EU’s member states and the Russian Federation (Delegation of the European Union to Russia, 2012). The EU sees this new instrument as a possible successor of the current Partnership and Co-operation Agreement (PCA). According to the EC, a new legally binding agreement could be promoted under the

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aegis of the Modernization agreement, hence providing a comprehensive framework for bilateral relations with stable, predictable and balanced rules for bilateral trade and investment relations. However, conceptual differences over what “modernization” consists of have already started. Russia has prioritized joint industrial policies, support for innovation projects and visa-free travel, while the EU side has insisted on the need for enhancing the rule of law and civil society, market opening and integration, and co-operation in science and research. Thus, while the EU-Russia “Modernization Partnership” is blocked by inertia, Moscow had concluded bilateral modernization partnerships with individual EU countries, such as Germany and Finland. From the EU’s perspective, this new agreement is therefore expected to boost the EU-Russia cooperation and consequently facilitate the ongoing negotiations for a new bilateral agreement providing for the contractual framework for EU-Russia relations in the years to come and replacing the 10-year old PCA. In that sense, the Russian WTO membership, that the EU strongly supported is considered as a fundamental step towards the conclusion of a new agreement to replace the 1994-PCA. The European approach based on values such as human rights is downplayed by the Russian political discourse based on sovereignty, non-intervention and a preference for quid pro quo commercial deals. Yet, if we consider how Russia is desperately gasping for European FDI to develop its Arctic and East-Siberian energy fields, but also more generally to bring more dynamism to its stalled manufacturing and hi-tech industries, then prospects for a closer EU-Russia energy cooperation look fairly good (Chapter 9). Europe will continue to rely heavily on Russian natural gas, mainly because of its characteristics of an environmentally friendly fuel. Russia is equally highly dependent on the EU for energy revenues and desperately looking for help in the modernization of its transmission lines and in raising the energy efficiency. Europe’s money and transfer in technology will be needed to maintain and expand the output of Russia’s outdated energy sector and to modernize the rest of the economy. One EU diplomat describes the process: “It is all embedded in ambiguity. Is energy part of the Partnership for Modernization for Putin? The EU is continuing the process, for the EU the stress is on energy efficiency.” Most likely for Russia “partnership for modernization” means that Moscow would like to exchange hydrocarbons for investment and technology, or in other words swapping assets of similar market value or utility, which is at odds with the EU’s preference for a substantive bilateral agreement with clear investment rules. With this new strategy the Kremlin aims to harness Western investment and technology in order to develop the Russian economy, reducing its dependence on oil and gas sales while promoting technological innovation. However, the EU is just one player among what Medvedev has termed “modernization alliances” - especially with the United States and major EU states such as Germany, France, and Italy - in which Russia offers investment opportunities and greater political cooperation in exchange for foreign capital and know-how (Mankoff, 2010). At this writing, in line with Russia’s top-down idea of modernization, Western companies are allowed to invest in Russia’s gas fields only under the conditions considered admissible by the Russian government, mostly as “junior partners”and to the disappointment of Western “modernizing” enthusiasms. Generally, the companies (and states) that are awarded the most investment are the ones that do not interfere in Russia’s internal affairs by giving lessons on democracy and human rights. The most practical area of cooperation has thus far been the EU’s decarbonization of the energy sector. According to a EU diplomat: “Russia has shown an interest in working of the decarbonization strategy within the EU-Russia Road Map.” Some experts warn that if the EU insists too much on legal and political reforms, the modernization partnership will join the list of stillborn projects, like various previous EU initiatives that linked economic perks with political chores (Barysch, 2011). More recently, in a situation of gas over-supply in the EU, as oil prices fell and Russia’s economy started contracting, Russia postponed most of its upstream investments for better times, since in Russia’s view the current status quo is preferable to expensive and uncertain prospects for modernization.
4.2 The Multilateral arrangements

The Energy Charter Treaty is the only attempt to attain a multilateral and multi-regional energy regime. Despite its vanguard nature, the energy Charter Treaty showed its limits when most of the energy producing countries, including Norway and the OPEC members refused to either sign or ratify the treaty. However, it is worth keeping the process going, especially because its provisions have inspired many discussions within the EU’s energy security discourse from a global governance angle. In the next section the main features of the ECT and the reasons for Russia’s refusal to ratify it are examined.

4.2.1 The Energy Charter Treaty

4.2.1.1 Introduction

The ECT is the only institution in the energy field that has legally binding rules backed up by a dispute settlement mechanism; it is the first binding multilateral agreement for the promotion and protection of foreign investment in the energy field and it is the first multilateral instrument that sets forth detailed principles of energy transit (Selivanova, 2010). The process that resulted in the ECT started after the break-up of the Soviet Union. The collapse of the Soviet Union resulted in a new international order and a new map of Eurasia that led to increased attention to the “governance of the pipelines” and the external dimension of the European energy policy. The Charter was signed in 1994 and it incorporated 51 member states, substituting no less than 1,275 bilateral investment treaties (BITs) with a single multilateral regulatory framework, with especially notable provisions in the area of investment protection. Its importance lies in that the ECT and its accompanying series of conferences form the only multilateral framework for exchanges between producer, transit and consumer countries (Westphal, 2010; Yafimava, 2012). The ECT entered into legal force in April 1998. By 2010, the Treaty had been signed or acceded to by 51 states plus the European Communities. The Energy Charter Treaty became the most important legally binding multilateral instrument dealing specifically with inter-governmental cooperation in the energy sector. The provisions of the ECT range from investment to trade and transit. It is beyond the scope of this study to analyze them in great detail, we will enumerate the important provisions in terms of the EU-Russia relationship and outline the main point of contention. Although today the ECT covers great parts of Eurasia and some geographically different countries (see box 1), it was conceived as a European initiative. The very fact that the ECT was regarded as “European” has been at times its strength, at times its major weakness. After all, its headquarters are located in Brussels, the EU funds more than 65% of the budget and most importantly, the ECT has been integrated into the acquis of the EU. As such, the first problem relates to the fact that the ECT is perceived as a Western, consumer countries’ organization (Lesage et al., 2010) instead of a global forum for energy cooperation. The EU has always openly considered the implementation of the European Energy Charter Treaty of ‘fundamental importance to Europe’s future and its security of supply’ (Haghighi, 2007, p.187). The ECT is a mixed agreement between the EU and the Member States due to the fact that various provisions of the treaty necessitate the membership of both. At the beginning of the process that led to the ECT, the United States wanted to take part in it to be able to “shape” the process and also to prevent it from becoming an exclusively European affair, but at the end the US had never signed or ratified it. As far as Russia is concerned, the EU spent years trying to get Moscow to abide by the provisions of the ECT, which would compel Russia to open up the development of its hydrocarbon reserves and the running of its pipelines to foreign commercial involvement. Moscow, on the other side, signed the ECT and applied its rules on a provisional basis, but had never ratified the Treaty. For years, Russian officials had complained that the ECT was outdated and favored consumers. In August 2009, Prime Minister Vladimir Putin signed an order withdrawing from the Treaty.
Box 1: Members and Observers of the Energy Charter Conference, as of November 2012

Members of the Energy Charter Conference

Albania, Armenia, Australia*, Austria, Azerbaijan, Belarus*, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, European Community (now part of the European Union) and Euratom, Finland, France, Georgia, Germany, Greece, Hungary, Iceland*, Ireland, Italy, Japan, Kazakhstan, Kyrgyzstan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Moldova, Mongolia, the Netherlands, Norway*, Poland, Portugal, Romania, Russian Federation*, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tajikistan, The former Yugoslav Republic of Macedonia, Turkey, Turkmenistan, Ukraine, United Kingdom, Uzbekistan.

* - denotes state in which ratification of the Energy Charter Treaty is still pending

Observers to the Energy Charter Conference


** - denotes observer which has signed the 1991 Energy Charter

° - denotes observer in which signing of the 1991 Energy Charter is pending

International Organizations with Observer Status

ASEAN, BASREC, BSEC, CIS Electric Power Council, EBRD, IEA, OECD, UN-ECE, World Bank, WTO

The Energy Charter Secretariat and the Secretariat-General of the League of Arab States signed a Memorandum of Understanding on 19 March 2012


4.2.1.2 The ECT Objectives

The ECT aims to achieve several broad objectives that are spread across provisions such as:

- Investment protection (i.e. by granting investors non discriminatory treatment),
- National Treatment and Most-Favored Nation Treatment,
- Compensation in cases of expropriation and other losses,
- Trade in energy and energy related products based on WTO rules,
- Freedom of energy transit, improvement of energy efficiency,
- International dispute settlement including investor-state arbitration and inter-state arbitration,
- Improved legal transparency
What immediately comes to our attention is the fact that most of these very generic provisions are already included within the general WTO framework and the existing BITs. Indeed as noted by Haghighi (2007) various provisions mirror those already included in the BITs and the WTO, except for being indeed the first treaty that explicitly brings those rules into the realm of energy and it also introduces for the first time ‘energy efficiency’ provisions. Apart from these novelties and its provisions on “Transit,” the so-called Transit Protocol, which is definitely the most important and controversial innovation, albeit still in the bargaining phase, the ECT essentially, complements the WTO. The value of the Treaty should not be however underestimated. Its value lies in that it is the only treaty based on the mutual relationship between producers, consumers and transit countries; the interests of each of them should be revealed and compared to the provisions of the ECT (Haghighi, 2007). However the pooling of the interests of all the participants in the energy value chain into the ECT has brought most of problems and lies at the core of the EU-Russian controversy regarding the ECT. As mentioned previously the ECT codifies some elementary rules of investment and trade that are in a way duplicating the already existing WTO rules in trade, and in the realm of investment the BITs. Yet the element of uniqueness comes in the shape of a common platform for all the stakeholders along the value chain. Thus, there should be not much of a reason for Russia to withdraw from a treaty that codifies basic principles already included in its BITs if it weren’t for the Transit Protocol. Admittedly, at the time of Russia’s withdrawal, the latter was not a signatory of the WTO while simultaneously the ECT carried very ambitious provisions in investment protection, which mirrored those of the BITs with a further ambition in aiming at improving the conditions for EU investment in producer states. The ECT has been in a sense too ambitious and too deficient at the same time. As mentioned earlier, the ambitious investment protection regime raised concerns in the US, as the investment provisions did not include a pre-investment phase (i.e. exploration phase) but only a post-investment phase, stating that once the investment has been placed (post-investment phase) the investor should not be discriminated over the investment.43 Generally the producers, including the United States, want to have the possibility to discriminate on the grounds of sovereign rights.44 Moreover, the US has conducted a parallel, very active energy diplomacy, to build alternative supply routes, which would bring oil and gas from Central Asia to the European markets without transiting Russia. In any event, a strong investment regime is not the main cause explaining the Russian non-ratification of the ECT. Let us briefly review the main points of contention between the EU and Russia in the next section.

4.2.1.3 Russia and the EU – the Obstacles to Ratifying the Treaty

Russia signed the ECT in 1994, but then backtracked and refused to ratify it. The EU’s overarching aim was clear: it was trying to put up with the fact that it will depend on energy imports for decades to come and to develop a stable relationship with Russia as arguably the most reliable gas supplier (Morozov, 2008). The aim was to entice Russia into the EU’s regulatory web, requiring gradual changes in Russia’s legislation to bring the country in line with the rules in force within the European community. Key to this effort was the ECT, which would place Russia’s pipeline network under multilateral regulations and challenge Gazprom’s monopoly. When Russia refused to ratify the treaty, the EU tried to tie the Russian ratification to talks of Russia’s accession to the World Trade Organization (WTO), a strategy that was highly criticized by Putin at the time. Subsequently, in response to Russia’s withdrawal from the ECT and an increasingly hostile investment climate in the

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43 For that reason, the United States did not sign the ECT because it does not include the necessary clauses for a pre-investment climate and treats purely post-investment situations.
44 For Gazprom, a non-discrimination clause for a pre-investment situation is necessary for its strategy to get distribution markets in the EU.
country, the EU adopted a set of “securitizing” measures. The most controversial one is the EU’s third liberalization package, which puts barriers on Gazprom to move downwards in the EU gas markets; it includes a provision forbidding foreign-producing companies to own part of transit and transmission companies stock in the 2008 Gas directive (the so-called ‘Gazprom provision’), despite the Energy Charter Treaty principles (Finon, 2011). Facing fierce Russian criticism about attempts to “arm-twist” Russia during the accession talks to the WTO, the EU Commission agreed to decouple the WTO entry talks and Energy Charter Treaty ratification, which has resulted in the latter being delayed indefinitely. The WTO entry in the end did not envisage any obligations on Russia’s part as regards to gas transit from the third countries. Over the years the ECT has lost its strength, especially after it failed its main test, in addressing the two Ukraine-Russian energy wars. As noted by Yafimava (2012), the failure to use the ECT to prevent, resolve or at least assess the crises has further undermined the instrument and made it less relevant during future disputes. Politically speaking, taking advantage of rising energy prices, Moscow felt confident enough to ignore many of the policy preferences of the European Union, including the ECT. In the Russian view, the EU was expanding its value system and laws through the cross-border gas value chains, stretching from the EU to the gas producing countries. The EU’s first directives were ‘exported’ through the Energy Charter Treaty (ECT), because the ECT has been based on the principles of the EU’s first Energy Directives that had been obviously tailored without the Russian participation (Konoplyanik, 2012). Russia increasingly pointed to the one-sidedness of the treaty and its failure to address Russia’s concerns. The refusal was also accompanied by claims that it was an obsolete and unfair treaty, since it was drafted at a time when Russia was rather weak (Liehto, 2009). More precisely, Russia lamented that the ECT:

1. Does not include a mechanism for the effective prevention of crisis situations like the Russian-Ukrainian gas crisis

2. The ECT is a constituent part of EU legislation and it is applied according to the "minimal standard" principle. It means the following: in its national legislation every country can go further that what is required by the ECT, in terms of the level of competition, liberalization and non-discrimination. In accordance with the "minimal standard" principle, however, it cannot ask the other ECT member countries do likewise, and even less, it cannot punish them for not applying more liberal than the ECT norms. Under these circumstances, withdrawing from the ECT will deny non-members of the EU the possibility to negotiate with the Europeans a "new world energy order" on other than EU legislation conditions. The European Union was criticized for trying to constantly impose on Russia this interpretation of ECT provisions. This interpretation stressed the progressively liberal internal legislation of the EU, but it clashed with the ECT "minimal standard" principle (Konoplyanik, 2010). Russia argued that the forcibly accelerated use of the EU liberalization model could have the worst impact on the producer countries planning to implement large-scale capital-intensive projects involving the production and transportation of, above all, natural gas.

3. The ECT cannot make its signatories fulfill the treaty’s provisions, the ECT has no mechanisms for compelling the Contracting Parties to honor their own obligations and prompt and effective sanctions for violations of ECT provisions.

4. Most crucially, Russia objects the possibility to interpret the provisions regarding transit to Russia’s detriment.

a) Russia refused to accept the ECT’s Transit Protocol, which entails “the freedom of transit without distinction of the origin, destination and ownership of such energy materials and products or discrimination as to pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges” (art. 7, Transit, ECT). The latter would have been a tool to limit Russia’s
monopoly in the transportation and export of gas through the existing gas corridors and
would have allowed Central Asian and independents’ gas to be exported without Gazprom’s
intervention (allowing the so-called “Third Party Access”).

b) Russia objected the fact that the ECT’s crucial protocol would not apply between
European countries themselves (the EU defining itself as a single economic space).

c) Moreover, Russia has been consistently insisting on the right of first refusal. This is based on
the idea that an existing shipper with a long-term gas contract must have the opportunity
prolong access to transit capacities when their transit contract expires. The absence of this
provision, coupled with the EU’s Third Party Access (TPA) regime, means that the Russian
exporter, Gazprom, would have a significant risk of losing access to the transit
capacities. According to the Russian side, this would easily translate into the impossibility of
fulfilling the long-term supply agreement.

In short, the main obstacle for the application of the Treaty is its Transit Protocol. Its
provisions seem not to correspond to the Russian interests. Some observers underscored
that despitestaying bound to the EU, the Kremlin remained unwilling to surrender any
sovereignty to the multilateral EU. This argument appears incomplete or if anything, quite
irrelevant; for example in the ECT, Article 18 provides that: “The Contracting Parties recognize
state sovereignty and sovereign rights over energy resources. They reaffirm that these must be exercised in
accordance with and subject to the rules of international law” (ECT, 1995). This thesis argues that the
sovereignty issue (or a discrepancy in other norms) is not the main impediment to
ratification; the problem rather lies in different economic interests between the EU as a
consumer and Russia as a producer. Broadly unsatisfied with accepting a system of laws that
it did not help to fabricate and which is considered highly disadvantageous for producers,
Moscow came up with the idea of a new global energy regulation. In the aftermath of the
January 2009 crisis, Russia tabled an ‘alternative’ to the ECT: the ‘Conceptual Approach to
the New Legal Framework for Energy Cooperation’ was President Medvedev’s alternative
document which, according to a EU official “is pretty comprehensive, including strong borrowings
from the Energy Charter Treaty. The slight ambiguity is on its legal nature; it was transmitted as a Draft
legal text, in many ways resembling the ECT plus many provisions clearly in producer’s interests.”
A strategy group has been put in place in 2010 starting a review process for the modernization
of the ECT. As an EU’s energy expert points out: “At this point, it is important to keep Russia on
board. Russia is so insisting on a new document altogether, but we cannot refrain from a treaty that has been
already ratified by 46 states. Some diplomatic solution should be found instead.”

The process is still ongoing, in 2012 a new ECT secretary, Mr. Rusnak, a diplomat from Slovakia was appointed
and was met with a warm welcome by the Russian side. According to Mr. Rusnak the next
few years are crucial for the future of the Energy Charter Treaty. If it does not manage to
expand its constituency and to adapt its rules to a changing world, it risks remaining a
regional player in Eurasia. In fact, in the last years the ECT has lost its momentum because of
the new “transit-avoidance” geography of gas transportation that has emerged (with the
construction of Nord Stream). The ECT will further lose in importance if either of the
Southern Gas Corridor’s competing pipelines gets built. That is proven by the fact that the
EU Member States are already less interested in advancing the cause of the ECT as an
overarching legal regulatory framework. Hence, if the ECT Secretariat truly wants to
revitalize the support for the ECT it should aim at modernizing the treaty, taking into
account new elements brought up by the Russian government around Medvedev’s new
‘Conceptual Approach’ proposed in April 2009. Thus far, the Medvedev proposal has been
met with skepticism in the EU. Yet, in order to de-block the current deadlock the EU will

41 Interview with the Author, May 2012, Brussels
42 Phone interview with the Author, January 2012
have to find common ground with Russia, respectful of the concerns on both sides and with practical benefits to both. In the Russian view, when in the 1990s it tried to implement the Western recipes of economic neoliberalism “to the letter,” the outcome was chaos, widespread corruption and baron capitalism. Today, Russia is promoting its own institutional environment and the challenge is to find a solution respectful of the interests on both sides. For many years the European officials have spoken of the need for an increased pressure on Moscow to achieve a “level playing field” for Eurasian energy investment, while Russia perceived it as an “unleveled field” (Bressand, 2010). Medvedev’s concept complements the ECT, including improvements to the country’s unappealing business environment, a stronger legal system and more individual freedoms. Should the EU decide to seize the moment, President Medvedev’s proposal to establish a successor to the Energy Charter Treaty could be the starting point in articulating common guiding principles towards a genuine Eurasian energy community. Such guidelines should be established in a spirit of mutual recognition by combining key Russian principles—notably the longer-term, oil-indexed contracts that add significantly to Europe’s cost of gas presently—with significant partial liberalization of the midstream and a significant decrease in the massive amounts of gas flared at great long-term cost to the Russian economy and to our planet (Bressand, 2010). Yet, a key challenge is to find decisions acceptable to both parties. This becomes even more difficult in times of great paradigm changes that raise the transaction costs of cooperation. Thus, paradoxically, the institutional arrangements that within national governments are erected with the purpose of lowering the transaction costs of trade, when brought into the transnational level may actually increase them, due to the difference in regulatory environments that creates impediments to trade and cooperation. The real challenge is how to reconcile this. Hence, there is no reason a priori to believe that decisions made in the EU’s setting are better than the ones in Russian or any other. Of course, different institutional arrangements have different distributional implications, but how can we affirm ex ante that the European model is more desirable than the Russian one? This is a particular point of tension precisely because defining the rules of the game of interdependence is difficult between actors that have so different immediate interests and different domestic institutional arrangements (see table 5).

This dissertation argues that the de facto existence of different jurisdictions in different parts of the world respond to the historical and geographical developments in these regions, hence regulations and norms should strive to reflect national conditions and preferences. Nations should not distort energy trade by imposing border barriers. With regard to energy trade between Russia and the EU, no import barriers exist anyway. The EU is scrambling to increase imports and Russia would not benefit from export duties or a cartel. Therefore, the essential element in the relationship remains investment, which is already addressed in the BITs rules. The only unique innovations of the ECT are the rules about pipeline transit. Yet, they have thus far derailed Russia’s ratification of the ECT, and meanwhile the question of how to find common ground in developing effective and predictable Eurasian energy markets and how to respect the interests and concerns of both the EU and Russia and still get both players into the act, remains open and unresolved. Although the question on how multilateral or bilateral institutions should be reformed in the future in order to get both parties into act is a fascinating one, the research question and the scope of this dissertation is forced to concentrate predominantly on the reasons why such institutions have not emerged in the past. In doing so the following section will analyze the regional dimension of cross border energy cooperation.
Table 5: Institutional “heterodoxy” between the EU and Russia: who is right?

<table>
<thead>
<tr>
<th>Institutional domain</th>
<th>The EU ideal</th>
<th>“Russian” pattern</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property rights</td>
<td>Private, enforced by the rule of law</td>
<td>Private, but govt authority occasionally overrides the law.</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Shareholder (“outsider”) control, protection of shareholder rights</td>
<td>Insider control</td>
</tr>
<tr>
<td>Business-government relations</td>
<td>Arms’ length, rule based</td>
<td>Close interactions</td>
</tr>
<tr>
<td>Industrial organization</td>
<td>Decentralized, competitive markets, with tough anti-trust enforcement</td>
<td>Horizontal and vertical integration in production (chaebol); government-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>mandated “cartels”</td>
</tr>
<tr>
<td>Financial system</td>
<td>Deregulated, securities based, with free entry. Prudential supervision through</td>
<td>Blank based, restricted entry, heavily</td>
</tr>
<tr>
<td></td>
<td>regulatory oversight.</td>
<td>controlled by government, directed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>lending, weak formal regulation.</td>
</tr>
<tr>
<td>Labor markets</td>
<td>Decentralized, de-institutionalized, “flexible” labor markets</td>
<td>Lifetime employment in core enterprises (Japan)</td>
</tr>
<tr>
<td>International capital flows</td>
<td>“prudently” free</td>
<td>Restricted (until the 1990s)</td>
</tr>
<tr>
<td>Public ownership</td>
<td>None in productive sectors</td>
<td>Plenty in upstream industries.</td>
</tr>
</tbody>
</table>

4.3 Multilateral Cross-border Programs at a Regional level

Within the EU energy competency has been shared between the Member States and the EU-supranational level. This section argues that the regional level can act as a “facilitator” to foster dialogue between producing, transit and consuming countries, which traditionally have very different priorities and prerogatives. In this dissertation, Chapter 8, analyses the case of cross-border regional cooperation in South East Europe. Here, we theoretically sketch the benefits of regional cross-border cooperation that will subsequently be tested in the case study in Chapter 8.

Given that the EU-Russia relationship is defined as bilateral and “strategic,” the “fit” with an alternative approach at the micro-level might seem challenging. Despite the paramount importance of this relationship at the macro-level, the benefits of cross-border regional energy cooperation are fully relevant. For example, at a sub-level an enhanced cross-border cooperation would contribute to a smooth functioning of (cross-border) energy pipeline transportation, thus increasing cross-border energy trade and allowing to apply the EU’s principle of solidarity among the member states (i.e. alternative supply from other member states in the case of supply shortages). With Russia, cross-border cooperation may serve as a binding force on different levels in which countries could debate on how to harmonize their very different regulatory systems and strive versus more convergence, to be achieved with a bottom-up de facto approach versus a top down de jure harmonization.

In accordance with the argument advanced by Romanova (2008), that in an estimable analysis of the Northern dimension of the EU-Russian energy dialogue praises the benefits of regional cross-border cooperation, this dissertation argues that regional cross-border cooperation complements and strengthens the top-down EU-Russia energy dialogue. In this study, South East Europe is selected for a more specific analysis, due to its status at the intersection between different regulatory and political systems:
1. The EU-27 subject to the *acquis communautaire* and the ECT that in itself incorporates the *acquis*,

2. The Western Balkans that through the EnCT (that we will discuss in more detail in chapter 8) have adopted the *acquis* in their jurisdictions, although the majority of which is not yet part of the EU, and

3. Russia, which although not physically bordering the region, historically has played a great role in it and is back today, especially with active pressure for its preferred solutions to the Southern Corridor question, or in other words the South Stream gas pipeline.

This chapter has stressed that a lack of harmonized “rules of the game” in the EU-Russian energy interdependency exacerbates the conflict and stimulates the two actors towards finding their own non-cooperative solutions, in order to increase respectively “security of supply” and “security of demand.” The various pipeline projects such as South Stream, Nord Stream, Nabucco and several smaller projects respond to this ‘securitization’ drive and are in a way the tangible proof of the Energy Charter Treaty’s failure to achieve a shared governance of the system and thus address the “security of supply/demand” concerns in a multilateral (and much cheaper) way. In light of that, one of the core questions this dissertation addresses is the following: is it really in everyone interest to advance the ECT as a coordinating system? Who would be the winners and who the losers of such a unifying framework? Most crucially, where do the dominant actors stand?

I will attempt to provide an answer to these questions in the next chapter where, after an outline of the already existing interpretations in the theory, I draw my view that challenges some of the conventional wisdom. Here, I argue that because it is so difficult to reach a compromise between all market players, a tool to mitigate the differences is to be found in the cross-border cooperation at a regional level. The region that I define as South East Europe is the area consisting of the regions of Italy, Slovenia, Croatia, Bosnia and Herzegovina, Montenegro, Albania, and Serbia, which is an area of great institutional and cultural heterogeneity and at the same time a crucial transit region for resources on their way to the bigger markets. The multilateral instruments already present in the area are:

1. The Adriatic IPA Cross-Border Cooperation Programme 2007-2013, co-funded by the Instrument for Pre-Accession Assistance (IPA). The eligible area consists of the regions in Italy, as well as in Greece, Croatia, Bosnia and Herzegovina, Montenegro, Albania, Serbia and Slovenia.48

2. South East Europe (SEE). Eight EU member-states (Italy, Austria, Hungary, Slovakia, Slovenia, Romania, Bulgaria, Greece), as well as Croatia, Serbia, Montenegro, Bosnia and Herzegovina, Albania, the former Yugoslav republic of Macedonia, Moldova and Ukraine participate in the Programme. The Programme is co-funded by the European Regional Development Fund (ERDF), but participating bodies from the candidate and potential candidate countries are co-funded by IPA and from neighboring countries by ENPI.49

3. The interregional cooperation Programme of the Programming Period 2007-2013, INTERREG IV C, co-funded by ERDF. All EU member-states, as well as Norway and Switzerland, participate in the Programme.

4. The Energy Community of South East Europe, whose treaty was signed in October 2005 and entered to force into force on 1 July 2006.50

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48 See http://www.adriaticipacb.org/
49 For more details see http://www.southeast-europe.net/en/
5. The Central European Initiative, established in Budapest on November 11, 1989 as the first forum promoting regional cooperation among the countries of Central and Eastern Europe.\(^{51}\)

In the field of energy the above-mentioned programmes mainly aim at improving energy efficiency and enhancing the use of renewable energy sources. Thus, those crucial objectives are not immediately linked to issue of Russian natural gas. However, they also aim at increasing cooperation in the legal and administrative aspects while increasing institutional potential for cross-border cooperation (Interreg III, Strand A). This is where the importance of cross-border cooperation (CBC) comes into play in our case: in its focus on the rule of law and the role of local governments in providing robust frameworks for foreign investment, which has spillovers in the energy sector as well. The area of South East Europe is one where several sets of potentially different national rules apply to the same geographic area, but where CBC can foster convergence towards a model acceptable to the EU, the transit countries and Russia, and while doing so have the effect of bolstering regional stability. The opportunities and benefits offered from developing EU-Russian energy regional cooperation in South-East Europe are best illustrated by concrete examples. Unlike Northern Europe the region of South-East Europe has no established tradition in CBC and does not possess many assets that Northern Europe has. Further, the South-East Europe region does not directly border Russia, but is of paramount interest to both Russia and the EU to support the potential pipelines projects that would cross this area and supply the wider European market. For these strategic reasons, Russia has renewed its presence in the region. The ties that Russia and its traditional ally Serbia have always had are confirmed by the fact that in the 1990s, as the country struggled to make the transition into a self-sustaining or market economies it received preferential rates for the gas it bought from Gazprom. However, solidarity is not the only motivation that led Gazprom. The price for a continuation of the “preferred nation status” in gas pricing was the relinquishment of equity in Serbia’s gas infrastructure to Gazprom. To that end, in January 2008 Serbian and Russian officials signed several agreements for the sale of Serbia’s state oil monopoly, the Petroleum Industry of Serbia (NIS), to Gazprom subsidiary Gazprom Neft and for a construction of South Stream through Serbia.\(^{52}\) In the chaos of the 1990s, Russia’s weakness prevented Moscow from exerting much influence in global and regional affairs in general. Yet, by the mid-2000s Putin had successfully recreated an autocratic system and reestablished state ownership or influence over strategically important sectors of the economy. A strengthened and confident Russia, wanted a voice in global affairs and was back to fight tenaciously for influence and freedom of maneuver in areas where it claimed privileged or historical interests: Central and Eastern Europe (CEE) and the Balkans were part of it. The EU, alarmed by Russian keen interest in the region, quickly decided that the countries in question needed to be stabilized by an adequate common legal/regulatory framework for energy. Indeed, given no progress in convincing Russia to accept the EU’s proposals for a common regulatory regime based on the acquis communautaire as a foundation for mutual energy relations, the European Commission (EC) proceeded simultaneously along another route in an attempt to persuade the Balkans (and the Western CIS) to adopt the EU energy acquis by means of joining the Energy Community Treaty. The EnCT was signed by the (then) European Community (but not by the single EU Member States) on one side and the following Contracting Parties - Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Romania, Serbia and the United Nations Interim Administration Mission in Kosovo (UNMIK). The Energy Community is a process that aims to extend the EU’s internal energy market to the region of South East Europe. Its main objectives are: to introduce a stable regulatory market framework capable of attracting investment; to create a single regulatory space for trade; to enhance security of supply; to improve the

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\(^{51}\) http://www.cee.int/

\(^{52}\) Putin also declared that Russia had designed Serbia as a key transit junction for its energy supplies to Europe.
environmental situation and to develop electricity and gas market competition on a broader geographical scale.\textsuperscript{53} In short, it is ‘an extending of the EU’s energy norms and infrastructures’ as the main solution to energy security concerns. This dissertation argues that the EU should not respond to Russia’s renewed interest in South-East Europe with efforts to delink the region from Russia. The EU should see the “energetic return” of Moscow in the Balkans not only as a challenge, but also as an opportunity to create conditions of more concrete energy cooperation with both Moscow and the region itself. This sub-national approach could be better suited to accurately represent the views and interests of the local communities at the intersection between different regulatory spaces. The basic assumption behind the case for cross-border cooperation is that it encourages regulatory experimentation while allowing for a close matching between policies, preferences and costs. Decentralized decision making at a regional level accommodates down-to-earth cooperation (Romanova, 2008), facilitates governmental accountability respecting the subsidiarity principle and is an effective mechanism for giving voice to divergent historical and cultural experiences while developing a new, reinforced communal solidarity. In that sense the activity of the Central European Initiative,\textsuperscript{54} which was established in 1989 with the purpose of promoting regional cooperation and dialogue between the countries of Central and Eastern Europe, could serve as a platform for dialogue with Russia as well. At this writing, the organization counts eighteen members, including Belarus and Ukraine. Through this forum, the contracting parties could promote legal approximation within the region, without the active involvement and the top-down leadership of the European Commission (EC). The EU understands that its energy security depends upon the development and the security of these peripheral states and their populations, where the EU has been instrumental in providing an anchor of stability. However, in order to fully utilize the CBC’s potential, in Morozov’s (2008) words “it is up to the peripheries themselves to mobilize and create alliances in favor of a less centralized and more open Europe.” It is up to South-East Europe to take advantage of its role as a “supply” bridge between Western Europe and Russia, by ways of maximizing the number of ‘transit’ related investments in the region, that can be best exploited with an enhanced understanding and a sharing of common practices with the most proximate neighbors. So far, we have witnessed that the rows and the harsh rhetoric between centralized Europe (i.e. Brussels) and Moscow, are not reflected at the level of general every-day business. Therefore, the discrepancy between the priorities and interests in Bruxelles and the local incentives, create opportunities for a promotion of cross-border cooperation with Russia, including in the areas of energy and the environment. Italy, a traditional partner of Russia and a regional power in South East Europe, should be particularly keen on supporting a regional dialogue complementary to the Brussels agenda. The Regional CBC dimension and its benefits in fostering dialogue with Russia will be discussed more in detail in Chapter 8.

4.4 Conclusions

Starting from the mid-1990s, the EU and Russia began to formalize their energy relations through international treaties and regular consultations. To date however, the EU-Russian energy cooperation has no clear legal basis. At the same time energy has been the most intensive sector of EU-Russian cooperation. When the situation is examined both from the EU and the Russian side, a picture of mutual dependence (with a variable degree of asymmetry) between the two blocs emerges. This chapter has examined the existing bilateral and multilateral arrangements and shown that to date, indeed there are no legally binding frameworks regulating the relationship. The question ultimately is: why is that the case? In the historical overview of the EU-Russian energy relations and in this chapter looking at the

\textsuperscript{53}See http://www.energy-community.org/portal/page/portal/ENC_HOME/ENERGY_COMMUNITY/Legal/Treaty

\textsuperscript{54}http://www.cei.int/
existing institutional frameworks, I have laid out conceptually the problem of the lack of legally binding institutions regulating the otherwise very active energy cooperation. I have intentionally abstained myself from making any judgment on the reasons for such a situation, because this is to be done in the next chapter and to be tested in the empirical case studies. I also pointed to the benefits of cross-border regional cooperation. The purpose of the next chapter is to move from the general to the specific. I will place the already existing answers to my central question within the three strands of IR theory described at the beginning and then I will offer my alternative proposition.
PART III
Literature review and my alternative explanation
5. Existing explanations and my alternative for the failure to promote legally binding institutions governing the EU – Russian Energy Interdependence

This chapter attempts to shed light on the EU-Russian management of their strong interdependence and to answer the central question of why there is such a shallow regulatory integration between the two parties. To do this, the chapter is divided into five parts. Following an introduction into the debate, the second part gives an overview of the answers to my research question through realist lenses, followed by a discussion of the same from a liberal perspective. The next part continues with a constructivist explanation. By looking at the central question from the lenses of the familiar triumvirate in international relations: Realism, Liberalism and Constructivism, this dissertation provides a comprehensive overview of the existing explanations to the research question and the scope of this study. Yet, the aim is to open new theoretical perspectives in addition to these well-established perspectives. Thus, the fifth part focuses on my alternative explanation to the puzzling lax institutionalization of the energy ties between the EU and Russia. This discussion leads into a subsequent exploration of the dominant actors shaping the relationship and provides some concluding remarks on why the status quo reflects the best interests of the leading actors on both sides of the energy interdependent relationship.

5.1. Overview of the debate in the Energy literature – setting the ground for the EU and Russia’s controversy

In August 2011, the IEA released a ‘special report’ revealing the potential for a ‘golden age’ of natural gas. The report titled, “Are We Entering a Golden Age of Gas?” presents a trend scenario in which global use of gas rises by more than 50% from 2010 levels and accounts for more than a quarter of global energy demand by 2035 as shown in figure 4.

Figure 4: "Golden age of gas" scenario

Source: The Economist
The very fact that the Paris-based energy think tank of the OECD considered necessary in 2011 to publish an intermediate “exempt” from the World Energy Outlook (WEO) focusing specifically on natural gas reveals the extent of the changes occurring in the global energy markets. Events such as those at the Fukushima Daiichi nuclear power plant and the turmoil in parts of the Middle East and North Africa (MENA) have directed more attention towards natural gas as a probable strategic fuel for the future. According to the IEA, the global trade in natural gas will double by 2035 and more than one-third of the increase will go to China. Russia, the first gas producer in the world, is expected to remain the largest gas producer in 2035 and will make the highest contribution to global supply growth, followed by China, Qatar, the United States and Australia. Natural gas is expected to outstrip coal by 2035 and potentially bypass oil at some point in the century (Maugeri, 2011). All that signals one thing: Russia will remain an uncontested player in the EU’s gas scene.

Demographics best illustrate the new challenges of this century. In late October 2011 the world population hit 7 billion. By looking more closely at figure 5, one can see that Asia, with 4.1 billion inhabitants (over 60 per cent of the world population) in 2010, and 5.2 billion in 2050, is desperately looking for oil, natural gas and water while, just on the northern frontier, Russia, with its shrinking population of 142,905 million inhabitants, controls over 30 per cent of world gas reserves and 4.5 per cent of world oil reserves and has huge water resources. This map illustrates some of the most important geopolitical stakes of this century.

Figure 5: Concentrations of Gas Reserves in the World

While there is consensus on the fact that demographics will certainly put pressure on how to manage the resources on our planet, in IR theory there is an ongoing vivid and divisive debate on how to make sense and respond to the complexity of contemporary energy politics. In gas, the current debate focuses on the impacts of the massive increase in natural gas consumption for the environment and how to best achieve the goal of energy security. From a "realist" perspective, the diagnosis of energy crisis is quite simple, remarked by former US President George W. Bush, “Demand for energy is increasing while supplies of oil and natural gas are diminishing” (Laft, 2009). Under such conditions, agreeing on a unified energy security agenda will be increasingly difficult and each country is likely to pursue its own interests based on what it perceives as energy security. According to the realist historian and energy author Michael Klare, it is unavoidable that today's decisions will

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55 See http://worldpopulationreview.com/world-population-2012/
be steered by two major developments. One is that there will not be enough oil and gas to keep up with the expected 40% global increase in oil demand. Two is that climate change will hit so forcefully that politicians will have no choice but to take drastic action against further use of fossil fuels, in particular oil and coal. A Hubbert’s peak for gas will occur, although it may follow the “peak oil” by a decade or two. With the growing competition for energy, it can be expected that these local schisms will only be exacerbated and that the risk of turmoil will increase concomitantly. Although, according to Klare, there is not much we can do to stave off a predicted energy war, we can at least try to come out on the winning side. He takes stock of some the possible winners and losers in his essay “the New Thirty Years’ War,” and concludes that war is an inescapable eventuality that will happen thirty years from now: in 2041. Michael Klare considers the prospects for natural gas and the shale gas revolution “oversold” due to the many threats that new technologies such as fracking pose. Hence, the world is evolving into a hotter, stormier place marked by energy conflicts and environmental degradation. Whether we agree or not with his dark brooding, this view is not uncommon among energy security realists. The principal challenge to realism comes from a broad family of liberal theories. In the energy spectrum some scholars call them “Idealists” as they envisage a slightly rosier future. This scholarship argues that economic interdependence would discourage states from using force against each other because warfare would threaten each side’s prosperity (Yergin, 2012, Elkind, 2010). As gas and oil are traded globally, a supply disruption would affect prices everywhere and given that energy players are rationally motivated by profit maximization, “interdependence” is the key to ensure energy security and “energy independence” is thus undesirable. This strand of liberal thought envisage a future where natural gas will take the role of a “transitional” or “bridge” fossil fuel towards a more sustainable future, because it releases less carbon dioxide and other greenhouse gases than oil and coal. In addition, global supplies of natural gas are far greater than previously believed, thanks to new technologies – notably horizontal drilling and hydraulic fracturing (“fracking”) – that allow for the exploitation of shale gas reserves once considered inaccessible. Pursuing new technology will thus provide newsources of energy and thus dismiss the threats that “peak pessimists” like to use about the end of fossil fuels (Umbach and Kuhn, 2011). This strand of liberal theory is very influential today. A relatively recent addition to energy realism and liberalism is the new attention to the problem of climate change in relation to the more “classic” energy security concerns. Whereas realism and classical liberalism tend to focus on material factors such as security, power and profit maximization, in contrast these approaches emphasize the impact of energy policies on the environment. I will call them “optimists.” In this view the advent of natural gas is bad news for the planet, because it will compete with renewables. Clean energy advocates fear that if the “loose” gas market phase in Europe is prolonged in addition to a commitment to develop unconventional reserves in the US, the interest and enthusiasm in investing in non-fossil energy sources, and new “green” technologies would slacken off. This would be fatal, given the requirements of environmental protection. While the present economic crisis of the Western economies had the effect to slow down emissions, it also reduced the natural gas price in the United States, Europe and elsewhere as an outcome of the American “shale gas” revolution. These factors combined will probably decrease state funding and private risk capital for the worldwide expansion of renewables as well as for innovative energy research and development programs in order to mitigate global climate change, which may slow down the transformation to a global non-fossil energy future. So broadly put, this is the state of the current debate in energy. Who is right? They are all right in different ways and they capture different aspects of our complex and uncertain energy reality. But the question we ought to answer here is – what does all that mean for the EU-Russian energy governance in a short and in a long-term perspective? We will examine these aspects in the next sections from a

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56Klare, M.T. The New Thirty Years’ War, European Energy Review, 5 September 2011
Realist, Liberal and Constructivist point of view, before approaching to my alternative assessment of the failure of governance structures between the two partners.

5.2. The (Neo)Realist view

This chapter sheds light on some of the most controversial and salient realist arguments on the nature of the EU-Russian relationship and their rationale behind the failure to create a legally binding institution regulating the relationship. It proceeds along the following lines. First, it lays out the complex and dynamic relationship between Russia and the EU from a ‘radical realist’ and ‘moderate realist’ perspective. After a descriptive analysis of the two approaches, it argues that the ‘moderate’ realist narrative is well grounded; yet, it has a flaw in that it does not recognize the growing importance of the private sector directing important policy choices within the respective states. The final section examines the EU-Russian competition in the shared Neighborhood, as acase in point mirroring the realist stance.

5.2.1 Introduction

Ever since Putin became president of Russia, the concentration of power in the hands of few individuals and the reinforced state control over the “strategic” sectors of the economy led to a growing number of scholarly works and other analyses describing the relationship from a geopolitical realism perspective. Especially since Putin’s second term this view has grown in importance in both Russian and European foreign policy thinking. Geopolitical realism leads to a tendency to see international relations in zero-sum terms. This means that the EU’s energy dependence on Russia is seen as dangerous and likewise, Russia’s growing dependence on the EU’s market is seen with suspicion and as something to be avoided. The mutual mistrust leads to a securitization of energy relations and the so-called energy security dilemma, whereby the Union’s suddenly desperate diversification drive and its talks of energy independence from Russia, force Russia in response to diversify away from the EU, which appears to have become less dependable. The fear of both entities that one might diversify its imports/exports leads both to pursue the same logic of diversification, at least verbally. This in turn, leads to a downward spiral of mutual mistrust. From a standpoint of political realism, there are certain things that are built into the nature of world politics and that cannot be resisted. The world is dominated by power politics and states follow their interests. The states are permanently in competition, which allows for only moderate cooperation as part of the rapidly changing interests of the states, which are also the basic and dominant units of world politics. Therefore, it is not wise to pay too much attention to international institutions. International institutions are fundamentally insignificant since states wield the only real power in world politics. The highest value is accorded to the preservation of sovereignty, territorial integrity and independence, while the most important principle of international law is considered to be the principle of non-intervention. Two main interpretations on the EU-Russian energy predicament emerged from this strand of theory:

a) The “security dilemma”, where their mutual dependency supposedly puts the two blocs in a dangerous state of dependency and compromises their strategic position towards the other, a situation in which both sides diversify away from each other, only to leave them in a worse position than before.

b) The more “moderate realist” interpretation, which views the situation of mutual dependence as a reason not to pursue policies which would antagonize the other partner and that does not view the supremacy of the states in the energy trade as an unalterable reality.
5.2.2 Classic Realists and the Security dilemma narrative

In general, multilateral forces have become weaker in the last ten years. In coincidence with the 9/11 terrorist attacks, world politics has become much more securitized. As noted by Belyi (2009) energy security can be defined in relation to perceptions of perils associated with a political atmosphere in inter-state interactions. Security concerns in Europe were raised in the aftermath of the Russian–Ukrainian crisis of January 2006 and reinforced after January 2009 dispute. The instability in the transit of gas triggered a growing politicization of the issue of dependency upon gas coming from Russia. There was a mounting, largely unfounded fear of Moscow’s possible use of energy supply for foreign policy ends. Some Western experts argued that gas disputes with Ukraine were indeed the proof that Moscow was not hesitant to flex its energy muscle in the pursuit of political objectives (Baran, 2007; Umbach 2010). Developments such as the imprisonment of Mikhail Khodorovsky alarmed European “realists,” who in the aftermath of the 2006 energy crisis with Ukraine started highlighting the risks of market power resulting from Gazprom’s monopoly and the possibility of the Kremlin playing the ‘gas weapon’ card. Most of the scholars that adopted this alarmist tone, also stressed the necessity of decreasing the malign dependence on Russia by diversifying gas supplies and routes with the construction of new pipelines directly from the Caucasus and Central Asia. This position was strongly backed by the United States. Meanwhile, Russia responded to the growing anti-Russian rhetoric within the EU at times threatening to re-route its exports towards the East, or more mildly, by pointing out that a new understanding of energy security is necessary that goes beyond security of supply and takes into consideration the interests of all participants in the energy market (Konoplyanik, 2010). Moreover, Russia has declared diversification of its energy supplies towards China, Japan and South Korea as one of its top priorities. At this writing, a growing discord and tension characterizes the most interdependent dimension of EU-Russian relations. Energy relations are imbued with emotional and political considerations that defy economic logic (Sherr, 2010). This means that any increase in Europe’s security of supply is perceived to cause a diminution of Russian security of demand. In this state of affairs multilateral cooperation is seen as undesirable and impracticable. The absence of a world government and of an effective international legal system, to which victims of injustice may appeal, means that states prefer relative gains (doing better than others) to absolute gains. They seek to protect their power and status and will resist even mutually beneficial cooperation if their partners are likely to benefit more than they are. Such a dynamic finds its best manifestation in the EU-Russian contended Neighborhood. Those realists who perceive the EU as a sort of super-state view its competition with Russia in the Neighborhood as a game of “circles of influence.” Both sides see the overtures of the other towards the common neighborhood as an attempt to approach the area in a neo-imperialist way. The EU stresses that Moscow unduly perceives the former communist world as its sphere of influence. In Moscow’s view the EU’s “regulatory imperialism” in the area is pursued through instruments such as the European “Eastern Partnership,” that are seen as European attempts to incline the post-Soviet states against Russia. Given the irreconcilability of Russian and the EU’s interests and a mounting competition in the shared Neighborhood, in this narrative only a very sporadic low-profile cooperation is attainable. Moreover, the possibility of conflict is not excluded only by virtue of economic interdependence. In sum, given the frantic efforts to diversify against one another this strand of thought concludes that interdependence between Russia and the EU will be inevitably reduced over time.

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57 Authors’s interview with Christof van Agt (Clingendael Institute of International Relations), January 2012
58 For an extensive analysis of the “energy security dilemma,” see for example Monaghan, A. Russia-EU Relations: an Emerging Energy Security Dilemma, in “The Power of Oil and Gas” edition of the Pro et Contra journal (Volume 10, No. 2-3, 2006), the Carnegie Moscow Center
5.2.3 “Moderate” realist storyline

A less radical but more enduring objection to the desirability of institutionalization of the EU-Russian energy relationship comes from the scholarly tradition that I call “moderate” realism, to which I partly subscribe in this dissertation. I say “partly” because although this study is based within the realist tradition, it employs a critical realism approach, which allows for simultaneous engagement of other interpretative perspectives, such as the cross-border cooperation approach.

Moderate realists view interdependence and diversification as not contradictory, but in a supplementary light. They argue that the interdependent nature of the relationship means that it is unlikely that Russia would interrupt supply to the EU for political reasons, given that the importance of the EU market is too great (Westphal 2009, Van der Linde 2008, Finon and Locatelli, 2007). Diversification is necessary because of the widespread concern whether Russia can actually keep energy production at sufficient level to meet its growing domestic and the foreign demand. These concerns are raised by Russia’s chronic underinvestment in the hydrocarbon industry and not so much by Russian potential use of the so-called “energy weapon.” This strand of realism has been very critical of European liberalism in its foreign policy dealings with Russia that has been too focused on providing for energy security through its norms and economic liberalization recipes, too focused on international law and not sufficiently attuned to power (Van der Linde 2008; Bressand, 2010).

The theoretical critique primarily regards the EU’s use of its internal economic and regulatory arrangements to provide for energy security, in face of a Russian neighbor that clearly has no intention to adopt the EU’s legislative arrangements because they simply do not reflect its immediate interests. This strand of realism has also been critical of the European Commission’s efforts to erode the sovereignty power of the member states by transferring more and more energy-related competences to Brussels, in an attempt to increase its imperial-style power. If due to historical choices pertaining to particular structural situations in single member-states there is no convergence toward one homogeneous European energy mix, then there should be no unified European external energy policy dictated by Brussels. A European energy policy is rather to be achieved through the coexistence of differentiated models, where policy coordination becomes a central and desirable tool. Hence, the realists make the case for shallow coordination that corresponds better to the needs of a still pluralistic Europe. Shallow energy integration promotes accountability of governments for local concerns and is preferable due to the difficulty and sensitivity of energy supply issues. Given that there is no single EU energy mix model, the external energy policy of each state should reflect national conditions and preferences. The “one-fits-all” approach should not be promoted, instead, an array of instruments to address solidarity, interconnections in an overall internal energy market integration are more consistent with this approach to foreign energy policy (Bicchi, 2006; De Jong, 2011; Van der Linde, 2008; Noel, 2008; Bressand, 2010). Some critics go further to claim that the European Commission insistence on a “common voice” masks its pursuit for power (Mandril, 2012 Noel, 2012). In this view, the substantial strategic nature of energy security motivates member states to pursue their own best strategies, and to compete with other states over the best deals with Russia. Russia’s politics should be understood as “power politics” framed within the peculiar Russian institutional design. In Putin’s autocratic, centralized regime most of the strategic energy decisions are taken by very few people within the Kremlin and under a careful scrutiny of the president. Russia prefers the bilateral channel in its dealings with main European customers and prefers to skip the EU’s mediation. Ever since the Soviet era bilateral contractual frameworks have been an essential element of the Russian – Western customers (typically Germany, Italy and France) gas trade and they reflect a well-established tradition of business-to-business relationships backed by state-to-state political understandings. The ECT failed to foster the perception of a strong and independent treaty because bargaining problems impeded the attainment of joint gains. The
EU was not willing to compromise on the *acquis communautaire* and Russia was not willing to accept a treaty that was not perceived as defending its best interest. Although the promotion of a comprehensive treaty is in principle in the best interest of both players, both sides staked out tough bargaining positions, hindering efforts at credible compromise. Thus, multilateral frameworks when two parties have too different immediate interests are prone to failure. Contrary to some liberal interpretations where the member states are seen as passive victims of Russia’s “divide et impera” tactics, Realists stress that the European member states too, look for best deals in the pursuit of their self-interested strategic external relations, even if that means less solidarity and unity at the European level. For years now, the European Commission has pursued complete liberalization (deregulation) of the gas market and more recently it has aimed to gain control over external energy policy from the EU member states, a move that would eliminate the competition between independent EU operators that are supposed to compete. Moreover neo-realists warn, competition is in itself a good thing but can have adverse consequences when there are not enough producers on the market that are really forced to compete. These critics point to the fact that it is fruitless to increase the number of gas sellers within the EU if they are still forced to turn to the same supplier (i.e. Gazprom). Above all, they doubt whether this strategy helps to reduce prices or increase the security of the end consumers (De Jong 2012; Maugeri, 2011). Yet, lately things have been changing for Gazprom and other producers at the European market, due to the arrival of new LNG supplies mainly from Qatar that were previously destined to the US. These structural changes could force Gazprom to compete on the European markets in the future. Empowered by the ‘paradigm changes,’ the Commission has lately embarked in a multitude of new tasks that according to Realists should not pertain to its sphere of competency; for example, as mentioned earlier, at the beginning of September 2011 Brussels has taken concrete steps to gain control of external energy policy from the EU member states (Ibid., 2012). The European Commission wants to monitor all intergovernmental energy deals between EU member states and third countries. In the longer term, it wants to be allowed to negotiate energy deals on behalf of the EU. Moreover, the EC has adopted a mandate to negotiate a legally binding treaty between the EU, Azerbaijan and Turkmenistan to build a Trans-Caspian Pipeline System. Some gas experts believe that the EU should concentrate on attracting imports at competitive prices and facilitating investments in new infrastructure and that it cannot and should not afford the luxury of experimenting with a new gas market design (De Jong, 2012). In the framework of the Third Energy Directive, the EU should be empowered to coordinate solidarity internally to provide support for the development of interconnections and storage facilities within the EU. In fact, with the Third Energy Package, the EU policies are supporting a multibillion-euro program of interconnection of national gas grids, expansion of natural gas storage and diversification of gas supply sources, notably in the form of LNG. Energy experts disagree whether public money is needed to build these interconnectors, and if so, how much (Barysch, 2010). In any event, the direct support of new import infrastructures, such as the Trans-Caspian pipeline or the even more notorious Nabucco, puts the EU in an ambiguous role as a catalyst for competitive markets and at the same time a promoter of selected long-term energy security projects. According to many observers, Europe does not need an “external” energy policy. In the blunter words of Claude Mandril (2012), “There is a substantial confusion about what "speaking one voice" means. That is very good and very necessary for governments, as long as they remain in their constituency: energy policy, tax regimes, regulation, research. If it refers to contracts and agreements between operators, which are competing with each other, it is awful and should be strongly opposed. Ironically it is the exact opposite of achieving a competitive internal market, which the Commission wants to export to neighboring countries.”

This dissertation agrees with the view holding that the EU should rather focus on creating a liquid gas market internally, which would in and of itself, help to increase energy security because

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59 van Renssen, S. *External energy policy: Brussels takes charge*, European Energy Review, 12 September 2011
ideally, in a liquid market it would not matter where Gazprom delivers its gas. Externally the European Commission should avoid prioritizing some external pipeline projects over others, such as Nabucco and the TransCaspian pipeline over South Stream for example, because with this stance it is distorting itself from its own market principles that it champions internationally. From the Realist standpoint, the Commission’s drive to take more competencies from the member states and play to subordinate the member states and Russian countries’ own legitimacy as an impartial facilitator of the liberalized gas market. The Realist argue, precisely because there are many “Europes,” whose level of dependency on Russia varies, a decentralized national decision-making accommodates differences in national preferences. In the rapidly changing interregional gas markets, states should have the freedom to maneuver and should not be locked-in by the creation of large multi-faceted organizational bureaucracies and by legally binding transnational agreements. Also, on the issue of Russia’s imports from Central Asia to meet its contractual requirements with Europe, this strand of thought prefers a less alarmist line considering Russia’s possibility to actually meet the European (in the long-run) growing demand for gas driven in part by Europe’s decarbonization policies. They drive attention to Russia’s impeccable record as a gas supplier and warn that confrontation with Moscow over alternative pipeline projects should be avoided.

On the Russian Realist front, Moscow does not bother to understand how the Brussels bureaucracy works and due to its vision of sovereignty it prefers to deal bilaterally with the European ‘Great Powers’ (especially Germany, Italy and France). These states, by promoting their own ‘energy champions’ have historically built good ties with the Kremlin and Gazprom. In that sense, the EU as a whole led by Brussels has a substantially different relationship with Russia than the Europe of sovereign states. Brussels encounters hostility while it still persist with seeking implementation of its own integration logic with Russia, based on ‘shared values’ and the compliance with specific conditions for cooperation, as it was successfully accomplished with the “Europeanization” in Eastern Europe and more recently, the Balkan area. For Russia, the European external policy reflects a realpolitik whose main purpose is to enhance the EU’s influence in the Russian ‘Near Abroad’ and to block Russian economic expansion, by a strategy that is just covered with the niceties of human rights, liberal democracy and market economy. Russia prefers to speak about cooperation in strictly commercial terms, without mentioning common values and/or the European body of rules. Furthermore, Russia does not like the logic of conditionality of the EU’s diplomacy, as it considers itself a great power that does not need to respond to conditions from the outside (Gomart, 2008). Moreover, Russia’s “realist” energy experts (Paltsev, 2011) argue that the EU has had a quite confusing, at times schizophrenic policy towards Russia alternating from the perceived dominance of the Russian gas imports for the years to come and a threat to a European energy security, to a perceived inadequate investments in Russia’s gas infrastructure and the resulting projections for more cooperation to avoid deficits in future supplies, and then to a perceived combination of LNG and shale gas replacement for the majority of Russian gas imports that would reduce drastically, if not eliminate, the need to natural gas imports, and then again to a development of wind, solar, and biomass-based generation that would eliminate the need for fossil fuel use. Russia is frustrated by such an instable stance, and given an increased demand for natural gas from the Asian countries, Russia, in turn, tries to diversify its export destinations eastwards. Yet, the prospects for natural gas expansion towards the East require not only massive new financial investments in the exploration and development of new fields, but also overcoming a psychological blockade in establishing stronger relations with the East Asian countries, particularly China (Poussenková, 2009). As Gazprom ‘gets

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60 For a recent overview on these issues see: “EU readies ‘pragmatic’ answer to Putin’s energy agenda”, Euractiv, 18 December 2012.
squeezed’ in Europe, diversification towards the East could become a stronger imperative in the years to come. At the moment, due to the EU’s multiscalar structure and fuzzy objectives, Russia is more comfortable in trading with national governments that are treating Russia as an equal partner and are limiting their relations to economic considerations (i.e. with joint-ventures to build pipelines and storage capacities). Russia cooperates with the EU’s governments and companies through a network of commercial relationships and quid-pro-quo. For instance with ENI, in 2006 part of the massive quid pro quo was the expanded access for Gazprom to the end-use market, in exchange for a long-term gas contract and ENI’s partnership in the construction of South Stream (Konoplyanik, 2010). In 2011, when the big German company RWE was left seriously out of money due to its long-term contracts, Gazprom offered a discount in exchange for a strategic partnership with RWE that would expand access for Gazprom in the German and European markets (European Energy Review, 2011). The arrangements between Gazprom and the European utilities companies are based on a quid pro quo concept of reciprocity, while the EU Commission would like to push for a diffuse reciprocity, based on common rules and values. Once again, the conflict in norms (see section 5.4.3) related to Russian and European divergent interpretations of sovereignty and reciprocity, creates mutual misconceptions. Moreover, it is easier for Russia to identify ‘who is who’ at thenational levels than to deal with the complex Brussels bureaucracy. In the realist view, all the above-mentioned reasons explain why negotiations on the ECT were delayed; not only because of resistance from Russia, but because of disunity concerning regulatory policy in the EU and in the Western camp more generally. Even though there was at least a basic consent on the imperative around Russian ratification of the Energy Charter Treaty, for a long time different views on regulatory policy in the EU continued to hamper unity. For example, the proposal for mandatory third-party access to export and transit pipelines, put forward by the Commission and supported by Great Britain was for a long time dismissed by France and other member states fearing liberalization of their monopolistic energy sectors (Grätz, 2009). There were several lines of division between new East European States that were still quite resented vis-à-vis Russia and were fearing its ambitions (like in the Polish case), the more general Eurosceptics and pragmatics like the UK and Denmark and the big ‘energy friends’ like the Germany (with EON and RWE), France (with its national champion EDF) and the Italy with ENI, that did not want to spoil the atmosphere with Moscow (Leonard and Popescu, 2007). This last set of countries has been largely responsible for the fact that important initiatives by the EU to put energy relations on an international legal basis, such as the Energy Charter Treaty, have been consistently undermined. The different approaches within the EU for securing the future energy supply materialized in the split of political support for Nord Stream, South Stream (both initiated by Russia), and Nabucco sponsored by the European Commission. The latter has consistently tried to persuade Russia of the benefits of splitting the supply and the transport business (“unbundle”), and even stated that it was in Russia’s interests to ratify the Energy Charter Treaty. Conversely, the Russian authorities have made clear to the EC that if any of the new proposals were perceived as a threat to Russia, this could lead to a risk for the global supply security of the European gas markets (IEA, 2008). As emphasized by Van Agt (2009), in the absence of an effective understanding with international stakeholders, Russia treats foreign energy investment and trade flows at its own sovereign discretion. In short, the failure of the ECT regime is partly due to the interest formation and the insufficient political will for joint action (i.e. the pursuit of self-interest) of some member states that have played according to the balance of power logic and competed against other EU states to get their best deals with Russia. Once again, energy supply coordination with Russia and within the EU is desirable as long as it respects the consolidation of differentiated energy models, or in other words different national regulations, standards and practices. A shallow coordination to eliminate the transaction costs of cooperation is desirable, but if national interests, tastes or conditions lead to different laws, the playing field of international energy trade will not, and should not, be level. This thesis is framed in the partial acceptance of the neo-realist
argument. However, the main criticism to the neo-realist position regards its failure to recognize the predominance of the private sector in leading energy policies on both sides. In the Realist view, states are the main units of energy politics. Although companies do exert some influence in gaining backing from their national governments to secure long-term preferential deals with their preferred third party producers on bilateral basis, on broader geopolitical aspects of energy security the energy companies commonly follow, more than influence the positions of their respective governments (see Tkachenko 2008; Youngs, 2009). These analyses of the EU-Russian energy cooperation fail to contemplate the rise in importance of non-state actors (such as Gazprom, the European “national champions” and the other NOCs and IOCs). In many instances, the companies, which are bound by profitability constraints, are the ones that determine the direction of their state policies and are the principal actors that oppose any changes in the current lax governance structure between Russia and the EU. Moreover, the “moderate” realists do not do justice to the multi-level and multi-actor based interactions in the Eurasian gas trade. This dissertation for instance, puts an emphasis on the importance of other entrants who participate in the energy policy at the sub-regional level, such as the regional cross-border organizations and the small enterprises.

5.2.4 A new Approach within this Literature

It is important to stress that a new fruitful line of thought does argue persuasively that depending on the situation and the issue at stake, the companies and their pursuit of profit in lieu of the state’s calculations might be the real cause of a certain policy course. The closest contribution to my approach is Rawi Abdelal’s view that “A Realist account would, identify neither the most important agents nor their essential logics. Instead of states’ pursuing security amidst anarchy, we find firms’ pursuing profit in the face of uncertainty. The geopolitics of European energy has fundamentally commercial and ideational origins.” Abdelal makes a compelling case for the centrality of firms in determining energy policy for Europe. In that sense, this author systematically deals with the differences between firms’ and governments’ decision making in shaping the European energy policies, to demonstrate that firms are driving these political outcomes and firms are motivated by profits while at the same time employing sociological conventions along their ways (Abdelal, 2011). Other scholarly work along these lines involves Locatelli and Boussena’s (2011) analysis of the new developments in the gas markets and their explanation of firms’ behavior as bound to profitability constraints and Westphal (2009) that identifies firms’ interests as significant drivers of the changes in the global governance structure. This literature, whose important works do not fit neatly into realism, but somewhere on the boundaries between realism and liberalism, emphasizes the growing influence on non-state actors in influencing the energy policies outcomes. While these studies are informative and offer valuable empirical and theoretical insights into regional energy dynamics between firms’ and governments’ decision making, no study to date analyses the puzzling inability of the EU and Russia to achieve a legally binding agreement regulating their energy interdependency, from the analytical angle of an increased role of the firms’ leverage and their reluctance to change the current structural arrangements. Moreover, no study to date examines the sub-regional energy security policies through a comprehensive cross-border cooperation perspective that emphasizes the promotion of more regionalized patterns of EU-Russian energy relations and sheds light on South East Europe’s position in the Eurasian gas trade. The next section proceeds to look more closely at the Neighborhood case, which is considered here as the case that most strongly reflects the neorealist explanation of the EU-Russian rivalry as an obstacle for any cooperative endeavors that go beyond mere coordination.
5.2.5 Contended Neighborhood – A case in point of the Neorealist narrative

Empirical evidence shows that regarding the shared neighborhood, it is often more accurate to talk about strategic rivalry or competition rather than strategic partnership. The tactics of the EU and Russia in this area and the lack of proper information of the other’s goals are key aspects of a process that not necessarily leads to cooperation. Both sides share the perception that their maneuvering in the Neighborhood has clear geopolitical connotations. Considering that the length of the land border between the EU and Russia after the EU’s 2007 enlargement counts 2575 km, it is self-evident that the Eastern border with Russia is of immense strategic importance.

In order to account for the rivalry in the Neighborhood, alongside with Russia, the EU-Europe of Brussels centered integration and its sphere of influence will be the analytical focus of this section. As already pointed out, there are many “Europes” with which Russia interacts. Single member states have their own foreign policies. Yet, for the purposes of this section we will consider the EU as a bloc. Before going into more detail, the aim is to analyze the Realist-centralized EU, the one that is trying to consolidate as a (super) nation state with a Westphalian brand, implying a clear division between the inside and the outside and a single sovereign center governing domestic and foreign politics. The best illustration of this model is first, the EU’s enlargement and second, its Neighborhood policies, which force the periphery to accept certain conditions in order to move closer to the core (Morozov, 2008) that basically rests upon the EU’s regulatory model.

5.2.5.1 Introduction

Given the strategic significance of the region, it is no big surprise that relations in the area are strained. The rivalry between the EU and Russia in the ‘Neighborhood’ can be best summarized in a struggle over rents in both the traditional fossil fuel value chains and the future ones. But it is also a “system” struggle, in which regulatory regimes, ownerships, supply routes, trade and neighborhood policies are all part of the overall political tension between the two blocs. Ukraine in particular, became an important battleground over the control of transit routes between Russia and the West.

During the 1990s, Russia viewed the EU as a sort of ‘anti-NATO’: a benign organization that provided economic and technical support for Russia’s transformation, but without substantial strategic weight of its own and with the potential to de-link the United States from Europe – a long-standing Soviet-era foreign policy goal (Greene, 2012). Over the years though, the ‘Common Neighborhood’ became a very sensitive security issue that went through periods of deep crisis. Especially from 2003 onwards the relationship took on greater practical urgency at both sides, as the EU’s enlargement eastwards opened a waste range of contentious issues. Later on, differences over the future status of Kosovo, Russian objections to US plans to develop a missile defense system and deploy elements of the system in Poland and the Czech Republic, and the ratification of the Conventional Forces in Europe, sharpened relations with Russia. Russia’s relations with the EU gradually became a subset of Russia’s more general dissatisfaction with the West’s expansion in its ‘Near abroad.’ Even more dramatically, the Georgian war froze the talks on the new PCA agreement. The extending of the NATO invitation to include former Soviet Union states, such as Georgia and Ukraine became the neuralgic point of Russia’s growing irritation with the West. Russia was displeased with the growing spread of Europe’s norms, standards and policies in the area that Russia historically considered its ‘backyard.’ The EU considered Russian alarmism as another demonstration of Russia’s tendency to approach the “enlarged” EU in a dangerous neo-imperialist way, since it continued to view the former communist world as part of its
sphere of privileged interests. Especially since Putin came to power, Moscow insisted on its independent position in a multipolar world and on its modified view of world politics, complementary to the Western model. The EU objected the series of new terms that entered Russia’s political lexicon to mark its specificity—such as “sovereign democracy,” “managed democracy,” “democracy for the people,” with their comprising leit motiv: the acceptance that Russia has no longer any interest in adopting European values and standards in its domestic affairs. The Russian model will reflect respect for the rule of law in Russia, in accordance to the needs of its constituency. One of Putin’s foreign policy priorities was the determination to reassert Russian power and influence abroad, particularly in the post-Soviet space.52 Aided by a significant rise in energy prices in the first years of his rule, he largely succeeded in doing so (Larrabee, 2010). The rising authoritarianism in Russia was based on a two-fold strategy: first, Putin greatly expanded the coercive capacity of the state and second, he took control over Russian society to prevent it from taking any autonomous action (by attacking the media freedom and suppressing the civil society organizations). The EU was growing increasingly alarmed about its dependency on authoritarian Russia, in light of the linkage between democracy and security issues established in the Western discourse. When in 2006 and 2009 the gas cut-offs due to Russian-Ukrainian disputes occurred, for many Western energy analysts it simply meant that Russia was attempting to play zero-sum games in the pursuit of political power. The relationship was growing hostile and the two entities increasingly perceived each other as destined by geopolitics to compete (Morozov, 2008). With an empowered Russian identity, the European overtures towards the East, in what was considered the Russian ‘near abroad’ began to be seen with growing suspicion. Meanwhile, from the EU’s standpoint the energy interdependence with an authoritarian Russia became a source of instability and frustration. That led to the difficulties in reaching any common goal and determined the failure to agree on the replacement of the Partnership and Co-operation Agreement (PCA). In energy, the two Russo-Ukraine disputes ‘awakened’ the EU and reinforced its attention on the common Neighborhood, as a key area for the purposes of EU energy security. The EU decided to deal with supply risks embarking on a systematic diversification of energy supply and a “Europeanization” of the countries of the Neighborhood, in an effort to mitigate the potential “supply shocks” deriving from the transit of gas through these countries. All Eurasian countries’ relations with the EU, (with the exception of Belarus that the EU considered too undemocratic), were already shaped via the European Neighborhood (ENP) a foreign policy instrument of the EU designed for the countries on its borders. However, the ENP offers abstract and distant incentives, linked to the promotion of democracy and the rule of law. Thus, the EU (and the US) rushed to involve Ukraine, Belarus and Moldova in a more concrete regulatory structure as a security measure to avoid risks for Europe’s security of supply. The rationale behind was simple: the political instability across these countries could hinder, as it did in the Ukrainian gas disruptions, the development of a secure energy stream. With that in mind, the EU launched its Eastern Partnership (Eap), which was formalized after the war on Georgia. Essentially it was an attempt to bring several post-Soviet states (Belarus, Moldova, Ukraine, Georgia, Armenia, and Azerbaijan) around its frontiers into a zone where European standards apply. The EU’s declared aim was to prepare these countries for eventual membership and a possible free trade agreement. Not surprisingly, Moscow perceived the move as a geopolitical provocation, more like an example of the old-fashioned zero-sum thinking that was trying to undermine Russian-led ‘integrationist frameworks’ within the CIS (Mankoff, 2011). Russia understood that the EU’s engagement had the potential to shape the broader economic environment in the former Soviet space infavor of increasing transparency, good governance and rule of law — undermining Russian-led practices in business and politics (Greene, 2012). In fact, Putin’s more recent Customs Union with Belarus and Kazakhstan

52 For a recent comment see for example Trenin, D. Integrating Russia’s Post Imperium, Project Sindicate, November 2, 2012.
and the priority assigned to the proposed Eurasian Union, are indicators of the urgency that Putin puts on retaining its sphere of influence in the Near Abroad, even at a cost of compromising a deep and comprehensive FTA with the EU. Even more, the EU and the US pro-NATO efforts in the region generated a larger concern. On that question Russia was clear: for example, the 2009 ‘Concept of Foreign Policy of the Russian Federation’ states that if Ukraine and Georgia joined NATO, this would lead to ‘the rise of new dividing lines in Europe’ (Bogomolov et al, 2012). Foreign Minister Lavrov went on to declare that the Commonwealth of Independent States (CIS) constitute an “absolute priority” in Russia’s foreign policy, implying a region over which Russia is willing to sacrifice the harmony of its relationship with the West [Lavrov, 2009 in Skak, (2010)]. Over the years, the West accepted that Ukraine and Georgia’s NATO membership marked a new red line for Russia’s vital interests that Russia was not ready to cross. On the one hand, NATO introduced a new strategic concept in November 2010, where it made clear that there was no room for further NATO enlargement to the East, because a further enlargement would ‘undermine the strategic ‘Partnership for Peace’ with Russia. This meant that NATO withdrew its commitment for Georgia and Ukraine’s NATO membership, perhaps indefinitely. Moreover, a fundamental change in the United States’ foreign policy happened: the U.S let the EU to achieve an independent architectural project in Eurasia and to take the lead in defining its own relationship with Russia. Furthermore, Washington has recognized Russia’s increasing power, and in order to safeguard the vital interests it shares with Russia, has given up its overtures towards Ukraine and Georgia. From a European point of view, a pragmatist rapprochement in the Neighborhood is a better strategy with Russia, especially due to Russian proximity and importance as an energy supplier for the Old continent in the years to come, but also considering China’s peculiar rise. Concretely, a German-led “rapprochement with engagement” is the stance that the EU has taken in the last years.

5.2.5.2 Moscow’s lead in the race for the Neighborhood

The ‘pragmatic cooperation’ approach suits Russia much better than the EU’s previous focus on common values and democratization. And indeed the improvement of EU-Russia relations has coincided with decreasing tensions in the Neighborhood. Although there are still deep disagreements over Georgia, the ‘frozen conflicts’ areas of Transnistria, Abkhazia and South Ossetia and the unresolved Nagorno-Karabakh conflict, the withdrawal of Russian troops from Perevi (Georgia) at the end of October 2010 can be seen as a result of the joint efforts of the co-chairs of the ‘Geneva Talks’ and of the improved relations between Russia and the Western international actors in general. In energy, a joint “energy road map” is a step toward closer cooperation. Naturally, decreased tensions do automatically lead to a weakened competition in the Neighborhood. In the past Washington, and with a less interventionist approach Brussels - have seen Moscow’s attempts to influence the foreign and domestic politics of its neighbors as violations of their sovereignty. In response, they sympathized and helped finance color revolutions that brought anti-Moscow leaders to power in Ukraine and Kyrgyzstan and have pressed for Georgia and Ukraine’s rapid admission to NATO. Yet, such efforts have slowed recently, mostly due to ‘balance of power’ type of concerns and an interest in keeping Russiaproof amidst China’s exceptional rise. Thus, whereas the EU and even the U.S have become “softer” in an attempt to not antagonize the Kremlin, but rather to co-opt it in face of the growing Chinese power, Russia goes on in restoring its ‘greatness’ in the Near Abroad.

64 That with its growing energy appetite is devouring resources and could put a question mark over the security of Russian supplies to Europe.
Indeed, to Moscow's gratification, recent efforts to influence its neighbors have been very successful. Russia has come up with a number of new proposals, such as the “Customs Union” between Russia-Belarus-Kazakhstan in March 2011. Ukraine, without whom President Putin considers the Customs Union as “incomplete” has been invited to join the Custom Union as well. In 2012 Ukraine’s President, Viktor Yanukovych, has stated that Ukraine may potentially join the Customs Union in the future, but that the Constitution of Ukraine currently does not allow it. On the other hand, he has also stated that Ukraine will not join the Customs Union. Ukraine is negotiating an association agreement with the European Union, and entering the Customs Union with Russia, Kazakhstan and Belarus would end the chances for this agreement according to the European Commission. In the meantime, the three former Soviet republics forming the Customs Union - Russia, Belarus and Kazakhstan, introduced a common economic space starting from January 1, 2012. All this illustrates that contrary to some expectations, the regional coordinating body of the Commonwealth of Independent States (CIS), is indeed favoring the promotion of friendly regimes in its vicinity and helping Kremlin's supremacy in the area. At the same time, the fragile relationship between the EU and Ukraine, and the prospects for Ukraine to sign an Association Agreement with the EU on December 2011, after five years of negotiations, came to an unsuccessful conclusion, largely due to the imprisonment of former Prime Minister Yulia Tymoshenko that Brussels sees as "politically motivated." At stake are not only the economic partnership, but also the country's political future, caught between historic ties with Moscow and uncertain prospects of prosperity and 'Europeanization' with Brussels. Ukraine has become something as a "geopolitical test" of the EU's ability to influence and democratize neighboring countries on the continent, even when the carrot of integration is not included. The EU leaders made it clear that the deal would not be signed until improvements to the "quality of democracy and rule of law" in Ukraine are made. While the atmosphere is becoming difficult with the EU, Russia carefully watches and offers incentives towards its perimeter without bothering with democratization, stable governance and human rights. These developments signal a declining Western “soft” power in the region, counterbalanced by an increasing Russian economical and geopolitical influence (Popescu, 2006, Wilson and Popescu, 2009). Ever since the break-up of the Soviet Union, Moscow has been trying to increase its sphere of influence in the “Near abroad.” Its gas giant Gazprom has worked hand in hand with the state to regain control of the web of pipelines that are integral to its business and Russia’s geopolitical positioning in Eurasia and Eastern Europe. Especially Ukraine, that before the inauguration of Nord Stream was responsible for the transit of approximately eighty per cent of Russian gas into Europe (and for cultural reasons), has proven to be still a zone of privileged interests. Developments such as proposals for free-trade agreements between Russia and Ukraine and the extended lease of Russia’s Black Sea fleet in return for cheaper gas illustrate the point. According to experts, Russia and Ukraine may even agree for a lower price of gas in exchange for Russia's Gazprom taking control of the country's pipeline network (Pirani, 2010). What makes Russian ascendence so surprising is that on almost all indicators of power – soft and hard - the European Union seems to surpass Russia. Measured only in ‘soft power’ terms, the EU’s lead is even greater (Popescu and Wilson, 2009). The attractiveness of Europe’s successful economic and political systems and its culture more generally, are sources of formidable ‘soft’ power. While the EU is in general better positioned in terms of “soft” power, Russia has been more organized and skillfully took advantage of the EU’s structural weaknesses. In fact, Russia is quicker in achieving its objectives and it frequently uses its leverage to weaken the Union’s influence in the Neighborhood. Aleksandr Lukashenko, the dictator of Belarus, 

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66 Hallbach, U. Vladimir Putin’s Eurasian Union — A new Integration Project for the CIS Region?, SWP Comments, January 2012
67 "Russia, Belarus, Kazakhstan are launching common economic space Jan 1,” Moscow January 1, 2012, Ria Novosti
69 Euractiv “EU ponders ‘losing Ukraine to Russia’ May 15, 2012
despite the recent cooling of his relations with Moscow, is dependent on Moscow’s benevolence. The election of Viktor Yanukovich in Ukraine has provided Russia with a new and important ally, much more docile than his rebellious predecessor, Julia Tymoshenko. Now Moscow is offering its Custom Union to Kyrgyzstan too, an offer that is undoubtedly tied to an increased dependence of the country upon Russia. Moscow’s growing popularity among its neighbors is demonstrated by its fruitful deals. In May 2007, Moscow reached an agreement with Turkmenistan and Kazakhstan on a new gas pipeline to Russia, effectively killing plans for a Trans-Caspian gas pipeline which would have delivered gas to Europe without passing through Russia. Moreover, in 2008 the Russian leviathan Gazprom signed two major agreements outlining a new scheme for purchase of Turkmen gas, aiming to head-off any possibility of Turkmenistan committing supplies to the Nabucco line. The first agreement elaborates the price formation principles that will be guiding the Russian gas purchase from Turkmenistan during the next 20-year period. The second agreement is a unique one, making Gazprom the donor for local Turkmen energy projects. In essence, the two agreements ensured that Russia would keep control over Turkmen gas exports. In the geopolitics of gas, that marked a huge defeat for the EU (and the United States) in the race for Caspian gas. Through possessing the world’s largest gas reserves Russia sought to acquire a significant share of exported natural gas from Central Asia, in order to be able to meet its contractual commitments and influence prices – especially in Europe. Since 2002, Moscow has reached long-term exploration and supply deals with Kazakhstan and Uzbekistan to preempt them from reaching independent exporting arrangements with the West. And the Kremlin has increased its leverage over countries such as Georgia and Ukraine. As Kravets (2011) shows in the case of the Odessa-Brody Pipeline, there was a formidable shift in Ukraine’s executives’ orientation after the Russian government pressured Kyiv to concede to its preferences. With the help of commercial lobbying and pressure from the Russian government and with the incentive of shared benefits in the distribution of rents, in a mix of sticks and carrots, the then President Kuchma changed his initial preference in favor of the Russian proposal, i.e. the reversal of the pipeline flow, which would make it transfer Russian oil southwards to the Black Sea and from there to Mediterranean destinations. More critically from the standpoint of the EU’s quest for diversification, the Russian project South Stream competes directly with the EU (and U.S backed) Nabucco project. Nabucco choices are shrinking as Russia has paralyzed all its potential suppliers and Iran is not a viable solution for political reasons, while Gazprom is building up its influence in Europe and reaching agreements on alternative routes. In the last few years Moscow completed acquisitions of companies, pipelines, and storage facilities in all the Neighborhood countries and in great part of Europe. In November 2011, even the Belarusian dictator Lukashenko that in the past has been very successful in keeping Russia away from domestic gas infrastructure, succumbed to Moscow’s power. Russia has taken control of the Belarus gas pipeline network in an economic rescue deal that helped Minsk survive isolation by the West and increased the Kremlin’s influence over Belarus. Gazprom already owned a 50 percent stake in the pipeline, called Yamal-Europe, which carries about 20 percent of Russia’s gas to Western markets. Most of the rest travels through pipelines crossing Ukraine, which for now, remain outside Gazprom’s control. Mr. Putin said that: “full ownership on the Belarus pipeline will “allow Russia to provide secure transit through Belarus for our energy to customers in Western Europe.” This latest move is another proof of Russian successful game in the region;

71 In 2009 however, the heroclean Turkmenistan-China pipeline was inaugurated, despite Russia’s lobbying against it. However, more crucial for Russia is that most of the Central Asian supplies are locked-up (even if that for Russia means losing potential market shares in China) so that they cannot reach its own most important market, namely Western Europe.
72 Bhadrakumar M.K. Russia takes control of Turkmen (world?) gas, Asia Times Online, July 30, 2008
73 Which was originally intended to reach Gdansk in order to transfer oil from the Caspian Sea (mainly from Kazakhstan) to Poland and from there to the rest of Europe
Moscow is promptly coming in “rescue” of the smaller authoritarian state in exchange for economic benefits, while the EU is isolating it over its depressing human rights records. The Kremlin is becoming a champion in opposing the Western-controlled pipeline projects that would directly link Eurasian energy-producing countries to European markets. The battle of the pipelines is still open, but European notorious divisiveness and slow decision-making play all in Kremlin’s favor.

5.2.5.3 Conclusions

While Europe has passively relied on the Neighborhood’s attraction to the European model, Russia has learned the power of incentives as well as of coercion. Russia offers its neighbors straightforward, concrete benefits, such as open labor markets, cheaper energy and an easy membership in its web of organizations. Europe offers unclear incentives, such as the Neighborhood Policy with its set of overly vague aims. Russia relies on what Nye calls “smart power,” the combination of hard power of coercion and payment with the soft power of persuasion and attraction (Nye, 2011). For instance with Ukraine, its soft power is built on historical and cultural affinity, its hard power was seen in the 2006 and 2009 cut-offs of the natural gas supply and the extension of the Black Sea Fleet. In the last years Russia’s strategy to use “smart power” to convey the idea of an “alternative model to the EU” is much more successful than the EU’s waning influence. Russia devotes more political, economic and even military resources to influencing its neighborhood than the EU does. While the benefits that the EU offers seem attractive, they are also distant and hard to achieve. Russian benefits are more palpable. A widespread frustration with the Western growing demands for reform, coupled with possibilities for shared rent seeking between local post-Soviet and Russian elites, has helped to drive these regimes into Russia’s embrace (Popescu, 2006). Russia’s political offers emphasize the building of alliances with all neighborhood states irrespective of their political regimes. As noted by Wilson and Popescu (2009) “while Russia readily makes use of its black arts of political manipulation to serve its own foreign policy interests, it is also happy to make these techniques available for export to friendly regimes.” Russia’s concept of “sovereign democracy” – a political model that emphasizes the need for states to follow “national paths” to democracy, free from foreign intervention – has found echoes throughout the neighborhood. Russia has today many more sources of soft and hard power than Europe is able or willing to provide in the region. Even a traditional source of hard power, such as Russian formidable nuclear power can simultaneously contribute to wielding soft power. Paraphrasing Joseph Nye, “dictators often cultivate myths of invincibility to structure expectations and attract others to join their bandwagon.” Russian nuclear power for instance can stimulate admiration and fear at the same time, and be used as a double-edged sword to keep its neighbors docile. On the contrary, the EU is devoted to an energy security approach that encompasses concerns over human rights and democracy in producer states. This means that the contest is not evenly balanced, because if the EU ignored its commitment to normative values that would in turn undermine European credibility and effectiveness as a promoter of democracy and human rights in other countries. In the EU energy security is, (despite the trade-offs between governance reform and pure energy interests and some sporadic unilateral member states’ action, i.e. as advances towards Iran), not pursued in isolation from the broader tenets of EU’s identity and strategic presence (Youngs, 2009). This plays to Russia’s advantage, as the Kremlin does not strive to ‘reconcile energy and democracy.’ Nye’s concept of ‘smart power’ that involves “the intelligent integration of networking, defense, development, and other tools of so-called ‘hard and soft’ power into successful strategies,” (2011, p. 209) best describes Russia’s astute techniques in persuading their neighbors to ‘do what they want them to do.’ The array of hard power tools includes economic coercion such as threats of reductions in supplies and trade blockades (Balmaceda, 2008), the presence of Russian nuclear weapons and a formidable conventional army. As noted by

75 Nye, J.S. The future of power, Public Affairs, 2011
Balmaceda (2008), the Russian energy sector has been aggressive in increasing its leverage over the transit countries of Ukraine and Belarus through takeovers of sensitive parts of their energy infrastructure, while in parallel accelerating the development of oil and gas infrastructure in its own territory. More generally, Russian businessmen have acquired assets and extended their businesses throughout the whole area. Russia’s hard power against Georgia has been somewhat less successful but still stronger than the EU’s virtually no military engagement in the region’s security crises due to the EU’s notorious reluctance in using military means to exert power. Consequently, due to the lack of military sticks, the so-called “smart” targeted sanctions have largely proved ineffectual. And when, from time to time, the EU has been willing to introduce coercive measures against the neighborhood, like with the withdrawal of trade preferences from Belarus on the grounds of disappointing records on human rights, Russia hurriedly opted to rescue the neighbor, in exchange for pipelines. But apart from Russian hard power, Russia leads in the general exposure of the Neighborhood to its culture, language and media outlets. By contrast, hardly anyone watches EU-sponsored TV broadcasts. All this made Russia a more attractive state for populations in the region than it was in the 1990s, and that the EU is today.

Realists warned against the EU’s democracy and human rights “pilgrimages” in the region and stressed the importance of astuteness and prudence in competing with Russia. Nevertheless, the EU values-based influence was indeed the utilized tool as a counter-balance to Moscow. In short, in yielding influence in the Neighborhood, Russia outplayed the EU. At this writing both the depth and the nature of the EU’s engagement in the area remains unclear, as both its seduction powers and coercion efforts have produced slim outcomes. The prospects of significant supplies from Central Asia entering Europe other than through Russia seem thin as well in the medium term.

To conclude, the EU-Russianshared neighborhood is likely to remain an area of political tension for some time. In this area Russia and the Western powers have been engaged in a long struggle for control of the transport corridors bringing oil and gas from Russia and from the Caspian Basin to Europe. Thanks to its expanding influence in the region, Russia is leading in the battle. For this reason, the Common Neighborhood is a region more likely to generate conflict than to engender cooperation. As Dmitri Trenin, director of the Carnegie Moscow Center puts it: “Eurasia will be the battlefield of clear competition between Europe and Russia in the years to come. EU and single Member states will aim to reach the land-locked Central Asian’s gas reserves, so there is no room for compromise in the area and I foresee a good fight between the two.”

Although low-key cooperation, in managing daily issues in the zones of “frozen conflicts” and in guaranteeing the security of energy transit, is still possible.

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76 A 10 bcm pipeline is not considered as significant diversification in this thesis (see Chapter 10)
77 Interview with the Author during the presentation of Trenin’s new book “Post-Imperium: A Eurasian Story” at Harvard University, October 5, 2011
5.3 The (Neo) Liberal view

As already mentioned the main challenge to the Realist position came from a set of Liberal theories. The Liberal thought argues that economic interdependence would discourage states from using force against each other because warfare would threaten each side's prosperity. Moreover, in order to lower “transaction costs” given by economic interdependence, countries decide to delegate some functions to international institutions such as the International Energy Agency (IEA) and the International Monetary Fund (IMF) that help to overcome selfish state behavior, mainly by encouraging states to forego immediate gains for the greater benefits of enduring cooperation. Looking at the EU-Russian relationship this confronts us with a puzzle: namely, how is it possible that in the past year the EU and Russia have cultivated such a contentious diplomatic relationship and at the same time traded large and ever-increasing quantities of natural gas? Moreover, if policy makers and managers in the EU and Russia understand that a more coordinated approach would result in greater benefits for both sides, how to make sense of the fact that there is no single binding institution regulating the relationship? Liberals and Liberal institutionalists adapted their own theories to make sense of this puzzling reality; the answer is to be found partly in the structural anomaly of the European Union. Secondly, in Putin’s growing autocracy that rejects any “universal” principle such as human rights, international law and democracy. Therefore, the EU-Russia institutional predicament should be explained by two concurrent structural factors:

1. The “weakness” of the current EU internal institutional arrangement
2. The deficiencies of Russia’s undemocratic system

5.3.1 Weaknesses of the current EU internal structure

5.3.1.1 Introduction

At this writing there are still twenty-seven internal energy policies and twenty-seven foreign (external energy policies) in the European Union, often contradictory and often irreconcilable. All core energy policy competences are still the responsibility of the individual member states. In the liberal context this is exactly the crux of the problem; that all member states continually emphasize the importance of a common energy policy and a coherent external stance in relation to Russia, but as soon as practical implementation is called for, the Commission’s initiatives are thwarted and member states resist any attempt to curb their national competencies. Liberals admit that this situation is in great part due to structural constraints given by the different historical and regulatory paths that led member states to different “energy mixes” and diverging strategies to achieve energy security. That in turn, spurs different strategic responses among the member states and the energy companies, on how to pursue their energy policy and how to even conceive, for the purposes of our case, their relations with Russia. No EU member state displays the same political, historical, ideological and cultural background and the geographic proximity or distance to Russia makes their policies diverge. In their domestic politics, member states respond to different political and societal incentives and several national traditions, which place them in vastly different positions. Despite these challenges, Liberals argue that the best way to act for “the common good” (Helm, 2007) of the Union is to delegate more power to the supranational level, that would enhance the EU’s strength and devise an instrument to “speak with one voice” in energy matters, that would in turn increase the EU’s leverage power in its relations with Russia. From the liberal standpoint, the EU states should learn to change their narrow definition of national interest, by endorsing the benign influence of international institutions that act for the “common good.” Following this logic, the basic problem is that the European Union does not have full competency over the external energy policy. From the liberal perspective, the problem stems from the fact that the bigger member states are still
ex inexplicably not convinced that a truly common European energy policy is in their interest (Umbach, 2010; Helén, 2010; Schmidt-Felzmann, 2008). Liberal theorists contend that as long as the security of supply policy is left outside the realm of EU policy-making, member states’ weakness will persist and member states will fail to forge an effective strategy vis-à-vis their main supplier, Russia. Hence, Liberals inquire: if policy makers and managers in the EU countries are aware that a coordinated approach would result in greater leverage and contractual power over Russia (and other suppliers), why is the EU’s declared solidarity still missing? This school of thought tries to answer the question by analyzing the processes, problems and dilemmas generated by the EU’s energy security policy and the complicated contours that the multilayered relationship between the Member States, the European Commission and Russia has taken. They develop the discussion along several institutionalist points. This chapter seeks first to disentangle the liberal propositions and second, to explain why this approach does not provide a satisfactory answer in terms of my central question.

5.3.1.2 The bumpy road of the EU’s gas governance

In the liberal perspective, in order to gain a better understanding of the EU’s approach towards Russia as a whole (i.e. the European Union and its member states) it is necessary to focus on the characteristics of the EU and look at the gradual transformations of its internal structure. A number of important works focused on the characteristics of the EU and its internal contradictions in dealing with exogenous challenges [(Stern 1995, Van der Linde (1991, 1994) and Bressand (2010)]. There is thus an already well-established debate on the historical evolution of the EU’s energy competencies and its multilevel relationships with member states and external producers. I will not review this long and lively debate, ranging for example from Umbach (2010), Helén (2010) and Schmidt-Felzmann, (2007). My intention is rather to highlight that according to this strand of theory the EU’s main weakness stems from the fact that it has no full mandate on energy matters and that the partial loss of control by Member state governments achieved with the Lisbon Treaty, has not necessarily curtailed their capacity to act.

From the Liberal lenses, the break-up of the Soviet Union coincided with an enthusiastic embrace of globalization in the West. At the time it was believed that since globalization had triumphed, the EU’s organizational features had to be expanded to the Post Soviet space, in order to create what was dubbed as a “global village” in which the extensive reach of human relations and networks was matched by a free and liberalized market economy. As far as the energy market was concerned, in the 1990s the European Union believed that Russia would readily accept the extended European internal market networks and the transposing of the EU’s regulatory norms, notably the famous acquis communautaire, into the Russian national context in order to limit the risks associated with investment partnerships, facilitate funding needed to develop new gas and oil fields and the associated major infrastructures, and enhance transparency in energy trading. Today Liberals admit that Wilsonianism marked this phase in world politics, i.e. a utopian belief that institutionalizationper se would suffice to forge cooperation and discipline in world affairs. As naïve as it might seem from a present day perspective, in line with the Liberal standpoint, the European Union adopted the so-called “Markets and Institutions” (Correlje’ and Van del Linde, 2006) approach to its general energy policy, and also more concretely, in its dealings with Russia. This approach envisages an international energy system integrated through markets and institutions. In the 1990s the prices for energy were low and the market was expected to provide by itself for Europe’s energy security, according to the neo-liberal paradigm that was popular at the time. Many critics pointed out that Europe was rather naively expecting that its regulatory export and economic ultra-liberalism would provide for energy security (Van der Linde 2007, Youngs 2009, Barysch 2010). However, by the early 2000s the world was turning to the “Regions and Empire” logic, or in other words a fragmented global system dominated by power politics. In Russia, by the mid 2000s it was clear that Putin’s climb to power would include a
resurrection of a “strong Russia” and the withdrawal of all the ‘concessions’ made in the period of its relative weakness. Putin was quick to recognize the importance of energy as a strategic tool arguing that it was energy which “to a large extent determines Russia’s place in World Politics.”

Putin mastered the politics, economics and even the technical details of the energy industry. He also made clear, by breaking up the respected Yukos oil company and imprisoning its chief executive, Mikhail Khodorkovsky, that he would allow no one to challenge his authority. The liberal approach emphasizes the essence of Putin’s project to use high gas prices as the basis for assertive foreign policy, while attempting to play “divide and rule” policies with the Member States, as a reason for the fragmentation of multilateralism in energy (Umbach, 2010; Rosner, 2009). In James Sherr’s words, “Putin shifted from geopolitics to geo-economics for political gains.”

According to this approach, one of the strongest mistakes on the part of the EU, was its closure in the so-called “Fortress Europe,” as a response to growing Kremlin’s assertiveness, driven by the more general growing securitization context following the 9/11 terrorist attacks. The response of many governments has been to turn inwards and to seek to defy the realities of interdependence by elevating narrow definitions of national interest. To make things even more complicated, while the European Commission hand in hand with the United States was moving towards a harder and more politicized stance towards Russia, individual member states and their energy companies continued to cultivate fruitful energy relations with Gazprom, in line with European Commission’s own market paradigm. Thus, according to the Liberals, the problem is not simply that the member states defined energy interests differently according to their energy mixes, but more that they were not willing to surrender their sovereignty on behalf of a ‘common EU good.’ Hence, first, there was a ‘common good’ embodied in the EU Commission, and second, the problem was that the governments that had long-term friendly relationships with Russia were lacking confidence in the EU. Thus, they preferred to retain their sovereignty in energy matters. So, it was a problem of “confidence” in the EU and of the fact that the states were “back-in” and unwilling to pool additional sovereignty in favor of the Commission. Thus, ‘state interference’ towards progress for a common good stalled, because states wanted to shape energy security policy unrestrictedly according to national preferences.

Nevertheless, the EU has gradually been able to gain more powers. When the Lisbon Treaty entered into force on 1 December 2009, it opened up a new chapter in European foreign policy. The post of ‘High Representative of the Union for Foreign Affairs and Security Policy’ was considerably upgraded. Unlike her predecessor, the current High Representative, Catherine Ashton, sits in the European Commission, chairs the EU council of foreign ministers, and has at her disposal a brand new European External Action Service that is nothing less than the EU’s very own Foreign Office. In the liberal view, as foreign policy becomes more Europeanized, it seems only natural that external energy policy should follow. And indeed, despite the fact that under Article 194 of the Lisbon Treaty, EU member states still have competency over their energy choices, Brussels is actively pushing for changes. In September 2011, EU Energy Commissioner Günther Oettinger in Brussels unveiled his plans for a new external energy policy for Europe. He highlighted the potential of an increased weight in negotiations “if we are able to speak with one voice.”

The most concrete element of the legislative and policy proposals that Oettinger presented, proposes for member states to run all new and existing bilateral energy deals with third countries past the Commission. There are some 30 intergovernmental agreements on oil and twice that on

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80Energy Strategy of Russian for the Period up to 2020, approved by the Decree No.1234-p of August 28, 2003, issued by the Government of the Russian Federation, Accessible at:
gas in place today, the Commission estimates. The only reporting obligation that exists to date is for member states to report gas deals to the Commission under a 2009 gas security of supply regulation. The Commission’s new proposal strengthens and extends this reporting obligation to all intergovernmental deals ‘which are likely to have an impact on the internal market for energy or on the security of energy supply.’ Before an agreement enters into force, the Commission would have the right to carry out a ‘compatibility check’ to verify that the deal being formulated is in keeping with EU law. Thus the EC is moving forward, but still quite not satisfied. As Pierre Vimont, executive Secretary General of the European Union’s new European External Action Service explained, “we are very far away from achieving a strong and coherent position on what a common vision on “External Energy Policy” should be. States want to retain their national sovereignty because they think that if they work on their own they have a better leverage and they will achieve better deals. In the meantime, Russia plays putting one country against the other.”

Liberal theory highlights the historical differences in the national energy mixes, showing how tricky it can be to establish and maintain a common stance in face of large differences of the constituent parts. However, the problem could be solved if Member States accepted a common internal energy market and a coherent external voice that would eliminate the actual structural differences. The European Commission would take the lead in speaking under the slogan of “one for all.” According to the Liberals if the institutional diversities were eliminated, then the particular energy situation of each member state would not matter anymore. I believe that the causal arrow runs on the other direction. There is such a persistent institutional diversity, because of the very fact that the rate of dependency and the particular situation of each member state vary greatly. The biggest divide is between New and Old member states, but also between large and small gas importers, and there are still countries that are net exporters (see Figure 6).

**Figure 6: Natural Gas Import Dependencies of Member States in 2007**

Source: Data are compiled from Eurostat’s webpages, available at <http://ec.europa.eu/eurostat>. Notes: Imports include Member State to Member State gas trade. Import dependency = net imports/gross inland consumption. Negative numbers indicate that the country is a net exporter. Values over 100 per cent are possible due to changes in stocks.

Interview with the Author, Harvard University, October 11, 2011
Therefore, Liberals argue if only member states managed to achieve some convergence towards a “common model,” then they would be stronger in talking to the outside producers. The Liberals don’t tell us though what this “common model” would look like. We can assume that it would somewhat resemble the so called Anglo-Saxon model, due to EC’s frantic efforts towards liberalization and due to the powers of DG Comp. Traditionally continental Europeans tended to favor a more stringent government and have relied on national firms, most often public utilities, to take charge of the major part of their oil and gas supplies and to reduce dependence by promoting technologies such as nuclear power. From a public policy perspective, the interaction between political actors in continental Europe has relied on an “iron triangle” model where industrial (i.e. energy) investment decisions were often carried out in a three-sided tight relationship between the government, the trade unions, and a particular industry or interest group. The continental business mentality has also relied on a much more regularized relationship between the important actors. By contrast, the Anglo-Saxon model of capitalism is wary of the regulatory overreach that would cripple their industries. Therefore, its public policy decision-making is better depicted by a number of overlapping and loosely connected policy networks and communities that vary according to the issue discussed and the interest promoted (Van der Linde, 2010). The model adopted by the European Commission is very close to the latter; therefore if any “convergence” were to emerge, states such as Germany and Italy would have to “harmonize” political practices deeply rooted in national institutions, which is never an easy task. But the question remains: is that a desirable thing and how would it precisely contribute to enhance the EU’s energy security? Liberals argue that the main impediment to greater unity is the unequal dependency on Russia’s gas faced by old and new member states, and that the challenge in reaching a “common voice” was exacerbated by the 2004 enlargement eastwards. Let us briefly review this set of arguments.

5.3.1.3 Asymmetric exposure to the “Russian risk” between Old and New Member states

With the enlargements, not only defining the EU identity became more and more complicated, but also in energy-related matters it increased the asymmetric exposure to import-dependency from Russia. The biggest marker of the divide became the gap between the ‘Old’ and the ‘New’ member states. As we know, there are countries with low dependence on Russia (Spain, Sweden, Portugal), a group exhibiting medium dependence (France, Italy, Germany) and countries with high dependence on Russia - some of them obtaining 100 per cent of their imported energy from Russia (Finland, Latvia, Lithuania). Dealing with these differences will become increasingly important in a situation where domestic production is in decline and the import dependency on Russia will increase in the future.

Table 6: Dependence of some EU countries on Russian Gas in 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Dependence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>100%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>77.6%</td>
</tr>
<tr>
<td>Germany</td>
<td>36%</td>
</tr>
<tr>
<td>Finland</td>
<td>100%</td>
</tr>
<tr>
<td>Greece</td>
<td>76%</td>
</tr>
<tr>
<td>Italy</td>
<td>27%</td>
</tr>
<tr>
<td>Latvia</td>
<td>100%</td>
</tr>
<tr>
<td>Hungary</td>
<td>60%</td>
</tr>
<tr>
<td>Romania</td>
<td>27%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>100%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>52%</td>
</tr>
<tr>
<td>France</td>
<td>14%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>98%</td>
</tr>
<tr>
<td>Austria</td>
<td>49%</td>
</tr>
<tr>
<td>Belgium</td>
<td>5%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>92%</td>
</tr>
<tr>
<td>Poland</td>
<td>48.15%</td>
</tr>
</tbody>
</table>

Source: European Commission, Staff Working Document, 2011
In absolute terms the largest importers of Russian gas are Germany, Italy and France. In their case we can talk about “balanced interdependence” with Russia because these countries are big consumers but at the same time enjoy a well-diversified energy mix. They provide the highest revenues that Russia needs to maintain its poorly diversified economy, thus Russia is by no means a threat for these countries. However, the case of Eastern European countries is different. In Nye’s words “Russia and the Germans have a degree of balance in interdependence. That might be true but it does not help the smaller states. We are clearly talking about asymmetrical interdependence in that case. German rationale for an increased supply security by diversifying the supply routes is understandable, however Germany did not hold itself back from building a pipeline that circumvents Poland (and Ukraine), showing that the Nord Stream project did not happen in the spirit of EU solidarity.” Germany followed its narrow national interest as it was shown in the lack of consultation with Poland for the construction of this new Baltic gas pipeline coming from Russia. Harvard’s Nye further argues, “manipulating the asymmetries of interdependence is an important dimension of economic power” (Nye, 2011). Russia’s attempt to gain power by structuring market asymmetries, if tried, could be more successful in the case of the Eastern countries, which are the most exposed. In addition, a more fundamental divide between the ‘new’ and ‘old’ member states regards the general perception of Russia: there are those who view Russia as a friendly partner and have “special” relationships with the Russians (Italy, Germany, France), then the “pragmatists” that see it as a potential partner occupy the middle ground, and at the other extreme are the frosty states who for historical reasons see Russia as a threat and are wary of Russian expansionism (Leonard&Popescu, 2007). Among the “frosty” countries Poland has been the worst alarmist, but its tone has somewhat changed recently. According to the liberal line of thought, the persistent disconnect among the interest and perceptions of different member states led to the fragmentation of the EU’s energy policy, which in turn weakened its position in the negotiations for the renewal of the PCA and the ECT with Russia. These divides have created a major weakness that has to be addressed in two ways: first, by creating a real common internal energy market, which would enhance the energy supply security of all the 27 member states. Second, by agreeing on a shared external policy vis-à-vis Russia. This study however argues that the European Commission should strive to pursue the first objective primarily and distance itself from highly politicized “pipeline politics.” This way of doing politics undermines its traditional role as a steward of the market principles. This study also contends that the EU should promote further liberalization of the EU’s internal energy market accompanied by a real interconnection of the energy infrastructure first, and then think about the external dimension of its energy policy. Some scholars recommend a European external energy strategy that would be deeply incorporated into the Common Foreign and Security Policy (CFSP) framework (Umbach, 2010; Baran, 2007), others believe that the CFSP has not enabled the EU to assume an international role due to the major role retained by the Member States in the decision-making system of the CFSP, compounded with their national egoism, distinctly divergent foreign policy interests, and an inefficient decision-making system in the CFSP, all of which make it a too “weak” institution for collective action (Checchi, Behrens, Egenhofer; 2009). In any case, liberal scholars agree on the fact that solidarity between member states should be understood in the sense of a diffuse reciprocity over time and not in the realist quid-pro-quo terms, but rather in the motto “despite our national differences if we work together we will all be better-off in the long run.” They remind that this was the spirit that guided people like Robert Schuman or Jean Monnet when they spoke of solidarity and the common destiny between the free states of Europe. Also, liberals warn that today narrow interests and egocentric views are informing policy-making in Europe. The situation is due to a broader geopolitical and economic paradigm change. Europe is facing difficult times when getting 27 members of the EU to stand shoulder-to-shoulder is proving extremely hard. In the midst of the financial crisis it is very challenging to fashion a political strategic vision and to define a perception of where the EU's common interests stand. However, according to liberals, the EU has to find a common vision and give

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new vigor to its common interests, because only if the EU acts together its relative strength and credibility will be maintained.

5.3.1.4 Criticisms to this view in connection to my central question

While I agree with the broad family of liberal theories that intra-EU solidarity and cooperation are crucial to its energy security, this study does not believe that speaking ‘with one voice’ by thwarting national regulations and preferences is the right way to go. If ‘speaking with one voice’ means that the EU and its member states must, if and when energy flows are jeopardized, defend the interests of all member states, then ‘a common voice’ is a desirable and beneficial thing, to be supported by internal gas interconnections and joint crisis mechanisms, in a spirit of solidarity. However, given the member states’ inherent differences in their energy mixes, taxes and regulations that respond to peculiar national needs, having one common external energy policy with its super-center in Brussels, is not economically desirable, attainable or affordable, nor it is democratically accountable and legitimized.

Moreover, more European convergence has thus far not been achieved not because the majority of the member states don’t trust delegating their sovereignty to the Commission, as it is commonly lamented by liberal observers, but simply because the member states are wary about compromising their independent interests and varying agendas in energy matters. In states like Italy, Germany of France the big utility companies see themselves as “gatekeepers” (Finon & Locatelli, 2007) of their domestic markets. Again, in Finon and Locatelli’s words: “One of the contradictions that reveals the entanglement of interest and objectives is the fact that major member states (Germany, France, Italy) do not perceive a real advantage to ceding more powers to the EU to manage energy foreign policy and energy foreign trade, in particular when it involves their foreign relations with Russia acting as a geopolitical power with energy.” The sole “lack of trust” objection, would not explain the wide array of policy sectors where the Member States have already pooled sovereignty and where the EU has now complete powers. Hence, from the perspective adopted in this study, the liberal stress on the lack of trust in the EC is viewed as an inadequate response to the difficulty of reaching a common position. Yet, this is not to say that the member states have or should have complete trust in the European Commission.

In the last few years, the EC, despite officially claiming that it does not support any diversification project in the Southern Gas Corridor and besides its admirable goal of striving to secure a clean and environmentally sound energy mix, has seen itself engaged in actively promoting highly politicized projects in order to diversify energy consumption away from Russia. In that sense, the EC is playing a dual role as catalyst for competitive and environmentally sound energy markets and as a promoter of long-term energy security (i.e. with promoting “European” projects such as Nabucco and the Trans-Caspian Pipeline that would provide gas directly from Central Asia, circumventing both Russia and Ukraine). Thus, despite its liberalization drive, the Brussels-led stance towards Russia proved to be equally multifaceted and politicized as the ones of single member states. Such an approach only fueled mutual mistrust between Russia and the EC, which largely failed both to place itself as an “honest broker” to represent the interests of the member states, and also to mediate between member states and Russia. If the EC wants to take a more coherent stand, it will have to rethink its role and find a good balance between laissez-faire and improper intervention. The Russian reluctance to comply with the European normative rules should spur the Commission to be innovative and resourceful in order to devise a better solution, respectful of the concerns of both sides instead of engaging in ‘pipeline politics’ like it was done with the Nabucco project. Trying to meet its goals of creating a single European gas market by 2014 that would in itself create a liquid ‘pool’ and preempt Russia from using its monopoly power could be a divergent and more reasonable way of thinking. Further, the EU could design a general framework for relations with energy-supplying (especially Russia)
and transit countries and the energy enterprises, for a multi-level discussion on energy security. In that sense, energy security would become a more frequent topic of discussion at the European level. Also, the EU should push for a better and deeper coordination from the angle of environmental and energy efficiency issues, which are both areas where Europe can do more and be more easily in the vanguard, both at the regional and at global levels. That could be best done through the promotion of a forum as a platform for discussion and the integration of views about energy regulation, climate, and more broadly, a dialogue on the definition of energy security which as we have seen, differs strongly among producer and importer countries, but also just within countries with a different energy mix.

Lastly, this study disagrees with the liberal claim that the 2004 and 2007 enlargements made it much harder to obtain a common EU energy policy. Admittedly, the enlargements increased the asymmetric exposure to security of supply risks and underscored the fact that the internal market really necessitated cross-border interconnectors for energy trade and coordinated crisis mechanisms. However, even before the enlargement, the single energy mixes of the member states were diverse both in the distribution of the various sources of energy and in their import-dependency from Russia, and this lied at the core of their different external energy policy approaches. An important factor must be noted here is crucial that Europe finds its way to act in a real spirit of loyalty and mutual solidarity, otherwise the credibility as a whole could be tarnished, and offer justification to be exposed to ridicule, as it occasionally happens in Washington and Moscow alike. However, it is undeniable that EU member states have different political and economic interests in their relations with Moscow and the EC’s forceful pursuit of the “common interest” by envisaging common European energy contracts and common regulations does not speak in a spirit of free economic competition and pluralism that the EU seems to promote.

Summarizing, this study does not see a direct causal link between the fact that state interests can be independently created and pursued outside the interactive framework of the CFSP, (and thus Moscow can easily pursue the ‘bilateralization’ of its energy cooperation with individual European states and firms alike), and the failure to come up to a legally binding institution regulating the EU and Russia’s energy cooperation. This study holds that the lack of binding institutions is a consequence of the political unwillingness of the dominant actors that are benefiting from the status quo. Even with a more empowered EU at the central level, these interests would (and should) persist. Therefore, reducing the institutional weakness of the EU would not increase the likelihood of success of its multilateral policies. The national energy policies reflect national priorities with respect to regulations, taxes and sources. Hence, the “weakness” of the EU energy structures does matter, but it is not the direct cause of the lack of multilateralism in the case of the EU and Russia.

5.3.2. Russia’s autocratic turn

Another Liberal explanation of the failure of multilateralization of the relationship between the EU and Russia is offered by the rise of “realpolitik” in the autocratic and centrist Russia. Hence, alongside with the EU’s structural deficiencies, parts of the problem are the structural features of Russia’s political system.

With Putin’s rise to power the identity of the Russian state has dramatically changed (Barkanov, 2011). Central to this change has been a new interpretation of the sovereignty concept that has become even more deeply embedded in the Westphalian notion of sovereignty. Vladislav Surkov, Kremlin’s chief ideologist under Putin, has carried forth into the twenty-first century a vision of “sovereign democracy” evocative of Hobbes’ and Bodin’s idea of “sovereignty,” where the Kremlin and Gazprom together make a symbiotic Leviathan and there is little space left for the “democracy” component of the term. Within Russia,
President Putin reversed the halting trend toward democratization that occurred through the 1990s by controlling the appointments of the governors and the upper house of parliament, and consolidating control over most broadcast media (Orttung, 2009; Pascual, 2010). He orchestrated a change in rules for parties and appointed Kremlin officials to corporate leadership positions in gas, oil, rail, airline, shipping and other industries. With power thus centralized, Putin rejected in hostile tones any external criticisms of Russia’s political system and policy choices. From a liberal perspective, in fact, this vision of sovereignty that leaves Russia intolerant to values and rules imported from the outside is explicative of its little regard for international law making and multilateral institutions. When Russia does grant some rights to international institutions, it requires its own active participation in the decision-making on the multilateral level. Therefore, sovereignty-related considerations have stayed on the way of the ECT’s full application. Liberals argue that Russia’s disregard of international principles and practices exemplify its Hobbesian belief that the Leviathan (Gazprom and/or the Kremlin) holds absolute sovereignty over his territory, which allows little space for transnationalism. In the liberal West, that has once again, just confirmed Russia’s reputation of a country disregarding the supremacy of law. Russia sees itself as a state in its own right and has no plans to become part of the European common political and economic space; consequently, it has no immediate interest in bringing its regulations in line with European legislation. Therefore, Liberals argue that a stronger central political guidance is required in Brussels to face Russian forceful rhetoric.

In the aftermath of Russia’s refusal to adopt free-market legislation in the energy sector, a gap was created in the EU-Russian dialogue in spite of the efforts to keep the process formally ongoing. Europe was expecting a country congenitally distrustful of decentralization and liberalization, to adhere to these “shared norms and values” that would facilitate cooperation and create legal alignment. Russia not only does not share these values but it does not even bother to comprehend the European Union’s modus operandi. After the failure to persuade Russia to adopt free-market legislation in the energy sector, the European Union struggled to find a new position towards Russia. It tried to incorporate some of the principles of the ECT in the new PCA, but the Russians were firm in their refusal. Even more, in January 2009 President Medvedev had suggested that a thought has to be given to either amending the operating Energy Charter (provided the contracting parties approve the idea), or drafting a new multilateral document. By April 2009 that position has changed into one "leaving no alternative." At the end of April, President Medvedev said that Russia has expressed a need to provide legal basis of relationships with its energy consumers and transit countries. Part of this was a five-page "Conceptual Approach to the New Legal Framework for Energy Cooperation” that the President had posted on his official website (Medvedev, 2009). After that moment, the Russian leadership began pushing the second option to develop a new set of documents based on Russian objectives and goals. As a EU energy expert pointed out,“Replacing the ECT with a new legal framework to accommodate Russia appears frivolous and difficult in substance.” However, a way to accommodate Russian legitimate interests has to be found. Alternative approaches will involve a diplomatic solution to modernize the ECT, but the EU should not consider giving up on a treaty that is codifying elementary rules to safeguard energy investments and tradeand that has been already ratified by 46 states. According to Europe’s liberals, giving up on the ECT would mean acknowledging defeat and retreating from rules-based multilateralism to a system where the “balance of power” dominates. While Russia has not ratified the Energy Charter Treaty and does not intend to do so in the future, it continues to affirm that it will follow its key principles. Hence, it is the EU’s interest to keep Russia actively engaged in the process. In sum, in the Liberal interpretation Russia had no real reasons to withdraw from a document that would codify some elementary rules present in any bilateral investment treaty. Consequently, in this view, the refusal is certainly politically motivated, since as long the Treaty is not signed Russia can engage in expropriations like it did in the

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Yukos case. To borrow van Agt’s term Russia’s ‘tabula rasa,’ the reservation of its full sovereign discretion over energy sector affairs is more absolute than all its technical issues with the ECT (Van Agt, 2009). Thus, the liberals believe that Russia’s refusal of the ECT stems from its ‘high’ vision of sovereignty and its rejection to follow Europe’s models and standards.

5.3.2.1 My reservations

I partly disagree with this view. While Putin’s authoritarianism and sovereignty concerns, certainly contributed to the failure of multilateral energy arrangements, they are not the direct cause of the lack of multilateralization with EU. Despite Russia’s political system, Russia joins the international institutions that it finds responding to its own interests. Russia is still a member of the Organization for Security and Cooperation in Europe (OSCE), and joined the Council of Europe in 1996, so it has some institutional ties to the continent (Rutland, 2012). Russia recently joined the WTO and as it will be shown in more detail in the case study about the Kyoto Protocol (Chapter 7) Russia was instrumental in bringing that multilateral treaty into being. Thus, Russia does not inherently oppose multilateral organizations due to its autocratic regime, but it selects those that are perceived as advancing Russia’s “national interest” and most importantly those that are promoted by the most important actors in the system, in energy namely Gazprom. While there is an important dynamic connection between Russia’s ‘reaffirmation’ of its sovereignty and Putin’s shift towards authoritarianism, these aspects do not directly explain the ‘deadlock’ in the Russia-EU multilateralization. The most proximate cause of the withdrawal from the ECT is that simply Russian leadership sees nothing to gain from accepting the ECT-like discipline.

5.4 The Constructivist Perspective

The following sections will try to illustrate the Constructivist perspectives on the research question under investigation in this study: despite the EU and Russia’s highest degree of economic interdependency there is no binding institutionalization of the relationship, why is that the case? Whereas the dominant realism and liberalism tend to focus on material factors such as power and economic incentives, constructivist approaches emphasize the impact of norms. Constructivists argue that there is a “clash of paradigms” in the relationship, as a consequence of the different “framing” of main norms entangled in the relationship. The insufficient clarification of what the common standards are, and the difficulty in even defining the problems poses an immense challenge in negotiating for example, a binding Treaty between the EU and Russia. I will emphasize in particular four contested norms that underpin the argument for an insufficient and inefficient cooperative effort. First, the sovereignty principle, second the reciprocity principle that is claimed by both sides and it is creating mutual misperceptions, third the transparency in the provision of information between players and forth the interdependence concept. Of course, there are other contrasting norms such as the Western capitalism and the Russian version of state capitalism or the Russian “democratic multipolar world” in contrast to the EU’s “democratic multilateral” world.” However these are not invoked when the EU and Russia debate their interdependent energy relationship and are not directly impacting on the degree of institutionalization between the EU and Russia. Hence, my choice is motivated by the fact that issues such as reciprocity, information sharing, and sovereignty are embedded in the more general identities of the two blocs, and thus shape the way they formulate their energy cooperation. Against this background, the chapter discusses from a constructivist perspective to which extent and why the two blocs have fall short in the achievement of the goal of multilateralization of their energy relationship.
To do this, the chapter is divided into five sections. First, a brief review of the constructivist literature is presented. This helps to provide the context by outlining the ways in which this theory conceptualizes the contentious relationship. In the second section, issues that have arisen with respect to the governance of the troubled relation are presented – here the key point of contention has been with respect to the operationalization of two partners’ norms, an attempt that has largely failed because there is no consensus on the crucial norms’ meaning. This discussion leads into the exploration of the norms on which the Russia – EU cooperation should rest and over which it has stalled—namely the norms of sovereignty, reciprocity, information sharing and interdependence. There is already substantial energy interconnectedness in place, but the difficulty to reconcile the way basic norms should be framed in the two contexts yields to “different conceptions of reality.” In the constructivist view, strengthened institutional dialogue, which would create the potential for norms’ collusion, and the subsequent creation of “new” shared identities represent a possible solution.

5.4.1 The EU and Russia: preparing the ground for a Constructivist perspective

Constructivism holds that people construct their own understanding and knowledge of the world, through experiencing things and reflecting on those experiences. When learners encounter something new, they reconcile it with previous knowledge and experience. This representation is continually open to modification, its structure and linkages forming the ground to which other knowledge structures are attached. Learning is thus an active process in which meaning is accomplished on the basis of experience. Constructivists focus on the role of norms, arguing that norms, but even interests and identities of states are highly malleable and interlinked products of specific historical processes. Just as Realism and Liberalism, Constructivism is not a single theory, as its thought has evolved considerably over time. Nevertheless, the common theme in each of its strands is the capacity of discourse to shape how political actors define themselves and their interests, and thus how they modify their behavior.

In the last decade the relationship between the EU and Russia has gone through a period of deterioration that is rooted in a series of misunderstandings and that resulted in a gradual drifting apart of the two neighbors. The main challenge of the Russia-EU deadlock is the contentious understanding of most of the leading norms on which the relationship is based. The problem started with the European ambition to export its free market norms and regulatory principles in the 1990s. An increasingly self-confident Russia began criticizing the basic fact that it should align its rules with the norms and standards of the EU. Subsequently, the EU failed to modify its approach in face of an evident transformation of the Russian state under Putin towards a much ‘higher sovereignty’ compared to the Yeltsin years (Barkanov, 2011). Many constructivist studies have pointed out a “normative gap” or the failure to organize consent around the leading norms in the two blocks’ cooperation. According to Constructivists, the latter is the outcome on one side, of Europe’s “regulatory imperialism,” and on the other, of Russia’s ambitions as a “great power” and the tendency to prefer modes of manifest realpolitik objectives and out-fashioned (19th century) modes of foreign and energy policy instead of adopting a more cooperative stance towards the EU.

Assuming that the relationship between the EU as a whole and Russia approximates closely to the ideal type of “balanced energy interdependence” we can outline the following obstacles toward multilateralization:
1. The identity question that bifurcates into two concomitant problems:

   a) The EU’s lack of a Common Identity
   b) The lack of a Common Identity with Russia

The next section will explore first, the intra-EU lack of a strong common identity and outline the problems that a fragmented identity poses when the EU tries to talk to the “outside.” Second, it tries to explain what are the drivers of the EU and Russian ‘normative gap’ (Gomart, 2008). Identities are constructed and they evolve in time, and they also shape the way states understand and respond to different situations (Ruggie, 1993). Therefore, it matters for example, whether the EU addresses reciprocity in the same way as Russia does, it counts how Russia addresses power and what Russia’s view of sovereignty entitles the State to do. We will take on these questions in the next sections.

5.4.2 The EU’s lack of a common identity

The development of the European Union has been a spectacular success. All European citizens benefited from cheaper products, cross-border investments, and job and study opportunities. The advantages of the European Union common market havemade Europeans wealthier and on average the aquis communaunataire improved the organization and the quality of European citizens’ lives. Thus, one does not have to be a Euro-enthusiast to notice the benefits that the Union has offered in the last sixty years. Since the end of the cold War the European Union (EU) has become active in new policy fields, not strictly connected to the common market, including former core competencies of the respective nation states – like constitutional policy, social policy, security and defense, immigration, internal security and many others. In that sense, the EU is undoubtedly the most successful world’s bloc in terms of pooling sovereignty. Pooling sovereignty is a political act. Europe is a remarkable example of an experiment that started with economic integration but gradually involved the pooling of sovereignty in an amazingly large range of issues alongside with the common market (Rodrik, 2011). But the EU is managed by technocrats and supervised by high governmental officials. That is, it is run by faceless élites. Its executive body, the European Commission, has very indirect ties to the public. Therefore, the stronger the Commission gets, the more pressing the “democratic deficit” seems to become. Regardless of the EC’s undoubted expertise in numerous policy fields where the EC has proven capacity and efficiency, and constantly sought to improve the European Union, when things go wrong national identifications experience a rebirth and strengthen their reach. To date, there has been a lively academic debate on who governs the European Community in terms of relative power of the member states as compared to that of the Community institutions, above all the Commission (Habermas, 1992; Leonard, 2005). The Commission as a bureaucracy finds justification in expanding its powers, and in the issues where it has full powers the Commission’s top civil servants often adopt a heavy top-down approach. In the energy, fiscal and other sectors where the states still retain national power, the debate has translated into a rivalry not only between the diverse member states, but also between the Commission and the member states. This situation poses a question mark over the legitimacy of such a system. In fact, how to establish and maintain democratic legitimacy and accountability for Europe's extensive supranational setup has long been a thorny question. Thus, we live with a challenging paradox - that governance is becoming increasingly a multilevel, intricately institutionalized and spatially dispersed activity, while representation, loyalty and identity remain stubbornly rooted in traditional ethnic, and national communities. Europe’s own dilemma is no different from that faced by the world as a whole. However, in Europe the absence of a European citizen identity and a weak European party system poses a serious challenge to its political legitimacy.
Moreover, the fact that a major part of European policy-making takes place “behind closed doors” covers its politics with a delegitimizing veil. The lack of a collective political identity combined with a lack of the EU res publica, makes national debates, concerns and leaders still emerge as the predominant ones. The future of Europe and the problems it faces are seen first through the lens of national politics and interests, and only secondly from a “European” perspective. The Constructivist school argues that with the growing complexity of the world today, the decision-making gets disaggregated in very specific networks of knowledge – or epistemic communities, dealing with the very specialized exigencies of the system. However, very specialized knowledge is already a form of influence. Thus, not only in Europe, but perhaps more dramatically evinced in the EU’s case, a growing divide has to do with the contrast between the elite of experts that shape the policies (i.e. the European integration) and the so-called demos. The European integration has always been perceived as an elitist and technocratic project. The very fact that the institutional integration has absorbed new areas and those processes had happened “top-down” is delegitimizing the European Union in the eyes of the European citizens. Since Europe is a work-in-progress (we do not even know the future direction: federal state or supranational commonwealth or something else?), the European citizens should be encouraged to engage in the “Project Europe.” In that sense, “the European Citizens’ Initiative,” a new tool that the European Union will launch to enhance participatory democracy and dialogue between the EU institutions and citizens, is a step in the right direction, in that it could help to bridge the “information gap” between the EU’s executives and its people.

This study considers the EU’s aspirations to become a de facto superstate with the traditional attributes of power as the wrong approach to its identity dilemma. A narrative of strong identification based on European symbols like the Euro-anthem or a European foundation myth and heroes, belong to the concepts of the classical secular nation-state. Insisting on them could only result in a dangerous reproduction of nationalisms and xenophobia on a European level. Europe is a successful laboratory of economic and political integration, where “new” mutually reinforcing hybrid collective identities are formed as a complement to the national ones. Thus, a ‘melting pot’ or a continent with a ‘common soul’ and ‘destiny’ should not be part of the wider discourse. Europeans should be proud of their extraordinary achievements and the peculiar modus operandi that they have established within the EU’s institutions. Common goals should underpin the acceptance of common rules and institutions. Thus, there is no need for a traditional-style “strong common identity,” to be able to function as a unit. However, the EU’s decision-makers should be able to explain to their constituencies what are the gains of working in unison and what are the implications of it in their daily lives. No need for strong collective identities to do that; in today’s world they are anyway a thing of the past. In conclusion, how is all that related to our central question? According to the constructivist scholarship, the fact that Europe has still several co-existing national identities means that the national actors have very different cognitive frames in respect to Russia, that consequently influence their fragmented policy choices. The more fragmented the policy choices, the weaker the common position towards Russia. For example, let us consider the EU’s declared gas solidarity in the case of a gas shortage. Despite the opposition the some member states Article 100 I of the new Lisbon Treaty was amended so that solidarity measures are now at least a possibility. Article 100 I states that “the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between Member States, upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy.” However, the fundamental problem is that despite the Commission has been talking about solidarity for years, what that concept means is still contested. Although a “general” notion is accepted, its proper implementation is still vague. Baumann and Simmerl (2011) conducted a survey among political officials from all

86 Euractiv, Štefčovič: Citizens’ Initiative to bridge European divides, 26 January 2012
27-member states. They found that among the respondents, the Central and Southern European participants were the ones that most commonly agreed strongly on basing an external energy policy on solidarity mechanisms and full-scale joint crisis reaction procedures, or at least coordinated common measures. Other countries, such as Austria, Germany, or Great Britain define solidarity more in terms of a “declaration of intent” and favor national counteraction in case of an energy crisis (Ibid.). As Klaus Welle, Secretary General of the European Parliament observes, “This issue has caused very complex disputes. Now a special Fund for cross-border interconnectors has been launched.” However, as Welle admits, “we need a more common approach, we are not very strong on the compatibility in energy legislation and market development.”

In light of that, it remains to be seen whether the multi-billion gas infrastructure fund to move gas West-East will be spent efficiently. Clearly, a true single market in gas would help to ensure a EU-wide solidarity in the case of emergency, with the European Commission acting as the vector for coordination (Helm, 2007).

5.4.3 The missing link: The EU versus Russia identity puzzle

Unfortunately the key obstacles to cooperation lie not only in the member states’ identity dilemma and residual sovereignty within the energy sector, but also in the normative gap between the EU as a whole and Russia. According to this school of thought, the EU-Russia predicament can be best explained by the two partners’ identity crises. On the one side there is the EU that continues to question its own identity (and its borders) and struggles to become a really credible security and energy player. On the other side, we have a Russia that for centuries has been culturally torn between Westernized and anti-Westernized positions and whose core question of identity has been caught up in its relationship with the West. The outcome of this process of identity formation can be described as the ‘agony of the Russian question’: the perpetual debate over the extent to which and how quickly central Western values, practices and institutions should be adopted in Russia (Kempf, 2010). The Russian ‘Self’, has indeed been defined through the prism of Western expectations on one side, and the “Russian way” of doing things on the other. In the post-Soviet years Russia has once again, struggled to redefine its rhetoric of the Russian ‘peculiarity’ vis-à-vis Europe. This section, within the constructivist storyline, presents a more systematic way of thinking about the EU-Russian cooperation in order to avoid easy generalizations and personal prejudice.

In the last decade we have seen an increasingly assertive Russia, that using its richness in natural resources, sought to reestablish its status on the world stage and to counterbalance for its lost military power. Europe has struggled in finding a common position to the Russian increasingly politicized stance on energy politics, and resolved at first to guide the relationship with a common EU-wide “market and institutions” approach. This approach did not provide the member states with security of supply, and thus the states quickly dusted off their national energy security policies and fought independently to gain their best deals with Russia. The already anemic common EU energy policy was getting slashed by a growing “regions and empire” logic, a label that Correlje and van der Linde (2006) gave to describe the neo-realist style of energy problem-solving between single states and Russia. In an interesting contribution, E. A. Morgan (2006), draws upon institutional and social learning theories, particularly from the conceptualization of Peter M. Haas about the importance of “epistemic communities” to investigate potential learning processes between the Russian and the global energy sectors. In his study, Morgan shows that Russian officials sought to reform and modernize energy production, increase profitability and make the sector more attractive.

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87 Interview with the Author, Harvard University, October 3, 2011
to global investors, whilst cementing the state control over energy production domestically and in the CIS republics. At the same time, the EU’s ‘epistemic communities’ objectives have been to erode Russian autonomy and regional influence and to promote Russian integration with global energy organizations and markets. In the 1990s the Russian energy sector was expected to “learn” from the European epistemic communities: the learning revolved around the economic liberalism paradigms that included support for relatively unhampered energy markets and the “spill-over” of European internal energy regulatory and market practices into the Russian energy sector. The rapid decline of the Russian economy and the weak political development in the 1990s, were all the more reason why the European Union approached Russia on the basis of an unequal power relationship. It was believed that the energy ‘acquis’ could and should be exported to Russia. In the energy issue-areas, the European epistemic involvement was most strongly felt in the tented persuasion of Russia into adopting the European gas-market proposals. This went side by side with the European attempts to export its acquis communautaire in energy matters, showing rigidity towards the Russian view, both in energy and in the wider economic relations. Peter Haas writes, “Policy coordination within epistemic communities is ultimately based on consent, shared beliefs and mutual expectations,” specifically to distinguish them from other groups. However, the epistemic communities that existed in the Russian energy sphere in the 1990s did not include the “mutual learning” component, instead a more a unidirectional spillover from the West to Russia was attempted. Political factors following the break-up of the Soviet Union and the relative weakness of domestic epistemic communities impeded the application of consensus views on energy politics. It could be added that in this case reciprocity, as the main precondition of a cooperative behavior, was not respected. The increase of oil prices starting after 1999 facilitated the Russian economic recovery. In 2000 when Putin took office political and institutional direction was reached, which ended the political chaos and economic turmoil of the 1990s. Attracted by energy revenues and the potential leverage, Putin began to restructure the energy industries away from full privatization, setting limits to (foreign) private capital. Henceforth, the direct influence or the “spillovers” of the EU’s ideas into Russia began to be seen as improper interference. In that setting, commercial and intellectual relationships with the West became more assertive and less welcoming. Russian epistemic communities were now increasingly turning into antagonistic advocacy coalitions. The cleavage among the newly enhanced Russian epistemic communities and the Western groups was underpinned by the existence of fiercely opposing ideas on how the fundamental norms regulating the EU-Russia energy relationship should be defined. Russia was no longer willing to accept norms from the outside that it did not help to craft, and was willing to show that the Western model was not considered the only right one for the human race to follow (Morozov, 2008). Admittedly, the EU has had a “first mover advantage” in defining concepts such as democracy, sovereignty and reciprocity. Putin’s Russia did not reject this model, but it wanted to propose its alternative perspective. Obviously enough, the expected privatization and liberalization of the Russian energy sector did not materialize. Rather, Putin intervened and partially renationalized oil and gas resources to develop a predominantly Russian-based industry. The Russian powerful advocate groups and individuals within the presidential administration (such as Vladislav Surkov, Igor Sechin and Aleksey Kudrin) were now promoting a new ideology embodied in terms such as – “sovereign democracy,” “financial sovereignty,” “multipolarity in world politics” and so forth. The next section will compare the contrasting views on leading norms entangled in the existent energy interdependence.

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5.4.3.1 The sovereignty principle

The fundamental issue of sovereignty led to a set of unfulfilled expectations between Russia and the EU, which in turn created a stumbling block for constructive cooperation. This case can be defined as one where two opposite models of sovereignty coexist, but they barely interact with each other, because none of the two parts shows interest to “learn” from the other.

The Russian official discourse espoused the term “sovereign democracy.” In this view, sovereignty and democracy are two necessary components for the stable development of the country. But democracy is merely defined as a system of political cooptation to select the suitable leaders, with the aim of being integrated in the world economy, to have access to technologies and investment that are considered needed, under the approval and the scrutiny of the leadership. Strong sovereignty and state capitalism have been the Russian responses to globalization and the challenges of the post-Soviet and post-Imperial era (Medvedev, 2008).

The strategic thinking in Moscow is embedded in a Westphalian notion of international relations in which large states are the primary guardians of global order, free to pursue their national interests while respecting one another’s primacy within a circumscribed sphere of influence, maintaining a general balance of power among themselves, and rejecting the applicability of “universal” norms in favor of respecting states’ sovereignty within their own borders (Mankoff, 2011). Kremlin’s chief ideologist, Vladislav Surkov, described a state whose goals and methods, both home and abroad, are made solely on the basis of calculations of national interests, rather than because of external pressure to conform to behavioral norms (Ibid.). The EU on the other hand, constitutes nothing less than the emergence of the first truly post-modern and post-sovereign political system in the world (Ruggie, 1993). In Ruggie’s view the novelty pertains to an increased ‘fluidity’ and the multi-level exchanges in a networked governance system. Such an extensive pooling of sovereignty as the one of the EU is an unprecedented phenomenon on the world’s stage. National sovereignty is understood as a resource that can be delegated and pooled to achieve governance across specialized issue-areas that often require effective multilateral institutions, because problems transcend the boundaries of one country. As argued by Keohane (1998, p.92) “Economic interdependence and its regulation have altered the notions of sovereignty: Few states can still demand to be completely independent of external authority over legal practices within their territories. The best most states can hope for is to be able to use their sovereign authority as a bargaining tool to assure that others also have to abide by common rules and practices.” The EU can be regarded as a case in point of this notion that encompasses the gradual erosion of sovereignty in favor of the representation of more diffuse interests (Ruggie, 2012).

Now, when Russia, with its high concept of sovereignty (Barkanov, 2011) gets to interact with this weird political animal, the EU, with its multilayered structure and diffuse power structures—the dialogue is hampered by the lack of an internal consensus between the key priorities and a reluctance to learn from the other, which in itself reflects the ‘dialogue of the deaf.’ In short, whereas Russia strives to maintain the greatest possible freedom of action, the patterns for policy and cooperation of the EU are based on treaties and common norms whose observance is mandatory for all its members.

5.4.3.2 The reciprocity Principle

Here again Constructivist theories provide some insight. In the energy trade both partners have used this term meaning essentially two different things. Russia’s focus is on relative and not absolute gains (the latter of which would imply focusing on long-term reciprocity in a win-win situation). This notion implies that the worldview of Russian and EU leaders differs in many respects: Russian leaders have adopted a clear-cut realistic self-help worldview, while the EU’s policy is shaped around the importance of international institutions and

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90 Interview with the Author, Harvard University, May 2012
interdependence (Medvedev, 2008). The Russian notion on reciprocity is “specific,” one that is based on quid-pro-quo of equal value and proportion. In energy, for Russia reciprocity means swapping assets of similar market value or utility (Locatelli and Boussena, 2011). For years now, this has been Gazprom’s corporate philosophy and export strategy in the EU. For example, the EU companies can get upstream access to Russian gas, only if Gazprom is allowed to acquire downstream access inside Europe as part of a “quid pro quo.” Such business deals are entangled in a traditional web of bilateral relationships: like Russia-Germany, Russia-France, Russia-Italy, and Russia-Finland. For example, in 2010 Gazprom and Eni finalized their asset swap in Libya.91In 2009, the German utility company E.On AG has gained a stake in the Yuzhno-Russkoye natural gas venture under an asset swap deal with Russian state-owned OAO Gazprom.92 And again, in 2012 German group Wintershall, agreed to swap parts of its oil and gas fields in the North Sea for a stake in a Siberian field owned by Gazprom.93 In contrast, the EU’s vision of reciprocity can be termed as “diffuse reciprocity” which implies an ongoing relationship where gains are absolute rather than relative, which does not require a player to win each time. A temporal element is added to this interpretation, to show that if one side wins today, the other side can win at the next round. The relationship is ongoing to ideally achieve reciprocity over time. These two interpretations of reciprocity are not easily compatible. If the EU engages in the kind of deals that Russia prefers, it compromises its own principles of open markets, transparency and equal investment opportunities for everyone (at least in principle). On the other hand, Russia does not want to accept the EU’s normative and regulatory discourse. Russia objects that the West (or Europe) had used its “first mover advantage” in defining a set of norms that Russia did not help to craft. In the 1990s Russia was “weak” and forced to bea “norm-taker.” The EU is accused to be a “norm entrepreneur” that aggressively presses the outside to conform to its behavioral standards. In energy the discrepancy in framing the term ‘reciprocity’ has become the symbol of the contentious relationship. For example, Gazprom’s growing penetration into the EU’s market was accompanied by some EU’s protectionist moves in contrast to its own liberalization principles, targeted to prevent Gazprom from buying greater stakes in the EU market. For instance, the political uproar surrounding a rumor that Gazprom was interested in buying Centrica of the UK in February 2006 was indicative of the EU’s rather protectionist mindset at the time, which has been formally enshrined in the Commission 2008 “reciprocity clause” dubbed as ‘the Gazprom clause.’ That provision forbade foreign-producing companies to own part of transit and transmission companies stock, despite the EU’s liberalization principles (Finon, 2011). Thus, it prevented foreign companies from acquiring energy assets in Europe unless their home countries reciprocated. Russia responded that the European companies were in fact investing more in Russia than the Russian companies were in the EU, therefore Russia should have more reason to worry. More recently, Russia has reacted particularly angrily to the European Commission’s antitrust probes against Gazprom, raised on the grounds of its resistance to “unbundling” when operating in the EU markets. A decree signed by president Putin, blocked “strategic” firms from co-operating with foreign investigations without government permission.94 The crux of the problem is that Gazprom’s political friends within Europe also prefer Gazprom’s quid-pro-quo idea of reciprocity that has functioned well for decades. Core member states do not want to strain relations with Gazprom and would rather mediate a mutually acceptable solution, like it was done in the arbitration cases with E.On and the other companies (due to the linking of gas and oil prices) that are in the process of getting settled outside the courtroom. The EU companies warn against the dangers of a EU that is well regulated, but left in the cold. Thus, there appears to be little interest within the core

91 Ria Novosti, Gazprom agrees asset swap with ENI to join Libya’s oilfield project, April 12, 2010
92 Gazprom Press Release, Gazprom and E.ON close asset swap deal, October 30, 2009
93 Bloomberg, Gazprom Offered New Assets by Wintershall in Siberian Swap, Jun 6, 2012
94 The Economist, Burst bubbles – The European Union squeezes Gazprom. Russia retaliates, September 15, 2012
5.4.3.3 The information gap

Another key normative component in the EU-Russian energy relationship is somewhat flawed. Russia depends on the EU for security of demand and the EU depends on Russia for security of supply, in what we have simplified for the purposes of this chapter (we are looking at the EU as a whole) as an “evenly balanced interdependence.” Another problem relates to the transparent provision of information between the two partners. Here again, the Russian notion of “transparency” is far from the EU’s standards. Moreover, Russia is “fixing” the meaning of this norm according to the government’s goals and methods. Therefore, somewhat paradoxically, despite the plethora of meetings and summits dealing with the energy issue in particular, uncertainty pervades the EU-Russian energy politics. Russia has often closed its decision-making process to outsiders, restricting the flow of information about its preferences or its likely future actions. Yet, the reputational cost of not providing high-quality information could rise for Russia, now that the EC is determined to make it hard for Gazprom to defend bilateral deals against the rules of the EU’s common market. Keohane (1984, p.259) writes “Admittedly, there are tactical gains to be made from concealing preferences and “keeping others guessing.” But such a policy can undermine one’s ability to make beneficial agreements in the future. Being unpredictable not only disconcerts one’s partners but also reduces one’s own ability to make credible promises. From the Constructivist perspective, as demands for information rise, networks or communities of specialists capable of producing and providing the information proliferate. The members of a prevailing community become strong actors at the national and transnational level as decision makers solicit their information and delegate responsibility to them. In short, transnational epistemic communities are a solution to transnational “information asymmetry” problems. This argument suggests that Russia should seek to combine reliability of action with the provision of high-quality information to its partner, the EU. However, both the reputational cost of a damaged reliability argument and the gains to be made from providing high-quality information to others, challenge the traditional Realpolitik ideal of an autonomous, hierarchical state that keeps its options open and its decision-making processes closed. Evidence suggests that a cadre of politicians, corporations and industry specialists dominates the paradigm of the Russian epistemic community and insulates it from outside influences, including the global epistemic forces, for example by controlling the media outlets (Morgan, 2006). If free exchange of information (together with the respect of reciprocity) might be indicated as necessary elements of a cooperative relationship, Russia definitely dissatisfies on the ‘information’ aspect. Russian unwillingness to make adjustments in response to the EU demands that Russia increases its transparency recordprovoked recurrent frustration from the EU’s side. In energy, a particular source of contention has been Russia’s hostility to speak clear about the true volumes of its reserves, the conditions of production increases and the state of exploration. In the gas sector, Russian notorious concealing of the estimates regarding remaining gas reserves pushes Western analysts to make their own estimates which often result in the dramatic assumptions that the country owning the world’s largest gas

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99Peter M. Haas, “Knowledge, power, and international policy coordination”, pg. 4
reserves risks to virtually run out of gas. These kinds of assumptions certainly don’t work in favor of a flourishing EU–Russia relationship and on the contrary, increase the EU’s drive towards diversification of its natural gas imports (Goldthau, 2008). Equally vague is the information that the EU gets concerning Russian gas production partly because of unclear amounts of flared volumes and a Russian practice towards reporting gross production figures, that is, not excluding flared, vented and reinserted volumes (Goldthau, 2008). Further, there is lack of transparency over the conditions under which access is granted to export capacity of international energy firms and especially a lack of clearly-established criteria for the setting of transit tariffs and more generally prices for natural gas that are charged domestically and to the CIS countries. It is well known that natural gas is sold with a politicized price domestically and in the CIS republics. Although Russia is slowly moving towards “market” (oil-indexed) prices, the price is still significantly lower than the price charged in the EU markets (Konoplyanik, 2012). The EU sees with suspicion Russian notorious dual gas-pricing policy that allows Russian domestic consumers and to a certain extent, the consumers in the Russian so-called “Near abroad,” to buy gas at significantly lower, state-subsidized, prices. In essence, Russian domestic gas consumption is subsidized by the revenues from higher-priced sales of gas to Europe, which also permits Russia to sell gas to CIS countries at lower prices. Russia’s double, murky pricing of gas is thus a particular point of tension with the EU. The formulas regulating these prices are still unclear. EU officials are not surprisingly irritated by such a totally non-transparent, arbitrary, and politically charged manner of setting gas prices. Although bridging the “information gap” would reduce the transaction costs of the relationship, which is the interests of both sides, progress towards greater transparency has been virtually inexistent.

5.4.3 Interdependence

Constructivism, either in its mainstream or in its post-structuralist forms, even focuses on the interesting fact that some of the norms apparently accepted by both sides still need some further clarification. For example, in his study Barkanov (2011) is especially attentive to the sources of Russia’s state identity change and he argues that an empowered Russia in 2008 was reconceptualizing not only ‘energy security’ to include ‘security of demand,’ but also pointing the world’s attention to a new understanding of interdependence, defined as ‘responsible interdependence’ and the significance of balancing the interests of consumer and producer (or alternatively net importer and net exporter) countries. Therefore, by late 2008, Russia was no longer “buying” into the Western vision that interdependence in world politics simply refers to situations characterized by reciprocal effects among countries or among actors within different countries. More subtly, in the EU’s view, “interdependence constrains a nation’s ability to undertake autonomous domestic policy initiatives, quite apart from intentional foreign interventions” (Keohane & Nye, 2008). Very far from that, in the Russian perspective a harmony of interests in energy security and more broadly, in the international economy, requires concerted political action by states. Russian attempts to alter how the energy relationship between the EU and itself was understood were growing in parallel with its rising power. Once again, Russia was not prepared to have the EU dictating on the normative essence of their relationship, with an emphasis on ensuring that Russia had free hands in interpreting the notions according to its will.

5.4.4 Conclusions

In general, the chapter is embedded in the Constructivist belief that identity structures and the framing of political discourses have a direct influence on the quality and the outcomes of the EU-Russian energy relationship. Summarizing, the ECT was crafted in the early 1990s on the initiative of the EU, which means that when this new concept (a multilateral treaty) appeared, the EU had a “first mover advantage” in defining the new issue. The framing of
the Treaty reflected the main Western liberal norms, and in the energy trade, the rules were formulated from an importer's country perspective. The codification of some of the Western norms into ECT common rules did not fit the Russian vision of independence, equality and self-determination. Europe on the other hand, sought to promote an ongoing cooperation, or in other words “a diffuse reciprocity” based on the implicit assumption that the more the parties interacted, the more compatibility they would get. Ideally, the continued dialogue would result in shared values and growing similarity between the two. Yet, to achieve this goal Russia was indirectly expected to “transition” towards Western democratic standards, that would reinforce cooperation and everyone would benefit in the long run. However, Russia and the EU’s competing, and at times incompatible narratives have hampered these efforts. According to the Russian “high concept” of sovereignty Russia does not tolerate to be told what to do and how to do it, moreover Russia is determined to make sure that any possible ‘partnerships’ with the EU are indeed seen as being between equals. Moreover, Moscow does not like the Brussels logic of conditionality. The last one has been the largest problem; the EU simply has difficulties to define a position towards this new dominant neighbor and offer incentives that do not include the export of Brussels criteria, norms and rules. That is why cooperation remains thin and sporadic, and the very deep commercial interconnectedness, is accompanied by a very weak institutional system. Let me illustrate the main issues discussed thus far in table 7.

Table 7: Some Constructivist key Reasons for a deadlock in the EU and Russia cooperation

<table>
<thead>
<tr>
<th>Norms</th>
<th>Sovereignty</th>
<th>Reciprocity principle</th>
<th>Information sharing</th>
<th>Interdependence</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>Liberal democracy</td>
<td>• Diffuse reciprocity</td>
<td>• Transparent, accountable and free exchange of information</td>
<td>• Situation characterized by reciprocal effects among countries or among actors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Unequal stance vis-à-vis Russia</td>
<td>• Pluralist channels of information provision</td>
<td>• Interdependence constrains a nation's ability to undertake autonomous domestic policy initiatives</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Market and rules-based governance but directed towards the export of the “acquis communataire”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>Sovereign democracy</td>
<td>• Quid-pro-quo reciprocity but based on equality in power</td>
<td>• Independence from external influences</td>
<td>• “Responsible interdependence”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• State-led, based on swaps of assets of similar market value or utility</td>
<td>• State control of strategic information</td>
<td>• Harmony of interests in energy security and more broadly, in the international economy, requires concerted political action by states</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Provision of selected information</td>
<td></td>
</tr>
</tbody>
</table>

Source: Own analysis, based on secondary data and expert interviews

5.4.5 Reservations in terms of my central question

In general, this study praises constructivist theories and shares the opinion that norms indeed matter in the case of the Russia-EU energy relationship. Nevertheless, by arguing that these competing perspectives have been the central impediment to an agreed framework for regulating the energy trade, these works fail to contemplate cases in which in the midst of the political crisis created for example by the Russo-Ukrainian crisis in January 2006, and thus in the moment of the largest normative gap, individual member states’ gas companies did not think twice about negotiating new contracts with Gazprom without fears of having to accept a long-term mutual dependency. For instance, in November 2006 Eni and Gazprom signed a strategic partnership, which envisaged the commitment of both parties to jointly develop
projects in the entire gas chain for the next thirty years. Second, these studies do not account for instances when in the midst of the worse political stagnation, the EU companies built joint ventures in gas fields or large-scale pipeline projects in conjunction with Gazprom. For example, in July 2011 Gazprom announced a strategic partnership with the German big utility RWE, just a month after one of the frostiest EU-Russia Summits (June, 2011). The history of the EU-Russia relationship is full of examples like that. Moreover, the “normative gap” did not prevent the energy relationship between the Soviet Union and individual member states, at the time, to flourish, when the “ideological irreconcilability” should have prevented such contacts on the grounds of an absolute “identity gap.” Despite the even wider ideological divide, multi-decade contracts were signed starting from the 1970s between the Soviet Union and Austria, France, Italy, Finland, West Germany and Sweden. In the first thirty years (1970-1990), diversification away from the Soviet Union did not seem such an urgent priority as it is today in the EU’s discourse. If competing perspectives are the key to understanding why a shared framework was not agreed upon, how did the multi-decade gas-for pipelines frameworks between Germany and Russia, Italy and Russia and so forth function so well despite the ideological abyss? If anything, changes in the international environment after the collapse of the Soviet Union have induced a closer perception of European and Russian identities that transcends traditional ideological boundaries. This trend does not mean that all the problems between Russia and the EU have vanished. On the contrary, on several issues the entrance of the EU, as a new actor in the game, has made things more difficult than in the past. Apart from Russia’s long-standing emotional antipathy toward the EU’s policies, Russia simply has no interest to formalize its relationship with the EU as a whole, and even within the EU, core Russia’s customers have no interest in being locked-in by a “one-fits-all” approach. Historically, the member states have had very diverse approaches to reach the target of energy security. In that sense, even today a decentralized approach respectful of the national situations, in a spirit of the subsidiarity principle is more adequate to deal with the complexities of each case. Therefore, I believe that the main question is to identify where do strategic interests of the main actors lie. First of all, within the EU, member states’ divergent interest still outnumber the shared interests, therefore major interests do not lie in “more common institutions.” Nor do clearly the major Russian interests.

5.5 My Alternative Approach Within the Neorealist Perspective

5.5.1 Introduction

The purpose of this chapter has been to examine the potential answers of the diverse approaches in the International Relations theory to the central question and the purpose of this dissertation: to understand why, given the high degree of mutual dependency, not a single binding institution regulating the EU-Russia energy trade has been created thus far? Although starting with different assumptions, the three approaches display wide theoretical sophistication in emphasizing the multilevel complexities of the relationship between the EU and Russia. As mentioned earlier, this dissertation draws upon the neo-realist theory, but it allows for a simultaneous engagement of a wider interpretative perspective, as for example drawing attention to the gains of cross-border cooperation. Much of the existing “classic” realist literature on the Russian-EU energy relations consists of studies pointing to the inevitable "energy dilemma" between the two players and fails to recognize the importance of actors other than the states, which are considered the basic and fundamental units of

97 For a more detailed discussion see: Makarychev A. and Sergunin A. EU-Russia: Divergent logics of communication, CEPS Policy Brief, No. 244, 17 June 2011
world politics. A second stream of relevant “realist” theorizing is given by the “moderate” realist observations that the public and the private are somehow "linked" in determining the energy direction of the states in question. However, the bulk of this literature still considers the states’ interests as the driving forces in the pursuit of the strategic interests and national energy security. More recently, an interesting exception to this is the work of Rawi Abdelal (2011) that in his study on the companies’ behavior within the EU-Russia’s gas trade persuasively argues that gas firms, rather than the governments’ in question, actually produce political outcomes. This thesis indeed builds on Abdelal’s powerful intuition and goes on to examine the possible causal relationship between the centrality of the companies’ in the EU-Russian gas trade and the lack of clear legal basis regulating the relationship between the two partners. A second group of relevant sophisticated contributions that this thesis draws upon is the work of Jonathan Stern and the Oxford Energy Institute more broadly. Along the lines of the approach employed by the Oxford Energy Institute this thesis adds the category events to the conceptualization of the processes of energy policy formation. For example, it matters how actors observe and react to key events, such as the recent changes in the energy paradigms that put pressure on old equilibria and multi-decade business practices in the European gas contracts, and how they readjust their strategies with potential consequences for the governance structures between the gas producers and consumers. Finally, this thesis also builds on the landmark works of Locatelli and Boussena (2011), Finon (2011) van der Linde (2011) and Bressand (2010) that, from different angles, have all emphasized the impact that gas companies’ interests and objectives have on the outcomes of the EU-Russia energy relationship.

Thus, this dissertation arises out of a debate in the literature of International Relations and Political Economy over identifying the dominant actors in the EU-Russian gas trade and assessing to what extent have the corporate sector’s interests influenced final political outcomes. While the above-mentioned studies offer valuable empirical and theoretical insights into the EU-Russia’s gas trade dynamics, these works do not purport to account for instances of causal inference between the predominance of the companies’ interests and the lack of legal formalization of the EU-Russia relationship. Nor do they examine cases in which the cross-border regional energy politics of some regions have the potential to act as a catalyst for engagement closer to the interests of both parties.

As noted in the previous chapter, Liberal and Constructivist theories are informative in yielding different “framings” to the EU-Russia energy relationship, one pointing to the structural defects of the EU and/or the undemocratic structure of the Russian political system, the other emphasizing the “normative clash” (Emerson, 2006) as a possible cause for the current institutional deadlock. However, I find no tight casual identification between their propositions and my central question, as illustrated above. Although as aforementioned, in his discussion of the states and business actors in Eurasia, Abdelal has already underlined the centrality of the corporate sector’s will in determining political outcomes, here the novelty pertains to linking the dominance of the big gas firms in energy policy formation to the institutional fragmentation between the EU and Russia. Thus, no study to date examines the institutional energy arrangements between the EU and Russia through a rigorous analytical assessment of the crucial actors, while emphasizing the centrality of the corporate sector to shed light on the fact that powerful business actors have no interest in changing the shallow governance structures.
5.5.2 Overview of the Puzzle and the Methods

This chapter offers a theoretical answer to my puzzle, but it begins with underlying the empirical material that “led me” to the answer. Methodologically, grounded theory is utilized to build a perspective that starts from the collected data. The reason for starting my analysis from the data is simple; the first question to determine who are the dominant actors on both sides, and second, to understand the motives that drive their actions. In order to do this, the dissertation analyzes a multitude of materials in the public domain, such as on the EU side the minutes of the EC meetings, the minutes of the EU-Russia Gas Advisory Council, press documents, Eurostat figures. On the Russian side, the documents include government’s statements, Gazprom’s press releases and Gazprom’s statistics. The analysis of this data allowed for a subsequent formulation of several hypotheses on what could be the strongest lobby group on both sides, to consequently bring the “lobbying material” on a “higher” level of abstraction. Once I established that the strongest lobby on both sides is de facto the powerful gas industry lobby, that information allowed for opening of new theoretical perspectives. The deriving questions are:

1) What are these actors’ main interests, and why?
2) Is there a casual connection between their interests and a lack of binding institutions regulating EU-Russia’s gas trade?

Thus, I start from my raw empirical data (documents, statistics, news material, earlier research, interviews and field experience), from which I generate some hypotheses, and then I bring my conceptualized data on a higher level of abstraction in order to get the concepts (and theories) that will help me to organize and give analytical value to my empirical observations. The scope of my approach is to re-think the baseline expectation of the several Realist, Liberal and Constructivist theories on the factors explaining why there is such a lax energy institutionalization between the EU and Russia, or more precisely, why there is no single legally-binding institution regulating the relationship?

Existing classic realists’ explanations emphasize the “security dilemma,” the Liberal literature stresses the structural unsoundness of the EU and the defects of the undemocratic Russia, and Constructivist scholars point to the identity gap between the two partners. The closest contribution to this work is the “moderate” realist school, that recognizes the importance of the private sector, and among them the most sophisticated work is Abdelal’s analysis of the private sector’s influence on energy policy outcomes in the Eurasian gas trade. This dissertation goes further in aiming to:

1. Identify the main actors,
2. Re-think the way the main actors form their preferences when pursuing their interests and
3. Test how, if at all, this impacts the institutionalization of the EU-Russia gas trade.

In order to make a new conceptual point, I go back to the bedrock of the assumptions of the other theories, to see how my concept contrasts with the empirical implications of the other perspectives. This dissertation is based within the Realist tradition, but with a “learning and adapting” approach, which allows for the opening of new perspectives with the aim of re-evaluating salient assumptions within the Realist framing. In summary, the aim is first to shed light on the general conceptual dynamics between the dominant actors, which according to my findings are the big gas companies, second to demonstrate that they behave as reasonable rational actors, third explain what is their course of action and lastly, update some key assumptions in the theory on the reasons why there are no legally binding institutions in the gas trade between the EU and Russia. See figure 7.
In this section I will give some more detail on how I used the data to build my alternative approach. In this study, comprehensive and far-ranging empirical research is employed to test and deepen our understanding on who are the main actors shaping the EU-Russia gas trade, what are their interests and objectives and how do their pursue them. The approach is grounded in rationalistic premises of the actors’ behavior. Now, how do I determine who are the main actors? I analyze more than 50 semi-structured interviews with key experts, officials, gas companies’ executives and I interpret several policy documents, reports, press releases. In order to obviate the subjectivity bias, I simply analyze the recurrence and the intensity of the involvement of the same actors in documents related to the institutional negotiations at the EU-Russia level. The reports are useful for obtaining an overview of the lobbying efforts of various actors over time, thus adding a diachronic perspective to my study. I believe that taking into consideration the elements that changed over time when interpreting and using the empirical material is of fundamental importance in the analysis. I used diverse source materials and then I classified them according to a list of political and corporate “lobbying actors,” using inductive content analysis. The resulting dataset includes political and business actors who have participated in the negotiations for the agreement/renewal of governance structures between the EU and Russia (i.e. the PCA and the ECT negotiations), but also other documents were examined, such as the gas contracts renewals or renegotiations, with the premise that, if only the actors that participated to the negotiations at the EU-Russia level were examined, that might have not led to the identification of the main actors because being involved in the negotiation process at the EU-Russia level might constitute the exact opposite of the priorities of those who happen to be the crucial actors. Provided that my main interest was to identify the dominant actors and test whether there is tight casual identification between their interests and the failure of the legal institutionalization of the relationship, the content analysis offered a basic outline of the data, the actors and their most important concerns. In addition, I sought to learn more about their interests and the impacts of their interest-formation on the legal approximation between the EU and Russia.

Besides employing existing research and scholarly work, the list of the other main sources used is:

1. The existing legislation: ECT, PCA
2. Minutes of the Meetings of the EU-Russia Gas Advisory Council
4. Other Publications, Meetings and Documents of the Energy Charter Secretariat
5. Documents and lobbying materials of Eurogas, the natural gas trade association
6. Intergovernmental documents (when available)
7. Gas contracts
8. Media sources
9. Interviews with gas experts and scholars
10. Interviews with gas executives and governmental and EU officials
The next chapter will deal with the three-fold process that I followed as illustrated in figure 7.
6. Identification of the predominant Actors and their Interests: interlinkages with the deadlocked EU-Russia’s Energy governance

6.1 The European gas theater

The recent developments in the world’s energy industry are clearly associated with an increasing complexity: complexity of the energy markets with their regulatory frameworks, complexity of the general environment, political and geopolitical complexities. Complexities create uncertainties and risk. At a regional level, the EU and Russian energy trade is undergoing an unprecedented transformation towards “spot” market elements that have been challenging multi-decade state-to-state and business-to-business practices. New actors are entering a world that is becoming more and more multi-level and polycentric. In Europe, the growing economic integration has been matched with greater complexity of the internal governance and a gradual and inexorable process of pooling sovereignty in favor of the supranational level. In energy, the European Commission has gradually become an important actor, with its own agenda on what the EU’s energy security ought to be. In such a system, the diffusion of power has diluted the resort of traditional national policy tools and has gradually brought-in the supranational level, while exacerbating the political rivalries over policy-issues that are now co-chaired by the European Commission and the Member states. Moreover, new considerations, such as environmental concerns, are now embedded in the agenda dealing with energy security. The growing importance of free competition and the environment, has given the European Commission a new window of opportunity to tackle energy security from different angles. Russia, partly due to its centrist tradition, has had troubles in dealing with an empowered and multi-level EU.

6.1.1 The role of the European National Governments in relation to Russia

In the last few years, given the rise in importance of the European supranational architecture, the European governments and the EU are, simultaneously, the protagonists in facing the challenges raised by gas security. Unsurprisingly, the energy governance situation is much more complicated in the EU than in Russia, due to the simultaneous presence of the EU, the national competences in energy policy-making, the various levels of regulation, an asymmetric exposure to import-dependency of the different member states and a divergence in pre-existing organizational structures of the national energy sectors. Changes like the re-thinking of oil indexation in long-term gas contracts and the emerging of a global gas market are demanding for new forms of market regulation, therefore the supranational pressure for a “unitary” EU-wide response in the regulation of the gas sector, has grown in importance. Moreover, the fundamental thinking about European gas security has dramatically changed over the past few decades. In the 1970s, when the first molecules of gas started arriving from Russia, Moscow dealt only with the national governments and their nationalized energy firms. Indeed, in the period after World War II, the strategic importance of the energy sector convinced policy makers that the market could not be trusted to ensure security of supply in all circumstances. This belief justified state intervention that led to the post-war nationalization of the energy sectors in the UK and France, Italy and Germany. In the 1980s and 1990s a reversed trend to open up gained impetus, and the energy sectors were reopened to foreign investors, although this did not happen everywhere with the same pace. The major Russian clients such as Germany, Italy and France kept vertical integration as long as they could. In this phase, the European Commission and its DG Comp were gaining power, and systematically proceeding towards a liberalizing wave of the European gas sector.
Indeed, the government’s involvement in the economy came to be considered as an obstacle to economic progress, due to governments’ limited ability to invest (Van der Linde, 2010). Instead, governments began more and more to switch from a role of producer to that of regulator of privatized interests, including within the utilities sector. While in the 1990s the electricity market liberalization was quite successful, in the gas market the big utilities retained their vertical integration structure and the “majors” continued to behave as “national champions” backed by their respective governments. In that phase, national governments still remained the most important interlocutors of the Kremlin, with the political backing of long-term gas contracts. In the 2000s resource nationalism experienced a renaissance in Russia and other natural resource exporting countries, and the European Commission started to demand more and more for a “common strategy” on Russia that would counterbalance, from the EU’s perspective, the risks of the EU’s worrisome dependency on the autocratic neighbor. The situation was complicated by the fact that in pushing for a common stance the European Commission was pushing for market-based policies and an export of its energy acquis, while the national governments favored bilateral, geopolities-based approaches. Complicating the already complex scenario was the fact that each European country had its own type of heritage in the evolution of the energy industry. The difference in heritage meant that in devising a European energy policy, the fact that each country started out with a different energy mix, a different national tradition and different levels of dependency on Russia would have to be taken into account. The differences in the energy mixes explain the plethora of European standpoints vis-à-vis Russia and for example, the disunity on the long-term contracts’ issue. This dissertation holds that the project to build a unitary external energy policy is not desirable from its very foundation. If the declared goal of the EC’s policy is free competition, then the European companies should be allowed to compete for their best deals with the producers. There is nothing inherently wrong in fiercely competing for supplies, even more if that is exactly what the companies are asked to do in the internal market. Moreover, the goal of multilateral organizations is to assist domestic publics to achieve goals that they would otherwise have difficulty realizing (Keohane et al. 2009). Despite the perhaps, good intentions of the EC’s objectives, the goal of securing supply is accomplished well at the national level, thus the EC should not override the will of fairly elected national governments. Energy security is a field where traditionally national governments have been “touchy” about their sovereignty, and only recently the EU started to gain a say in the matter. When the EU institutions are endorsed by national legislatures and occasionally in public referenda, that process is indeed respectful of the democratic principles. But, when the EU acts as a “benign technocracy” by promoting highly politicized pipeline projects such as Nabucco, those actions deserve a constructive criticism on democratic grounds. The national governments should be allowed to freely formulate their external gas policies provided that they respect the internal rules of the common market. Today, national governments are still strong actors in terms of energy security and there is nothing wrong with that. Empirical evidence of the sheer number of intergovernmental agreements to back “critical infrastructure projects” and the political backing of crucial gas contracts suggest that. Moreover, within the European Union the European Council made up of heads of government or state is still where the real power lies in energy matters. For the first time, the Treaty of Lisbon introduced qualified majority voting (QMV) in energy, which is set to replace unanimity starting from 2014, but it is beyond doubt that Germany, Italy and France will still have the power to safeguard their overwhelmingly “national” interests, even when QMV is introduced within the Council. Nevertheless, in the data analyzed for this dissertation, I find that their influence has been outstripped by the corporate sector, i.e. by the large gas companies. Let us consider for example the Nabucco project, that is a stark reminder that pipelines happen only if they benefit all the parties involved, or in other words have a commercial rationale (Guillet, 2011) and not because of “political” factors. Within the EU and the ECT fora that I considered and whose documents I systematically analyzed, I found that the gas corporate lobby is the
strongest, the best-organized and represented actor. For example, within the Energy Charter Secretariat in 2004 an Industry Advisory Panel\(^8\) was put in place with Members comprising all the big gas (and oil) utilities in Europe. Within the EU-Russia energy Dialogue, a Gas Advisory Council was founded,\(^9\) which is a platform for dialogue on issues of common interests, and consists mainly of representatives of the leading EU and Russian gas companies. Not to mention that some companies such as the Italian ENI, have their Delegations to the European Union.\(^10\) The natural gas trade association Eurogas is a crucial lobbying player too. Eurogas represents the gas sector interests at the EU institutions and, as such, participates in the Madrid Gas Regulatory Forum, the Gas Coordination Group, the Citizens Energy Forum and other stakeholder groups.\(^11\) Eurogas main concerns are the changes that are currently made in the industry structure (i.e. unbundling) and the industry regulation but also any change in environmental regulation and policy. These few examples just comprise cases of corporate lobbying efforts within the EU and the ECT process, not to count their fruitful bilateral contacts with the producers or directly with the governments’ of the producers. These actors are bound to profitability considerations and have multiple institutional structures in place to help them channel their will, which is profit. Before investigating more thoroughly the influence of the corporate sector, the next section will briefly look at the interests of the national governments following the three-step process as illustrated in the research outline (figure 7).

\(\text{6.1.1.1 Analysis of the EU National Governments’ Interests}\)

As in key member states (i.e. Germany, France, Italy) national security in the field of energy seems to be interpreted as maximizing the market-shares and profits of their respective energy companies, with a consequent lack of a comprehensive “national” strategic vision decoupled from the corporate strategy of the big gas firms, their policies are invariably affected by the corporate, profit-driven agendas of their national champions. Just as the Majors that they support, they oppose some of the EC’s regulatory actions in the EU, which are the result of the EU’s drive for internalliberalization. Obviously, energy companies’ and governments’ interests do not always converge, but today the main rivalry seems to be unfolding between the Member states and the EU Commission, and not between the member states’ interests and the corporate interests. For example, until recently, in the gas trade with Russia, the member states together with the gas companies have been opposing the DG Comp’s banning of long-term contracts that for decades have been essential to infrastructure development. Lastly, in face of a growing ‘resource nationalism’ in Putin’s Russia, European governments’ approach is no longer a pure market-driven approach with minimal government input. Instead, it is favoring a strategy that demands a careful planning in a highly cooperative effort with Russian officials and the private industry. In my research, the latter is confirmed by the frequency of meetings between the European heads of state and government and the Kremlin.\(^12\) Although a stronger government involvement is needed in a situation where European energy companies increasingly have to deal with state-owned companies such as Gazprom and Rosneft, this “strong involvement” should not be misused in terms of obstructing the free market internally. On the other hand, having the mandate to ensure a liquid free market does not automatically empower the EC to lead a common external energy policy at the EU level. The key challenge for national policy-makers in Europe will be how to align their policy goals with the strategies of the Big Majors, which

\(^8\) See http://www.encharter.org/index.php?id=23

\(^9\) For more information: http://ec.europa.eu/energy/international/russia/dialogue/dialogue_en.htm


\(^11\) http://www.eurogas.org/

after all are the main actors in the gas trade.

6.1.2 The role of the European Companies in relation to Russia

Many private, public, state-owned or state-controlled companies are involved in the EU-Russia gas trade. Since gas is a very strategic sector, almost all EU countries have opted for some state control of the energy industry. A great number of member states’ energy companies have signed bilateral deals with Gazprom. This number of inter-linkages stands in stark contrast with the poor institutionalization of norms and standards at the EU-Russia cooperation level. In fact, in order to secure contracts with the present-day autocratic and centrist Russia, most of EU companies opt for public-private partnerships backed by the respective national governments instead of potential multilateral arrangements led by Brussels. The relationship between the EU energy companies and Gazprom is one whereseif-interest profit considerations prevail. Admittedly, in the balance between the government and the market, in the 2000s there was a growing role for the governments. However, their action was mainly directed to the political backing of gas deals decided at the corporate level, with fluctuating levels of involvement depending on the type of producer they were dealing with. In relation with Russia, the European corporate state-backed companies have been the uncontested protagonists. For example, let us consider the geostrategic aim of diversification of the gas supplies away from Russia. In the aftermath of the Ukraine-Russia gas disputes, the EU became a strong proponent of a Southern Gas Corridor independent of Russia. In principle, for European energy companies, diversification via LNG and smaller pipeline projects provides a positive perspective by increasing their options in terms of sourcing, duration of contracts and price. Indeed, in such projects the companies are the ones making the final decision in terms of profitability; when the investment seems profitable they are ahead of governments in pressing to diversify into new areas, when it is too risky and commercially unsound, like in the Nabucco case, they are the ones warning that the projects must guarantee profits to the shareholders and banks. In order to get the companies take any action, the projects have to be economically justifiable and not just a geostrategic idea. The European companies do not favor EC’s drive to act as a broker for the EU’s common contracts with external suppliers. The EU’s main companies prefer to retain free hands without the constraints of the EU level policies. In sum, the main organizations representing the gas industry such as Eurogas prefer a less strong European foreign policy and argue that the EU should resist the temptation to interfere in private gas contracts. On the Russian front, as already noted, Russia’s big European clients are France, Germany and Italy. These countries have been seeking separate deals with Russia, favoring their “national energy champions” such as German E.ON Ruhrgas, French EDF and Italian ENI. This caused a strong opposition to any “common” external energy policy, due to a desire to retain free hands. Many observers have criticized the behavior of these gas companies, pointing out that the European Commission was unable to complete an internal market during the 1990s (Helm 2007, p. 38-39; McGowan, 2008) due to the primacy of these national champions, with the support of their governments. In that sense, these companies are considered to be severely undermining the EU’s attempts to build a common external energy policy, by signing bilateral deals with Gazprom. In contrast, this study argues that these actors are simply moved by self-interested considerations of profit maximization. If retaining their special long-standing relationship with Russia, secures them lower prices, the companies will do so at the expense of altruistic considerations towards other EU actors. This economic realism might clash with the EU’s multilateral approach to Russia, and is a severe reason for implementing more solidarity-based mechanisms at the internal level, but it should not spur the primacy of the EC decision-making in the external energy policy. Instead, a benign action of the EU could revolve around increased creativity in designing the cooperation between the EU, Russia and the transit countries, along with the implementation of regulations on energy efficiency and the use of renewable sources.
Further, there are still too few interconnectors on the European gas market and a deeper integration would also be an advantage on the electricity market. The more developed the integration of the single energy market, the better can bottlenecks or disruptions in supply be absorbed. These aspects can altogether already enhance European unity and energy security. An expansion of the LNG infrastructure would also contribute towards improving the flexibility of the system. In each of these cases the structural leadership of the Commission is opportune and desirable. However ‘speaking with one voice’ to negotiate common European gas contracts is not attainable, desirable nor democratically justifiable, and therefore it should not even be on the horizon. As eloquently discussed by van der Linde, the general link that has existed between governments and national companies is also a product of different national business mentalities. As Van der Linde (2010) puts it: “The integration and liberalization of the European energy markets placed much emphasis on the functioning of markets. This process seems to fit best with the Anglo-Saxon model of capitalism. It leaves little space for government intervention, other than regulation of markets. Direct collaboration with the industry is limited, as this is viewed as a distortion of the market and as hampering fair competition. For a number of countries this model implies a break with history, as agreements to not compete have traditionally been part of the European (continental) business mentality. From this point of view, it is not very surprising that the attempts of the European Commission to change the historically grown structures toward more market based structures meets opposition in a number of Rhineland and Latin countries. It is also not surprising that the pace of implementation of reforms in these countries is relatively low.” Since in Europe a number of different capitalistic models co-exist and differ, the behavior of the related companies does too. Italy and Germany are both states that have strong domestic companies, and historically friendly relationships with Russia. Moreover, in the southern and continental states, such as Germany, France and Italy, there is a stronger link between governments and energy companies than in the Northern (Anglo-Saxon) states. The organizational structure of the energy market in these countries changed only under pressure from the European legislation, whose slow regulatory evolution in energy was in turn influenced by the pressure from these two member states to align EU legislation to fit their market interests. Companies from other member states expressed particular anger at German and Italian business ‘doing their own thing’ and undermining the EU’s attempts to speak ‘with one voice’ in energy. Significantly, the traditionally more skeptical British private sector was seen as having shifted position notably, to become one of the firmest advocates of a common European energy policy, as a result of the UK moving towards being an energy importer (Youngs, 2009). This thesis argues, however, that there is nothing inherently wrong in pursuing corporate self-interests, if the rules of the common market are not violated. The EU states have historically given different responses to their energy security concerns, which led them to prioritize different suppliers. Varying geographic positions also motivate their choices, which leads to different geographical priorities in terms of supplies. For example, a country such as the Netherlands might not keep the focus in North Africa, but Italy due to territorial proximity is more prone to do so.

6.1.2.1 The EU Companies as the decision-makers

In many cases the big European utilities are at the forefront of the geopolitical strategies of their respective states, engaging actively in the political dimension of energy security. Therefore, they often become policy-makers of their countries’ strategies, and not just mere policy-takers as some scholars who see them as mere proxies of the state might consider (Baran, 2007). As Ruggie (2004) underscores “corporate influence on global rulemaking is well documented.” This recalls the on-going debate over the general relationship and especially the

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103 To avoid, in Philip Lowe’s words, Director-General for Energy at the European Commission, “the situation of 5 or 6 years ago where 600 projects were declared of European interest but basically they were all nationally oriented and none of the interconnections got built.” Interview Philip Lowe, "If there's one area where the European dimension makes economic sense, it's energy" By Sonja van Renssen and Karel Beckman, European Energy Review, December 2012
degree of autonomy between the state and business in Western economies. Rawi Abdelal argues convincingly that companies are not mere followers of the national and EU market design but are active participants in shaping this process. In analyzing the European gas companies Abdelal offers interesting insights of the fact that in the EU, German, Italian and French gas companies are directly involved in the shaping of the EU’s energy policies. They make corporate decisions that have political consequences. In the Nord Stream pipeline example, Abdelal writes “While German energy companies could not and would not have proceeded with Nord Stream without German policy makers’ having signed on to the project, the agenda was driven from within the firms, which then sought public consent.” In his study based upon the cases of the Nord Stream, Nabucco and South Stream pipelines, Abdelal shows powerfully that many of the decisionstaken were the political outcomes of corporate strategies. Largely for this reason, the European Commission has officially endorsed Nord Stream and has not opposed South Stream, the two Russian proposals in trying to keep out potential intruders from the European market. The energy interdependence of France, Germany, and Italy with Russia has drawn the European nations closer to the East, occasionally at the expense of their multilateral relations with other member states and the United States (Abdelal, 2011). German and Italian (and Austrian) relationships were built on long-standing historical relations. This cooperation has been very successful and even in the midst of the Cold War trade went on without interruptions. The relations have been built on personal trust basis over the years. This explains why, even though many studies such as the Stanford University and the James A. Baker III Institute for Public Policy GRI Index (2006) define Russia as a “risky country,” relations are still fruitful and Russia continues to play a pivotal role in the EU natural gas market. For example, the Democracy index of the Economist Intelligence Unit for year 2010, on a scale from 0 to 10 places Russia at 4.26 and its scores have even deteriorated since 2008. Russia is thus placed within the hybrid regimes. It is already becoming a constant that in international rankings of transparency, accountability and democratic freedoms, Russia has continued to slump. Thus, in judging the riskiness of the relationship, the European companies mainly neglect indicators of good governance and human rights, while at the same time underscoring that since the 1970s Russia had proven as a reliable partner even during the worst times of the Cold War. Largely for that reason, a lack of trust and/or detrimental political relations between the Kremlin and the EU do not jeopardize fruitful commercial relations in the EU-Russia private sectors. In sum, the EU companies prefer to disengage from evaluations about the quality of political freedoms in their partners’ countries, and in lieu are driven by profit considerations. Besides, so far in dealing with Russia, the EU companies did not incur high reputational costs, as it would be the case for example in business with Iran.

6.1.2.2 Analysis of the EU Companies’ Interests

In sum, this study builds upon Abdelal’s work on the corporate influence in the EU-Russian gas trade and in addition, seeks to determine to what extent the centrality of corporate interests correlates to the lack of institutionalization of the EU-Russian gas trade. As argued by Abdelal (2011), the role of firms in the EU’s energy politics have been either systematically misinterpreted or relegated to the status of an input. Although complaining about Russia’s growing ‘resource nationalism’ every major EU company has some bilateral deal in place with Gazprom. In the future, an even bigger challenge lies in how to benefit

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105 See: “EU readies ‘pragmatic’ answer to Putin’s energy agenda,” Euractiv, 18 December 2012


107 Economist Intelligence Unit, Democracy index 2010 - Democracy in retreat, Report from the Economist Intelligence Unit, 2010
from governmental of even the EU’s backing for many large gas contracts and initiatives that stimulate trade and investment, and at the same time avoid their interference in attempts to influence investment decisions.

Even assuming that the EU’s intentions for the “common good” are in good faith, the companies still prefer clear deals based on quid-pro-quos, such as the one between ENI and Gazprom in 2006, that were securing increasing quantities of Russian gas at good prices, in exchange for Russian downstream penetration in European national markets (see Chapter 8). The EU companies have no interest in a common external energy policy with the European Commission at the lead, because that would decrease their possibility of maneuver and “lock them in” contracts or positions that do not reflect their immediate priorities. European companies are driven by profit, thus the purpose to gain competitive advantage over their EU competitors, simply outweighs the benefits of a greater EU foreign-policy unity. In my findings the corporate lobby is the most active one within the EU institutions, with the currently primary task of pushing for its interests in face of the colossal regulatory changes in the structure of the EU internal gas market.\textsuperscript{108} With Russia, the companies want to make sure that long-term contracts are still kept as the guarantors of the EU’s energy security. In the words of Jean-François Cirelli, President of natural gas trade association Eurogas “The vast majority of the Eurogas membership still favors long-term contracts because security of supply is the first priority for a gas company to offer society and long-term contracts are well-suited to that. But clearly the market is going to have to change towards a gradual decoupling of oil and gas prices.” In sum, companies face the simultaneous complexity of national and EU market designs in which they must shape their strategies both at a national level and decide on their overall EU approach. Due to large historical and regulatory differences, member states have at their disposal different strategic toolsets to develop EU strategies. On one side, the companies are pressing for less rigidity in their long-term contracts with Gazprom, thus pushing for revisions in the oil indexation and the take-or-pay clauses. On the other, they recognize that Russia will remain an important energy partner for the EU in the years to come and thus have a strong interest in avoiding confrontation with Moscow.

6.1.2.3 Strategies of the EU Companies in Face of the Liberalization of Gas Markets

As already discussed, the external environment has become increasingly uncertain. In the past years many companies still expressed skepticism over the actual and potential role of the EU’s CFSP in international energy matters. While this thesis holds that the doubts are justified, the Commission advanced from another front – the unbundling of the internal gas market. The policy proposals in the Third Energy Package intend to strengthen the regulatory instruments and devices, and also to promote the far-reaching step of ownership unbundling, requiring a full divestment of the transmission networks from the vertically integrated gas and electricity companies. The Third Package was accepted by the EU Council and came into force in March 2011. Complete internal liberalization, combined with stringent climate regulation and mature energy markets, forced energy companies to adapting their strategies to the new reality. In the late 2000s an increasing gap was created between the “European energy security interests” embodied in the Third Energy Directive and the “European energy companies’ interests” that were warning against over-regulation. When former monopolistic markets are privatized, the old monopolists generally retain a very high market share in their home market. This means that opportunities to grow through market penetration are limited and hence other growth strategies must be found (Van der Linde, 2010). Moreover, the European market has reached the maturity stage (growth rates have declined), which leaves energy companies with two basic growth opportunities. The first one is growing in new markets, in other words, becoming European instead of national companies. Cross-border expansion of these firms (together with broadening the scope of

\textsuperscript{108} Interview with a European gas executive, Brussels, May 2012
products) is often the answer for these players. This trend is widely practiced in the European energy industry and has led to consolidation (through mergers and acquisitions) of the European energy players. The other growth opportunity is growing with new products.

In general, companies reacted similarly to the new challenges they were confronted with. First, several major companies directed their growth strategy toward “the east.” E.ON, RWE and Enel engaged in several takeovers in Central and Eastern Europe to benefit from privatization opportunities and investment needs in those markets (van der Linde, 2010). Enel and E.ON in particular have focused on growing in Central and Eastern Europe and Russia. Second, the “green agenda” offers new opportunities for growth. Renewables, energy efficiency services, nuclear power, grids, and carbon capture and storage are the major fields where investments are needed. The remarkable growth of the German “green industry” is illustrative of this point. Third, concerns about security of supply and market integration offer opportunities for companies to invest in gas storage, LNG terminals, interconnectors and long distance gas corridors. Most major European energy companies have chosen to be active in both the gas and power businesses to widen their possibilities. Lastly, as already emphasized, the “green” agenda represents a very dynamic sector, with possibilities of export of environmentally superior technology, in which Germany is already a world leader. In summary, the ‘maturity phase’ represents an extremely complex challenge, and the role of energy companies is vital in being able to “reinvent themselves” with creative changes. Companies are already reacting to this by diversifying to other products and markets and by buying young and innovative companies, hence ensuring continuity. The major European utilities (E.ON, RWE, Eni, Enel, GDF-SUEZ, EDF, Centrica) are all heavily expanding outside their home markets. The sell-off of non-energy activities (such as real estate, telecommunications, water, chemicals, etc.), together with a semi-protected dominant position in their home markets (i.e. guaranteed demand), provided them with very strong cash positions and thus the ability to expand through mergers and acquisitions. In conclusion, companies adapt their strategies to a changing environment, a process that often moves faster than the implementation of new policy measures.

6.1.3 The European Commission

This section will proceed as follows: first, we will review the competency of the EU and the recent achievements in the EC’s drive towards a common external energy policy. Then, we will criticize these efforts and explain why, under the current market circumstances, the EU has been “playing with fire.” We will focus especially on DG Energy. Lastly, we draw some conclusions.

The so-called multi-level governance best characterizes the decision-making within the EU, or in other words, the existence of overlapping competencies among multiple levels of governance and the interaction of political actors across those levels. In 1992 the Treaty on the European Union (the Maastricht Treaty) established three main pillars (or areas) of activity. The first pillar, the European Communities, is the most developed. Over time, this pillar has been expanded from free trade issues to deal with social and environmental issues as well. In these areas the EU policy-making is the most supranational in character. Excepting taxation policy and monetary integration, decisions can be generally reached by the Member States through a weighted majority in collaboration with the European Parliament (EP) and the Commission (EC). The other two pillars—the Common Foreign and Security Policy (second pillar) and Cooperation in Justice and Home Affairs (third pillar)—are still primarily inter-governmental in character. Energy policy falls under the umbrella of the Common Foreign and Security Policy (CFSP) which means that energy issues are one of the areas where the EC (the EU’s executive) and the EP are still constrained in their action and the real power lies with the European Council made up of heads of government or state and the Council of the Ministers, which brings together
national ministers to agree on decisions, and thus incorporate the positions of 27 countries with often sharply contrasting interests and views even just on the meaning of concepts such as ‘energy security,’ ‘energy internal solidarity’ and ‘external common vision,’ and their practical implementation. Already in 2003, energy security has become integral part of the EU’s common foreign and security policy (CFSP), however thus far progress in the direction of a common external energy policy has been modest. Intuitively, despite of the arrangements at the intergovernmental level, member states still zealously guard against the EU’s excessive interference with their foreign policy goals. Consequently the Member States remain the pivotal actors when it comes to defining energy policy preferences and arrangements with external partners. Despite the agreed general supremacy of member states, in the last years the EC presents a tendency toward a more active external energy policy that it was the case in the past. The EC started to develop its independent geostrategic position in the aftermath of the first Ukraine-Russia gas war in 2006. Given the political panic following the cut-offs and considering the fact that Europe's own reserves would further decline in the future, the EC became a strong proponent of a Southern Gas Corridor independent of Russia. Especially for that reason, the European Union became more active with the Lisbon Treaty that entered into force on 1 December 2009. For the first time, this treaty contains a section on energy, which assigns power to the European Union in ensuring the proper functioning of the energy market,¹⁰⁹ and the development of new and renewable forms of energy. Hence, with the Lisbon Treaty, energy falls within the “shared competences” of the EU and paves the way for a truly European external energy policy. Moreover, the Lisbon Treaty considerably upgrades the position of the High Representative of the Union for Foreign Affairs and Security Policy. Catherine Ashton currently occupies the position; she also became the Vice-President of the European Commission and chairs the Foreign Affairs Council at the Council of Ministers and is assisted by the European External Action Service. The Lisbon Treaty thus provides greater “coherence and unity” to the European Union’s external action. For the first time, Brussels is taking concrete steps to wrest control of external energy policy from the EU member states. However, even after the ratification of the Lisbon Treaty, the EU still copes with the interplay between the supranational decision-making in energy policy (the internal market, competition rules, a solidarity clause, etc.) and the intergovernmental decision-making based on parameters set on the national level (e.g. foreign policy, the energy mix). Hence, even with the Lisbon Treaty in place, the EU is still not a geostrategic player per se as for instance are the United States, Russia and China. The European Union is a geo-economic power, but ‘neither meat nor fish’ as a geopolitical player. Geopolitics still predominantly resides in the capitals of the member states despite the EU’s formidable economic power. In contrast, on climate change and in competition policy, the EU has emerged as a player in its own right, in a way that it had not in relation to the geopolitics of energy security. Thus, the EU is trying to reap Members States’ sovereignty in energy security matters, acting from these two fronts, where it has more powers. Another challenge for the EU administration stems from the fact that since “energy security” still resides mainly within the national capitals, the latter has been one of the most fragmented and diffuse issue-areas at the EU level, with the least attracting jobs, in contrast to the more organized agenda of environmental policy where the EU emerged not only as a player, but as a directional world leader. In any case, the wind has somewhat changed within the European Union since 17 February 2010, when DG Energy was established, as a product of a split from DG Transport.¹¹⁰ Since then, politically energy became a more attractive issue and the promoters of a more geostrategic energy stance at a EU level, begun to be gain a bigger say in the EU Commission.

¹⁰⁹In particular in the energy supply and the promotion of energy efficiency and saving
6.1.3.1 Analysis of the DG Energy Interests

The European Commission’s energy interests can be summarized in the words of the EU’s Commissioner for Energy Günther Oettinger that in September 2011 said: "The EU energy policy has made real progress over the last several years. Now, the EU must extend the achievements of its large internal energy market beyond its borders to ensure the security of energy supplies to Europe and foster international energy partnerships. Therefore, the Commission proposes today a coherent approach in the energy relations with third countries. The need is to improve internal coordination so that the EU and its Member States act together and speak with one voice." 111 Thus, the first goal has been to promote a liberalized, liquid European gas market where gas can freely flow from one point to the other. That is to be achieved by harmonizing the EU internal regulations and by providing internal interconnections. To that end the ‘third energy package’ has been promoted, which came into force in March 2011. With this law, the Commission succeeded in incorporating its 2007 proposal to ‘unbundle’ the generation and distribution of power. Since 2011, the Third Package requires all energy companies active in the European market to run their supply, transport and sales businesses separately. The underlying assumption is that breaking apart national energy champions within Europe also makes it harder for non-European firms, like Gazprom, to negotiate their way into dominant positions simply with a number of bilateral deals. This thesis holds that the action of the EU on this front has been justifiable and passes the “democratic” test, since the Council has endorsed the Third gas directive. However there are other complexities to take into account. Although developing a liquid liberalized market is per se a good thing, the European Commission should calculate the consequences of its endeavors. Continental Europe cannot be compared to the US market and to some extent the UK market, both based on gas-to-gas competition (i.e. spot trading) and independent benchmark prices set at the Henry Hub in the US and the NBP in the UK. What made liberalization possible in these two markets was essentially one prerequisite: these two countries had ample natural gas reserves and many gas producers, making them practically self-sufficient. Coupled with many different suppliers and buyers active in those markets, it generated real competition in all segments of the gas chain. At the same time, it allowed the formation of spot markets, where the price was set by the daily meeting of demand and supply, not connected to the prices of alternative fuels such as oil (Maugeri, 2011). In the European market, despite the growth of new alternatives, such as increasing shares of liquefied natural gas (LNG) and supplies from other regions, the bulk of the gas supply is still concentrated in the hands of few producers; Russia and Algeria in primis, that act as oligopolies. As long as this situation remains, by definition there cannot be a free market and increasing a number of sellers in Europe will not change this ultimate reality. Admittedly, with the increasing shares of “other,” cheaper gas on the EU markets, Gazprom will gradually lose market share. That was proven in 2012, when Gazprom choosing between lower markets shares, or lower prices opted for lower shares while maintaining the price intact - because it is more profitable for the actor that retains the dominant market share to lose small market shares, than to start a “price war” by putting the price significantly down, which would largely decrease all of its profits. On the other hand, in this situation other competitors have to offer just a small reduction from Gazprom’s price, to be able to sell on the European markets. 112 In any case, the erosion of Gazprom’s dominance on the EU’s markets will be progressive, but Russia will remain a crucial actor. That means two things: first, the EU should be aware that antagonizing Gazprom might be quite dangerous, because the company’s reaction to the changes in the EU has so far been a punitive reduction of upstream investment. Second, the EU is contradicting itself in trying to act as the backbone of liberalization and at the same time supporting highly politicized diversification projects, such as Nabucco. Critics, such as De Jong (CIEP, 2012) go even further in arguing that the EU is taking a big risk. He warns that there might be not sufficient investment in gas

111 Communiqué 07/09/2011 - speaking with one voice – the key to securing our energy interests abroad, European Commission

112 Author’s Interview with Giacomo Luciani, Princeton University, May 2012
production and infrastructure projects, like pipelines and LNG terminals, if investors do not have long-term supply and capacity contracts to rely on. This study agrees with De Jong’s position; in the long-run Gazprom should be forced to compete in the EU’s gas markets, but gradually, provided that the EU has secured enough alternatives. Moreover, the European Commission’s ambition to monitor all intergovernmental energy deals between EU member states and third countries, and thus become the arbiter of member states’ external energy policies seems just impractical and undesirable. How and why should a multifaceted bureaucracy be entitled to negotiate energy deals on behalf of the member states? Would the EU be democratically accountable for such deals? The answers to these questions are far from clear, thus this dissertation expresses skepticism about the EU’s ambition to take such a strong stance on external policy, instead of keeping itself busy in delivering a common internal market by 2014, which would in itself create more security and communality between member states. Also, it is unclear how the new policy can be made to work in practice. More precisely, how would this policy counter the incentive for member states’ governments to continue taking unilateral action in order to achieve their individual energy security goals? The answer to that question is also far from clear. In the words of a Russian energy expert: “We understand that now gas contracts can be challenged or even terminated by the European Commission, an actor that has no commercial responsibility. We currently don’t know who is our counterpart, neither whether the transfer of responsibility and liability from the national governments to the EC has happen already or not. We don’t know...” We assume that there is still a struggle between the member states and the EC.” The new Policy is currently non-binding, whereas to be implemented successfully some fresh transfer of sovereign powers to the European Commission would be needed. Despite the fact that in Europe, an enviable political culture of pooling sovereignty has emerged, the Commission should restrain itself from pushing as soon and as much as possible for the transfer of external energy competences to the EU level, which might provide an negative impression that the only real goal of the EU is to increase its powers.

6.1.3.2 Conclusions

This thesis agrees with scholars arguing that the prerequisite for an external EU energy policy is to clearly have internally something that would deserve the name of a single, or at least common gas market (Van der Linde, 2008, Bressand, 2010). But it also holds that a “EU energy policy” should not empower the European Commission to decide the energy supply sources on behalf of the member states. If there is no single EU energy mix, then the member states should be free to determine their supply sources independently.

In conclusion, the European Commission does not have a strong mandate in foreign policy and energy security policy. For the time being, the EU seems to remain a weak actor in this field, but its powers are rising and are to some extent, ironically jeopardizing its own energy security. If the European Commission wants to be vocal on the external front, a benign way to do that would be to engage in the modernization of the Energy Charter Treaty, which calls for the involvement of various actors, such as the governments of both exporting, transit and importing countries, energy companies, consumers and investors. The EU is not ready for a truly common approach on energy policy. The diverging approaches taken by the European governments to shale gas exploration, which threaten a major row in Brussels about how, if at all, it should be regulated, cause already major headaches for the Commission given the prominence of gas in its roadmap (Euractiv, 2011). According to

113To achieve this transformation, the Policy relies on the creation of a new institutional framework that includes an “information exchange mechanism” to share information within the EU on all bilateral, “intergovernmental” energy deals that member states make with non-EU countries. The proposal adds “the Commission may give an ex-ante assessment of the conformity of a future intergovernmental agreement with the EU law before such agreement is signed.” See: van Renssen, S. External energy policy: Brussels takes charge, European Energy Review, 12 September 2011.

114Which is the EC self-proclaimed goal for the completion of an internal energy market

115That ideally would focus on non-binding, consultative aspects such as an “information exchange mechanism” to share information within the EU on all bilateral, “intergovernmental” energy deals that member states make with non-EU countries.
many Euro-enthusiasts, the shale gas issue is one of the most striking examples of the need for an internal and external energy policy, and the epitome of the troubles encountered when security of energy remains a national, rather than EU, competence. On the contrary, this dissertation argues that the lack of an internal consensus over European external priorities and the institutional wrestling among the key member states are more than welcome as long as they follow a democratic process legitimized in the eyes of the European constituencies. The idea of Brussels as a broker for energy projects is unjustifiable from the perspective of the stark differences in supply among member states that thus requires some room for maneuver. Thus, an efficient energy policy that encompasses all aspects (internal and external) of energy security should not even be attempted in the current situation where the EU is still highly segmented and depends on a handful of external suppliers acting as oligopolies.

6.1.4 Other Actors on the EU side

Despite the centrality of the actors analyzed in detail above, the gas trade cannot be understood solely by looking at the nation-state level, the supranational level, or by only examining the crucial but not self-sufficient role of the energy companies. In fact, a multiplicity of other interest groups and actors – public and private, European and non-European interact at different levels, all trying to support their cause and/or gain from the broadly speaking, EU-Russia gas trade. On the one hand, considering that pipeline projects are colossal economic and not just geostrategic projects, they involve a wide array of shareholders, such as the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and large commercial banks in their realization (i.e. the Unicredit Group participation in Nord Stream).116 The WTO is another actor that is potentially involved in the EU-Russia energy trade, with its rules on investment and its mechanisms for international dispute settlement. Various NGOs and environmental advocacy groups participate in the decision-making process within the EU. The commitment of these groups played a crucial role in transforming the EU in the by far most advanced environmental bloc in the world. However, these groups do not form a unified and influential front, as it is for instance Eurogas, the union of the gas industry at the EU level. Therefore, the most powerful interests groups are undoubtedly the energy companies’ unions. At the regional level, the connection between geopolitics and geo-economics assumes new significance and a potential for bottom-up change. Therefore, local advocacy groups, such as for example the Central European Initiative,117 with the voicing of their interests can help to establish a dense network of official and informal contacts with the Russian counterpart that could facilitate a more effective formulation of EU-Russian energy cooperation.

116 See “How to be a Tiger - What emerging Europe can learn from East Asia”, Finance – the Executive Magazine for Emerging Europe, Spring 2011
117 See http://www.cei.int/
Figure 8: Main Players in the European Gas industry and trade

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Source: Compiled by the Author, division of Gas Security in sub-indices partly based on the United States the Chamber of Commerce “Energy Security Index”, 2011

### Abbreviations:

- Inv: Investment
- LGS: Large Gas Companies
- MS: Member States
- EC: European Commission
- ECT: Energy Charter Treaty
- REG: Regulators
- ACER: Agency for the Cooperation of the Energy Regulators

6.2 The Russian Gas Theater

As argued in the previous chapters, the Russian gas scene is more concentrated than the European one, thus here we are talking about a smaller number of influential actors. The Russian gas sector is strongly dominated by the interests of Gazprom that acts hand in hand with the Kremlin to achieve its objectives. On the one hand, the Kremlin’s involvement in all energy agreements is a fact since Putin came to power. On the other, it would be misleading to assume that the presidential endorsement necessarily fits into an overarching power project and geopolitical vision (Dellecker & Gomart, 2011). The increased importance of purely commercial considerations, internal power bargains, not to mention personal favors involving money in Russian decision-making processes has been continuously underestimated by Western expertise (Dellecker et al., p.207). In any event, the centrality of the energy business in Putin’s worldview and daily schedule is beyond doubt. Gas in particular is considered as the strategic resource to be used to restore Russia’s “right place” in the world’s scene. The fusion of Russia’s external agenda and gas strategy has reached such a degree that it is almost impossible to establish whether it is foreign policy that serves Gazprom’s interests or Gazprom is an instrument for restoring Russia’s “greatness.” In this section, we will take on this difficult question, by trying to identify first who are the main players in the Russian gas industry, second we try to determine who is “running the show” on Russian gas, the Kremlin or rather Gazprom and whether their interests are symbiotic or not, lastly we draw some conclusions based on empirical data. Just as a preview, in 2009, income from the oil and gas sector amounted to 17% of GDP in Russia,¹¹⁸ which reveals the fragility of Russia’s economic power, and its high dependence on oil and gas sales.

That is why energy policy is a domain of strategic importance both for the Kremlin and Gazprom, and the crucial question whether there is a symbiotic coherence or perhaps lack of

¹¹⁸ “Hydrocarbon revenues to fall to 13 pct of Russia's GDP by 2020,” Ria Novosti, December 9, 2010
coherence between the two has attracted increasing academic attention (see among others Tkachenko, 2007; Grigoriev, 2011; Bilgin, 2011; Demakova and Godzimirski, 2012). Once determined the dominant actors, the last section of this chapter will examine the interaction of the dominant actors on the European and Russian side and test whether there are casual implications between their interests and the absence of clearly defined rules regulating the energy relationship.

6.2.1 The Russian Government

In this section, by government we refer to the president and his cabinet and the prime minister and the ministries. In principle, other important bodies include the Duma and the Russian courts. In practice, however, the executive has an interest in keeping the Russian parliament, the Duma, and the judiciary power quite weak and all the main decisions are made by a small group of insiders. Therefore, only the executives’ role will be examined. Conventional wisdom holds that the government, or more precisely the personal power of Vladimir Putin is the key element to understand all the crucial decision-making processes in Russia, especially when speaking about a resource like natural gas. These authors refer to Gazprom as the proxy of the Kremlin (Baran, 2007), as ‘synonymous’ with the Kremlin (Light, 2008) and more moderate literature simply argues that while business is important, the Kremlin is the “head” and Gazprom is the “hand” in achieving strategic goals decided by the Government (Youngs, 2007; Tkachenko 2008, Overland, 2008, Barysch, 2010). This section provides a counterintuitive argument, and thus challenges conventional wisdom about the role of the government and the role of Gazprom. A common critique regards the fact that, after the partial privatization of the oil sector by Boris Yeltsin, president Putin firmly recaptured state control over the energy industry and made the conditions of entry for foreign companies tougher. Just before the second term elections, it was important to show that the people’s wealth was under Kremlin’s control. It was also politically important to show that the Great Russia was back on the international scene. For instance, IOC cooperation in joint ventures were cancelled, concessions were withdrawn, and sometimes there were even expropriations. The transferred ownership of the Sakhalin-II oil field and the Kovytka site in Siberia epitomize Russia’s determination to re-gain control over its energy resources.119 As a result many scholars came to the conclusion that it was the Kremlin and its quest to reassert Russian power, rather than profit considerations to guide Russian energy-related decisions. In the EU the political panic was understandably rising as new notions such as ‘state capitalism’ and ‘sovereign democracy’ had come to the fore of Russian politics and were here to stay. Experts were also pointing out that Putin had transformed Russia’s traditional geopolitical approach in foreign policy into a more innovative geoeconomic approach, which, according to Chatham House’s Sherr (2010) has become a leitmotif of the Putin era. This transformation was enabled by the 1993 change in the Russian Constitution that established a new reality in Russia: the only center of real (public) power in the country became the president, and any contacts between the president and other state institutions now involved the presidential administration as the only mediator (Tkachenko, 2008). The mixture of Putin’s personal political style, his conviction that natural resources were the means to restore Russia’s economic (and political) strength120 and the general growth in importance of the executive, fueled concerns about Russia’s growing ‘resource nationalism.’ Because of the sheer number of works that misinterpret ‘resource nationalism’ in Russia, the next section will provide a conceptual analysis of Russian ‘resource nationalism’ while relating it to the country’s legislative activity in the last decade.

120 Energy was the topic of Putin’s doctoral dissertation that he defended in 1996 at the St. Petersburg Mining Institute, defending state control of energy companies and invoking the country’s national interests to limit the rights of private owners.
6.2.1.1 Russian Government’s “resource nationalism”

The switch of the oil and gas markets from buyers’ to sellers’ markets in the 2000s mixed with the strengthening grip of autocratic regimes in most of the exporting countries caused the rebirth of resource nationalism. The process was also accompanied by a weakening of globalization, due to the fact that poor countries were increasingly dissatisfied with the uneven distribution of globalization’s benefits (Abdelal & Segal, 2007). These sentiments combined with the phase of high hydrocarbon prices prompted the producing countries to re-nationalize their energy policies. In the world today the situation of the 1960s is inverted; National Oil Companies (NOCs) represent the top 10 reserve holders worldwide, whereas Western international oil companies (IOCs) control less than 10% of the global oil and gas resources. OPEC member Saudi Aramco, for instance, holds 20 times the oil reserves of ExxonMobil, as the biggest privately owned supermajor. The new “Seven Sisters” are now Saudi Aramco, Russia’s Gazprom, CNPC of China, NIOC of Iran, PDVSA of Venezuela, Petrobas from Brazil, and Petronas from Malaysia (Hoyos, 2007). Russia, one of the largest oil producers in the world and the first producer of natural gas, with its centralization of state control over natural resources represents one of the most notorious cases of ‘resource nationalism.’

However, in order to make sense of our case a key issue concerns how ‘resource nationalism’ is defined. Given the recent revival of interest, there are plenty of different definitions and interpretations. In this section, a definition proposed by Paul Stevens (2008) is used: ‘Resource nationalism’ is assumed to have two components – limiting the operations of private international oil companies (IOCs) and asserting a greater national control over natural resource development. The drivers of ‘resource nationalism’ are many and are a function of history as much as the current context. It can be driven by a concern that the IOCs are taking too large a share of the cake. Another driver is the perception amongst ordinary people that they have seen little or no benefit from the extraction of ‘their’ oil and minerals, despite IOCs paying taxes to their governments. This ‘exclusion’ variable is the main driver in Russia, where people perceived that the sell-off of oil and gas resources in the early 1990s was an outrageous giveaway that created a bunch of oligarchs tainted by corruption. Bremmer and Johnston (2010) have recently proposed a framework for understanding resource nationalism. They identify four varieties of resource nationalism and provide examples of each: a revolutionary type, tied to broader political upheaval (as for example in Russia and Venezuela); an economic type, driven by a more measured desire to improve economic terms (for example Kazakhstan and Algeria); a legacy type, inherited as a consequence of a reassertion of historical control (for example Kuwait and Mexico); and a soft type, conducted through legal channels without threats to tear up contracts (as in Canada and the United Kingdom). According to Bremmer and Johnston, in its most virulently populist form, resource nationalism can pose political risks for governments that pursue it. It can deprive them of the foreign technology and expertise they need to expand, or even sustain, the output and revenue streams they need for long-term survival. So long as prices remain high, governments can extend international influence and sustain popularity at home. But if and when prices begin to fall, it will make difficult to buy the needed technology from outside and resource-drunk politicians may face, or produce serious local and regional instability. A second feature of revolutionary resource nationalism is its dangerous effect on international resource companies. According to Bremmer and Johnston, Russia and Venezuela exemplify the highest-profile, and most notorious cases of ‘revolutionary type’ resource nationalism in the 2000s commodity-market cycle of high prices. This thesis argues that whilst the Bremmer and Johnston’s framework has a vast analytical utility, it should be couched more clearly in a historical, cultural and ideological context. The authors are right on the point that Russian ‘resource nationalism’ encompasses the broader reconsolidation of state power under the Putin presidency beginning in 2000 and the larger rollback of privatization in strategic sectors, just as it happened in Venezuela.
However, a more nuanced view of the phenomenon is needed. We have to bear in mind that each resource-rich state has unique cultural, ideological, historical, political, and economic reasons for the policies it enacts. As commodity prices spiked between 2003 and mid 2008, both Russia and Venezuela used the amassed substantial reserves of hard currency to spend lavishly on projects meant to bolster their political popularity. But unlike Venezuela, Russia is not a member of the OPEC and unlike Hugo Chavez or Mahmoud Ahmadinejad, Russia does not threat the use of ‘the energy weapon’ against its main customers. On the contrary, it takes great pains to remind the EU that it has always been a reliable energy supplier both during the Cold War as today (see Belova, 2010, Grigoriev, 2011). Russia knows that European markets are far too important for Russia and it is also painfully aware that the EU if challenged, could turn to other producers or alternative energy sources. The curtailing of gas shipments would cause a great harm to its reputation, which explains why Russia has never purposefully used gas as a political tool in its dealings with Europe. Some occasional threats to divert preferences towards China are still mostly empty words. That makes Putin a significantly different player than Chavez, who is frequently threatening the United States, its main customer, to use the ‘energy weapon.’ Even though many observers see Venezuelan threats as ‘empty rhetoric’ this aspect however signals a significant difference between the two leaders. With a highly developed educational system and a large industrial economy, as argued by Yergin (2011, p.110) and in contrast to Goldman (2008), this thesis agrees that despite holding some elements\textsuperscript{121} of a petro-state, Russia is much more that.

6.2.1.2 Turning Gazprom’s Interests into Law

However, where the Western concerns about Putin’s intentions proved to be right was in the fear that Russian “resource nationalism” would translate into an anti-Western IOC campaign and a closure of the Russian pipelines to other producers. On 20 July 2006 the federal law “On Gas Export”\textsuperscript{122} approved by the state Duma granted Gazprom exclusive rights to export natural gas.\textsuperscript{123}Thus, in 2006 the Russian Duma unanimously approved that “third-party access” will not be introduced in Russia and that Gazprom will remain the only Russian company authorized to sell gas abroad. The law iterates the export monopoly of Gazprom, including non-pipe gas, such as liquefied natural gas and Condensate. That also means that the company is entitled to full control and management over the transmission system in Russia which consists of a network of 144,000 kilometers of high-pressure inter-regional pipelines, as well as the country’s compressor stations and storage facilities (Nicchia, 2008 p.47). By authorizing Gazprom to be the only company allowed to sell gas to the lucrative markets outside Russia, this law cements an inordinately Gazprom’s interest and not a “Russian” interest, given that all the pipelines are managed by Gazprom and that other potential Russian independent producers (such as Novatek and Itera) are in a position where they can sell gas only if Gazprom grants them access to the pipeline and only to the less lucrative domestic market. Russia has adopted other two Laws, with the apparent aim to get state control over investments into natural resources. They are the Strategic Investment Law\textsuperscript{123} and the Subsoil Law\textsuperscript{124} (Belyi, 2009). The Strategic Sector Law applies to investments above certain thresholds by non-Russian investors. Its article 6 lists 42 activities to which the Law is applied. The Law integrates the meaning of control over natural resources and pipelines into the Russian legislation. The meaning of control links the energy sector to national security. Control is defined as having more than 50 per cent of the voting share in a strategic enterprise and in the energy sector the limit can be about 10 per cent. Therefore,

\textsuperscript{121} It depends upon oil and natural gas for for 70 percent of its export revenues, almost 50 percent of government revenues, and 25 percent of GDP – all of which means that the overall performance of the economy is closely linked to these commodities price fluctuations, which generates a constant debate about how to diversify the economy away from oil and gas.

\textsuperscript{122} Law of Russian Federation of 18 July 2006, N. 117

\textsuperscript{123} Law of Russian Federation of 29 April 2008 N 57 – AP

any investment into the energy sector should be subject to particular approval. Here again, it seems that Gazprom’s interests were the main drivers of the process. For Gazprom, protecting its access to new fields is of crucial importance, while neutralizing the competition of other, often more technically advanced companies. The competitors are in fact granted licenses only when Gazprom finds it suitable, as for example with Total that was granted a license for the Shtokman field and the reduced technical participations of Shell and BP in both their onshore and offshore projects in Russia. The Russian Subsoil Law goes further (Belyi, 2009). Article 9 stipulates that the holder of production license must be a Russian Co. Clearly, in this case again, it seems that Gazprom is the principal, whereas the state is the agent that helps Gazprom to achieve its goal of control of the access to strategically important and commercially attractive gas fields. Lastly, in September 2012 in face of the anti-trust investigation against Gazprom due to its monopolistic position in the EU that contrasts with the EU’s “ unbundling” policy, a decree signed by Vladimir Putin blocked “strategic” firms from co-operating with foreign investigations without government permission. The “Decree on Strategic Companies” stipulates that any negotiations on gas prices and the contractual terms now have to be approved by the Russian government directly. In conclusion, it seems right to agree with Grigoriev (2011), and Demakova and Godzimirski (2012) that Russia’s politicized approach in the gas industry largely mirrors Gazprom’s own interests.

The next section focuses on the emergence and development of the Russian gas giant Gazprom. The structure of the section is the following. There is an introductory part presenting Gazprom’s historical development since the breakup of the Soviet Union and its remarkable rise that made it the biggest gas company in the world. Then we deal with the famous principal-agent question, and we present the specific strategy that Gazprom has developed to deal with its customers, in conclusion we discuss whether is right to consider Gazprom as synonymous with the Kremlin or rather something else. We find that Gazprom acts more and more like any other multinational company with an independent logic of profit maximization. We discuss a number of examples where the company has acted as a rational actor trying to maximize its profit. The final section provides the conclusion.

6.2.2 The gas Colossus: Gazprom

Gazprom is the largest extractor of natural gas in the world and the largest Russian company by market capitalization. In 2010 the Gazprom Group produced 508.6 billion m3 of natural and associated gas, 10% up versus 2009. The increase in gas production was induced by a recovery of the international and, in the first place, domestic markets after the global financial crisis. In 2010 the share of Gazprom in the total Russian and global gas production accounted for 78 per cent and 15 per cent respectively. Gazprom holds a monopoly over gas transportation within Russia and over all gas exports. It is thus Russia’s interlocutor with the global gas markets. It is a very remarkable expansion for a company that was created from the Soviet Gas Ministry. However the history after the break-up of the Soviet Union was not quite linear. Gazprom, just as the other oil companies in the early 1990s incurred the large wave of liberalization. However, in contrast to the oil industry, Gazprom had not been divided into several companies but was kept as a single unit. By 1994, 33% of the Gazprom’s shares had been bought by 747,000 members of the public, mostly in exchange for vouchers. 15% of the stock was also purchased and allocated to Gazprom’s employees. The state retained 40% of the shares, but the amount was gradually lowered to 38%. Trading of Gazprom’s shares was heavily regulated, and the by-laws of the company prohibited foreigners from owning more than 9 percent of the shares. During the depression period, the non-payments for gas deliveries severely undermined the company’s finances and had a

125 Author’s Interview with a Russian energy expert, October 2012
127 http://eng.gazpromquestions.ru/?id=7, accessed in April 2012
negative impact of its investment policy. Low domestic gas prices were kept heavily regulated and Gazprom literally subsidized Russian customers throughout the 1990s. Thus, natural gas sold abroad is considered to have kept the Russian economy afloat during the economic crisis (Yergin, 2011). Moreover, until recently, Gazprom provided the former Soviet republics with gas at prices considerably lower than those paid by EU importing countries (Pirani, 2010). Accumulated debts and accusations of stealing the gas designated for the EU market became a source of growing tensions between Russia and its neighbors (especially Ukraine). Gazprom’s situation changed abruptly in June 2000, when Vladimir Putin became the president of Russia. With Putin in office, the murky exchanges in the top management diminished and the company was put under control. In the words of a Russian energy expert: “Upon his arrival Putin centralized and took control over Gazprom. For his part, Miller came first and foremost with this task.”

In October 2003 Putin clearly expressed his view to German Chancellor Schroeder that Gazprom is not going to be divided (Demakova and Godzimirski, 2012). In 2004, the state increased its stake in Gazprom from 38 per cent to a controlling 50 per cent plus one share. At the same time, the restrictions on foreign investments were lifted and the company became fully open to foreign investors. Private shareholders and companies (such as E.ON) now own the other half of its shares. As already noted, the federal law approved by the state Duma also granted Gazprom exclusive rights to export natural gas. The company became the so-called ‘national champion’ and one of the cornerstones of the new government’s strategy to retake control over the ‘commanding heights’ of the economy, and in particular the energy sector. Through a combination of acquisitions and organic growth, Gazprom reasserted itself as a major player in Russia and abroad. In 2008, Gazprom claimed to had produced alone some 10% of Russia’s GDP. Today the company provides about 8 per cent of Russia’s GDP (Aslund, 2010). Moreover, it enjoys a particularly intimate relationship with the political power. Mr. Chernomyrdin, the former Chief Executive of Gazprom, became Prime Minister of Russia (1992-8). Mr. Medvedev, a protégé of Putin who served as the chairman of Gazprom’s board of directors, was elected Russian president in 2008. And, as Yergin (2011) puts it: “In many meetings with the Western businessmen, Prime Minister Vladimir Putin has demonstrated a deep interest and an extraordinarily detailed knowledge about the gas business.” Despite the mostly symbiotic relationship between Gazprom and the executive, there is one issue where the two clashed throughout the 2000s: i.e. the subsidized prices that the CIS republics and the domestic consumers were paying for gas. Since the break-up of the USSR the former Soviet republics were first getting gas through barter trade arrangements, then gradually moving towards market levels but the transition has been very slow. Obviously, Gazprom would want the adjustment to be faster (Grigoriev, 2011). In fact, in the last years Russia has been raising the prices for natural gas in all the CIS republics, for its adversaries (e.g. Georgia) and allies (e.g. Belarus) alike, although at varying speeds (Perovic, 2008). Moved by Gazprom’s concerns for profitability and its warnings that large-scale subsidization was no longer affordable, Russia’s government even accepted a loss of political influence in the CIS subsequent to price increases. Thus not only Ukraine and Georgia, but also ‘friends’ of Moscow in the neighborhood have been asked to pay higher prices for energy, including Belarus, Armenia and Kazakhstan, due to Gazprom’s insistence on the “commercialization” of these relationships. If one looks at when these hikes happened in the above-mentioned republics, except for Ukraine, they do not coincide with “political” crises. By hiking the prices, Gazprom and not Russia, liberated the special relationships Russia had had with the CIS (Treinin, 2011). Moreover, Gazprom has been consistent in raising the heavily subsidized domestic prices for gas. Prices for gas sold by Gazprom to its domestic customers have been regulated by the Russian state throughout the post-Soviet period and kept at relatively low levels in order to protect the country’s economy from excessive price movements for its most important fuel. However, by 2006 this strategy had become increasingly untenable as Gazprom’s need to invest in expensive new fields and

128 Interview with the Author in October 2012
129 Gazprom in figures Factbook 2004-2008
Russia’s need to increase energy conservation demanded a higher price level. As a result, President Putin introduced the target of domestic industrial gas prices reaching netback parity by 2011, implying a doubling of the price level over 5 years and the consequent introduction of a fully liberalized market at the end of the period. However, although this target has been constantly referred to since then, in 2011 Russian domestic gas prices remained as far from netback parity as they have ever been over the past five years (Henderson, 2011). The government’s use of natural gas as a “social shock absorber” (Nicchia, 2008) can explain the prudent policy towards any increase in domestic prices. Yet, another escamotage was set up to prevent Gazprom’s damages from this situation: the independent gas producers have now a higher share in domestic production, while Gazprom is free to direct its energies to modernize and improve production in order to meet its commitments and in the medium term (say ten years) be able to direct its attention to the Asian markets. Thus, the independent producers that accounted for basically all the growth in the gas sector in recent years will be allowed, domestically, to fill Gazprom’s unattractive gaps. In the last years, domestically Gazprom accounted for negative or zero growth allowing the independent producers to flourish. However, if producers such as Novatek or Itera start to produce profitably gas at lower prices than Gazprom, then Gazprom might find itself at a competitive disadvantage at home. In 2010 the “Non-Gazprom” gas players in Russia produced 142 bcm of gas, equivalent to 22% of the country’s total gas production (Henderson, 2011). In the future, the Russian gas scene could evolve with the dynamic production growth coming from these so-called 'independent gas producers' such as Novatek and Itera, or oil majors seeking to develop the gas business (Stern, 2010). However, in the current situation where netback parity is still a long way off in Russia, Gazprom has still time to catch-up. In 2010, the European export market accounted for just 23% of Gazprom’s total gas volumes sold, but 54% of its total sales revenue. Thus, exporting gas to Europe is far more profitable than domestic sales, and, as such, Gazprom logically favors the European market.

6.2.3 The Principal-agent dilemma

The central question of what are the dynamics in a principle-agent type of relationship has intrigued many students of International Political Economy (IPE) for a long time. This literature pertains to the dynamics that arise when the principal, that according to conventional wisdom in our case is the Kremlin, tries to control or affect the behavior of the agent (Gazprom), to make the agent act more in accord with its strategic objectives. There are many studies of the challenges inherent in the delegation of authority to an agent whose preferences may differ from those of the principal, which examine the strategies available to principles to ensure the obedience of their agents (e.g., McCubbins and Schwartz 1984; Weingast 1984). Part of the problem arises from the fact that the government (the principal) might not have at its disposal all the information about the activity of its agent, which often voluntarily discloses it in the pursuit of its own interest, and thus the government faces the so-called information asymmetry problem. Principal-agent considerations are also important in the design of the institutional structure of regulation of the financial markets (Stiglitz & Greenwald, 2003). In the Government-Gazprom dynamic, Gazprom was figuratively called by some authors (Victor et al. 2006) as a “state within the state,” implying that the power and the interests of the two have been intertwined. The evidence provided by the case studies in this dissertation (Chapter 7 through 10) and the documents analyzed, lead me to argue that Gazprom as a principal, fully supported by the Kremlin, has been pushing to gain greater and more direct access to European gas markets. True, all the big pipeline projects were decided in accordance with the state. The relevant literature is right to look at the Kremlin-Gazprom relationship from the perspective of a principal-agent pattern, also

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130 Gazprom Export, 2011
called patron-client relationship, however, Gazprom is not “the hand” of the Kremlin, but rather the opposite is the truth. In general it is believed that the government (the principal) owns the nation’s resources, which the national energy firm (the agent) has the mandate to develop (Smeenk et al., 2010). In this kind of relationship Gazprom would be accountable to the government in terms of Russia’s priorities and goals as well as its export strategy. However, this thesis has provided evidence that it is rather the Government’s function to provide for the necessary circumstances to allow Gazprom to conduct its business in the most protected and profitable manner (i.e. the laws). Therefore, it is more “what is good for Gazprom, is good for the Government,” in the sense that Gazprom is the driver rather than the tool of the expansion strategies. In a way, that is justified by the fact that Gazprom alone provides 20% of the earnings of the federal budget tax revenues. Over the years, Gazprom fully asserted itself as a global energy player. Yet, some observers argue that despite Gazprom being the world’s largest multinational natural gas company, it is still a NOC and has to play under the framework of the Russian style state-capitalism. But, as we have seen, the Russian state-capitalism creates fewer constraints to Gazprom than the regulations in a competitive market economy do to any other European company (i.e. the Third energy Package). To a certain extent, Gazprom is free to do almost anything to boost its profits. Admittedly, during the 2000s the company was facing two often-incompatible tasks: first, aligning with the state’s geopolitical interests and second, boosting profits. If we take a more nuanced view of their relationship, we recognize that Gazprom has often clashed with the government in the pursuit of its economic interests that did not always match the state’s political design. Since the subsidized prices in the CIS and in Russia were undermining the firm’s profitability, they were gradually eliminated. Hence, in the only real domain where the Kremlin’s strategic interests were not harmoniously in line with Gazprom, the latter’s position triumphed. For Gazprom the discounted prices that the CIS were paying on the grounds of the status of ‘zones of privileged interests’ were inadmissible and it thus pushed for a liberated market-based relationship with the whole FSU, with some controversial results. It suffices here to say that Gazprom’s will prevailed. Its insistence over higher domestic prices coincided with the substantial uncertainties over its sales to European markets that were increasingly looking for other sources, meaning that their commercial viability would need to be underpinned by domestic sales to guarantee a minimum rate of return (Henderson, 2011 p.15). With the current slump in the gas prices and the development of gas-to-gas competition and pricing in Continental Europe, a liberalization of the domestic prices will become an even more urgent imperative. Clearly, Russia is moving towards a gradual deregulation of its gas market and a significant victory for Gazprom has been achieved. Hence, despite being a national firm, Gazprom has become a dominant global player with the same profit logic and the actual strategies of any other private gas company. Evidence of that is its expansion in Europe via joint ventures and mergers and acquisitions, following a business-oriented logic. We have seen it in partnerships with RWE, joint ventures with the German-Russian Wingas and Austrian RAG or ENI and we have seen it investing downstream in the EU. For example, in July 2011, Gazprom announced a planned strategic partnership with RWE, one of Germany’s four major utility companies, to construct gas-fired power plants in Germany, Britain, and the Benelux states. Such a partnership, should it come to fruition, would effectively provide the Russian gas giant a foothold in the EU downstream business and would expand its European market share. Besides its notorious offensive in underground gas storage facilities, the company has been actively acquiring assets in oil, petrochemicals, electricity generation and coal. The company’s official objective is to become one of the largest integrated energy companies in the world, spanning oil, gas and electricity. At home Gazprom might be, to a certain extent, a

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131 See http://www.globalsecurity.org/military/world/russia/budget.htm
132 For more a detailed analysis on the quid pro quo with Ukraine and the other CIS see Pirani (2010)
133 Natural Gas Europe, “RWE and Gazprom to Pursue Strategic Partnership”, July 14, 2011
134 Financial Times, Majors must go to Gazprom to get access to Russia’s vast natural oil and gas store, July 12, 2005
politicized export monopoly intertwined with the State, but in the European arena the company views itself as the ultimate market player. As a truly global company today Gazprom adopts brands and standards like the Corporate Social Responsibility (CSR) agenda. Aside from criticisms, which (frequently with good reason), consider these agendas no more than improving companies’ image and reducing their ‘reputational costs,’ a state-owned monopolist like Gazprom would not need this rhetoric if it weren’t a competitive company in terms of entrepreneurial logic. According to Gazprom in this regard: “the company strives to secure the sustainable development of its business, paying great attention to both the economic and social aspects. Gazprom steadily pursues the following social responsibility principles: creating new jobs, implementing social programs for its employees, placing a focus on sponsorship and charity, taking environment and education related actions.”\(^\text{135}\)

In sum, today Gazprom acts as any other profit-oriented company that tries to adopt brands, standards and best practices, and above all maximize its profits.

### 6.2.4 Other Actors in the Russian Gas Industry

**The Independent Gas Companies — such as Novatek and Itera**

In 2010 the “Non-Gazprom” gas players in Russia produced 142 bcm of gas, equivalent to 22% of the country’s total gas production.\(^\text{136}\) The latest Russian Energy Strategy, published in 2009,\(^\text{137}\) sees this share increasing to 27% by 2030, but the potential is for that target to be reached much earlier if the non-Gazprom companies are encouraged to produce their relatively low-cost gas that is located in the heartland of West Siberia close to existing infrastructure (Henderson, 2011). The problem is that these companies to be successful need the right combination of well-located reserves, available capital for development, access to infrastructure — both processing plant and the Gazprom pipeline network — and solvent customers willing to purchase their gas (Stern, 2005). This still remains a difficult combination to achieve and arguably these Independent gas producers still depend on Gazprom’s goodwill in terms of access to networks and processing plants. Moreover, given that Gazprom retains the monopoly on gas exports, for the purposes of the EU-Russia relationship and hence this analysis, Gazprom is the only company that really counts.

**Russia’s commercial banks and regional actors**

While large companies dominate the Russian economy, Russian private banks are largely small, leading to a mismatch between small banks and large creditors, which have to turn to international banks (Aslund, 2009). Russia’s banks remain weak players compared to their counterparts in Europe, since Russia is still a very different state compared to the Western democracies with their long histories of free associations, multiple interest groups, developed civil society, and an established banking system.

### 6.2.5 Conclusions

As noted earlier, even though in Putin’s Russia one of the top priorities has been ‘reasserting’ a strong state, in the gas trade the pivotal actor influencing Russia’s export strategy, its strategic priorities and actually making decisions with political consequences, is Gazprom. Just as its European counterparts this company is moved by profit considerations. This does not imply that markets exist in a vacuum; political factors do come into play in any


\(^{136}\)Interfax, 11 Jan 2011, “Gas production in Russia up 11.6% in 2010,” Moscow

\(^{137}\)Energy Strategy of Russia for the Period up to 2030 - Approved by Decree N° 1715-r of the Government of the Russian Federation dated 13 November 2009
investment project, especially in the construction of pipelines where building the political momentum really counts (see Chapter 10), but the predominant motive for action remains the maximization of profits. Drawing on the previous chapters and on the considerations that have been made, the next section will test the linkages between the European gas firms' and Gazprom’s interests (which we identified as the main actors) with the legal formalization of the EU-Russia’s relationship. Prior to this, however, let us briefly conclude on the interplay between the Russian actors in the domestic scene. As noted above, Russian 'resource nationalism’ approach has been driven by the desire for geopolitical leverage abroad and political stability at home. While geopolitical leverage abroad is still growing as Russia’s influence in the “Near Abroad” is de facto rising, the international drop in “spot” gas prices in 2010 has impacted Gazprom’s business in Europe, shaken the political stability in Russia and the legitimacy of the ‘commanding heights’ of the economy. In today’s Russia, the state is no longer able to provide political patronage and co-opt middle-class Muscovites as it was possible in the early 2000s. The hard economic recession that hit Russia in 2009 and the current (2009-2012) phase of low gas prices has reinforced Russian economic problems of income inequality, endemic corruption and poor health care, which returned on a grand scale, leading to considerable conflict. The demonstrations of tens of thousands of middle-class Russians in early December 2011 at the fraud in the December 2011 Duma election, evidence that Russian citzensry is today more attentive to the political conduct of its leadership than it was the case before, and asks for more than a mere distribution of rents. As noted by The Economist “for a decade middle-class Muscovites have pursued their careers, sipped coffee in cafés, read glossy magazines and traveled abroad allowing Vladimir Putin to consolidate power. Now they want the state respect as successful citizens.”

The upheaval at home could be somehow connected to the slump of natural gas revenues, given that the economic picture in Russia is so intimately connected to what happens with the price of gas, and considering that gas revenues are so strongly needed to feed the Russian poorly diversified economy. The December protests show a significant change in people’s attitude and more engagement in the res publica, which signal a dramatic break with the past. Even though the period of low gas prices could be just temporary and sow the seeds for the next surging round, nevertheless in the next rising cycle a mere redistribution of resource rents might not be enough to ensure the loyalty of middle-class Russians to the center.

**Figure 9: Main Players in the Russian Gas industry and trade**

![Diagram of the Russian Gas Security system](image)

Source: Compiled by the Author, division of Gas Security in sub-indices partly based on the United States the Chamber of Commerce “Energy Security Index”, 2011

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138 See section 5.2.5, Chapter 5
139 The Economist, *The birth of Russian citizenry*, December 17, 2011
6.3 Testing the linkages with the legal formalization of the relationship

6.3.1 Introduction

Having determined who are the main actors on both sides of the relationship, in what way they act and for what reasons, now we are moving onto a higher level of abstraction. We will try to test whether the interests that are informing the dominant actors’ actions are directly connected (i.e. whether we can claim casual inference) with the fact that thus far there is no legal institutionalization of the EU-Russia energy relationship. To do that we will turn our attention back at the very active energy diplomacy between the EU and Russia, while placing the key actors and their interests within it to see how our general picture changes. Traditionally, the EU-Russia energy trade has been dominated by crude economic realpolitik concerns. The reason for that is simple: the corporate’s sector approach is wary about welcoming multilateral institutions even in instances when these institutions could reduce risks (i.e. by crafting common regulations and facilitating investment), because the cost of being “locked-in” such arrangements simply outweighs the benefits of predictable rules. In the next section we will analyze the failure to renegotiate a new PCA, the reluctance of Russia to ratify the ECT and the lack of progress within the Energy Dialogue. The last section draws the conclusions.

6.3.2 Main findings

6.3.2.1 Failure to negotiate a new PCA

Conventional wisdom holds that conflicting normative views and psychological factors continue to plague ongoing talks on a new PCA. Moscow objects the acquis principles included in the PCA and the EU is failing to adapt to the new dynamics of the EU-Russia relations. Many scholars point to the fact that the PCA has been written on a purely EU conception of how relations with Russia should be organized (Medvedev, 2008; Westphal, 2009). For example, Article 55 implies that Russia would make its legislation compatible with the acquis. Also, the document stipulates the respect of human rights, market economy and democracy as its general principles. Moreover, the EU’s focus on complex, often low-level projects is seen as at odds with Russia’s preference for less substantive, but more visible statements. In short, Moscow is considered as discarding the PCA because of its form, because the same instrument was offered to all former Soviet states (Aslund, 2009) and because Russia would prefer the new PCA to grant the EU-Russia relationship a status of a strategic partnership (see Westphal 2009, Kulhanek, 2010, Mankoff, 2011). Whereas these explanations have analytical utility, they only tell part, and not the crucial one, of the story.

6.3.2.1.1 Deadlocked PCA and Key Actors’ Interests

Contrary to most expectations regarding the failure to reach a renewal of the PCA, progress in the negotiations has been anemic basically because Russia does not see anything to gain from the Partnership of Cooperation agreement with the EU. Surprising as it may sound, Russia’s slim interest is not resulting from a crude zero-sum game mentality reminiscent of the “Cold war modes of thinking,” but rather from objective calculations of national interest. Moscow has little interest in better EU market access: three-quarters of its exports to the EU

140 Contrary to liberal institutional theories holding that legally binding institutional frameworks have to be set up in order to create transparent and predictable rules of game within a market economy and that the need of “legislative” legitimacy is inherent in national economic systems.

141 See art 1. “The Parties recognize that an important condition for strengthening the economic links between Russia and the Community is the approximation of legislation. Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community.”

When the PCA should have been strictly linked to Russia’s accession to the WTO. But in 2008, Putin himself opted for freezing accession talks with the WTO, as no advantages for Russia were visible from the membership, while it had to carry the entire burden.\textsuperscript{142} In fact, despite the EU’s backing of Russia’s bid to enter the WTO, Russia’s interests in that matter were mixed until the very end. WTO membership benefits certain sectors, such as nonferrous metals, while hurting others, such as automobiles (Shleifer&Treisman, 2011). Thus, although at the end Russia decided that it would gain more if regulatory and bureaucratic barriers were removed, some in Moscow remained ambivalent. Despite the WTO membership, Putin’s current perception is that energy (unlike electricity or service goods) is not included in the WTO provisions, thus even with the WTO in place Russia will resist the trend to open up its energy sector.\textsuperscript{143} Obviously, this decision is greeted with delight by Gazprom and most probably influenced by Gazprom. Gazprom has nothing to gain from Russia’s signing up to bilateral and binding rules on energy trade, transit and investment with the EU. It already sells its gas to the EU tariff-free and simply has no interest in such an agreement. Even just on an expectation level, my research confirms that finding common ground between the two positions is a daunting task. The EU believes that Russia has everything to gain by signing a deep FTA with the EU.\textsuperscript{144} On pure commercial basis, this makes partly sense. However if granting third party access to foreign companies is the price, then Russia sees it differently. On the EU companies’ front, obviously they would benefit from Russia opening up its pipelines. However, bilaterally within the EU traditional Gazprom’s friends are already rewarded with cheaper prices for gas (compared to other European utilities) and have everything to lose from spoiling the relationship with Gazprom. Therefore, they are wary about any radical moves that might upset Gazprom. In the words of a Russian energy insider: “There has been a too long, unsuccessful negotiating process and hardly anyone in Russia at this point believes that a satisfactory working formula can be found. The EU is not offering anything attractive and more prosaically, the summits and meetings to discuss a renewal of the PCA for both sides are largely symbolic, because its outcomes are expected and predetermined long before the meeting.”\textsuperscript{145} In sum, little progress has been achieved in advancing the process of introducing a new PCA, simply because Russia does not see anything to gain from the new PCA and the EU has not enough sticks at its disposal to force Russia to sign it. The previous PCA will remain in force as long as there is no new agreement, meaning that there is still a legal framework for relations. A new framework, when negotiated, should conform to the interests of both parties, which is very difficult since the EU seems not having anything new to put on the table and since Russia is not satisfied with the current offers. Thus, unfortunately in the next few years agreeing on a common PCA will become even more elusive. Nevertheless, considering that Russia is the third largest trading partner of the EU, and the EU is first Russia’s trading partner, the value of their cooperation cannot be underestimated. Even if normative impediments are not the main obstacle to progress, the EU will have to accept that for the next generation of EU-Russia relations, Russia’s proposals and ideas will have to be taken more seriously into consideration. In that sense, Russia’s vision on sovereign capitalism

\textsuperscript{142} Izvestia Online, 19.10.07
\textsuperscript{143} Interview with a European energy expert, January 2012
\textsuperscript{144} Author’s Interview with an EU’s diplomat (EEAS – dealing with Russia) in May 2012, Brussels
\textsuperscript{145} Author’s Interview with a Russian energy expert, October 2012
where Russians will define their own pace to liberalization and democracy, while protecting themselves from values exported from outside, will be part of the wider picture.

6.3.2.2 Russia’s reluctance to ratify the Energy Charter Treaty

As one European diplomat concedes:146 “the European Union and Russia are holding a large number of summits and high-level meetings but the substance is limited.” Soon after, he adds while talking about the “unbundling” issue: “in any case while operating in the EU, Russia and Gazprom have to respect the EU legislation, while a pragmatic way to implement the rules can be found.” While it is unclear what “pragmatic way” means in this context, it seems that a pragmatic way to accommodate both sides has not been found yet, because negotiations on the most important multilateral rules-based energy treaty are seeing virtually no progress. In this section we will try to tests whether a relationship of cause to effect exists between Russia’s decision in 2009 to stop the provisional application of the Energy Charter Treaty147 (ECT) and the interests of the main actors on both sides. In Chapter 4 we already illustrated the main reasons why Russia decided to opt out from the Energy Charter Process. As we mentioned in that context, President Medvedev (as then he was) also presented an alternative Treaty with, from one European diplomat’s perspective, “strong borrowings from the ECT.” After that, in 2010 a review process led by a “strategy group” has been put in place. However, Russia is now pushing for a completely new Treaty, which is not admissible from the perspective of the EU, given that the Treaty has already gone a long way and has been ratified by 46 countries, which means that the EU would incur in a huge reputational cost should it step back now. The goal is to keep Russia on board, and indeed Russia wants to stay informed and participate in the meetings. However, that is all what Russia wants – to stay informed. As illustrated earlier, Russia’s main grievance in the ECT is in regard to ECT’s provisions regarding transit that would allow for Central Asian gas to run through Russia’s pipelines to Europe, which is exactly why Russia, or more precisely Gazprom, will not accept it.148 To a lesser extent the second Russian criticism of the ECT transit protocol came amid the gas dispute between Russia and Ukraine in January 2009. From the Russian perspective the inaction on part of the political leaders of the Energy Charter Secretariat before and during the Russia-Ukraine gas conflict undermined the credibility of the Treaty as such (Konoplyanik, 2010). This dissertation holds that the non – ratification of the ECT is above all in Gazprom’s interest. As of 2011, Gazprom still accounts for 70 per cent of domestic Russia’s consumption, although the shares of Non-Gazprom producers are growing (Henderson, 2011, p.2). It is often forgotten that Russia, unlike any of the other major energy exporting countries, is also one of the world’s leading energy consumers. Russia is the world’s second largest consumer of natural gas, which consumes 54 per cent of Gazprom’s sales per annum.149 Yet, the EU is the source of Gazprom’s hard currency revenues because it pays higher prices. The question is, how does Gazprom meet its commitments at home and in Europe with virtually zero growth in production in the last years, and with most of its revenues invested in Russia’s costly projects abroad150 such as downstream in Europe and big pipeline projects (i.e. Nord Stream and the forthcoming South Stream). The answer lies in an interesting escamotage. Gazprom started to increase the volume of gas bought from Central Asia. The strategy adopted consists in importing from Turkmenistan gas to be sold in the

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146 Interview with the Author, Brussels, May 2, 2012
147 That is to say, officially it has just taken “a step back” while remaining within the Charter process nonetheless, but practically it withdrew from it
148 As noted by Belyi & Klaus (2007), Russian ratification of the ECT has been mainly blocked by Gazprom’s lobbying at Russian Parliament. The position of Gazprom concerning Russia’s ratification of the ECT has been clearly negative form the outset, with an intense lobbying of its position in the Russian Duma, which has stated in 2001 the conclusion of the Transit Protocol as a condition for the ECT ratification.
149 See: http://www.gazprom.com/about/ratification
150 Which are diverting valuable capital away from its own domestic energy sector, which is now plagued by inefficiency and an aging infrastructure
domestic market, while the Siberian gas is sent to Europe. That is why Russian diplomacy in Turkmenistan is so active, and Russia even increased the price it pays for Turkmen gas just to keep this indispensable country on board. That allows Gazprom to be the intermediary and until recently, the only buyer of Turkmen gas, that gets for relatively cheap and then resells for much more in the EU market, or keeps for domestic consumption. Therefore, arguably Gazprom’s strong lobbying is the main reason for Russia’s rejection of the Energy Charter Treaty. As noted by Milov (2011, p.92) Russia never actually tried to hide its intention to capture Turkmen gas through its transit monopoly, and has openly denied the right of European consumers to conclude direct gas purchase contracts with Turkmenistan. In Milov’s view this has been the primary (and probably the only) cause of Russia’s refusal to ratify the Energy Charter Treaty and its Transit Protocol – Russia has always defended its right to exert the transit monopoly over Turkmenistan and arbitrarily decide on Turkmenistan’s access to international gas markets. In Europe, Russia’s reluctance to open up access to its pipelines has intensified the interest for alternative pipeline routes, such as Nabucco. Yet, two things are missing from this diagnosis. Turkmenistan also benefited from its deals with Russia because it gave it the possibility to sell its gas without bothering to invest in new pipeline routes. Second, it is Gazprom’s interest that stands behind the non-ratification of the Energy Charter Treaty and not Russia’s as a whole. But what is more, the EU side is missing from most scholars’ explanations on why the ECT has not been ratified. With regard to investment, at the interstate level there is a useful instrument, which is frequently overlooked: the network of bilateral investment treaties (Romanova, 2011). Both Russia and the key EU’s member states, favor bilateral approaches, thus the potential of the BITs is big. However, it is uncertain what will be their role after the recent communitarization of external investment policy under the Lisbon Treaty. In any event, the EU companies, which are the main drivers of the EU’s unity and disunity, also favor non-ECT ways of managing the investment risk in their businesses with Russia. Typically, European firms choose to mitigate the risks with measures such as joint ventures/asset swaps, diversification of supply sources and routes, ensuring “resilience” (with gas storage, interconnectors, etc.) and Gazprom is managing the demand side with a planned diversification of export markets, mergers and acquisitions (de Jong, 1989). Gazprom in particular has put frantic efforts in the acquisition of energy firms and its international expansion. This is best illustrated by concrete examples. In March 2012, Gazprom put its bid to acquire the main Greek utility DEPA as cash-strapped Athens sought to sell state assets (Socor, 2012). Thus, the investment side is managed with BITs at the state level, and joint ventures, asset swaps, mergers and acquisitions at the company level. With regard to energy trade, (aside from the transit disruption risks), no import barriers exist. Since there is no protectionism in energy trade from either side, there is no need for trade agreements at the company-to-company or interstate level. With regard to investment again, Russia has recently joined the WTO. The WTO codifies under a different label all the provisions that exist in the ECT regarding investment and provides the WTO investment dispute settlement mechanism. Admittedly, the WTO does not address issues such as pipeline transit rules that have derailed Russia’s ratification of the Energy Charter Treaty. However, with Russia’s membership in the WTO, at least regarding investment provisions, the ECT becomes an unnecessary duplication of the WTO. Moreover, the member states and energy companies that receive preferential prices and have diverging sets of tariffs for gas trade might also be unenthusiastic about provisions such as Article 29 of the ECT, which stipulates: “Each signatory to this Treaty, and each state or Regional Economic Integration Organization acceding to this Treaty, shall on the date of its signature or of its deposit of its instrument of accession provide to the Secretariat a list of all tariff rates and other charges levied on Energy Materials and Products at the time of importation or exportation, notifying the level of such rates and charges applied on such date of signature or deposit. Any changes to such rates or other charges shall be notified to the Secretariat, which shall inform the Contracting Parties of such changes.” Also regarding prices, Article 3 stipulates an “efficient

151 In 2009 the massive Turkmenistan-China gas pipeline was inaugurated
functioning of market mechanisms including market-oriented price formation and a fuller reflection of environmental costs and benefits.” As documented by Youngs (2009 p.39) a number of member states reject the notion of transparency and information sharing between the EU on the bilateral deals they conclude. That is hardly surprising, knowing that Gazprom likes to strike deals country-by-country, which enables to reward friends and punish enemies. Germany, for example pays among the lowest gas prices in Europe. Lithuania, on the other hand, which has pushed ahead with unbundling with strong EU support, now has almost the highest gas prices in Europe. The intuition is simple; consumer countries do indeed have an incentive to contract supply on a bilateralized basis and to renounce EU or ECT rules, because that enables them to secure the best deals. As argued by Barkanov (2011, p.360) on certain questions, EU business actors are sympathetic to Russia’s policy. Thus, within the EU a “domestic” version of balance of power prevails. Consequently, it is not only Russia that “lives in a Hobbesian world,” where balance of power dominates, but for key EU energy companies backed by their respective governments, the European angle is secondary, and instead they prefer explicit modes of realpolitik in the pursuit of profit. In conclusion, as noted by Yafimava (2012), the ECT lost much of its momentum in the 2009 Russian-Ukrainian gas crises, in which it was almost completely sidelined. The perception of the Treaty as a weak instrument during the crisis further undermined its legitimacy in the view of all the contracting parties, including the member states and the EU’s corporate sector. On the other hand, the worst EU-Russia political crises coinciding with the gas disruptions did not overshadow nor complicate EU companies’ fruitful relationship with Gazprom. As eloquently described by Locatelli&Finon (2007) the six major long-term contracts that were concluded in 2006 before their expiry and despite political tensions created by the Russo-Ukrainian crisis in January 2006, bear witness to the autonomy and the bargaining power of these big companies, who did not think twice about negotiating new contracts with Gazprom without fear of having to accept exorbitant conditions. Furthermore, in line with its transit-avoidance policy, if Gazprom succeeds in its intent to build South Stream or even easier, to get ownership over Ukraine’s transit pipelines, then the cause of the ECT as such would become even less notable for the EU member states. In sum, Russia together with the EU firms and member states cares about the ECT less than the EU does. Gazprom, in particular does not see the exact benefits from adopting the ECT. In the words of a EU official: “I doubt that Russia is sacrificing from not being in the ECT.” In the blunter words of a Russian energy expert: “Inside Russia the main sentiment is that this Treaty simply doesn’t work and it does not protect the Russian interests, therefore is useless and at least in Russia, politically dead.” However, what is missing from this statement is that the EU companies and key member states are also content with the status quo.

6.3.2.3 The weaknesses of the EU-Russia Energy Dialogue

The EU-Russia energy dialogue was put in place to fill the legal vacuum that emerged following Russia’s non-ratification of the ECT. As the name suggests, the EU-Russia energy dialogue is a non-binding institutionalized forum, since the EU has no full mandate to act on energy matters. It offers a platform for discussion to ideally enable progress in the definition and the practical arrangements of a EU-Russia energy partnership. However, the progressive worsening of the EU-Russia political relations during Putin’s second term overshadowed and complicated the dialogue. The EU urges that Russia liberalizes its gas sector obtained scarce results. On matters of energy supply the dialogue has not been more than a consultative body, because Russia realized that in terms of concluding gas supply contracts, real power lies within the European companies and the respective capitals. In general, the EU companies considered the dialogue of little worth as well. It their pragmatic view, Gazprom


133 Interview with the Author, September 2012
and Russia did not need or want the dialogue, but rather clearer terms on what would Russia get in return for strategic energy cooperation, or in other words from allowing an acquis-based legislation on Russia’s territory. More recently, energy efficiency gave a new chance to the deadlocked dialogue. In accordance with the general objectives of the EU external energy efficiency policy, the EU aims to stimulate energy efficiency in Russia in order to guarantee the availability of energy resources for future supply to the EU (Boute, 2011, p.74). In this respect, the EU has real power and Russia is very interested to benefit from the EU’s know-how in order to reduce its energy intensity, and is keen to work on that in the framework of the EU-Russia Roadmap to 2050. It is the EU’s and Russia’s common interest to guarantee future Russian supplies to Europe, and energy efficiency in the Russian economy is expected to bring substantial gains to European and Russian companies alike, so such a commonality of interests makes the dialogue much easier right from the outset.

6.3.3 Conclusions

Overall, the ECT and its accompanying series of conferences form the only multilateral legal framework for exchanges between producer, transit and consumer countries. Its purpose is to codify very elementary rules regarding investment and transit. Despite that, the ECT lacks in that it does not sufficiently reflect the interests and concerns of the producers. The most proximate cause of the Russian withdrawal is that Russia’s key decision-makers simply see nothing to gain from accepting the ECT-like discipline. The fact that the final decision to opt out came after the possible verdict in the Yukos expropriation case, stimulated a lively scholarly debate on how Russia’s withdrawal could be of political significance (Van Agt, 2009). However, that quite overlooks the fact that none of big producing countries or suppliers of Europe is member of the ECT (including Norway, Algeria and the United States). Overall, the EU-Russia energy interdependence is managed with a dense web of relationships but little substance. As we theoretically defined at the beginning, promoting sustained cooperation requires formal institutions involving commonly acceptable rules and social norms for the parties involved. That is exactly the crux of the problem: the rules that have been promoted so far are not commonly acceptable because they do not mirror the interests of both sides. The reluctance of Russia to ratify the ECT is often interpreted in zero-sum assumptions about power and sovereignty: it is believed that, in Russia’s perspective, a growth in power of the multilateral ECT must be accompanied by a decrease in the power of Russia. Thus, the centrist Russia refuses to surrender its sovereignty. The main obstacles are rather of a different kind; Russia simply does not see the PCA or the ECT as ways as to further its own objectives.

On the European front too, instead of a commitment to rules-based multilateralism today the European companies and key member states favor a far more political approach in dealing with Gazprom and the Kremlin, itself to frame market-based policies. Whereas between the EU and Russia an emotional politicization of energy relations prevails, energy relations between Gazprom and the European Majors are based on pragmatic economic incentives framed by trust. In spite of the recent difficulties with the gas contracts renegotiations, these relationships are developing substantially. The way Gazprom and its main partners in the EU perceive and relate to each other after more than forty years of successful cooperation, is through an established political discourse based on trust, which partly explains the absence of clearly defined rules. In other words, the relationship among these companies assumes features of limited reciprocity, which allows them to act independently on the international scene without being locked in regulatory agreements (i.e. PCA and ECT) that are not perceived as necessary and which do not reflect the interests of both sides. In short, Russia’s main concern are longer-term, oil-indexed contracts that

154For more details see http://ec.europa.eu/energy/international/russia/press_en.htm
presently add significantly to Europe’s cost of gas, on the other hand the EU companies would benefit from third-party-access but are aware that Gazprom is not willing to concede on that point. Thus, there is no broad desirability for an overarching agreement, given that the immediate interests are so different, and considering that the cost of being locked in a binding agreement outweighs its benefits. Indeed, in the last years, individual EU countries have gradually distanced themselves from the support for a robust multilateral treaty, to give stronger preference to bilateral energy arrangements. The European energy companies have cooperated fruitfully outside the institutionalized domain, on *quid-pro-quo* basis, such as the one made known in 2006 between ENI and Gazprom that resulted in mid-2007 in the decision to build a new offshore gas pipeline, South Stream in addition to Blue Stream. From the perspective adopted in this dissertation, the relationships between the dominant actors at both sides of the EU-Russia interdependent energy relationships are aimed at expanding mutually beneficial economic ties, and only to a smaller extent at developing durable institutional exchanges. With regards to the ECT, global circumstances have profoundly changed and in the current energy governance system, the ECT is reviewed not only by Russia but by other stakeholders too. At the interstate level, the stronger role of national governments coincides with the current phase of low-trust divisive globalization, where governments are taking more decisive and active roles in shaping the challenges of the present and of the future, as powerfully argued by Dani Rodrik (2011). Furthermore, the balance of power between the actors has shifted towards energy producers and new centers of power; the 1990s vision of a liberalized governance structure for the international energy system has changed, and the EU itself, has closed in the so-called “Fortress Europe” domestically shaped by rules-based relationships, but in foreign policy dominated by old national rivalries and individual approaches. Yet, instead of countering a Hobbesian anarchy, the driving motive is profit. On Russia’s continued recalcitrance toward ratifying the ECT, Milov (2007) has argued that it is in Russia’s long-term interest to promote a comprehensive agreement with the EU on the conditions of energy supply. Obviously, in ultimate terms consumers’ quest for supply security is matched by producers’ quest for demand security. That means that both Russia and the EU have long-term shared interests: in developing effective energy markets, responding effectively to climate change, modernizing Russia’s decaying energy infrastructure and transferring the EU’s know-how to make the necessary investments, and above all to secure a stable pipeline gas flow from Russia to the EU. Meanwhile however, the real worry is how to accommodate the legitimate interests of Russia in the present agreements. According to Westphal’s (2009) persuasive point, the renewal of a constructive dialogue with Russia could begin from taking more seriously Medvedev’s proposal in 2009 for a new legal framework for international cooperation in the energy sphere. So far, this proposal has been greeted with little enthusiasm in Brussels. Clearly, if the EU and Russia’s interests remain polarized, the relationship will remain interdependent with a weak institutionalization. In conclusion, as intelligently noted by Douglass North,155 “institutions do not emerge spontaneously to create and nurture the market but reflect the interests of those players in a position to put them in place.” The European Union cannot act from a position of strength, as it was in the case in the 1990s, but it could and should reinvent its approach to make those interests coalesce. How and whether this will be done will greatly determine the level of approximation with Russia. Meanwhile, the problem of the interest gap in the EU-Russia relationship persists and accelerates the downward spiral in the already fragile cooperation. In summary, this dissertation finds a positive relationship between the centrality of the corporate actors in the EU-Russia energy relationship and the tendency to favor weak multilateral regulatory structures. As noted earlier, the argument that gas firms are driving political outcomes and that these firms are motivated by profits was already brought forward very clearly by Harvard’s Abdelal, by Finon and Locatelli (2007) and Westphal (2009) among others. The novelty of this study pertains to linking in a comprehensive way the influence of the main actors (the big gas companies) and the lack of

155 Quoted in Bressand A. (2010), North (1990)
binding governance structures regulating the relationship, therefore unlike other analyses this dissertation finds that the central influence of the industrial gas lobby on the decision-making processes is the direct cause of the lack of binding governance structures. The next sections proceed along the following lines. I will present four case studies that analyze the relationship between the EU and Russia from different angles and provide a testable ground for my propositions. The analysis will demonstrate how the dominant actors’ behavior is consistent with self-interested rational calculations and how corporate interests are the main drivers in the Russia-EU last decade’s cooperation, even when such argument seems counterintuitive. For example, Russia’s signing of the Kyoto protocol sheds light on one of the most controversial moments in the EU-Russia cooperation and provides a powerful example of the proposition advanced here, that the corporate actors are the ones “calling the shots.”

**Figure 10: Identification of the Main Actors in four different case studies: Diagram**

![Diagram of 4 case studies: Kyoto Protocol, Italy/Slovenia, EU's Energy Paradigm Shifts, The Southern Gas Corridor. Each case study has main actors, e.g., Gazprom, ENI/Geoplin, Western Gas Companies/Gazprom, Western Gas Companies/Gazprom/Local Gas Companies and Rulers.]}
PART IV

The Case Studies
7. Russia and the Kyoto Protocol

The institutional paralysis and the political deadlock in the EU-Russian energy relations is even more puzzling considering that Russia has ratified the Kyoto Protocol - a multilateral treaty. This awareness should allow for a more nuanced way of interpreting Russia’s reticence towards the ECT, by resisting approaches that interpret Russia’s non-ratification of the ECT as inherent reluctance towards any attempt to encroach on Russia’s high concept of sovereignty. The best evidence suggests that Russia does not inherently oppose multilateral institutions; on the contrary it welcomes them when Russia’s leadership sees an incentive to gain from accepting such discipline. The results of this thesis, that the power to determine the main decisions rests within the strong corporate lobbies is tested and confirmed in the case study. It is found that the omnipresent Gazprom stands behind Russia’s decision to join the treaty.

7.1 Introduction

The Russian Federation signed the Kyoto Protocol along with other industrial states in 1997, but ratified it only in October 2004 and on 16 February 2005 the Kyoto Protocol entered into force. Indeed, the Russian ratification was preceded by prolonged foot-dragging and speculation that started with the declaration of the United States’ withdrawal from the protocol in 2001. The country’s ratification was also accompanied by a complex struggle on the domestic front. For example, in the long pre-ratification period most of the Russian scientists tended to remain ambivalent on the effects of global warming. Both the opponents and the supporters of the Kyoto Protocol tended to view the commitment through the prism of specific features of the Russian economy and the country’s national priorities. In the early 2000s two contrasting forces drove Russia. On the one hand, Russia had to face enormous challenges to revitalize its economy and supported the argument advanced by other big emitters (and transition countries) like China, Brazil and India – that they still dreamed the kind of economic development the West had been enjoying for decades. Thus, in their perspective, they had the right to the same economic growth and were unwilling to support any climate deal that would hamper the attainment of that goal. On the other hand, Russia did not want to lose the opportunity to add luster to its reputation of a rising power on the world stage. Torn between the “developing country” and the “great power” rhetoric Russia’s ratification went through a long domestic jiggling before the final decision was made. Many observers were puzzled when Russia decided to ratify the Kyoto Protocol, knowing that Russia had never championed environmental protection on the world scale. Its metallurgical sector in particular has traditionally been among the most energy intensive in the world (Yulkin, 2007). Further, until recently the practice of flaring natural gas was not seen as a worrisome practice. Considering the circumstances under which Russia ratified the Treaty and Russia’s traditional low regard for environmental issues, many scholars have written about the Russian incentives for “greening” its economy. Although in the post-Kyoto phase Russia has largely failed to develop a climate policy, the Russian Federation will meet its relatively lenient Kyoto 2012 emissions target (Henry & Sundstrom, 2012). In 2010, Alexander Yakovenko, the Deputy Russian Foreign Minister said in an interview that “Russia is doing more than it has pledged under the Kyoto Protocol and is the world leader in reducing greenhouse gas discharges.”

The international climate community, however, has generally remained

156 Putin took the decision against objections from the Ministry of Industry and Energy and the Russian Academy of Sciences, which focused respectively on the potential negative impact of the Kyoto regime on Russia’s economy and on the insufficient evidence of the causal connection between the growing emissions of greenhouse gases and global warming.
157 “Russia exceeds Kyoto Protocol obligations”, Radio the Voice of Russia, Dec 7, 2010
unimpressed by Russia’s performance. First, Russia’s reductions were not the outcome of focused policies to cut emissions. The decrease was principally due to the economic decline that followed Russia’s transition to a market economy after the collapse of the Soviet system. Russia expected its carbon emissions to be down by 20% from 1990 levels by 2008 and in fact in 2010, Russia’s carbon emissions stood at 34.2 percent below their 1990 level – a notable track record, but also the result of an economic downturn that has shuttered factories and shrunk agriculture, and due to the re-growth of forests that has sequestered more carbon. Summing up, in 2005 there was no cost for Russia in adopting the Kyoto Protocol. Many observers speculated that Russia’s ratification of the protocol was a quid pro quo for the EU’s support for its application to join the World Trade Organization (WTO) (see Parker & Karlsson, 2010; McLean & Stone, 2012). This study argues, however, that that WTO accession is not a sufficient condition to explain the Kremlin’s final decision to ratify the Kyoto Protocol. The decisive carrots that persuaded Russia were more the huge amounts of pollution credit that Russia won under the Kyoto’s emission trading system. The country could profit enormously from selling unused emission credits and investing these revenues in clean technologies that would in turn benefit its industrial sector in its own right. The next section will provide evidence for this interpretation of the empirical findings. As mentioned earlier in this study, Putin’s Kremlin did not scramble to secure its membership in the WTO. For instance, in 2009 Putin said that Russia would only join the World Trade Organization (WTO) together with Belarus and Kazakhstan (he later backtracked). Until the very end, Russia’s interests in joining the WTO were mixed; for example the fossil fuels, Russia’s main export products, were already traded with no import barriers, and in general the WTO membership would have benefited certain sectors, such as nonferrous metals, while hurting others, such as automobiles. In fact, in 2009 Putin even opted for freezing accession talks with the WTO, as no advantages for Russia were visible from the membership, while it had to carry the entire burden (Wydra et al. 2010). Later on it was recognized that Russia would likely enjoy overall gains, because Russia’s businesses would gain a great deal if regulatory and bureaucratic barriers were removed. However at the domestic level, many groups still questioned the overall benefits of the WTO. In light of this, the puzzle is why has Russia’s decision to implement the Kyoto Protocol gained momentum over time and what has been the main driver for the final decision to go along with the Treaty? This study argues that the answer for the Russian U-turn in favoring the Kyoto Protocol lies in the money that could be earned thanks to the Kyoto Protocol - through selling allowances and receiving investments in Joint Implementation projects. This case-study has the advantage to probe the plausibility of the predominance of the corporate lobby in the key decision-making processes that my findings have shown in the previous sections, and also to show that the interests of the main actors are not given or inherent to them, on the contrary they adapt to different challenges and external events that require diverse responses, depending on the mutable external conditions.

7.2 The path to Russian Ratification of the Kyoto Protocol – A question of Gazprom’s Interests

In the last few decades, and especially after directing the Kyoto Protocol into existence, the EU emerged as a worldwide leader in environmental matters. Beyond the domestic measures adopted by some progressive ‘green’ states such as Germany and Denmark, the Commission, the EP, and the Council have each accepted the idea that climate change is a policy area where Europe can and should lead. In 1991 the Commission introduced a proposal for a EU strategy to limit CO2 emissions (European Commission, 1991). The Commission also played a central role in working out a EU negotiating strategy for Kyoto and in developing the burden-sharing agreement, which set individual targets for each EU Member State based on their different economic and geographic profiles. However, Kyoto also symbolized the
standoff of Europe versus the United States in environmental matters. The Europeans wanted the Americans to take deeper cuts but the Americans refused. At last, the Treaty was signed mainly due to the sudden arrival to Kyoto of the then Vice President Al Gore that managed to break the deadlock (Yergin, 2011). The Europeans then agreed to the concept of selling emission rights as a market system to mitigate climate change, an idea that was previously regarded as immoral and dismissed as “hot air.” 190 countries signed the Kyoto Protocol on 11 December 1997 and since then all but the United States ratified the Treaty. In the United States, it was a treaty that required 67 votes in the Senate to be ratified. The reservations of the American Congress were focused mainly on the fact that the Treaty did not include developing countries into a binding system, whose emissions were on a fast-growth track. Mainly for that reason and in a more generally “climate change” hostile context of the Bush administration the US rejected the Protocol as “fatally flawed” and President Bush announced in 2001 that the US was withdrawing from further involvement with it. The EU responded by taking on the mission to save the Protocol. In the face of the US hostility and opposition, the EU successfully rounded up enough followers for the Protocol to enter into force. Crucial to this was the EU’s diplomatic effort with Russia. Indeed, in the absence of the US, only Russia carried the weight to take the treaty across the hurdle of 55 per cent of the industrialized world’s greenhouse gas emissions. By 2003, the industrialized states that had ratified the Kyoto Protocol represented 44 per cent of these emissions. Russia, if it also ratified the protocol, would add a further 17 per cent to this figure. A summary of the world distribution in greenhouse gas emissions is shown in box 2.

**Box 2: Greenhouse-gas emissions, 2007**

![Greenhouse-gas emissions](image)

Source: The Economist

However, as noted by Korppoo et al. (2006), following the disappointment of the US withdrawal, in 2002 Putin still remained largely ambiguous. While accepting that the ratification did not carry any special risks for the country, he simply declared, “we are not against it.” According to Yulkin (2007) around the same time the Russian corporate sector, that initially was skeptical about Kyoto, started to express interest for a “capitalization” of the climatic benefits in their activities, in the form of investments or profits from emissions trading. Gazprom, but also other companies including RAO «EES» Euraz Holding, RusAl, AFK «Systema» started adopting this line. In 2004 many groups still opposed the Treaty including certain academics that were questioning the scientific foundations of the Kyoto Protocol altogether. On the other side of the spectrum an eminent scientist, Klyuev (Tynkkynen, 2010) from the Geographical Institute at the Russian Academy of Sciences introduced the idea of Russia as a ‘Great Ecological Power’ (ekologicheskaya derzhava) to capture Russia’s popular attention on the country’s great ecological potential.
Many business groups opposed the treaty on the grounds that it would hamper the growth of Russia’s economy.\[^{158}\] For Putin, the question of the ratification has always been a political one rather than an environmental one, or in other words related to the “relative gains” under the Kyoto mechanisms. In 2004, Russia was still clearly divided whether or not to adopt the Treaty. After the US withdrawal Russia’s economic interests in the Kyoto Protocol decreased, since it was left without a major buyer of its emissions surplus. Moreover, some lobbies were pointing out that if a rich country like the US was concerned about its economic impact, how could a country like Russia afford the treaty. Putin’s economic policy advisor, Andrei Illarionov,\[^{159}\] was notably the most powerful of the Kyoto Protocol’s critics in Russia. However, any comparison of Russia and the United States was misleading as the two countries were in diametrically opposite positions. If ratified, the US would be obliged to take action to cut emissions, while through ratification Russia was gaining from sales of its surplus. Gazprom was quick to seize the opportunity to sell its emissions allowances, and by mid-2004 fiercely lobbied in favor. In the words of Olga Pluzhnikov, Deputy Head of the Ministry of Economics’ Environmental Department, ‘business pressure played a positive role in the ratification process’ (cited in Tipton, 2008). The energy sector desired ratification of Kyoto for a number of reasons. Firstly, energy companies saw JI projects as a cheap way of rehabilitating the energy industry, with some industry insiders predicting an imminent and severe energy crisis without modernization. Secondly, the industry believed they could make profits from carbon trading due to Russia's generous emissions targets, especially with the help of improvements in energy efficiency from JI investment. Since Russia’s energy sector is notoriously carbon intensive, it has vast potential for energy-saving and emissions-reducing improvements. Thirdly, the energy sector looked forward to an increase in natural gas sales because, as an emissions-friendly energy resource, it would be in demand from other Kyoto signatories (Tipton, 2008). Since Russia is already the world’s largest exporter of natural gas, this increased demand represented an important source of revenue. Due to the characteristics of natural gas as an environmentally friendly fuel, it was estimated that the entry into force of the EU Emissions Trading System alone could boost European demand for natural gas by as much as 6 per cent in the period 2008–2012, since fuel switching is one of the cheaper, short-term options for industrial enterprises to meet their CO2 emission caps (Grubb et al., 2004). As witnessed by the EU’s present day decarbonization policy whose centerpiece is indeed natural gas, these expectations have proven right. Although its share somewhat decreased in the last years, in 2005 (according to its own estimations) Gazprom supplied about one third of Western Europe’s total gas imports. In fact, the natural gas monopoly Gazprom had been the key actor that vigorously led the political support of Russia’s participation in the Kyoto Protocol. Gazprom could further expect to benefit from emissions trading and JI by rationalizing its production and transmission to realize low cost emission reductions. According to Andonova (2008), Gazprom, (just as UES), had also reputational incentives to support the climate regime as a mechanism to increase its attractiveness for foreign investment. Long before ratification Gazprom and RAO UES had set up their own GHG inventories in preparation for the Kyoto Protocol. Early on RAO UES announced proposals to set up more than thirty JI projects over the coming years aimed at securing at least twenty million tons of emissions reductions. This early zeal for the Kyoto Protocol mechanisms may imply that these companies knew Russia would ratify the Protocol from the outset (Tipton, 2008). The power of the business sector in Kyoto politics

\[^{158}\] As noted by Romanova (2008 p. 74) most of the specialists in the field of climate change, as well as economists were against it. According Romanova, Russia’s ratification in February 2005 was a compromise on the part of Moscow and a demonstration of its wish of belonging to the ‘right’ reference group. She holds that economic gains from emissions trade were limited for Russia; it is thus unclear who would benefit from the Kyoto Protocol. According to this dissertation, in contrast, the ratification is the outcome of the lobbying power of the corporate sector because it is clear that the private sector would benefit handsomely from emissions trading.

\[^{159}\] Andrei Illarionov, Putin’s former economic policy advisor, was the most outspoken critic of the Kyoto Protocol: Andrei Illarionov, “Global Darkening: Absurd Goals, Expensive Decisions, Falsifies Arguments in the Fight Against Global Warming [in Russian],” Izvestia, 30 March 2005.
is also demonstrated by Russia's focus on using Kyoto as a means of boosting industrial profits through JI projects, while overlooking environmentalists' pleas for measures to secure significant emissions reductions. Not coincidentally, one of the first pilot energy savings projects of Gazprom was implemented in cooperation with the German company Ruhrgas AG in 2005–2006 for the optimization of gas transportation networks, and reduction of fuel gas waste, consumption and emissions. Gazprom was welcoming JI investment to upgrade its infrastructure and had drawn up a greenhouse gas inventory. Gazprom highlighted the project not only for its emission reduction benefits, but also as ‘an important driver for strengthening and improving production and commercial ties between the companies’ (Gazprom, 2006). In fact, to date Gazprom’s approach has been to cooperate with existing partners instead of looking for new investors by establishing a JI facility. The change in Gazprom’s (and UES’) interests with respect to climate cooperation was sufficient to set up a powerful industrial lobby in support of the Kyoto Protocol. By 2004, the interests of these giant companies, plus a number of smaller industrial actors seeking to benefit from the emerging carbon markets, formed a robust coalition that had been actively lobbying the Russian government on the Kyoto ratification and that created the political base for the ratification, which was absent in the early years following the adoption of the Kyoto Protocol (Andonova, 2008). As noted by some observers, the Kyoto ratification also boosted Gazprom’s image; on its website a range of energy saving measures, including the optimization of transmission system gas flow, replacement of gas compressor units, implementation of automated control systems and replacement of boilers are listed (Korppoo et al, 2006). In summary, Russian big businesses’ support came from the realization of the enormous financial gains from selling unused emission credits and investing these revenues in clean technologies through which the Russian industry would be strengthened. Above all, the natural gas lobby gained handsomely from Kyoto and its behavior was once again, led by profit maximization considerations. In fact, the interests of this powerful coalition of business actors informed considerably President Putin’s decision to endorse the treaty. As noted in the previous chapters, although technically controlled by the state, Gazprom’s influence in the presidential administration is formidable, in fact one of the priorities of the government is to assure that Gazprom conducts its business in the most effective way (Grigoriev, 2011), illustrating the complex and close relations between business and government in Russia. According to Andonova (2008) among the insiders, Dmitry Medvedev was a particularly influential figure as Vladimir Putin’s Chief of Staff between 2003 and 2005. In line with that, Henry et al. (2012) note that the Russian government’s increased attention for the environmental cause starting from 2009, has been the consequence of the policy priorities of President Medvedev himself (as he then was), shaped partly by the close advisors he consulted, and the ability to use international climate negotiations to reinforce his domestic agenda. Along these lines, several observers noted that there is some evidence showing that having established itself as a key player in the international regime, Russia intends to continue active engagement. In fact, under the presidency of Dmitri Medvedev, the main legislation for JI was passed and finalized (in January 2008). A synergy between the interests of climate change mitigation and economic modernization facilitated a period of greater attention to climate policy initiatives. Medvedev’s formulation of national interest based on economic modernization and energy efficiency has offered potential benefits for reducing greenhouse gases. As soon as he assumed power, in June 2008, President Medvedev signed a decree on increasing energy efficiency by establishing the goal of “reducing by at least 40 per cent the amount of energy used to produce the country’s grow domestic product by 2020, as compared to 2007.” Moreover, in May 2009 Russia officially adopted a climate doctrine, which is likely to commit the country to a number of climate-friendly measures. The document is very

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160 Joint implementation: defined by Article 6 of the Kyoto Protocol. It refers to the emission reduction activities implemented jointly between industrialized countries and economies in transition, thus FSU and Eastern Europe.


162 Klimaticheskaya doktrina Rossii, Government of Russia (2009), Ministry of Natural Resources
general and vague, but acknowledges the human-induced character of global warming. The latter could be a very positive turn, however, it seems that the document also signals that Russia does not intend to participate with the world community in eradicating the sources of climate change, and instead will face the problem in its “own way.” As noted by Baev (2010), the main instrument for achieving this goal would be the gradual increase of regulated domestic prices on energy and gas, a scheme, which in fact suits the interests of Gazprom far more than it promotes energy-saving technologies. The latter allowed Russia remaining consistent with its reluctance towards policies imported from the outside and pleased Gazprom’s corporate interest. In fact, the politics of the Kyoto Protocol are in the final analysis another (positive) example of the ‘Europeanization’ of international politics along the formula - European countries subordinate their domestic politics to international cooperation, and the European Union emerges as a key agenda setter. Yet, the deep economic recession that hit Russia in 2009 forced the government to abandon the plan for raising tariffs, so the intentions concerning energy efficiency were reduced to a figure of speech.163 As a result, thus far the Climate Doctrine that does not have legal standing, but has rather established the official basis for policies and measures to mitigate climate change and adapt to it. Yet, the action plan that followed provided no new concrete measures to do so. It has remained as a political declaration rather than a practical policy document (Korpoo et al 2012). At the end of 2011, Russia gave notice it would not enter into the second commitment period of the Kyoto Protocol.164 Moscow’s preference, shared by many other countries, is for a new global agreement that obliges all major emitters to participate. That preference could be interpreted as yet another illustration of rhetoric that is not backed up with action. It provides Russia a convenient way to postpone future climate commitments, maybe indefinitely. Yet, if Russia is serious in pursuing its own version of the climate change battle, the Climate Doctrine could provide the catalyst to a common effort to tackle climate change. Russia, with its ambition to become a potential Great Ecological Power, while still facing some of the problems of transition economies, could increase its visibility by setting itself as “a bridge” to overcome north-south divisions via collaborations on several dimensions of policy, including low carbon technologies and carbon pricing structures. Climate change nonetheless is a domain where Russian sovereignty concerns are once again, likely to step in and shape the process. For instance, V. Pisarev from the Institute for the US and Canadian Studies at the Russian Academy of Sciences argues that although international environmental policy is dangerous for Russian sovereignty, Russia cannot step aside from this cooperation, because “it would harm the possibility of the maximal utilization of the international policy on sustainable development.” The ‘greening’ of Russia will continue to depend on its economic concerns, the quality of the values and standards embedded within the its institutions, domestic public pressure for effective action as well as the genuine willingness of the leadership to move towards environmentally sustainable systems of energy production and consumption. In the words of a Boston based expert: “At present, Russia has decided to stay silent and have not yet shown its cards in environmental matters. Most probably in the future it will continue to ‘sit in the corner’ and let the US and China take the largest blame for the international environmental deadlock.”165 However if Russian intentions with its Climate Doctrine are genuine, that could in itself offer a political momentum for Russia to increase its leverage in international affairs and push the BRICS to increase their reduction efforts, without necessarily embracing entirely the western climate agenda.

163 Ibid.
164 “Russia supports Canada’s withdrawal from Kyoto protocol”, The Guardian, December 16, 2011
165 In fact, today Russia is the third largest emitter worldwide, after China and the United States.
7.3 Conclusions

After a protracted hesitance and a strong persuasion campaign on the part of the EU (which Putin welcomed to raise Russia’s international image while he was weighting the options with Washington and Brussels) in 2005 Russia ratified the Kyoto Protocol. In the aftermath of Russia’s ratification Putin noted: ‘The European Union has made concessions on some points during the negotiations on the WTO. This will inevitably have an impact on our positive attitude to the Kyoto process. We will speed up Russia’s movement towards ratifying the Kyoto Protocol.’ However, this dissertation holds that Russia’s ratification was more an outcome of the bargaining power of the energy lobby masked by considerations regarding the WTO membership. The empirical evidence illustrated above shows that explanations resting on the WTO membership incentive are not entirely satisfactory. When Russia was still studying the issue Putin never made secret that the decision will be made “in accordance to Russia’s national interests.” Russia’s ratification was critical to bringing Kyoto Protocol into force on 16 February 2005, but this decision had most to do with direct economic benefits rather than the benefit of the WTO membership. In fact, to secure the participation of Russia, the country was given more (sink) allowances, which effectively relaxed the emissions constraints negotiated previously in Kyoto. The decisive role of Russia in the enforcement of global climate policy gave it political leverage. Despite being a member of the G8, Russia wanted to be considered as a ‘developing’ and not ‘developed’ economy in Kyoto terms. Moreover, Russia’s capacity to fulfill its Kyoto obligations was to be assisted by the EU, which subsequently funded a project to help Russia develop its capacity to monitor greenhouse gas emissions and prepare a national inventory of them. Thus, Russia negotiated very benign terms for itself in relation to the compensation for carbon sinks, and, in exchange for the ratification, received the European Union’s support for its membership in the World Trade Organization (WTO). For the Russian corporate sector, there were clear economic incentives for participation. The protocol sets a zero reduction target for Russia, meaning that Russian emissions cannot exceed the level of 1990 between 2008 and 2012, the first commitment period of the agreement. In 1990, the Russian share was 17.4% of the emissions of the industrialized countries, whereas in 1999 the respective figure was only 6%. This meant that Russia could actually increase emissions, or sell its excess credits to other states within the protocol without violating the agreement. Experts of climate policy estimated that Russia could economically benefit about 10 billion dollars annually from the Kyoto Protocol through emission trading, joint investment projects and increased foreign investments (Kotov 2002). And as noted by Tynkkynen (2010) besides the economic incentives, also a “political” concern for Russia’s international image has been among of the main factors behind Russia’s decision to ratify the Protocol. In line with Russia’s Great Power self-identification and Putin’s strengthened national-patriotic ideology, Russia welcomed the opportunity to boost its image as a Great Ecological Power and consequently, to leave the Bush administration increasingly isolated internationally on climate change issues. However, as a climate specialist reminds: “the same card can only be played for so long. In the post 2012 scenario and Russia joining the WTO, there are not any more carrots that would keep Russia on board.” Indeed, as noted by Henry & Sundstrom (2012), Russia will technically meet its relatively loose Kyoto 2012 emissions target, but has done little to implement the agreement, resulting in missed opportunities to further reduce greenhouse gases. Moreover, the country has recently announced that it will not be signing the treaty renewal in 2012 (alongside with Japan and Canada), so Kyoto is unlikely to cover more than 16% of global emissions after 2012. In the way forward, Russia will certainly not lead the climate battle and it is not clear whether Russia will agree and/or how much it will be willing to contribute to any ‘green’ adaptation fund. Talking about further action, the broad ‘coalition of the willing’ in favor of international action against climate change that appeared

166EU-Russia Summit: Putin Signals Support for Kyoto Protocol  
168 “Russia says Kyoto protocol no longer effective”, December 16, 2011, Ria Novosti
to take contours under the European leadership and against American opposition, is now crumbling. Russia has no interest to follow the EU lead in climate change, as the circumstances that surrounded the signature of the Kyoto Protocol have changed and there are no fresh incentives to accept very ambitious environmental targets. In the United States, the Obama administration has given up on national cap-and-trade legislation. The Chinese government, in turn, faces an even harsher constraint. Although the nation has adopted important energy efficiency goals, the Chinese Communist Party has staked its legitimacy and political survival on raising the living standard of average Chinese. Meanwhile however, evidence about the implications of environmental degradation and the global warming are increasingly uncontroversial, but Europe has fewer and fewer followers. The slim success of the Durban Summit (2011) shows that none of the key polluters such as the United States or China have intention to follow the EU’s ambitious environmental goals. The risk for the EU is to be left alone in the battle: if so, it could fall in a disadvantageous position compared to its competitors who did not commit to such high environmental standards, but are benefiting from the overall decrease of emissions. On the other hand, if Europe did not achieve its own targets by 2020 (i.e. EU 20/20/20) the damage to its credibility would be even greater. The EU has emerged as a ‘player’ in climate change debates and has proven a genuine global leadership in that issue, as it has not, for example, succeeded with energy security. Despite the fact that its leadership did not produce many followers, the EU should proceed with its goals, because based on past experiences, the incentives for scientific and technological innovations will unquestionably create new markets, which simply did not exist in the past. In that sense, the EU is well placed to reap the benefits of being the ‘first mover’ with its high investment in R&D that will undoubtedly bring new economic opportunities by contributing to an increasingly energy-efficient world, and by creating a new market for low-carbon technologies.
8. Energy Interdependencies between Russia-Italy and Russia-Slovenia Compared: A regional perspective

8.1 Introduction

Conventional wisdom holds that smaller European states (alongside with the United States), praise the EU’s ambition to ‘speak with one voice’ in external energy policy, but that these attempts are vehemently opposed by the big EU energy players (Germany, Italy, France). For example, as argued by de Jong, van der Linde and Smeenk (2011), for smaller countries (i.e. Slovenia) or for markets dependent on Russian supplies, becoming part of the larger Europe-Russia relationship can provide the security that a bilateral relationship cannot. For example, while in Italy and France storage capacity represents 15 per cent of annual consumption, and in Germany 26 per cent, many smaller countries have much lower storage capacities; and nine EU member states have next to no storage capacity at all (Müller, 2011). Thus, it would be natural to expect that the smaller Eastern European member states, would want to establish first and foremost a crisis management policy within the EU, to have an “umbrella” of protection against potential gas shortages. As noted by van der Linde (2008) small countries have a lot to gain from collective crisis management policies because their markets (and often their companies) are too insignificant to influence or engage in security of supply strategies where there are great costs involved. In fact, they can rarely use their internal political power to leverage their position in the external energy policy debate. According to a number of scholars (van der Linde, 2008, Smith, 2012) because smaller member states may experience more difficulty to develop effective national policies and are unable to bear the cost on their own, they might need to align themselves to either a larger member state’s policy or aim for the EU’s action to further their interests. Thus, large member states are better positioned to secure their energy interests, despite the decline of the national instruments’ effectiveness due to the internal market. On the contrary, smaller member states hope for “a single European voice” in energy matters, or as shown by van der Linde they can become ‘followers’ of their bigger neighbors. In general though, it is believed that smaller and newer member-states hope for the EU’s “common action” to make sure that their concerns are properly taken into account within the EU. My analysis challenges this conventional wisdom, showing that even smaller states are eager to exploit their position and play against the “common vision” if that suits the profit of the dominant lobbies.

Italy and Slovenia are chosen as case studies because they are both EU countries and they are both Russian gas customers. However, Italy represents a large gas consumer (in absolute terms) with fairly diversified gas consumption (in relative terms) and a key European country in terms of qualified-majority voting within the EU’s Council, with several oil and gas companies and big Majors, namely ENI and Enel. Slovenia is a case of a smaller country, with a smaller consumption of Russian gas in absolute terms, but less diversified than its Western neighbor and with absolutely no domestic storage facilities. That gives us two countries with a great variation on the variable “vulnerability” on Russian gas, where we would expect different patterns of behavior. However, empirical evidence suggests a more nuanced picture. The next section proceeds as follows. We first analyze both the Italian-Russian relationship and the Slovene-Russian relationship on their own ground and then we compare them. Each of the two studies outlines the nature and the dynamics of the relationship by focusing especially on the following factors:
a) Tendency to favor independent external energy policy as opposed to concerted EU energy policies taken in unison

b) Tendency to favor energy deals and political friendship with Russia

In the final section, we explore if there is room for beneficial cross-border cooperation between these two countries and more generally, in the South East Europe region.

8.2 Italy

Italy is a good illustrative case of the proposition advanced in this study that international companies are not mere policy-takers, but often determine the external energy policies of their states by following their own logics of best practices and profit maximization. This section will first give a brief historical overview of the Italian early moves towards natural gas. Then, the following two sections will explore the Italian position within the EU and the Italian relationship with Russia.

8.2.1 Brief historical Overview of Italy’s Thirst for Natural Gas

Since Italy’s unification, the energy question has been debated both by contemporary observers and historians. The energy history of Italy shows that the country has been quite successful in dealing with its energy scarcity by rearranging over time the supply of primary sources in order to confront changing emergencies: water, coal, hydroelectricity, oil and gas have all marked different phases in the country’s process of modernization, the centerpiece of which has been to reduce Italy’s dependence on energy from abroad. Ultimately, in this century, natural gas has displaced oil in Italy, as the number-one source of energy.

Since the 1860s, and especially after the 1880s (the decade of the first, tentative, economic take-off), in only a few periods have energy exports accounted for less than 50 per cent of total domestic consumption (Pastori, 2008). Between 1880 and 1914, coal accounted for the lion’s share, gradually replacing wood and water as the main energy source. In 1914, about 74 per cent of the installed electric power was hydroelectric. Oil’s contribution was negligible, with a share lower than 1 per cent. However, oil production rose considerably in the interwar period, especially between 1921 and 1940, with the impulse of the Mussolini regime (Ibid. 2008). In 1926, the Mussolini’s government created AGIP (Azienda Generale Italiana Petroli). AGIP’s task was to promote oil and gas research and production, both at home and abroad and to counterbalance to the major oil companies: Standard Oil of New Jersey (later Exxon) and Shell, which had come to dominate the Italian market. During the second half of the 1930s the Italian government exerted considerable pressure on AGIP for a rapid exploitation of national mineral resources to achieve self-sufficiency. Backed by government financing, AGIP focused its energies on exploration in Italy, primarily in the Po Valley (in the north). When gas was found there in 1938, AGIP became the first natural gas producer in Italy. In 1939 a pipeline was built to Florence. In 1941 the state-owned company Società Nazionale Metanodotti (SNAM) was created for the purchase, transport and marketing of gas in Italy. Gas production was driven by the rapid industrial development concentrated in the northern regions. To speed up the use of gas, in 1949 the first Italian gas-fired power station was set up. Local gas distribution was controlled either by municipal companies or by small firms on the basis of local concessions granted by municipalities. In distribution and retail sales, a fragmented market structure allowed the existence of small private firms and municipal undertakings operating as local natural monopolies. Since its creation, SNAM has gained significant interests in the largest local distribution companies, but the local distribution market has remained fragmented up till the present time. After the Second World War, the government decided that AGIP should be liquidated and sold to private
companies. In the liquidation process it became clear that the Caviaga field (discovered in 1944) was a major deposit. Despite the pressure from various multi-nationals AGIP managed to halt the liquidation, with the argument that Italy should have a national company, which could defend the national interests. Until the second half of the 1950s, the reduction of foreign dependence was still seen as the main political goal. With this in mind, ENI (Ente Nazionale Idrocarburi), the state-owned company, was created in February 1953 with the task ‘of promoting and enforcing initiatives, in the national interest, in the field of oil and natural gas’ and ‘of promoting and enforcing initiatives, in the national interest, in the chemical sector and in the research, production, regeneration and selling of nuclear fuels, and in the mining sector pertaining to these activities’ (Pastori, 2009). ENI, inherited hence the former AGIP’s role both at the national and at the international level, and throughout the years it absorbed as its different sub-branches some of the most important actors operating in the domestic energy sector, in the petrochemical and in related industries, such as AGIP itself, ANIC, SNAM, ROMSA, SAIPEM, Snamprogetti. ENI was also given the exclusive right to look for and exploit hydrocarbon deposits and the exclusive right to build and run gas and oil pipelines in the Po Valley. Driven by robust economic growth during the 1950s and 1960s and subsequently by the high demand for gas, more gas infrastructure was built connecting the Po Valley with the north of Italy. The high profits from natural gas funded the search for new fields, the development of pipelines and the acquisition of new customers. While Italy followed the general European path from coal-based to oil-based energy, it had an unusually high proportion of natural gas consumption by the end of the 1960s. Moreover, in the mid-1950s, ENI became an important element in the Italian foreign policy, especially considering Mattei’s independent moves towards the states of North Africa, the Middle East and the Soviet Union. In fact, as mentioned in the introductory chapter, Mattei visited Moscow in 1959, where he brokered the first oil import deal with the Soviets over heated protests from NATO and the United States.\footnote{Italian Industry Insider, Interview with the author in April, 2012} In the rest of Europe, throughout the 1950s, natural gas covered only about 1 per cent of the primary energy needs of the continent. It was only with the discovery of the massive deposit at Groningen, Netherlands, in 1959 that natural gas began to break into the European market (Maugeri, 2011). Indeed, the only exception in Europe was Italy, thanks to the industrious leadership of Enrico Mattei, which upgraded the gas reserves of the Po Valley, developing an industry that by 1960s made Italy the top gas consumer in Western Europe and number 5 in the world (after the United States, the Soviet Union, Canada, and Romania). In fact, by 1965, the traditional dominance of the hydroelectric sector had been, de facto, reversed.\footnote{In concomitance with the rapid industrialization of the country following the II World War the contribution of fossil fuels had increased to more than 70% in the early 1960s, to stabilize at around 85–90% in the last decades of the century (Toninelli, 2010).} The Italian massive economic growth in the 1950s and 1960s often dubbed as the “Italian miracle” was mainly powered by oil: in 1973 the share of oil in primary energy consumption reached 79\% (Toninelli, 2010). However, the oil shocks of the 1970s turned even more attention toward gas as a useful alternative to petroleum. Especially throughout the 1980s, an increasing share of oil consumption was substituted by natural gas, mainly in the household/service sector for space heating, but also in industry and power generation (IEA, 2010).
The progressive rise in gas imports starting from the 1980s is explicable by a mix of factors: a decline in domestic gas production, a general increase of energy use related to the expansionary phase of the Italian economy after the 1980s, a somewhat increased environmental awareness, and most importantly due to Italy’s long-lasting decision to do without nuclear energy.\textsuperscript{171} Most recently, after many years of discussion whether Italy should adopt nuclear power or not, the decision to ban nuclear was deeply influenced by an emotional impact following the Fukushima accident. That in turn re-launched an increased discussion on higher shares of renewable energy, but for a real increase in usage of renewables a substantial subsidization of the government is necessary, which is difficult to obtain, especially in moments of deep economic recession.\textsuperscript{172} In that situation, import dependency on gas, which is already very high (standing at around 90% in 2009), is set to increase to over 95% by the 2030s. OECD Europe only accounted for 21% of imports (14.6 bcm) in 2009. Two countries alone – Algeria (22.7 bcm) and Russia (20.0 bcm) – account for two-thirds of Italy’s imports (IEA, 2010).

Ties between Italy and Russia were established from early days, but after the first oil shock new impetus was given to natural gas as an alternative source of energy and all Western economies identified diversification as a goal in their energy mixes. In recent years ties between ENI and Gazprom have been increasing, as Italy became the second largest importer of Russian gas (after Germany). Italy pioneered a number of bilateral business deals with Gazprom while in parallel petroleum’s relative share in the Italian market has decreased significantly in electricity generation, steadily replaced by natural gas. In 2005 Italy became the fourth major world importer after the USA, Germany and Japan, while Algeria and Russia were supplying most of the imported methane (Toninelli, 2010).

\textsuperscript{171}Italy closed and deactivated its four nuclear plants – opened in the mid-1960s and located in Latina (near Rome), Caorso (in the Po Valley), Trino Vercellese (near Turin), and on the Garigliano river (between Rome and Naples) – between 1987 and 1988, following two referendums: one held on 8 November 1987 and another held on 12 June 2011 (when with a turnout of 57% Italian voters, that expressed their opposition to nuclear power with a percentage of 90%).

\textsuperscript{172}“Rinnovabili: Italia ai vertici mondiali per gli investimenti privati” Corriere della Sera, March 30, 2011, and “La grande chance delle energie rinnovabili”, April 21, 2011, Panorama.it
8.2.2 Italy’s position within the EU

In the international arena Italy’s choices to cope with gas security reflected a preference for long-term relationships with traditional suppliers, in the form of an interdependence paradigm, with relationships managed through a web of very close personalized approaches, such as the one between ENI and Gazprom in the gas sector. As a result of this approach, bilateral policies came to the fore. A good example of the pattern is 2006 ENI’s long-term “strategic partnership” with Gazprom, (part of which is Italy’s current engagement with South Stream and Gazprom’s direct penetration in the Italian natural gas market, a result of Gazprom’s desire to get closer to European consumers where Gazprom now sells directly 3 bcm per year.173 Moreover, Italy is one of the pivot countries of Medvedev’s recent modernization alliances with its major European partners. Two main features can describe Italian position within the EU:

1. ENI’s dominance and a flawed implementation of the EU’s liberalization laws
2. The support for an unconditional friendship with Moscow

The next section explores both in more detail, and shows that they are interlinked.

8.2.2.1 ENI’s dominance a flawed implementation of the EU’s liberalization laws

Before liberalization, the Italian gas industry was vertically integrated. ENI was involved in the gas chain from production to retail sale, either as a monopolist or as the dominant player. In the past, ENI enjoyed exclusive rights in hydrocarbons exploration and production of the (few) resources discovered in the Po Valley, where, at the time, the most promising oil and gas fields were located. Gas storage was bundled with production and controlled by a subsidiary of ENI: AGIP Spa. SNAM Spa, another subsidiary of ENI holding, enjoyed a de facto monopoly over national gas transmission and supply to the wholesale market, and controlled international transmission pipelines in joint ventures with other foreign companies. During the 1990s, ENI was progressively privatized; ENI was converted into a joint stock company in 1992 with the Treasury owning 100% of the shares (IEA, 2008). Between 1995 and 1998 the government’s shareholding in ENI was reduced to 30.3% through four tranches of public offerings. Regarding natural gas import, prior to ENEL signing its own import contract in 1992, ENI, through SNAM, was the sole importer of gas into Italy. Therefore, Italy’s strategies to cope with gas security have for many years been decided by one sole protagonist – ENI – that has acted and that (somewhat still acts) as a “national champion,” in a de facto monopoly condition, rising substantial benefits from a series of conditions: its level of integration upstream and downstream, its capacity to heavily weight on the decisions of national energy policy significance by virtue of its substantial position withheld within the Italian gas market and its nature of an ex-state company.

The liberalization of the Italian energy sector was accompanied in 1995 by the establishment of the Regulatory Authority for Electricity and Gas, which became operative in 1997. In cases of suspected infringements of the EC Antitrust law, the Authority duty is to report the suspected violations to the Italian Antitrust Authority. Moreover, in the 2000s in coherence with the European competition law, several decrees were introduced to implement the three European gas directives (Luciani and Mazzanti, 2006). The European liberalization aimed to break vertical integration in the gas industry and to introduce competition by requiring each country to implement the following: (1) Unbundling potentially competitive activities of the gas industry (production, imports, wholesale and retail sale of gas) from those segments of the gas chain characterized by a natural or de facto monopoly (transmission, storage and distribution networks); (2) Third Party Access (TPA) to essential facilities (not only transmission and distribution networks but also liquefied natural gas (LNG) terminals and

173Gazprom also acquired stakes in other EU’s corporations’ infrastructure for gas distribution (Konoplyanik, 2010)
storage facilities) which dominant players continue to operate; (3) Liberalization on the demand side, by allowing consumer switching. Despite the liberalizing act, the rising imports of natural gas from abroad only increased the already powerful monopolies, ENI and ENEL (IEA, 2008). The liberalization law that passed in 1992 ended de jure the monopoly that these two companies had held in their respective sectors with the relevant increase of the number of subjects operating in the energy industry. De facto however, especially ENI in the gas sector succeeded to maintain a monopoly preventing real competition in the Italian natural gas market. Despite market share limits and the growth in the number of importers after liberalization, the market for gas imports still remains highly concentrated. The cumulative market share of the top four companies (ENI, Enel trade, Edison and Plurigas) accounted for 80% in 2005 (AEEG, 2006). As noted by Cavaliere (2007), when gas supply is characterized by long-term importing contracts with take-or-pay clauses, liberalization policies lead to entry and market segmentation without benefits for consumers. In order to foster gas-to-gas competition, the development of wholesale exchanges at market hubs is a necessary condition. However, new investments in essential facilities are required to reach this objective. In that sense, in the past years the government has actively supported a number of projects of strategic importance for Italy, like the construction of several new LNG terminals. However, these projects require the ability to make multi-billion investments in uncertain projects, which in turn requires a large balance sheet. In addition, LNG terminals demand specific knowledge and skills that are not always available to smaller players, especially those that were previously active only in the power sector. That means that the government simply has no means to “promote” such projects, because the incumbent (i.e. ENI) fundamentally opposes regasification projects aimed at increasing import diversification, while the “smaller” players such as Edison tend to be wary about the high investments burden. Therefore, to date besides ENI’s first LNG regasification plant Panigaglia situated near Genoa, only one new LNG terminal near Rovigo became operational in mid-2009. Another one in Livorno is under construction, and more than 8 other projects are still waiting to get authorization and are obstructed by frequent environmental opposition, financial and engineering issues. For example, in 2009 in the vast majority (98.1%) of Italian imports were delivered by pipeline, and only the remaining 1.9% by LNG cargoes (IEA, 2010). This situation is in part an outcome of ENI’s opposition to capacity expansion in transit pipelines and its reluctance toward new import projects, due to its forecast of an excess supply of gas in Italy (a ‘gas bubble’), as in the past years some new entrants were trying to by-pass the existing bottlenecks by planning to build new LNG terminals. On the basis of an impending gas bubble, the incumbent lobbied against projects destined to bring in gas from Central Asia, such as the competing Southern Gas Corridor projects, the ITGI (which is out of the race now) and the TAP. Meanwhile ENI pioneered its deep underwater gas pipeline transport in the realization of some major projects of geopolitical significance, such as the deep submarine gas pipeline project called Blue Stream (in collaboration with Gazprom, under the Black Sea), to connect South Russia to Turkey and bypass any third transit country, that was inaugurated in 2005. The realization of this costly and complex infrastructure project would not indeed be possible without the participation and the experience of ENI. Blue Stream is considered one of the deepest pipelines in the world. The sheer fact that ENI has the economic means and the engineering knowledge to take on the construction of such a potentially hazardous project, illustrates its corporate strength.

On the other hand, the Italian government has generally supported the liberalization policies of the European commission and the aim of creating a common internal gas market. To that

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174 ITALIAN INDUSTRY INSIDER, Interview with the author in April, 2012
175 “Rigassificatori ancora sulla carta”, February 08, 2012, Il Sole 24 Ore, and “Emergenza gas, la soluzione si chiama "rigassificatori": ecco i progetti in campo”, February 7, 2012 Panorama.it – all these editorials coincide with the February 2012 gas supply shortages from Russia in times of an unusually cold winter.
end, Italy has largely endorsed (at least at a formal level) European indications on energy policy. Indeed, as noted by Cavaliere, Italy almost completely complied with the obligations of the second European Directive (2003/55/CE) when implementing the first, although this was not sufficient to introduce effective competition. In fact, in the context of the Italian energy policy, the main energy decisions affecting natural gas security have been taken by ENI with little input from the government (Luciani and Mazzanti, 2006). In the past, when ENI was a national monopoly, the government had, in a sense, delegated the task of energy security protection to ENI. The problem is that even after the privatization very little has changed, as ENI is behind most of the energy decisions made by the government in the last decade, but its goal is no longer to replace the government in the strategic energy decisions for the country. ENI is, as any other privatized company, driven by profit maximization. As Italy is dependent on huge gas imports from outside the EU, and in view of the (geo-political) risk connected with gas purchases from Russia and Algeria, the supply security concerns compounded with the historical weakness of the Authority maintained a de facto the monopoly of the incumbent. The competences of the Authority have been downgraded by the weakness of the Italian governments that, especially during the Berlusconi years, have been particularly receptive to the lobbying of the corporate sector. The choice to depend on a highly concentrated (poorly diversified) energy supplies and mainly on non-European supplies is the consequence of ENI’s corporate choices, which puts Italy among the countries that have the lowest energy imports that are intra-European in nature. Indeed, in the last years ENI has reduced its shares of intra-European energy imports, to increase its concentration of imports mainly from the Middle East, Nord Africa and Russia (Escribano et al, 2012 p.221). Due to the fragmentation of the market, in Italy, the gas market seems to be characterized by free entry without competition. New entrants therefore benefit from liberalization, but consumers do not. As argued by Cavaliere (2007), while in gas producing countries such as the UK or the Netherlands, competition in gas markets may follow from the implementation of liberalization principles, in countries that are net importers of gas, liberalization is a necessary, but not sufficient, condition for competition. The main barrier to competition appears to be the lack of incremental import and storage capacity to transport additional volumes of natural gas independent from the incumbent, which is responsible for capacity and gas shortages. Negative implications of the Italian exposure have been emphasized, both at the European and at the national level. For example, Italy underwent another energy crisis in February 2012 as Russia cut back supplies again in the middle of the winter. Though Italy was much better prepared this time thanks to strategic storage capacities, new interconnectors, and reverse flows, storage for example remains a problem. The problem stems from the fact that Italy’s large storage facilities operated by Stogit are owned practically by the incumbent with limited or no access for new players, therefore storage remains a de facto monopoly. Italy legally unbundled storage facilities from gas production and transmission activities. A separated storage company (STOGIT SpA), although completely controlled by the incumbent, was created. With respect to the transmission network, Italy opted for legal unbundling from the former integrated gas utility. The national transmission network is operated by SNAM Rete Gas (that before the Monti liberalizations was controlled by ENI). The ability of the Italian Authority for natural gas and the Antitrust authority to tame ENI has been somewhat disappointing: in 2002, the Italian Competition Authority established ex-post that ENI was abusing its dominant position in the gas market, in the control of the import pipelines. In fact, the liberalization policies failed to consider that ENI continued to hold exclusive transmission rights in transit pipelines located outside Italy, to which it contributed to the building of when it was a vertically integrated monopolist. These facilities are furthermore exempted from the principle of non-discriminatory third party access (TPA), as they are devoted to transit. Therefore ENI still keeps the control of all the essential facilities located abroad, through which it is effectively

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preventing new entrants from bypassing its intermediation and importing more non-ENI gas to Italy. Although some expansions of capacity have now been completed, ENI’s structural lack of import and storage capacity might prove dangerous in the case of future crises. The strategy pursued by the incumbent allows an increase in profits compared to new entrants. Both the congestion of import facilities and the difference in market share limitations allows ENI to be a supplier of its competitors in the wholesale market. As the incumbent benefits from a lower cost of imports due to its ‘first mover advantage’ in the international gas market, it can obtain a supplementary mark-up by selling gas to new entrants, whose profit margin is significantly lower (Cavaliere, 2007). For example, when ENI was still vertically integrated, it had to be forced by the European Commission to expand pipeline capacity from Austria to Italy because it did not want more competition (Boltz, 2012). Thus, the Italian restructuring was linked to a tug of war between the DG Comp, the Italian regulator (l’Autorità) of one side and ENI on the other. Although the network has been partially separated from the ENI, the real ownership separation between Snam Rete Gas and ENI became only possible with the recent Liberalization Package implemented by the technocratic government of Mario Monti in January 2012. After the ownership unbundling measure, ENI was immediately prompted to sell 30 per cent of its shares of Snam Rete Gas, and by September 2013 it will have to reduce its quote to below 5 per cent (Carlo Stagnaro, Istituto Bruno Leoni, 2012). Seemingly, the ex-European Commissioner for competition, is testing his experience on the Italian gas ground. With a weakened ENI in Italy, the company will become increasingly international and its attentions will quickly turn towards other markets, such as North Africa and the Middle East where it can strike more profits, with some potentially damaging consequences for Italy’s gas security, that will be discussed in the next section.

8.2.2.2 Liberalization and the other side of the story

Although in principle, the Italian government has supported all projects aimed at increasing Italy’s import capacity, Italy’s position within the EU has alternated between a Euro-enthusiasm (at the official level) and the defense of the ENI’s strategic interests (in practice). Moreover, the traditional weakness of the Italian governments was accompanied by a legacy of the incumbent in providing for the national energy security and its hegemony “at home.” As noted before, in gas ENI has shown a marked lack of enthusiasm to either expand capacity, or offer unused capacity to “potential intruders.” On the other side the weakness of the Italian governments’ strategic vision in energy related issues, was a consequence of the general weakness of the Italian coalition governments during its first fifty years of history, when the first Italian Republic has been characterized by the highest rate of cabinet turnover in Western Europe (Curini, 2011) and which in turn led to the fragmentation of responsibilities between different actors. As noted by Pastori, since the mid-1970s, Italy has been engaged in producing constantly revised energy plans. Lacking coherent political drive, the national champion (i.e. ENI) was delegated to yield some stability, by efficiently providing for Italy’s energy security. Therefore, the interests and strategies of the Italian governments naturally converged with the interests of ENI, which replaced the government in energy matters and can be therefore analytically treated as the pillar of the Italian foreign energy policy. Since liberalization, however, ENI was forced to allow the entrance of other players in the market, which has been resisted by the incumbent. Indeed, for the next fifteen years ENI managed to act as a quasi-monopoly, despite the creation in 1995 of the Independent Regulatory Commission for electricity and gas (Autorità per l’Energia Elettrica e il Gas). In the past two decades the incumbent has seen the liberalization drive from a different

177 For the latest version of the Italian energy plan under the Monti government see: O’Brian, H. Italy finally has an energy plan, European Energy Review, 15 November 2012
perspective, whose line of argument has a justifiable underpinning rationale that will be briefly examined. Liberalization of the gas market does not tell the whole story of Italy’s gas security. The first point is that Italy’s indigenous production is declining. It is undeniable that in Italy gas is more expensive than in the Netherlands or the UK, and unlike these two countries Italy’s domestic production accounted for 8.0 bcm (6.6 Mtoe) in 2009, which is a drop compared to the country’s needs. Therefore, the underlying rationale of this perspective is that Italy is better off if it serves its gas security by means of strategic partnerships with key suppliers. Given that these suppliers act as oligopolies in the EU’s market, there is no utility in increasing the number of sellers in Europe if they all have to turn to the same supplier (Maugeri, 2011). Advocates of this line believe that mere competition between sellers within the EU does not help to decrease the prices for the end consumers. What is more, Italy’s drive to build new LNG terminals, does not answer Italy’s gas security dilemmas. Having an LNG terminal, does not in itself secure supplies to that terminal. It seems to be increasingly difficult to contract LNG supplies (Van der Linde, 2010). Given that the price of gas on the spot markets in Asia is almost twice as the price of gas in Europe, LNG producers are naturally more attracted to the Asian market, where they are able to strike higher profits. These experts note that a new pipeline, especially one that is being built in cooperation with a producer (which is obviously not the case of the Nabucco pipeline, but it is the case of South Stream), is a more certain option for securing supplies. Therefore, when forced to turn to a limited number of vertically integrated suppliers (Russia and a limited number of others) it is better to retain strong state-backed corporations to ensure energy security. Also, these scholars warn against excessive volatility in the gas prices, that when relying exclusively on market mechanisms can bring lower prices in some periods and higher prices in others (Konoplyanik, 2012). Italy’s policy line within the EU embodied this vision, of a strong opposition to full liberalization and the faith in the value of a state-backed national champion that has the leverage to attract supplies (albeit usually at higher costs for the consumers than in a thoroughly liberalized gas market). Contrary to this approach the European Commission sees the predominant role of national champions and the predominant role of long-term contracts and take-or-pay clauses as a great impediment to competition. This dissertation holds that long-term contracts are per se justifiable; they yield the needed security that the producers need to invest in costly gas investments. However, the linkage to oil is increasingly not justifiable, due to the rising spreads between the price of oil and gas in the spot markets. This thesis has also argued that member states should retain ample leverage in determining their export strategies given the big differences in their energy mixes, which are the basis for every energy policy. Moreover, since the liberalized market in itself does not guarantee infrastructural capacity and investments, some state action and differentiated responses are desirable, however the efforts of ENI to resist domestic liberalization and thwart the attempts to increase Italy’s diversification of supply are not. That said, this thesis demonstrates that the relations with Russia and other strategic partners are important when there is no ample competition in the domestic market. Therefore, adopting a pragmatic line with Russia is certainly preferable to the tougher line advocated by some smaller Eastern European member states. Also, the EU Commission militancy against the long-term bilateral deals with Gazprom is seen as a threat and not as an enhancement of the EU’s energy security. In substance, in the field of energy security, the EU still remains the creation of the states it is supposed to tame, therefore the EU is still for the most part paralyzed on energy security questions. Italy’s position within the EU has been the embodiment of ENI’s strategic choices. The main problem is that after privatization, ENI continued to be the largely predominant actor in Italy’s gas market, but its objectives have changed: it was not any longer responsible for the country’s energy security, but was now focusing on maximizing shareholders’ value. According to an Italian energy expert: “When Franco Bernabe was at the lead of ENI, he was more inclined to accept the competition policies. Scaroni’s policies are aimed to use ENI’s control of the company’s managing transmission and storage to limit capacity in order to preserve its dominant position in the wholesale market. This strategy is consistent with profit maximization by the
incumbent, as profits are higher in the wholesale market. However, today the company lacks strategic vision, and the goal of providing for the gas security of the country as a whole is now secondary to mere profit maximization considerations.” Today ENI has a great deal to lose from Gazprom’s “demonization” within the EU, thus it lobbies for a friendship through engagement. On one thing ENI has it right: it is obvious that Russia’s gas will not be the “marginal” one any time soon, thus no amount of the EU’s internal liberalization efforts can escape the simple equation that the EU cannot be energy secure without Russian gas.

8.2.2 The support for an unconditional friendship with Moscow

As noted earlier, despite the Iron Curtain that divided Europe into two hostile parts in the early 1970s several West European states signed multi-decade contracts with the USSR. Among other countries such as Germany, Austria and France, Italy was keen despite geopolitical tensions, to contract gas with the USSR. Moreover, the volumes contracted by the Soviet Union were constantly rising, as shown in table 8.

Table 8: Italy’s dependency on Russian gas

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Gas Consumption (bcm)</th>
<th>Soviet/Russian Share in Total Gas Consumption (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>22.0</td>
<td>32.9</td>
</tr>
</tbody>
</table>

Source: Closson (2009), IEA (2010)

For three decades the Italian gas sector was characterized by long-term supply relationships, above all with the Soviet Union, and later with Russia. The arrangement was designed for stability and a mutual benefit: Soviet gas for Italian pipes, financed by the Italian banks. At the heart of the gas relationship were long-term oil-indexed delivery contracts concluded for 20, 25 or 30 years, including an obligation to purchase at least 75 to 85 percent of the named quantity. These "take-or-pay" clauses represented a counterweight to the supplier's duty to produce and allowed the two parties to share the risks between them. The producer bore the price risk, the importer the risk of failing to sell the full quantity. The contracts included provisions for adapting prices to changing market conditions at regular intervals. Oil indexing followed the principle of basing gas prices on those for competing fuels. The advantage of linking gas prices to those for competing fuels was that the producer was unable to influence this mechanism (Westphal, 2012). On a strategic level, partnerships with Gazprom and interdependence with the Russian partner epitomized Italy's position vis-à-vis Russia. According to ENI's logic, the more Gazprom is embedded in the Italian markets, the more Italian gas security is enhanced. In a sense, paradoxically, this interdependence emphasizes Italy’s vulnerability to Russian gas shortages as it happened most recently in February 2012; on the other hand it yields Italy a considerable monopsony power in relation to the counterpart. Italy’s choice is at odds with smaller and typically “newer” member states that alongside with the European Commission lobby for higher diversification to cope with Russia’s dominance in their gas markets. This is part of a larger debate in Europe whose dividing lines are between those who believe that building competing pipelines to supply Europe with gas from Central Asia (that would circumvent Russia) is absolutely necessary and those who advocate a constructivist engagement with Russia. Of the former, notably countries such as Poland and the Baltic states, have seen in Russia a potential threat to the

178 Interview with the Author, May 2012
political independence and even territorial sovereignty of themselves and neighbors, and until recently looked to a US approach that robustly guards against Russian assertiveness. Advocates of engagement, on the other hand, notably countries such as Italy, Germany, and France, assert that the maintenance of extensive ties and constructive dialogue is the most effective way to influence Russia. They argue that Russia should be viewed as a strategic partner and observe that Russian cooperation is important on issues such as energy, but also Iran, climate change, and arms control. According to this group, the EU’s coercive attempts to undermine Russian influence in Central Asia (i.e. Nabucco and alternatives) have not improved the EU’s energy security. Rather, they have irritated and antagonized Russian leaders without making their behavior any more amenable to the Western goals. Among the advocates of strong cooperation with Russia as an instrument to facilitate energy security, ENI and therefore Italy, is perhaps the most prominent. ENI’s strategy is epitomized by the acquisition of Yukos through the Enineftegas consortium (60 per cent ENI; 40 per cent ENEL) in April 2007 (Pastori, 2009), and through signing a MOU between ENI and Gazprom for the building of the new underwater pipeline (i.e. South Stream), an extremely complex undertaking that would carry 63 bcm of Russian gas to the European market. This colossal project of a dubious economic rationale would benefit ENI because the latter is building the pipeline together with Gazprom, and potentially Italy, because the country’s dependence on gas transited through Ukraine would be reduced. As noted by an energy expert, “ENI and other shareholders have anticipated some equity, but the pipeline is largely financed by Gazprom, the rationale of ENI for building such a pipeline could come from interests close to ENI, in other words the realization of the project that will be granted to Saipem.” Although officially neutral, the EU Commission has in practice opposed this project, and it is still uncertain whether Gazprom will be granted an exception from the EU’s third package regulations, which Nabucco already received, thus making more difficult not to grant these permits to South Stream. While Moscow and Brussels’ dealings remain caught between mutual dependence and mutual fear, the Moscow-Rome relationship appears unmoved by Brussels doubts. That means that both the Kremlin and Italy will continue to seek a privileged partnership status, in parallel to their relationship with the EU as a whole. However, today Gazprom and ENI’s logic of a long-lasting relationship where both partners are sweeping the gains from a dominant relationship may suffer a blow as Europe forges ahead with its energy liberalization policy. For example, the EU’s Third energy package has already forced Gazprom to accept to “unbundle” its European assets and avoid anti-trust claims by the European Commission. Regarding the hostile statements by Gazprom against the EU’s liberalization process, to a certain extent ENI sides with Gazprom in warning that the current structure did not come about by chance. Those long-term, oil-indexed contracts were necessary, because of the long-term horizon of the investments. The eclipse of long-term contracts might jeopardize, rather than enhance the EU’s gas security. As noted before, despite the correct transposition of the two European gas directives, until the advent of the third energy package, the fundamental way that ENI and Gazprom have conducted their business has not changed. On the other hand, today all European majors, including ENI, are supporting a de-linking of the price of gas from the price of oil in their bilateral commercial contracts. In the last year, in concomitance with the changing paradigms in the European gas markets, ENI obtained a discount of the 10 per cent for the gas it had to withdraw according to its take-or-pay obligations. Hence, despite the difficulties of the last two years, overall ENI and Gazprom’s business arrangements produced very close ties that allowed ENI to establish itself as the uncontested intermediary for Russian gas to the Italian market. Italian close contacts with Gazprom allowed the latter to control and operate the external pipelines not included in the liberalization efforts. Indeed, ENI ships gas destined for Italy from the delivery point at Baumgarten through Austria via the TAG pipeline, which is jointly owned

179 Interview with the Author, May 2012
180 “Gazprom may unbundle to escape EU claims” (Euactiv, September 28, 2012)
181 Interview with an industry insider, February 2012.
by Eni SpA (89%) and OMV (11%). Moreover ENI was granted exclusive exploration and investment rights in Russia. In general, the more the two companies colluded, the more their mutual dependency was rising. In June 2007, shortly after the Russo-Ukrainian gas crisis reduced significantly imports to Italy, the two giants signed a memorandum of understanding to build the South Stream gas pipeline from Russia to Italy. To that end in November 2007 they agreed to form a Swiss-registered joint company on a parity basis to conduct a feasibility study in January 2008. With this move Gazprom was granted downstream access to the Italian market in return for guaranteeing supplies to Italy until 2035. Both ENI and Enel even helped Gazprom to acquire additional Yukos assets in return for a foothold in Russia’s gas field development and a seat on Gazprom’s board. In fact, after acquiring Yukos assets with ENI, ENEL became the first IOC to create a vertically integrated process covering the entire value chain in Russia (Youngs, 2009). In general, due to the traditional link existing between the Italian government and ENI, the Italian government has been strongly supportive of ENI’s corporate strategy. For instance, in December 2006, Italian foreign minister Massimo D’Alema made a trip to Moscow to agree bilateral energy cooperation initiatives with Russia. In 2007, a meeting between Putin and Romano Prodi accompanied the signing of the South Stream deal. The political importance of South Stream is reflected in the fact that Prodi was offered a position as head of the shareholders’ committee of South Stream AG, but he declined (Mankoff, 2011). Under Berlusconi, the bilateral relations and close political ties improved even more considerably. In fact, during Berlusconi’s last two terms (2001-2006 and 2008-2012), Italy became one of Putin’s closest political allies in Western Europe, with Berlusconi lobbying for Russia’s entry into the EU and blocking anything tough against Putin within the EU’s Council. Meanwhile, the leadership of ENI became even more closely entangled with the political power of Berlusconi. As noted by Liuhoto (2008), that economics and politics are intertwined and often even complementary in the Russian energy policy, to a lesser degree the same can be claimed about Italy. Therefore, the last two Berlusconi governments marked a particular symbiosis of interests with Gazprom and the Kremlin, including the numerous quid pro quo deals with Gazprom that gave the latter access to the Italian gas market. However, these tightly controlled bilateral structures have now started to crumble, as a result of a more dramatic drive for liberalization within the EU and a more visible spread between the spot prices for gas and the oil indexed prices, which could now challenge long established relationships and bring tremendous changes to the European gas market.

According to Kirsten Westphal (2012), the lack of resilience in the gas markets is partly a function of the current sensitive transitional phase in the gas sector, where markets alone are slowly responding to the changes, thus the market alone is unlikely to ensure security of supply. Thus, Westphal notes that political action is required both in the domestic market and in external relations. At the heart of the huge change, are the long-term amiable relationships between Russia’s Gazprom and many of the European major companies. Still today, in line with the EU founding treaties, Member States’ gas companies are the ones responsible for choosing suppliers and concluding supply contracts, and hence their previous decisions are the ones that resulted in the current EU energy balance and its degree of gas import dependence. Hence, it is important whether individual member states view Russian gas as politically acceptable or not, because given the highly unequal distribution in the member states’ dependence on gas (and on Russian gas in particular), and considering their differing attitudes towards such a dependence, the EU as a whole has not been able to lend its unequivocal support to Nord Stream, South Stream or Nabucco. Indeed, the EU inability to present a united front in support of a single pipeline that would supply Southern Europe and especially the Italian market, led to until recently, two complementary and competing projects, namely the Nabucco and the South Stream projects. The rhetoric that ENI used in its press releases to sell the South Stream project included the assertion that the project

aimed at ‘strengthening Europe’s energy security.’ On the other hand, according to some EU diplomats if South Stream outpaces Nabucco, it will at the same time defeat the EU’s interest in avoiding additional dependence on Russian gas supplies in the future. In March 2010, realizing the prohibitive costs of South Stream and in an effort to reconcile the two projects, the CEO of ENI Paolo Scaroni proposed to merge the Nabucco and South Stream projects to ‘reduce investments, operational costs and increase overall returns.’ Energy Minister of Russia Sergey Shmatko rejected this proposal, saying: “South Stream is more competitive than Nabucco’ and “Nabucco and South Stream are far from being competitors.” In the words of an industry insider: “Scaroni’s attempts to soften the South Stream’s burden got him in a worse position than when he started off. It added two new participants of the Consortium: Wintershall Holding of Germany and Electricité de France (EDF) in September 2011, but the project went on.” As of today, the South Stream project looks in better shape than its competitors for gas from Central Asia (i.e. TAP and Nabucco West) due to ENI’s participation for the marketing, financing and technology, and due to the presence of Russian gas. Nabucco seems out of the race because it did not have either of the two, plus it lacked the gas to justify such a huge tube (see Chapter 10). The “South Stream versus all-the-other-Competitors” commercial competition includes important political implications, however. The persistent agenda tension between those who stress the need for greater independence from Russia and those who praise the virtues of mutual interdependence is still fiercely debated. In the debate, prior to the Monti government Berlusconi’s Italy was the most forward leaning state seeking to deepen energy ties on a bilateral basis with Moscow.

8.2.4 Conclusions
For the first time in the Italian history, the Monti government undertook a real unbundling of ENI and SNAM. In the past all the strategic decisions regarding the Italian energy security were taken by ENI, which was largely delegated by the state to provide for Italian energy security. In the years prior to the Monti government, ENI continued to act as a “national champion” in the gas market. As long as ENI retained a dominant position, Italy was unable to realize its ambition to become a regional hub in the Mediterranean. In fact, if sufficient investments in new infrastructure were made, Italy could have launched a physical hub for gas exchanges in the Po Valley where the most important pipelines (carrying gas from Northern Europe, Eastern Europe and North Africa) cross close to huge storage fields and the centre of production. Italy could have exploited its geographical position and turned itself into a transit country for gas flows, and incremental amounts of gas outside long-term contracts could be traded at exchanges. In January 2012, the Monti’s liberalization package brought some changes that made this ambition more attainable. With the definite separation of SNAM Rete Gas from ENI, the network has now total autonomy to move within the competitive gas market. SNAM is in charge of the dispatching and the distribution of the gas network on the entire Italian territory: 31700 km of pipelines that cover the peninsula and that have made Italy the ideal candidate to become the European hub for the Mediterranean gas routes. With the unbundling of ENI, the network will be therefore at the disposal of other suppliers allowing thus not only the opening of the markets but also market alliances.

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183 Coinciding views of a Diplomat at the EEAS specialized in Russian Affairs and a Diplomat at DG Energy specialized in Russia - Interviews with the Author, May 2012
184 “Eni calls for South Stream, Nabucco links”, United Press International
185 Grove, Thomas (18 March 2010), “OMV says no ongoing talks to merge rival pipelines”, Reuters
186 Interview with the Author, May 2012
through acquisitions by Rete Snam of equity shares of other European transmission companies. From there, the actual path to the creation of the European hub is short: a project pursued for years by theAutorità per l'energia elettrica e il gasand that could now become a reality.

Lastly, the question is how will the Italian future governments respond to these major changes, given the traditional tendency to delegate ENI for Italian gas security and in turn to follow ENI’s logic of long-term horizon relationships with the main producers? How will the country react to a real “third party access” in lieu of a tendency to prefer concentrated supplies with a restricted number of “special” suppliers? First, hopefully aggregation of information and transparency within the system will be further improved. Changes in the Italian gas market will undoubtedly affect the Italian-Russian strategic energy relationship. The gas market is changing to a degree that has never been seen before. The new phenomenon is putting a great deal of pressure on the established preferential energy contracts, which no longer provide companies such as ENI with a competitive economic advantage, that in the past was tied to positive political relations with Russia. Russian gas is increasingly becoming the most expensive “gas in town” for its friends and enemies alike (see Chapter 9). This big contradiction is summed up in the fact that there is a spread of around €10 between the spot prices for gas and the oil-indexed prices. The market requires adaptation of long-term contract prices. For example, in Italy the Monti liberalization package implies an increase in market transparency and a reduction of "monopoly" prices, to eliminate a premium for security of supply that Italian consumers have been paying altogether with one of the highest prices in Europe despite close ties with Gazprom. The Monti measure implies ways of reducing this final price for consumers, although it has to be noted that “spot” gas does not mean cheap gas, it is rather about achieving a cost reflective price for whatever the markets (and fundamentals) suggest gas should be. It has been announced that the Authority will use a system to update the price of gas for the final consumers and the small enterprises, reducing gradually the oil-indexation, with (a potential) effect of a decreased price for the final consumer, but also more price volatility. In fact, energy experts such as Kirsten Westphal (2012) warn, “the market alone will not ensure security of supply because gas suppliers have an interest in scarcity.” She argues, “more than ever strong political action is required both in the domestic market and in external relations.” It seems that the Monti government has taken seriously on that task too. The technocratic government is supportive of the recent ENI’s willingness to renegotiate the long-term oil-indexed contracts with Russian Gazprom, which caused great financial troubles for ENI in the last few years. According to analysts such as Jonathan Stern (2011), at last the change in the European gas markets is irreversible and Gazprom will be forced to compete, the question is when this will happen and how should highly dependent countries such as Italy act in the meanwhile. Other observers such as one gas executive disagree: “Things are more complicated than that. The gas market will not open up easily, Gazprom has an amazing capacity to influence the price of gas due to its dominant share.” Whatever the verdict will be, it is certain that the gas market is amidst an unprecedented change, one in which the Italian government simply cannot any longer afford to delegate the entire job to ENI. As noted by Westphal “Although the companies are the main actors responsible for ensuring supply, security of supply is a public good and the final instance is the state.” And indeed the centerpiece of Monti’s strategy is to bring the state back in the game.

8.3 Slovenia

As noted earlier one of the dividing lines in the EU energy policy has been energy trade with Russia. In general, the new Eastern member countries have been very critical about a close energy partnership with Russia and have fiercely lobbied for further diversification. As UK’s indigenous resources are progressively depleting, this position has gained support from the UK as well. Unsurprisingly, all the countries that are the most vulnerable to Russian gas are located in Central and Eastern Europe, as illustrated in Figure 12. By virtue of their vulnerability, these are the countries where we would expect more urgent incentives to boost diversification projects than elsewhere. Slovenia is a case in point. However, a more detailed qualitative analysis of the Slovene case provides more nuanced conclusions. After a brief introduction dealing with the Slovene gas market, we will examine the same variables looked in the Italian case: i.e. the Slovene position within the EU and its relationship with Russia in particular.

Figure 12: Share of Russian gas imports in total imports by country, 2009

Source: BP Statistical Review of World Energy 2010

8.3.1 Introduction

Slovenia depends almost entirely on natural gas supplied from abroad, as it has only about one percent of its own gas sources. Moreover, Slovenia has no storage capacity and its dominant gas company’s business with external suppliers is managed through long-term contracts for the supply of gas primarily from Russia. Slovenia uses storage capacities located in Austria and Croatia. In fact, during the 2009 January gas crisis when Slovenia experienced a 50% gas supply cut, it was covered with gas from Algeria via Italy and gas from storage facilities in Austria, thus from its neighbors (Yafimava, 2012 p.185). With respect to safeguarding the reliability of gas supply, most of the responsibility lies within Geoplin d.o.o, which is the main gas seller, the gas transmission system operator and the main contractor of Slovene imports (Slovene Energy Agency, 2012). In 2009 as much as 48 percent of gas supplies was supplied from Russia, 29 percent from Algeria, 17 percent from Austria and 5 percent from Italy. Starting from January 2009 the sources have slightly changed due to a

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dispute between Russia and Ukraine. According to the Slovene Energy Agency “The reliability of supply was not at risk. However, the import from Russia decreased for 5 percent, and on the other hand the import from other countries increased on the basis of short-term contracts.” As demand stalled, the imports decreased to 1.01 bcm of natural gas per annum, which is a decrease of 6 per cent from the pre-crisis levels. In 2006, Slovenia imported around 0.5 bcm of natural gas from Russia, which covered around 60 per cent of its entire gas consumption. Today around 50 per cent of the total demand is covered by sources coming from Russia, which means that despite the decrease Slovenia is still heavily dependent on Russia’s gas (see Figure 13).

**Figure 13: Slovene Sources of Natural Gas**

Since the 1st of July in 2007 the Slovenian market for natural gas has in principle been privatized. On the demand side, all the customers, including households, have the option to switch gas supplier. Customers can now choose a gas supplier from any of the gas suppliers operating in Slovenia. However, the distribution network is still under Geoplin’s control. Since the 1st of January 2005, a subsidiary company of Geoplin was established, but the new company is 100-percent owned by the parent-Geoplin. In fact, the Geoplin Group consists of two subsidiary companies: Geoplin plinovodi d.o.o, the operator of the natural gas transmission pipeline system, which owns and operates the 970 km of pipelines within Slovenia that are part of the European gas network, and Geocom, another subsidiary company whose main activity is natural gas trading. Geoplin alone owns both of them. The latter has almost 70-percent share of the Slovenian retail market, as shown in the table below.

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Table 9: Market shares in the Slovene retail gas market

<table>
<thead>
<tr>
<th>Company</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geoplin, d. o. o.</td>
<td>69.56</td>
</tr>
<tr>
<td>Energetika Ljubljana, d. o. o.</td>
<td>6.95</td>
</tr>
<tr>
<td>Adriaplin, d. o. o.</td>
<td>4.61</td>
</tr>
<tr>
<td>Plinarna Maribor, d. o. o.</td>
<td>5.41</td>
</tr>
<tr>
<td>Energetika Celje, d. o. o.</td>
<td>2.63</td>
</tr>
<tr>
<td>Others</td>
<td>10.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Energy Agency of the Republic of Slovenia, accessed on November 11, 2012

As shown by table 9 Geoplin is the largest supplier of natural gas in Slovenia. In turn, the largest shareholder of the company is the government of Slovenia, thus Geoplin is a national company. The company’s activities include trade, representation and mediation in the natural gas market in Slovenia, as well as business with other countries, for which Geoplin holds a license issued by the Energy Agency of the Republic of Slovenia. Therefore, the company is the only Slovene intermediary in the dealings with external suppliers, such as Russia.

Figure 14: Company’s Ownership structure

Note: Share capital structure as of June 2011
Source: www.geoplin.si

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192 Geoplin’s website/ section “About us”: http://www.geoplin.si/eng/about-us
8.3.2 Slovenia’s Position within the EU

Geoplin is by far the dominant company in the Slovenia’s natural gas landscape. Despite the fact that in the last two years (i.e. 2010 and 2011) Geoplin, d. o. o., retained more than a 90-percent market share in the supply of industrial customers connected to the transmission network, the Slovene Energy Agency found no abuse of the dominant position by Geoplin, d. o. o., thus no measures for the promotion of competition were taken.\textsuperscript{193} In the same text the Slovene Energy Agency claims that supplies were reliable, linking somehow the reliability of Geoplinin negotiating with external suppliers to competitiveness issues. According to an insider from the Slovene Energy Agency referring to year 2011: “In our view the situation is that Geoplin found itself in some sort of de facto monopoly but it did not exploit its position to prevent others from entering the business. By virtue of this, the Slovene market recently witnessed the entry into the retail gas market of a new serious market player, i.e. GEN-i. This company began to overtake significant portions of the market and the market situation is rapidly changing. In light of these changes we expect that the picture of the market will be quite different in the next year’s review.”\textsuperscript{194}Seemingly, Geoplin still withholds a de facto monopoly, although the number of other players is rising.\textsuperscript{195}As already mentioned in Slovenia gas is supplied through long-term contracts and the price of gas is indexed to the price of oil. Approximately, the price of gas in Slovenia and Italy is around the same levels, and in both countries the price for gas is higher than the EU-27 average.\textsuperscript{196} Slovenia is obliged to comply with the EU energy \textit{aquis} regarding third party access, but findings regarding Geoplin’s willingness to allow new entrants use its pipeline capacity provide an uncertain picture. It seems that the authority of the Slovene Energy Agency in these issues is still weak. Officially, the competency of the Energy Agency is to decide directly on the issuing and the revoking of licenses, to decidein the case of disputes pertaining to third-party access, to oversee the level of transparency and the degree of competitiveness in the natural-gas market. In principle, the Slovene gas market is still highly integrated and the unbundling of the distribution and transmission from production and supply has not become effective yet. The mission of providing for energy security has in a way been delegated to the dominant company, just like in the Italian case. According to its own definition, Geoplin’s main objectives are: “a continued reliable and competitive supply of natural gas to the Slovenian market, as well as partnerships in market-attractive projects.”\textsuperscript{197} Moreover Geoplin aims at retaining its position of the leading supplier and a leading company in natural gas trade in Slovenia and to expand its business operations within the Geoplin group through strategic integrations (joint-ventures). Since Slovenia has no indigenous gas, the main activity of Geoplin is gas trading from foreign suppliers’ delivery points to the Slovenian border. In that regard, Geoplin prides itself for its strong performance during the Russo-Ukrainian gas crisis in 2009 in “being able to put rigorous, appropriate, and rapid measures into force in order to ensure a continuous supply of natural gas to Slovenia during the fourteen-day interruption in Russian supply.”\textsuperscript{198} In the same annual report, nothing is said about the need for adequate storage capacity on the Slovene territory, which at the moment rests on the capacity of the neighboring countries, Austria and Croatia. According to Geoplin’s annual reports,\textsuperscript{199} in 2008 the company has invested in a feasibility study for construction of a natural gas storage facility in Slovenia, but to date the construction is still “on the paper.”


\textsuperscript{194} Written response to the Author’s inquiry about the status of gas market’s liberalization in Slovenia and the position of Geoplin, October 24, 2012.\textsuperscript{194}


\textsuperscript{196} Slovene energy Agency, section “The prices for natural gas”, Accessed in November 2012

\textsuperscript{197} http://www.geoplin.si/eng/about-us/strategic-orientation

\textsuperscript{198} Geoplin Business Annual Report, 2009, p. 2

\textsuperscript{199} Geoplin Business Annual Report, 2008, p.11
8.3.3 Slovenia’s relationship with Russia

In 2011 the incumbent declared that its vision rests on the “the reliability of gas supply, based on the purchase of sufficient and diversified sources of supply, sufficient transport facilities from foreign delivery points to the Slovenian border, sufficient storage capacities and the development of natural gas reserves in optimal quantities.” It seems that from all the above-mentioned points Geoplin has best focused on providing the latter, i.e. gas in sufficient quantity, while diversification of supplies and storage capacity are obviously not of the highest a priority. Instead, to reinforce the already high dependency on Russian gas, in 2009 the company decided to support the South Stream pipeline, which will be partly executed by Geoplin’s subsidiary Geoplin Plinovodi. In fact, in March 2011, the Russian gas giant Gazprom and Slovenia’s Geoplin Plinovodi signed a deal to set up a joint venture to build the Slovenian section of the South Stream gas pipeline during the Russia’s Prime Minister (at the time) Vladimir Putin visit to Slovenia. The South Stream pipeline, estimated to have a capacity of 63 bcm a year, if built, will cross the Black Sea to Bulgaria. From there, the pipeline would supply Romania, Austria, Hungary, Slovenia, Greece and Italy (and the still non-EU members Croatia, Serbia and Bosnia-Herzegovina). South Stream is seen as a competitor (although both Gazprom and the EU institutions claim that this is not the case) to the Nabucco West and TAP pipelines, supposed to target the same markets: Italy, Central and South Eastern Europe. In general, the “new” member states that are highly vulnerable on Russian supply tend to favor the EU’s diversification strategy pursued hand in hand with the promotion of a common gas market. Slovenia is a case in point of a highly vulnerable state: it has no domestic storage capacity at all, its dependency on Russian gas is almost twice as high as Italy’s and the country has no alternative gas infrastructure, such as LNG terminals.

Geoplin is supporting the construction of the LNG terminal project of the Island of Krk in Croatia, however this project is still under authorization. The final investment decision is to be taken in 2013 and construction will not start before 2014. The upcoming Croatia’s membership in the EU in 2013 might reassure investors and speed up the construction of this terminal. Yet in the meantime Slovenia still depends heavily on Russian gas. Despite that, during its EU presidency from January to June 2008, Slovenia has supported South Stream on the grounds that it would address the projected growth for gas demand in Europe and that it would overall enhance the EU’s energy security. In contrast, the European Commission and notably countries such as Poland and the Baltic states remain skeptical about Russia’s intentions in the EU gas market. Nevertheless, Geoplin now goes ahead in its support for South Stream. In the past, for a long time Slovenia remained ambivalent due to its initial support for the EU-backed diversification options from Central Asia. In March 2011 the establishment of the joint venture company “South Stream Slovenia,” between Geoplin plinovodi and Gazprom, as part of the agreement for South Stream revealed that Slovenia was leaning toward the Russian project. It is important to emphasize that Slovenia’s Geoplin Plinovodi is involved in the project execution, while it is not involved in any of the diversification projects planned from the Caspian area. This situation indicates that, just as in Italy, profit maximization considerations of Slovène’s leading company, have been determining the fate of Slovenia’s gas security at the expense of wider strategic considerations “for the common good” of the country. In May 2011, during Gazprom’s official visit to Slovenia, high level meetings between Alexey Miller, Chairman of Gazprom, Danilo Turk, President of Slovenia, Borut Pahor, Slovenian Prime Minister and Darja Radic,

References:

200 Gazprom’s press release, March 22, 2011
201 Gazprom, Slovenia’s Geoplin Plinovodi sign South Stream deal; March 22, 2012, Ria Novosti
203 “EU heavily divided on South Stream”, by Roman Kazmin, July / August 2009 European Energy Review
204 “Gazprom and Geoplin Plinovodi agree on setting up joint project company South Stream Slovenia LLC”, Gazprom’s press release, March 22, 2011
Slovenian Minister of Economy, discussed the current status and prospects for a further deepening in the energy partnership between Russia and Slovenia.\textsuperscript{205} Mutually beneficial projects involve asset swaps and hefty quid-pro-quos. Further, there are rumors that Gazprom would be interested in acquiring a 30 per cent of the government’s share of Geopolin and that the government is interested in selling 30 per cent of its share but it rejects the offer of Gazprom as the only buyer.\textsuperscript{206} More broadly, knowing that the government is busy bailing out the leading Slovenia’s bank and struggling with a series of painful structural reforms amidst Slovenia’s first big economic crisis since independence, these rumors could be well grounded. Regarding compliance with the EU legislation, although Slovenia’s market for natural gas is somewhat compliant with the EU’s unbundling requirements and admittedly new participants are emerging, the sector is still state-dominated, with one main player deciding the gas security strategy for the entire country. Overall, Slovenia is geographically advantaged by its pipeline system with neighboring Italy, Austria and Croatia, which perhaps contributes to its scant attention for natural gas diversification. In summary, two strategic moves characterize Slovene’s gas market today: first, Geopolin is still the dominant actor in the gas market and the government is still its largest shareholder. The major issue for the Slovene government remains security in primary energy position: enjoying a favorable geographic position, gas connections and transit lines are plentiful compared to the size of the market. However, the non-existence of LNG terminals or storage facilities has undermined the overall gas supply security. Second, despite being a smaller player that is much more dependent on Russia, the Slovene case demonstrates that profit maximization of the dominant firm and the capturing of economic benefits deriving from its cozy political relationships with Gazprom, is indeed the preferred strategy just like in the Italian case. The expectation that, given that smaller companies (and states) in energy trade are generally not able to negotiate individual agreements with foreign governments in the same way as European and Russian energy giants are, would prompt them to scramble for the protecting umbrella of the wider European market context, is not confirmed by my case study. Instead, despite being a smaller and more vulnerable member state, Slovenia has a strong incentive to accommodate Russia politically at the expense of the European unity. As noted by Escribano et al. (2012 p.221) in the last years Slovenia has even increased its concentration of imports and is one of the “weakest” countries of the EU-27 in terms of geographical diversification of the gas imports. Nevertheless, Slovenia does not support the EU’s increasingly insistent push to find alternatives to Russian gas. This chapter demonstrates that contrary to received wisdom, not only larger member states can see the EU as diluting their interests, but also smaller member states with fewer diplomacy instruments and a higher vulnerability, could equally perceive the EU’s action as unwelcome interference where profits are concerned.

Once again, we find that companies are the dominant actors shaping the external gas policy. However, it has to be noted that the absence of an independent crisis management means that smaller states might become “followers” of larger member states in an event of a crisis, because the larger member states are better positioned to secure their energy interests. For example, Slovenia relies on Italy, Austria and to a lesser degree Croatia in the event of a crisis. Although Slovenia is especially well placed to benefit from the European market integration and from a EU action to further its interests, Slovenia has demonstrated a larger tendency to follow its own national approach or side with larger member states in a crisis moment (like in the 2009 January crisis). A country like Slovenia would greatly benefit from a regional strengthened gas crisis mechanism. Concretely, with regard to the gas transportation routes and the new infrastructure projects, Slovenia is well positioned to lobby for a stronger cross-border cooperation that would “spread” (through sharing of gas, strategic coalitions and enhanced interconnections) the cost of gas shortages and enhance the region’s security. Thus, while supporting joint mega-projects such as South Stream that only reinforce the

\textsuperscript{205} “Russia and Slovenia express interest in further partnership deepening within energy sector”, Gazprom press release, May 18, 2011

\textsuperscript{206} E-gazette.it, http://www.e-gazette.it/index.asp?npu=64&pagina=1, Accessed in November 2012
existing mutual dependency between the EU and Russia, Slovenia should capitalize on its geographic position to promote regionalized crisis mechanisms that could enhance its own gas security.

8.3.4 Conclusion

In conclusion, this section challenges the conventional wisdom arguing that the newer and smaller EU countries, which are highly dependent on Russian gas, are more prone to prioritize the diversification of gas supplies from the Caspian and lobby for an enhanced “Europeanization” of the gas market. The Slovene case has shown that even some smaller member states lack this “common vision” and seek to maintain the current levels of energy ties with Russia, if not even to increase them. Within the EU, just as countries such as Germany, France, and Italy, Slovenia has been an advocate of engagement with Russia, asserting that the maintenance of extensive ties and constructive dialogue is the most effective way to influence Russia. In contrast to the Baltic States’ or Polish more vigilant stance towards Russia, Slovenia has been wary about spoiling the atmosphere with Russia with the backing of politically explosive projects such as the Trans-Caspian pipeline project or the Nabucco project. A key reason is that, although Slovene gas security as a whole might result jeopardized from increased dependency from Russia, Slovenia’s Geoplin, which is the dominant actor, has much more to gain from backing South Stream than from backing the projects from the Caspian. In this chapter I have also challenged the conventional framing of the "old versus new Europe" debate, or more cooperation with Russia against the need to diversify away from Russia. This chapter’s discussion has shown that even smaller member states and smaller markets can act against the common vision of the EU, when such behavior is consistent with the profit maximization logic of the dominant corporate actor.

8.4 The Italian and the Slovene cases compared

Although Italy is a key country in terms of voting within the EU Council and in terms of its imports shares from Russia considering Germany and Italy together account for nearly half of the total Russian imports to Europe (Noel, 2008), the external gas policies of Italy and Slovenia are quite similar. In both countries the external gas policy is de facto delegated to the dominant firms that are driven by profit maximization considerations. Both countries have not yet fully transposed the EU gas directives to their national systems. There is a substantial similarity in the way gas contracts are signed by the still dominant “national champions” that benefit from strong political backing. Often government-to-government agreements are backing firm-to-firm deals with Russia. Since institutionally Italy and Slovenia are very different cases, there is more convergence de facto versus de jure. However, the list of analogies should not be over-exaggerated. Italy is still a fundamentally larger player with an undoubted higher contracting power vis-à-vis Russia than Slovenia. Italy has multiple locations of storage capacity while Slovenia has none. Unlike the Slovene Geoplin, Italy’s ENI is well balanced in size and power when negotiating with a giant such as Gazprom. Thus, ENI is a truly strategic partner for Gazprom while Slovene imports amount to a tiny share of the Russia’s company exports and profits. However, Slovenia could use its strategic position as leverage, since Gazprom needs to pull Slovenia into South Stream if it wants to realize the project. Anyhow, for the purpose of my research question, the approach taken in both Italy and Slovenia is an obstacle toward the hammering of real “European” energy integration and the multilateralization the EU’s relations with Russia. Yet, since Slovenia cannot implement an efficient crisis mechanism alone, which is of utmost importance due to its high vulnerability, cross-border cooperation is a good answer to collectively manage these

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challenges and bring about the economic benefits in the form of increased cross-border energy trade and investment. These aspects will be analyzed in the next section.

8.5 Opportunities for cross-border cooperation in South East Europe

In this author’s view the South East Europe (SEE) region is strategically extremely important; its achieved stability, strategic geographic location and increased openness make it an attractive pool for energy investments and an alternative route to supplies from Russia and Central Asia for Western companies and consumers. By South East Europe I refer to the region illustrated in figure 15.

Figure 15: Map of South East Europe

Gazprom’s penetration in South East Europe could be seen both as a challenge and as an opportunity. Whereas for years Russia has been distracted and disoriented by the break-up of the Soviet Union and the economic and political turmoil that has followed, in the last decade it has firmly recaptured its lost influence in areas of interests. Although Southeast Europe has been “liberated” from its core interests, it is still a region where Russia withholds interests on purely economic grounds, mainly in the form of increased downstream assets and, if the South Stream pipeline were constructed, an increased Russian supply and an undisturbed gas flow to SEE and further on to the Western markets. In the last decade, Russia was able to re-establish very quickly and effectively its old networks in this region. However, the increased Russian activity in SEE should not be seen only as a challenge, as it could provide an opportunity to forge beneficial cooperation, in a strategic region that needs stability and has the potential to become a laboratory for cross-border best practices in energy. The next section illustrates why this dissertation holds that cross-border cooperation in SEE could improve the overall EU-Russian dialogue. It is argued that across the borders of this region, a sub-regional interdependence through establishing specific dialogue and partnerships with Russia and in delivering shared energy (and environmental) goals could be best achieved, in a gradual bottom-up approach. Within the general advantages of cross-border cooperation in southeast Europe, in the energy context, this thesis emphasizes especially two elements: first, it can lower the transaction costs of energy trade in each country, and second, it can improve both natural gas security of demand (for Russia) and security of supply (for the EU). As a consequence, it can strengthen the attractiveness and
competitiveness of the SEE region. However, this thesis is pessimistic about any quick success in the direction of spurring the growth of international institutions, such as the ECT, because Russia and Gazprom obviously have an interest in maintaining the status quo, but also individual European firms simply profit from the status quo and the absence of robust rules and regulations for international transit, trade and investment.

8.5.1 South East Europe as a “contact” zone

According to cross-border cooperation theory, cross-border region building processes have gained momentum since the end of the eighties but they are still almost totally neglected in mainstream discourses in the social sciences (Blatter, 2000, Scott, 1989). In the 1980s indeed, cross-border co-operation on a sub-national level started to gain a great deal of attention in major social science discourses, and in those years both Europe and North America witnessed a mushrooming in the development of cross-border region-building (Blatter, 2000). By the mid-2000s however this trend had been completely reversed with a reaffirmation of national sovereignties in Europe and elsewhere, especially in the energy domain, a sector where states have been traditionally “touchy” about pooling their sovereignty. In light of these developments, this section firstly reviews the already existing cross-border cooperative activities in the region of South East Europe. This region is chosen because it lies at the intersection of the external borders of the EU and at heart of Russian’s economic interests. Therefore, in the author’s view it encompasses a zone of potential overlapping "synergetic" interaction between the two blocs, with considerable development potential. The opportunities that are opened up by cross-border cooperation will be highlighted. This thesis argues that SEE does have the potential to fulfil the role of “a contact zone” and serve as a platform for the kind of multidimensional integration processes in the energy sphere, that still need to find ways and means for compromise between the EU and Russia. However, based on the empirical data and considerations evinced earlier, this study does not foresee an enhanced multilateralism on a grand scale any time soon. In natural gas, the region of South East Europe has a strategic position; both from Russia (i.e. South Stream) and from the Caspian region (i.e. TAP and Nabucco West) gas is planned to pass through Turkey and through countries in the Balkan region. That gives the region a potential role in enhancing the social and economic cohesion between the EU and Russia, while at the same time promoting its own balanced development and competitiveness. As already mentioned, there are several cross-border programs currently in place in the region. The EU, as pre-accession assistance, funds most of the programs. Although currently it is mostly the EC that sets up the initiatives and the resources invested, and despite the fact that projects have so far been modest, this channel is considered here as an exceptional and original opportunity to counterbalance for the EU-Russian institutional deadlock at the macro level. Thus, a possibility to extend this cross-border cooperation to Russia, although Russia is obviously not bordering the region, is considered as a beneficial step in this dissertation – because SEE is an area where practical implementation of the energy dialogue is attainable and necessary. The main instruments currently in place are the South East Europe programme and the IPA Adriatic Cross-border Cooperation Programme. With regards to Russia, the EU-Russia Strategic Partnership, with its four Common Spaces and associated road maps could be further strengthened, with another local expression of this partnership such as the one that already exists (notably in the Baltic) set out in the Northern Dimension policy. Cross-border investment is generally in the interest of both the EU and Russia. It promotes interdependence and has the potential to increase competition. For a Europe worried about Russian attempts at strategic manipulation, promoting such investment is among the best ways of ensuring that the EU’s and Russian interests are

aligned. Making it work, though, requires both addressing EU’s concerns about transparency and corruption, and from the Russian perspective, ensuring that the EU’s regulation is consistent with Russian concerns about ‘security of demand.’ Moreover, transition to a lower carbon economy is in substance interlinked with energy security considerations and poses cross-border challenges. Hence, the cross-border regions might be ideal platforms where the power and dynamics of differentiated systems can be fruitfully brought together to discuss these shared challenges. For example, as pointed out by Romanova (2008) the adoption of the Northern Dimension has considerably enhanced the scope for cross-border cooperation between Russia and the EU, both qualitatively and quantitatively. The involvement of local and regional authorities in a down-to-earth cooperation was given prominence in the context of the Northern Dimension. From a historical-cultural perspective and in the context of an appraisal of SEE as an area with potential for EU-Russian constructive dialogue, essential characteristics of southeast Europe are the deep-seated and long-standing historical and cultural links which have been established over the centuries between Russia and Western Europe. From an energy practical-business perspective, today this region is of strategic importance as a gateway for the transport of energy. Presently, many European majors and Gazprom itself are shifting to this less saturated gas market, because the market has a strong demand potential and there is need for new capacity, thus the companies have larger potential to cooperate and grow together (i.e. with joint ventures) in the non-saturated energy market of the region. For example in gas, a multitude of major infrastructure investment projects are planned in the area, such as the LNG terminal in Trieste, Zaule and on the island of Krk in Croatia. Moreover, the two remaining pipelines that are still in race for the Southern corridor, the TAP and Nabucco West both claim to target particularly this area. TAP claims to be a strategic project that plans to supply not just Italy but the vulnerable Western Balkans countries. Nabucco West in particular affirms to be breaking the stranglehold of Russia over the energy sectors of Central and South East Europe, and by supply diversification via a string of interconnectors that have recently been built (or planned) it also aims to supply the Western Balkans. Meanwhile Gazprom is proceeding with its giant 63 bcm South Stream project, whose realization is done in strategic partnership with the largest country of the region (i.e. Italy), and for whose construction it has already signed a number of bilateral intergovernmental agreements with most of the other region’s countries, such as Hungary, Slovenia, Greece, Austria, in addition to non-EU members like Serbia and Croatia. With South Stream, Gazprom wants to reach directly to the consumers without having to cross any non-EU country, apart for Serbia, which is traditionally a loyalist and is covered by the EnCT. In fact, the region of southeast Europe still presents a vast institutional and regulatory heterogeneity. Outside the ECT, the Energy Community Treaty represents another vehicle to regulate energy relations between the EU and a number of countries in the region. Given the deadlock of the ECT all the countries on the Western Balkans (and the CIS) have now adopted the EU energy acquis by joining the Energy Community Treaty. According to Yafimava (2012), while overall EU transit dependence will decrease following the Russian construction of transit avoidance pipelines, transit dependence of individual EU and non-EU European countries (primarily in South-East Europe) will remain high until the South Stream pipeline is built. Therefore, she argues that the ECT (as a potentially workable transit dispute prevention and resolution mechanism), despite becoming less relevant for north-west European countries, it might have a second chance in South East Europe, at least until South Stream is completed. Further, she believes

210 “Bringing Energy Security to East Central Europe - Regional Cooperation Is the Key”, Keith C. Smith (2010), Center for Strategic and International Studies (CSIS)
that these countries, as contracting parties of the ECT together with the EU Commission, will need to make a major political effort to draw Russia back in the ECT. She goes on in arguing that any corridor that would bring gas to Europe from the Caspian, hence reducing dependence on Russian gas, would have to cross several countries before getting to the EU, obviously Turkey, but also Georgia, depending on the routes. As none of these potential transit states are part of the EU governance structures, in the event of a transit dispute there is no overarching jurisdiction under which the dispute could be dealt with, which means that the Southern corridor could become just as problematic as the western CIS corridor. As a result she concludes that the ECT is an obvious instrument that could serve the purpose to improve EU gas security in relation to transit via the Southern Corridor. Despite the insight of Yafimava’s analysis, as shown by my last case study (Chapter 10) this scenario is unlikely. Generally, the dominant firms have an interest in less ambitious cross-border relationships, moreover the Western Balkans are already included in the EnCT and just as Western Europe have no particular interest in advancing the cause of a robust regime that would lock-them in. The current status quo allows them to be guarded by the EnCT and at the same time flirt with Gazprom about the South Stream and other projects. For example, Croatia’s impending EU accession will give a boost to the ability of Croatia to attract the needed investments and will simultaneously give investors better certainty when doing business in the country. Moreover, with 60 percent of natural gas consumption being covered from its internal production, and the remainder (mostly of Russian provenance) being imported from EU companies across the border, Croatia’s position seems relatively comfortable. Therefore, actively lobbying for the ECT’s cause would not make sense in the case of Croatia, because it would prevent its gas firms to “play” at different tables, while keeping multiple options open in the pursuit of best profits. A less ambitious but more immediate way to bring about economic benefits and increased gas security in the region lies in increased cross-border trade and investment. As mentioned earlier, EU firms are already responding to the lack of growth prospects in the home markets (due to the saturated markets and the liberalization agenda), by moving abroad and becoming really “European” or even international. Most of the European majors started to grow in the “East.” The area of southeast Europe is an interesting growth area because of its strong demand potential and the need for new investment. It is also an area where cross-border best practices between Gazprom and the Western firms could somewhat compensate for the decaying relationship at the macro-institutional level.

8.5.2 Where can there be cross-border Energy cooperation?

The analytical focus of the next section will be on the critical role of the SEE region and the appraisal of cross-border cooperation to solve the challenges that cross-border gas trade can pose. As already noted, rather than a top-down state-led cooperation, a bottom up approach to foster people-to-people dialogue is preferred. The purpose of this section will be to demonstrate how an effective use of synergies is the SEE cross-border areas could permit to achieve mutually beneficial outcomes with regards to the EU-Russian security of natural gas supply/demand issues. Also, cross-border cooperation is the best way to improve Italy’s putative engagement, as arguably the largest country in the region.

Energy is a strategic good and energy technologies offer one of the most promising sectors for national economic growth, thus there are great interests involved. That is why generally states do not tolerate their energy sovereignty to be compromised (Lesage et al. 2010 p.183). In fact, this idea that the traditional category of “Westphalian sovereignty” could be supplemented or even eclipsed by the formation of cross-border regional, sub-regional, and local networks initially found little acceptance in Russia (Scott et al. 2010). Many scholars

213“Croatia Can Call Gazprom’s Bluff on South Stream”, Natural Gas Europe, August 15th, 2012
noted that the Russian official discourse is still dominated by thinking in traditional categories like sovereignty, security, national borders and interests, transposed into the concept of ‘sovereign democracy’ (Herd in Kanet, 2010 p. 59; Light, 2008, Perovic, 2003). This is also linked to the defense of a ‘strong state,’ considered the central element in the Russian political tradition. Many EU pundits and policymakers argued that with such a conception of sovereignty, for Moscow notions like “cross-border cooperation” most likely do not amount to more than meaningless hot air. This situation has now changed to some extent. For example in energy, with initiatives such as Basrec,214 even Russia has now recognized that cross-border cooperation (CBC) has an essential role to play, distinct from other forms of cooperation and by virtue of operating for the benefit of both sides of the external borders. Although the EU and Russia are not directly bordering in southeast Europe, an encouraged regional cooperation in energy, trade and investment is in the interest of both players. This thesis corroborates that by preferring the traditional realist politics of ‘interest,’ neither the EU nor Russia do a priori exclude the tools of cross-border cooperation at the sub-national level, as some strains of thought seemed arguing. For example, both parties recognize that taking a bottom-up approach to energy would help examine the development and investment needs related to the energy infrastructure, with the aim of creating efficient and balanced conditions based on reciprocity. The emphasis is on common interests and small-scale projects in regional infrastructure. In this respect, particularly the transport of energy, the expansion of storage capacities and more generally, the construction of cross-border links is and should be part of the larger plan.215Raising energy to a ‘cross-border’ dimension makes easier to gather the main parties together and plan the development of the EU-Russia energy cooperation and trade. On top of that, such an involvement in bottom-up processes of energy cooperation across borders could create partnerships and help to reduce the potential for conflict by making the best use of regional know-how (Emerson et al. 2009). In addition, if we consider the environmental aspect, the appraisal of cross-border potential in creating contact zones and fostering dialogue is even greater. As direct neighbors the EU and Russia share river basins, seas and lakes.216Each country has its own way of building sustainable energy systems by making use of the best practices available. Not all nations and governments have the same sensitivity to environment issues. Consequently, they have very different expectations about the appropriate way to manage the shared infrastructure and the environment. Some countries deliberately ignore environmental questions while others (the EU as a bloc in primis) are deeply involved in the battle. The point to emphasize is that the energy sector provides a particularly interesting arena for tackling such issues, in light of the global relevance of energy and the awareness that the shared burden of managing the environment does not respect international boundaries. The EU and Russia are already partners in tackling the environmental problems, in efforts to reduce trans-boundary air pollution, reduce risks from industrial accidents, clean up regional seas, and protect natural areas, threatened species, and biological diversity.

In summary, although this thesis agrees that energy relations remain highly dominated by inter-firm and inter-state activities, precisely for that reason it is justified to put more emphasis on cross-border relations, in order to encourage satisfactory diversified relations between the EU and Russia. In the SEE case analyzed in this chapter, the border regions are considered ideal to fulfil the role of “contact zones.” For example, the persistence of differences in the energy regulatory approaches that have emerged between the EU and Russia, suggest that much of these inconsistencies might be tempered with a more pragmatic stance. More effective synergies in managing the plentiful infrastructural cross-border

projects that are currently mushrooming in southeast Europe could provide a good start. Thus, a mixed and pragmatic dialogue that would have as its starting-point a program to assist the infrastructure development of southeast Europe, and only as its second step the creation of potential legal frameworks that both Russia and the EU would help to tailor, would be a more effective approach to undertake. The simultaneous challenge and opportunity of cross-border cooperation is to create a unified operational approach that would involve the business groups in primis, and that could then create mechanisms to facilitate the investments and the operation of cross-border gas pipeline projects. Both the EU and Russia have drawn lessons from the Russo-Ukrainian crises and have identified the magnitude of the leverage that a transit country can impose where there are no viable alternatives in the near-to-medium term. Cross-border cooperation can help decrease such risks in the absence of a shared desirability for multilateral mechanisms, such as the ECT. The states in southeast Europe, as well as the commercial actors in these countries, are in a key position for such cooperation in the development of natural gas transfer, transit and trade. Italy, as the largest country in the region and a country that has had some significant success in its bilateral cooperation with Russia, could be the catalyst and the epicenter of best practices in the region. Italy has the potential to set itself as a directional leader in boosting cooperation across national borders and in creating multi-actor regional configurations in energy decision-making, in order to reduce risks and promote energy efficiency.21 This study indicates that as the interests of the dominant business groups do not favor robust international institutions, these institutions will continue to play very little role in the Russia-transit countries-Europe cross-border gas trade. Rather, operating outside pre-existing treaties in the gas trade, while at the same time backing the contracts by state-to-state agreements will be prioritized, as long as this strategy is possible within the EU. Meanwhile, the poor state or absence of institutions can be supplemented by finding other ways to increase the governance of a cross-boundary regional resource like natural gas, with a cooperation that would take place through bottom-up “people-to-people” processes of engagement. As noted by Harvard’s Nye (2011), the EU has had extensive experience in building coherence by using harmonization, coordination in a more positive-sum view of power, of holding power with, rather than over others. In that sense Europe provides the largest pool of resources for dealing with common transnational problems. Although the EU’s and Russia’s interests are not identical, they share overlapping cross-border networks that open up opportunities for cooperation. The recognition of their mutual energy dependence as means through which to establish political dialogue, based among other things, on common interests could find its best expression in the bottom-up cooperation across the borders of southeast Europe.

21Italy is already active in energy crossborder cooperation with CBC initiatives such as “Friuli Innovazione”: http://www.friulinnovazione.it/sectors/energy-and-environment

This chapter focuses on the recent unprecedented innovations taking shape in the world’s gas private sector, that in turn started to put pressure on the long-standing governance frameworks existing in the business-to-business relationships between Gazprom and the big European companies. The European Commission has had a critical role in making the changes of the gas structures possible, because without its regulatory activity these transformations would have not occurred. However, the established relationships based on long-term oil-indexed take or pay contracts only started to crumble when the key corporate actors felt the pressure of the ‘old structures’ on their balance sheets, and thus started to push for changes. Thus, a significant paradigm shift has only occurred when it received the support of the community of crucial actors, i.e. the corporate actors. In fact, despite the fact that the Commission has been promoting liberalization of the gas markets for more than a decade, only when the European corporate sector started fiercely lobbying for revisions in its contractual conditions with Gazprom, a visible change was indeed possible. This chapter argues that given the increasing uncertainty of gas markets, the institutionalization of the EU’s and Russia’s gas relationship will become even more elusive, leading to an institutionally more fragmented relationship underpinned by a hybrid gas pricing system. The environmental cause, in principle, provides an opportunity for closer cooperation between the two blocs in the form of capital and know-how transfer, but the quantity and quality of cooperation will depend on how Russia will deal with the needed, albeit socially painful domestic reforms, and how the Russian grasp on the Asian markets will unfold. If Russia starts to turn increasingly eastwards, and the US decides to withhold its shale bonanza for domestic use, during a complicated shale gas evolution in the Old continent, the unreliability of the Russian gas could force Europe to rethink its strategies.

9.1 Introduction

Many scholars, observers from the industry and political commentators have recently written about the ongoing paradigm change within the European energy markets. One of the main objectives of this section is to conceptually define what is meant here by paradigm change and to briefly outline the paradigm changes that have been taking place in Europe since the postwar period. That is important because some of the legacies of the past can be traced in the changes that have been occurring more recently. My focus is on how the dramatic change that has happened in the last two years can be attributed to the interests of the leading European firms. As stressed by Kuzemko (2012, p.191), in the literature there is no overarching and consistent definition of what is meant by paradigm change. Among energy policy scholars, the word gained notoriety by the CIEP studies of the paradigm shift in the early 2000s from the “Market and Institutions” towards a “Regions and Empire” story line. Although there is no consensus on what are the analytical components of a paradigm change and what are the variables to determine it, maybe the most useful work to analytically think about paradigm changes is the contribution of Thomas Kuhn (1962). According to the

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latter, a paradigm shift is simply a change of the basic assumptions ruling theory or science. His monumental study\(^{219}\) led to a spillover of the term into other societal, historical and economic disciplines to indicate a moment that cuts with the past due to sudden breakthroughs in science, politics and economics, or new ideas that can have radical as well as steady and longer-term impacts, but also due to deep crises and other types of unexpected events. History offers plenty illustrative examples of events that represented breakthroughs or ruptures: the end of the Roman Empire, the French Revolution, the invention of the atomic bomb which led to the nuclear age warfare, the 9/11 terrorist attacks and most recently, the decline of the West and the rise of the East. Also, scholars disagree whether paradigm changes happen abruptly or gradually. For example, in an analysis of the life cycle of great powers the historian Niall Ferguson (2010) argued that Empires fall abruptly, in contrast with the long-accepted pattern of gradual rise and fall (Nye, 2012). An analogy between this debate and the ongoing debate about the European gas markets could be found; will the system of long-term oil-indexed pricing be overthrown or just attenuated? How sudden and how deep will the paradigm change be? In order to tackle this wider question let us first focus on the historical paradigm changes that have occurred since the post-war period. Then we outline the current changes in the European markets and through these lenses, we subsequently look at potential challenges in the future.

9.2 Paradigm changes in the European Energy Markets since the postwar period

The Oxford English Dictionary defines the basic meaning of the term paradigm as "a pattern or model, an exemplar."\(^{220}\) The rationale for the choice of one paradigm instead of another is a specific way of viewing reality: the personal choice and the status of a determined "pattern" are mutually reinforcing. Kuhn was very keen to point out that: “the conviction that the current paradigm is reality tends to disqualify evidence that might undermine the paradigm itself.”\(^{221}\) Well-integrated members of particular disciplines tend to embrace paradigms that often compete with other paradigms and scholars. Paradigms represent models of reality that help to set events in a given context, but the casual arrows go both ways; paradigms affect the way one perceives reality, but also relevant events from reality have an impact on paradigms. Since paradigms are lenses though which we view reality they also correlate with policy agendas (Goldthau, 2012). For instance, the post-war policy agendas in Europe were embedded in Keynesianism, or in what John Ruggie (1982) called embedded liberalism to indicate a system where markets were embedded in the society; the system was set up to support a combination of free trade with the freedom for states to enhance their provision of welfare and to regulate their economies to reduce unemployment. Embedded liberalism prospered in the 1950s and the 1960s until its breakdown in the late 1970s. The system was characterized by a capitalist model underpinned by a centralized and dirigiste politics with a proactive role of the government. In those years, Western European energy markets were dominated by a few state-owned providers; energy prices were, by and large, set by state authorities, only vaguely oriented at actual costs; and market access and exchange were highly regulated in order to control prices. As noted by Goldthau (2012) the state’s primary task was to ensure provision of basic and vital services to its citizens, notably in sectors that relied on networks and were hence considered natural monopolies, such as telecommunications, railways, water, district heating or even postal services. Companies providing for such services were predominantly state-owned, designed to provide across-the-board coverage of households, with little attention to their costs. As the aforementioned Italian example illustrated, the main purpose of the “national champions” was to ensure for the energy security of their own country, thus

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\(^{219}\) Thomas Kuhn, “The Structure of Scientific Revolutions” (1962)

\(^{220}\) http://oxforddictionaries.com/

\(^{221}\) Ibid.
companies were bound and determined to achieve that goal without paying overly attention to cost-benefit analyses. In that system, competition was not a top priority and state intervention in the economy was justified to create employment or economic growth. Because no price mechanism existed that would properly reflect supply and demand patterns, energy providers – whether state run or private – remained in control of the entire energy value chain, from energy input to energy conversion and output to the energy end-consumer. In this governance system, vertical integration dominated the industry as a predominant pattern until the late 1970s. In the early 1980s the change was spurred by a combination of exogenous events and new ideas that were gaining momentum. It is difficult to establish clearly the causality relationship between the two. In the 1950s and 1960s, the global economy prospered under the embedded liberalism, with growth more rapid than before or since, however, in the early 1970s the period of economic expansion came to an end, following in quick succession the collapse of the Bretton Woods system and the two oil price increases of 1973-74 and 1979-80. In that climate, the neo-liberal echoes of the Chicago School of Economics started to be heard far beyond North American campuses and gained political support. The basic idea was that since the profit motive is by and large absent in publicly owned companies, they tend to be inefficient and build up slack. That new idea freed the way to energy market liberalization, as promoted by the governments of Thatcher (UK) and Reagan (US). The governments began to switch more and more from the role of producer to that of regulator of privatized interests, including within the utilities sector. In Europe, the European Commission became the steward of liberalization and after the adoption of the Single European Market in 1985, undertook a process of gradual restructuring associated with the neoliberist ideas. In the early 1990s the EC promoted a series of laws that aimed to privatize previously public sectors of the economy, such as posts and telecommunications, transportation and the energy sector. Tax reductions, ‘rolling back the state’ and market-driven competition were introduced to reform the economy and increase efficiency (CIEP, 2006). However the process was not homogeneous in the whole Old continent. As noted by Van der Linde (2010), The United Kingdom view became strongly shared by the European Commission, whose DG Competition started to spread the model across the EU.222 However, different countries responded differently to the changes. While in the UK and in the US the governments of Ronald Reagan and Margaret Thatcher promoted the paradigm change, in some continental and South European states, the changes had to imported from the “outside.” In a way or another, the change brought the adoption of the so-called Anglo-Saxon model of liberalization at the European energy level, and the European Commission started with the first regulatory measures in that direction. In the gas market, in 1998 the European Commission issued the first gas directive, that was still a compromise in which core issues of harmonization, such as access to pipelines, market opening and regulation were still left to the judgment of individual member states. Meanwhile, by the early 2000s, after the terrorist attacks, with an increased resource nationalism among the producer countries and under the effect of surging oil prices, the general atmosphere in the world stage had changed once again: the 1990s enthusiastic belief that the world would become a “global village” governed by multilateral governance structures did not materialize. The major exporting states rejected any further liberalization of energy markets and the application of commonly shared rules about investment and arbitration procedures in the energy sector. In fact to date, apart from diverse informal energy dialogues, there is no forum of discussion for a universally applicable set of regulations for the energy sector. In a context in which multilateral institutions deteriorated, states tried to resolve their problems with bilateralism. Hence, in the 2000s for the most part the producers’ energy nationalism coexisted with the EU’s member states renewed intervention in energy markets. Also, recognizing that new challenges like climate change and energy poverty were not to be dealt only by market mechanisms, the European countries

recaptured to a certain extent the reins of the energy sector and shifted towards what Goldthau calls (2012) *interventionism*. Therefore, the state’s role was no longer one of a mere enforcer but rather, it was once again perceived as a stakeholder of ‘public interest.’ At the same time, climate change and energy poverty were being increasingly recognized as crucial concerns, and thus increased complexity was given to the already uncertain energy environment. However, in comparison with the statism of the 1950s and 1960s the European Commission had gone a long way in these few decades. In fact, as the European Member states were increasingly sliding back into realist approaches, the European Commission was proceeding with its leadership, and lobbying for the new challenges to be addressed within a multilateral framework presided by the European Commission. As noted in Chapter 7 the European Commission has proven an admirable commitment in tackling climate change. On the other hand, the DG Comp of the Commission has been inexorably pushing for internal liberalization of the gas market and struggling with the Member States wanting to retain their sovereignty in external energy matters. Therefore, these two advanced aspects of the EU policy-making: the environmental and competition policies were the two pillars from which the EU continued to erode member states’ sovereignty in energy matters. In sum, a somewhat contrasting pattern was unfolding in the 2000s; while the member states were reasserting their sovereignty in energy security, the European Commission was proceeding with its liberalization efforts. The second energy directive was adopted in June 2003, and it required full market opening of national sector regulators, regulated third party network access, regulated or negotiated access to storage and further unbundling of integrated companies.\(^{223}\) It introduced qualitative obligatory minimum requirements for access to transmission systems (network tariffs, third party access services, capacity allocation, transparency, balancing and trading of capacity rights). As noted by Talus (2012) much like the first gas directive, this new regime failed to create competitive natural gas markets in the EU. One of the reasons for this was the continuing existence of long-term transportation capacity reservations that were allowed to accommodate the underlying commodity contracts, and were based on considerations like legal certainty and the protection of legitimate expectations. The next directive, in 2009, the Third Package intended to strengthen the regulatory instruments and devices, and also to promote the far-reaching step of ownership unbundling, requiring a full divestment of the transmission networks from the vertically integrated gas and electricity companies.\(^{224}\) According to Talus (2012) only this new directive created the capacity to compete. This dissertation contends that these endogenous regulatory innovations while necessary, would not have been sufficient *per se* to create the conditions that led to the partial erosion of the old gas market rules and structures in Europe. The exogenous trigger came from the United States in the form of a quiet but formidable shale gas revolution.

### 9.3 The current paradigm change in the EU-Russia’s gas governance and the Gas Companies’ Interests

The effects of the economic downturn mixed with the shale gas revolution that made the US suddenly self-sufficient in gas, have made available large amounts of LNG, originally designed for American ports that were re-routed to the European harbors and delivered at the European hubs. As this gas hit the European spot markets, the result was that spot prices became structurally lower than the oil-indexed prices of primarily Gazprom’s contracts, with a large spread between oil indexed pipeline gas averaging around $12-14MMbtu against spot traded prices at $8-10MMbtu (Hulbert, 2012). Clearly, that put pressure on the oil-indexed

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contracts and increased the volume of LNG trading in the European markets. As noted by Hulbert (2012) close to 50% of all physically traded gas in Europe, was exchanged on a spot market basis in 2011. According to some observers (Mitrova, 2012; Konoplyanik, 2012) Gazprom responded in a rational and timely manner by starting to adapt its contractual structures and pricing mechanisms to the changing realities of the buyers’ market. In Mitrova’s words: “It is not fair to say that Gazprom is not adapting to the situation, but it is not happening as fast at the European customers would want it to happen. Obviously Gazprom favors oil indexation because it is providing high profits while it will be difficult to get any margin under the spot pricing system. Although officially Gazprom denies any possibility to switch to spot pricing, it already sells more than 20 bcm through spot elements, with its subsidiary Gazprom marketing and trading.”225 As noted by Konoplyanik, however, the downgrading of minimal TOP obligation in Gazprom’s European contracts from 85 to 60% plus converting 15% of contractual volumes from oil-indexation to spot price (calculated as the mean value at major European hubs) was an involuntary measure (see table 10).

Table 10: Gazprom: adaptation of contract provisions and pricing mechanisms in Europe since 2009

<table>
<thead>
<tr>
<th>Actions</th>
<th>Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyers’ demands for price reviews and contract adjustments following “significant market changes”</td>
<td>E.On, Wingas, RWE, Botas, Eni, GdF Suez, EconGas, Gasum</td>
</tr>
<tr>
<td>Downgrading minimum TOP obligations from Gazprom’s average 85%</td>
<td>E.ON, Botas: from 90% to 75%; ENI: from 85% to 60% for 3 years 1/4 &gt; Gazprom total 15 BCM for 3 years 1/4 5/140-145 BCM (2010) 1/4 3.5% RF gas export volume</td>
</tr>
<tr>
<td>No penalties for violation of minimum TOP obligations</td>
<td>Naftogaz Ukraine, Botas; Eni, E.ON pending</td>
</tr>
<tr>
<td>Gas sales above minimum TOP obligations at current spot prices</td>
<td>E.ON, GdF, Eni</td>
</tr>
<tr>
<td>Adding gas-to-gas competition component into pricing formulae thus decreasing /softening oil-indexation formulae link</td>
<td>E.ON, Gdf, EnieGazprom 1/4 15% based on a basket of European gas hubs, E.ON-Statoil 1/4 25%; Statoil average up to 30%, requests to Gazprom up to 40%</td>
</tr>
<tr>
<td>Increasing flexibility of contractual provisions</td>
<td>Gazprom’s “promotional package”</td>
</tr>
<tr>
<td>Recalculating base formulae price</td>
<td>Wingas</td>
</tr>
<tr>
<td>Direct price concessions</td>
<td>Naftogaz Ukraine, Botas (tbc)</td>
</tr>
<tr>
<td>Maneuver by contract volumes within contractual time-frame β requests to cancel obligation to off-take contracted volumes within 5-year period</td>
<td>E.ON, Eni</td>
</tr>
<tr>
<td>Stimulating measures (“packages”) for purchases in excess of (downgraded) minimum TOP</td>
<td>E.ON, Eni</td>
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<tr>
<td>Shorter contract durations</td>
<td>Sonatrach</td>
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<tr>
<td>Shortening of recalculation period/interval</td>
<td>Possible</td>
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<tr>
<td>Shortening of reference period</td>
<td>Possible</td>
</tr>
<tr>
<td>Some buyers files lawsuits against Gazprom over long-term prices (within Price Review/Dispute Settlement LTGEC clauses)</td>
<td>Edison S.p.A. (AC SCC), EON-Ruhrgas, RWE, PGNiG, etc.</td>
</tr>
</tbody>
</table>


Note: According to Mitrova in a “step by step” renegotiation more than 50 companies have received price discounts in addition to take or pay volume reductions.

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225 Interview with the Author, October 2012
It reflects Gazprom’s forced adaptation to the new reality of Continental Europe as result of the above mentioned trinity of reasons: the economic crisis, new liquefaction capacity and the American shale boom. Moreover, the regulatory measures pushed through by Brussels over the past decade towards an increased liberalization of the gas market, have made the efforts of the incumbents to protect their markets more difficult. As noted by Talus (2012) whereas in the past the incumbents would sign take-or-pay contracts with the external producers and then mirror the volumes of these contracts with downstream take-or-pay contracts with its own consumers, such as resellers or large industrial users, this is no longer possible. The importer is faced with a situation where it has significant take-or-pay commitments but no certainty that it can dispose these volumes in its traditional markets. Moreover, the effective liberalization within the EU had opened the door for second tier players to take market shares from incumbents, bypassing traditional wholesalers and going straight to large end users from spot. Incumbents are not just oversupplied, but unable to retain market shares by offering discounted supplies. That is why Gazprom’s concessions were not sufficient in itself to settle down the hostilities that had arisen with its big European customers (i.e. the incumbents) in the past few years. European big companies such as EON and ENI were left with a serious “liquidity” problem. To put it bluntly: according to a European industry insider, European utility companies such a RWE and ENI have lost around 1 billion $ in 2009 and 2,5 billion $ in 2010 and 2011 (RWE) and 1 billion in 2009 and 2 billion in 2010 and 2011 $ (ENI) due to their long-term “take or pay” contracts, remaining trapped in expensive long-term contracts with minimum take-or-pay clauses, while their downstream market fell away and their customers were often able to purchase gas cheaper on the spot markets. In fact, in some cases there is still ongoing arbitration about price disputes between Gazprom and a number of Eu companies, such as RWE. The most conspicuous dispute with the German energy giant E.ON Ruhrgas was settled in July 2012.227 A Russian energy expert observes: “Gazprom prefers to settle these disputes outside the courtroom with concessions and more adaptable contractual terms. In was the case of E.on and Edison, and I frankly expect that the other 3 will be settled in the nearest future.”228 However, a European executive sees the dispute very differently. He says: “A precondition for a real change is the removal of the take-or-pay clause. Meager discounts cannot alleviate the pain of the current contractual structures.” And he reminds: “In the past few years when the companies were unable to sustain the costs of Gazprom’s contracts, the latter would offer discounts in exchange of a directentrance in their capital, as it happened with RWE, but a substantial abandoning of the currently unaffordable take-or-pay rule, did not happen.” In fact, according to the above-mentioned industry insider, another concern stems from Russian participation in European energy markets, more precisely over the past years there was a debate inside Gazprom, between the advocates of direct access to the European markets and those in favor of a more moderate line, that were praising the European big companies’ intermediation in order to avoid a “boomerang-effect.” According to the European businessman, a middle-view prevailed, as Gazprom is not aggressively entering the market but it is equally not willing to deeply revise the take-or-pay clauses. In sum, although Gazprom did react in an unusually receptive way, the European counterparts see the debate in different terms than the Russian observers, pointing out that only thin discounts, and not a real revision of the take-or-pay were obtained. This has become a real problem. Gazprom’s official position is in favor of oil indexation and its executives are busy reminding that spot prices for gas cannot be compared to the price of gas in long-term contracts, because long-term contracts include the reliability of stable deliveries over a significant length of time, and consumers should understand that they must pay for this reliability as well as for the gas itself.229 Moreover, the supplier needs security in order to cover the expenses of new

227 Interview with the Author, January, 2012
228 Interview with the Author, October 2012
229 Author’s Interview with Alexander Medvedev, Director General of Gazprom export, November 2012
upstream investments. But the European utility companies increasingly find themselves in a situation where they are paying oil-linked prices in long-term contracts while their competitors – and their customers – have the opportunity to buy gas at hub-based prices. In short, in the last few years, the big EU utilities were left oversupplied with Russian gas, which spurred them to lobby for a long-run profound change. According to Talus (2011) work on corporate restructuring and cultural change, the merger wave that in Europe took place in the post-2000s period created very large utilities active in both electricity and gas. As noted earlier, the result of the Third Gas Directive was that EU gas firms were urged to expand their range of activities (i.e. "green" technology) and areas of operation (i.e. Eastern Europe) in order to continue to make profits, thus a relatively small number of very large utility companies - E.ON, RWE, EdF, GdfSuez, Eni, Enel, Endesa, Iberdrola and Vattenfall – owning a variety of utility assets across a number of European countries, started dominating the European landscape. According to Talus (2012) and Stern & Rogers (2011 p.20), these changes in industrial organization meant that the traditional business mentality in the EU’s gas market started to change. As noted by Stern and Rogers: “The resulting companies – usually with electricity executives dominating the board-level positions – share little of the corporate culture of the old European gas companies. They do not have the multi-decade "relationship culture" created by long term contracts, or any significant commercial experience of relationships with non-European external suppliers.” While agreeing in principle that for a number of countries, the new model implies a break with history, this dissertation, however, points out that the direct collaboration between the EU’s large utilities and Gazprom became strained only when the EU utilities started to incur losses, and not so much because the new leadership saw traditional long-term gas contracts (and oil-linked prices) as a distortion of the market and as hampering fair competition. In fact, in a recent interview for the European Energy Review, Jean-François Cirelli, President of natural gas trade association Eurogas and Vice Chairman and President of French energy company GDF Suez, says: “The vast majority of the Eurogas membership still favors long-term contracts because security of supply is the first priority for a gas company to offer society and long-term contracts are well-suited to that. But clearly the market is going to have to change.” This thesis holds that the European energy structures are in a sense the legacy of the past when European national and vertically integrated majors were responsible for ensuring energy security of their respective countries with little consideration for the costs. With the advent of liberalization measures, the EU’s utilities role has changed; they were no longer responsible for their countries large-scale and affordable (energy) service provisionand instead they focused their attention on maximizing shareholders’ value. Even in that situation large companies were able to strike profits, as long as they managed to maintain large shares of their markets at home and transfer the take-or-pay obligation further to the retail market. In fact, the EU’s industry largely resisted liberalization, until the exogenous elements hit so hard that the EU utilities had to desist, for their own sake as they were facing enormous losses. Ever since the LNG tankers destined to the US hit European ports, the European utilities contracted to expensive Russian pipeline gas have been losing customers and money, constantly being undercut by new market entrants using spot purchases to good effect over term prices. And it is this inability of incumbents to retain their consumers – rather than a changing mentality or the price per se – that has made disputes with Russia’s Gazprom so bitter in the last years, and that in turn, made the EU utilities favor spot elements and shorter contracts in their dealings with Gazprom. The point to emphasize is that this paradigm shift would certainly not have been possible without the input of the key-actors that supported and facilitated a switch from oil indexation to more spot elements in gas trading. It is also important to note that the European Commission alongside with the UK and the United States had for a long time framed long-term oil-indexed contracts as more of a problem than a solution, calling for more gas-to-gas competition, but only when the key corporate actors partly embraced this.

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230) We need a decarbonisation policy that favours gas", Interview: Jean-François Cirelli on change the European gas industry by Sonja van Renssens, European Energy Review, April 2012
idea, due to their self interest and profit maximization concerns, a big change in the Eurasian gas governance structures was made possible. As noted by Konoplyanik (2012) these changes have created a ‘hybrid’ pricing model in Europe ever since, with both pipeline gas and gas traded at hubs. The hybrid-pricing model has been accompanied by largely uncertain governance structures in the Eurasian gas. Increasingly hybrid or even fragmented environments between state dirigisme and market liberalism (Goldthau, 2012) are accompanied by transnational and globalized outcomes. Businesses will be operating in growing uncertainty, and although gradual, the market changes in the contractual structures and pricing mechanisms could be irreversible. Hence, the European and Russian interests are destined to clash even more in the years to come, probably resulting in a relaxing of the EU-Russia’s interdependence and by consequence an even more fragmented institutional landscape between the two blocs. In light of this, and looking ahead, it seems that the EU runs some risks if it wants to play with overthrowing completely the old gas structures, and introduce entirely new rules and structures. This thesis agrees with the need for gradual adaptation to the emergence of a new mixed or hybrid model, but is also stresses alongside with De Jong (2012), that the EU cannot afford the luxury of experimenting with a fully new gas market design. Also, it replicates Konoplyanik’s point that the change should be promoted in practice through negotiations, and not through radical top-down interventions.

The current oversupply is temporary; the world is growing in population and new emerging powers will dramatically increase gas consumption. According to the scenarios of major companies, the European gas demand should recover by 2012 (Gazprom) or by 2015 (EON-Ruhrgas). It seems that the US shale gas bonanza will not leave the American shores for some time, due to political and regulatory constraints compounded by a fear that export would make domestic prices of gas increase. But even if the US starts exporting shale gas in form of LNG, unsurprisingly American producers all favor the Asian market, where they can seize the biggest profits. Therefore, if the EU fails to develop its own shale gas in the near future, which is indeed probable, it could find itself in an uncomfortable position of having to chase an eastward looking Russia, in order to support its ambitious decarbonization policy. In sum, the rapidity of the changes in the gas markets, compounded with a broader paradigm change in the form of the rise of the East and a relative decline of the West, all indicate that energy companies will have to operate in increasingly complex and uncertain environments. The creativity of the companies will be at the center of the process to adapt the current Eurasian gas governance structures to the progressive globalization of the gas markets. However, in times of systemic uncertainty, the companies’ strategies will have to be backed more than ever by carefully weighted political decisions in Brussels and in the European capitals. The double challenge on one side, of changing energy structures in the Eurasian gas trade, and on the other, of changing power structures on the world’s stage might put the EU in front of uncomfortable choices in the future, that could force the Old continent to rethink its strategies towards Russia. In the following section we will discuss the two greatest challenges in terms of the EU-Russia’s governance: first, the expansion of LNG imports into Europe and an even greater expansion of LNG capacity, predominantly outside Russia. Second, the emergence of new gas shale fields in North America and potentially, on the European territory.

231 Discussed in Konoplyanik (2012, p.54)  
9.4 The expansion of LNG imports into Europe and the potential impact of unconventional gas fields in Europe

The swift and quiet development of shale gas in North America has resulted in changes in the supply outlook both in Europe and Asia. As a consequence of the U.S shale gas revolution, large LNG shipments that had been destined for the US market started arriving in Europe. This massive arrival of gas in Europe combined with the economic crisis resulted in a drastic drop in spot gas prices. In fact, the American gas revolution created enormous new liquidity in the European markets that in Europe combined with a decreased demand and slow recovery from the recession has resulted in a ‘gas bubble.’ That in turn, encouraged European consumers to ask Gazprom to ease the conditions of its long-term gas supply contracts (Gustafson, 2011). The gas bubble meant that Gazprom was unable to deliver the volumes it has become accustomed to in the recent past. European importers have naturally put pressure on Gazprom to lower the prices. As CERA’s Gustafson (2011) said: “Russia’s response has been logical, timely and consistent – a renegotiated price.” However, the problem is more profound: "Buyers - want to abandon the link to oil prices." The shale gas revolution in the US has shown two things: first, what happens in one part of the world – be it the Arab Spring, nuclear catastrophes, new resource finds or intractable economic woes – all have an influence on gas fundamentals, pricing and outlook far beyond their immediate geographic regions. Second, LNG growth in Europe started to erode old market rules towards new structures. Nevertheless, as it will be illustrated in the next sections, for Europe the new situation is not risk-free.

9.4.1 LNG: a game-changer?

In the last few years liquefied natural gas (LNG) technology has improved considerably. The latter has existed for a long time, but until recently it was too expensive and only in the last few years it has really taken off. LNG allows gas producers from far away, (notably Qatar, but also Algeria, Nigeria, Oman, Trinidad & Tobago), to freeze their gas in expensive liquefaction plants. The LNG is shipped like oil in supertankers to regasification terminals, from where it is distributed through pipelines. In the last years, huge investments have been directed to all three stages of LNG, flooding the European gas market with comparatively cheap LNG through multiple new regasification terminals (Aslund, 2011). As argued by Konoplyanik (2012) most recently Qatar has broke with the traditional business and started dumping spare LNG gas that returned from the United States to the European markets at spot market prices. Konoplyanik argued that EU-oriented LNG supplies mostly came from rather new projects in the Atlantic basin and the Middle East (in Qatar, Nigeria, Oman, etc.) that were recently started under “project financing” terms. This means that they were developed mostly by debt capital. According to the author, this is why LNG suppliers from such projects have by any means - even by deep damping, though still above their production cost level - to market their gas in order to pay back recent debt-financed project investments and to return their project-related debts to the lenders (banks and other financial institutions). The Russians are certainly not content with such a behavior. All this indicates that Qatar and the other smaller LNG producers do not wish to reach an agreement with Russia, and as such, for the time being that prevents the possibility of a feared gas-OPEC. According to CERA (2011 p.24) in Europe LNG imports are growing faster than imports of pipeline gas. LNG’s share of the European supply mix is projected to grow from 13% in 2009 to nearly 20% in 2020. According to a recently popular storyline, LNG in expected to replace much of the decline in production from the North Sea, that combined with plentiful flows of locally-produced European shale gas will lead to further expansion of short-term contracts and spot trade and pricing, with a development of liquid hubs, that would

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233 And in the fundamental economics of LNG and pipeline markets
ultimately lead to a decreased gas price for the European end-users. This scenario presents some problems, which need further clarification. First, contrarily to a common belief among consumers, setting gas prices based on gas fundamentals has nothing to do with being cheap – it is purely about achieving a cost reflective price for whatever the markets (and fundamentals) suggest gas should be. Second, the emerging “spot” gas market within the EU adds uncertainties and volatility to the prices, with a potential growing role of non-gas speculators (Konoplyanik, 2012). Third, despite the growth of gas traded through “spot” contracts, the EU will still need Russian gas as the backbone, at least in the next few decades, for its continued decarbonization of energy aided by a larger use of gas as a “bridge fuel” to a low-carbon future. The high growth of natural gas consumption projected by the IEA (Golden Growth Report, 2011) and other observers will continue to be imported mainly from Russia due to the territorial proximity and the long term contracts already in place. Whereas the domestic EU gas production is projected to decline, the longer run the EU demand is set to increase.

Admittedly, the sources of EU imports are expected to become more diversified, with a growing share of LNG, while the share of the Russia’s supplies falls from 61% in 2010 to 48% in 2035 (IEA, 2011). In spite of that, if the EU is serious about decreasing its emissions by 20% (or even 30%, if the conditions are right) by 2020 from the 1990 levels, and in order to achieve the goal of cutting emissions by over 80% by 2050 which is the new goal set up by the EU’s recently released Energy Roadmap 2050, European cannot afford to antagonize its gas main supplier, namely Russia. It is uncertain how the EU aims to cut greenhouse emissions by 80 percent by 2050 and at the same time first, spur economic growth, second, turn increasingly towards renewables and third diversify away from Russia. How will European policy makers make these goals coalesce with shorter-term pressures to create jobs and reform their fiscal systems among other things, it is still uncertain. Governments may impose new constraints for increasing energy efficiency, developing renewable sources and limiting all forms of pollution. These new developments are, however, shifting attention away from the short-term challenges of international geopolitics and fomenting the illusion that investment in renewables could obviate the need to take difficult foreign policy choices. As emphasized by Maugeri (2011 p.208) the ‘uncomfortable truth’ regarding renewables is that they have a very low energy and power density, so they can produce only limited amounts of energy. In part this is a technological problem because we still cannot exploit those sources fully, just as we cannot yet accumulate and store electrical energy on a large scale. That is why it is believed that combined-cycle gas turbines (CCGT’s) will be far more flexible partners for renewables in the future, much more than coal plants. That is also why Europe will increase its natural gas consumption even more, to phase-out dirty coal and as a “bridge” fuel towards a more sustainable future. Especially after Germany’s denuclearization, decided in May 2011, Russia will continue to have the lion’s share in the EU gas markets. Not surprisingly, in feeding the EU with the natural gas that Europe needs in the long run to meet its goals by 2050, Russia will try to resist the delinking of the price of gas from the price of crude oil. Besides the climate battle there is another reason why alienating Russia might be risky for Europe. As we know, there is no parity in gas prices and the Asian regional prices are the highest. Presently, spot prices for gas in the US are around $2.5/MMbtu to the other extreme of Asian spot around $20/MMbtu, with Europe occupying the middle (geographic and price) ground. In light of this, there are several obstacles that might hamper a substantial impact of the LNG in the European markets:

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234 In the IEA-GAS Scenario, pushing up imports to around 450 bcm by 2035 (about 30 bcm more than in the New Policies Scenario), nearly 70% of total primary gas supply in the region. According to the EIA World Energy Outlook 2011, Europe’s share of total inter-regional gas trade decreases to around 40% in 2035 (IEA, 2011).


236 “Germany’s Nuclear Phase-Out Brings Unexpected Costs”, Der Spiegel, June 6, 2012
1. In Asia the price of natural gas is higher than the European regional price for gas, which naturally prompts flexible LNG exports to look more at that market. In fact, taking January 2011 as an example, the price of natural gas in North America dropped to 2.2 per million of British Thermal Units (Mbtu). At the same time the price for methane in Europe reached between three to four times greater levels, around 12.5 $ per Mbtu. Finally, in the same month the gas in the Asian market reached the level of 17 $/Mbtu. The reason why prices vary so greatly from one region to another lies in the fact that we still have mainly three regional gas markets, which are segmented. If a really global market for natural gas is the goal, then LNG should be pushed as an increasing part of the mix in all three regional markets, which would in turn stimulate an increasingly globalized market. However, building LNG terminals requires very expensive investments, that have until recently been delayed due to the high costs of regasification. Even having a ready LNG terminal does not in itself secure supplies to that terminal because the producers tend to export where the prices are the most favorable in terms of gains. That is why it seems to be increasingly difficult to contract LNG supplies in Europe. On the contrary, new pipelines, especially those that are being built in cooperation with a producer, are a more certain option for securing supplies. Such pipelines have advantages. First, with a producer having a financial interest in the project, the chance that the pipeline will run dry seems very low. Second, connecting a newly built pipeline to a (new) gas field enables the pipeline to run on full capacity and increases security of demand for the producer (Van del Linde, 2011).

2. The second reason why Europe is in an unfavorable position to compete with Asia in terms of LNG is the fact that the Asian countries already possess the greatest capacity of regasification in the world (Maugeri, 2012) and are therefore able to absorb robust quantities of gas. Even the United States, whose policy-makers are currently debating in Washington whether or not the country should export its shale gas in the form of LNG, is looking at the Chinese market and not at the European one if such a move was decided. To compete with Asia, Europe should therefore need to increase its prices for gas, with unpopular consequences for the final consumers.

3. Despite growing (LNG) supplies, gas imports are also predicted to remain very concentrated for large parts of the EU. The concentration of supplies is already relatively high for the EU as a whole, but is very concentrated indeed for the Northwest and Eastern European markets where Russian pipeline supplies dominate. LNG development will only marginally relieve the structural import dependence because LNG exports are unlikely to shift that high north and that east to include significant portions of German, Swiss and Eastern European markets. This situation is also due to long-term friendly relationships between some companies in these countries and Gazprom. For example, E.ON-Ruhrgas, for decades the owner of the only potential LNG site in Germany, has still not developed this site, thus preventing Germany from obtaining LNG. Also, although the LNG import capacity of ports in the European Union, currently at 108 billion cubic meters, is expected to increase during the next five years, this expansion will not benefit the countries with the greatest vulnerability to an interruption in the flow of Russian natural gas, namely the East European countries.

4. Besides, significant regasification capacity has so far been built only in Grain Britain and Spain, while most of these projects in other states are still “on the paper.” For

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237 Which is the unit used in the world to indicate the calorific content of gas
example a country like Italy has only two functional regasificator facilities while 1 regasificator is currently under construction (Livorno) and 7 in a planning phase. Therefore, the still limited amount of LNG projects compared to the large number of pipelines and the rising demand for gas in Europe, can very quickly appease the enthusiasm that LNG would rapidly break the long term supply contracts dominance without risking supply security. Moreover, the political turmoil due to the Arab Spring could have a strong impact on the LNG from Arab producers exporting to Europe. Further, in March 2011 a giant earthquake and tsunami shook Japan, knocking out power and setting off a major nuclear accident at the Fukushima Daiichi plant. That in turn redirected Qatari and other smaller producers’ natural gas supplies to Japan on an even more massive scale because European hub prices are typically lower than the Asian ones. In summary, the initial optimism about LNG being able to provide the EU with ample diversification opportunities was tempered by the competition with the Asian region, including China, and in general, the rapid demand for energy that will be driven by that region in the coming years. A successful LNG exporter such a Qatar is contemplating alternative markets to the EU for its gas, such as the East Asian one - where the revenues are the highest. In fact, Japan and South Korea are the world’s largest LNG consumers, accounting for approximately 60% of global LNG imports in 2009. Moreover, according to CERA, Asia will remain the largest market for LNG (see figure 16). Countries like Japan and Korea have negligible domestic gas resources and meet nearly all of their demand with LNG. Much of Asia, with the exception of Japan, emerged from the economic recession faster than Europe – a boom for LNG trade. Europe still struggles with its very deep recession and the pace of recovery has been slow. In this situation providing financial assistance for LNG terminals is hugely problematic.

Figure 16: LNG Imports by Region

Source: IHS CERA, US Energy Information Administration and IEA. 01211-1

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239 Panigaglia and Rovigo
240 Especially due to environmental concerns and a EU action plan that relies heavily on natural gas
For the time being, Gazprom handled the perfect storm that hit the global gas markets with a double tactic of gradually adapting its contractual structure to the new situation, plus avoiding a "price war," which would entail much larger losses for a producer that in absolute terms retains the majority shares in the European markets (see figure 17).

Figure 17: EU-27 imports of natural gas - percentage of extra-EU imports by country of origin, 2010

![Figure 17: EU-27 imports of natural gas - percentage of extra-EU imports by country of origin, 2010](image)

Source: Eurostat

Therefore, Gazprom is waiting for fundamentals to tighten, while being aware that more flexibility in the long-term contracts will be needed. At the same time, however, Gazprom continues to repeat that oil-indexation is needed to provide ‘security of demand,’ which Russia needs to finance upstream energy infrastructure projects that take a long time to realize and require large investments for natural gas exploration, production, and distribution. Moreover, Gazprom points out that if there is no clarity about the EU’s future policy goals, this will cause incremental risks for the investors regarding payback of their prospective investment in gas supply (production plus transportation). For now, Gazprom has responded by reducing its output from existing fields, and postponing all the new investment to offset its lost market share in the EU markets. For example, in September 2012, Gazprom confirmed it was pulling the plug on developing the huge Shtokman gas field, because of the cost.

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242I.e. rather losing portions of market share than putting the price down
243"Gazprom cuts European sales target, raises price", Euractiv, 10 April 2012, updated 04 September 2012
Not too long ago, the Shtokman field was considered a top priority to reverse the country’s declining output. In fact, the Russian government criticized Gazprom unusually sharply in March 2012 for falling behind its development plan for storage capacity and gas production (Westphal, 2012). Gazprom’s strategy seems perceived as dangerous even by the Russian state, however, it appears that for the time being this is the way the company has chosen to “punish” the European customers for their requests of price reduction. This situation might turn out risky for the EU. In Europe, concerns over the sovereign debt and the Euro crisis have distracted the governments and shifted attention away from energy policy, boding ill for agreed gas governance objectives. At the same time, Russians are at pains to remind that companies have specific long-term visions in order to commit to long-term investments without the fear of ending up with obsolete investments because of policy changes. End-consumers on the other hand have understandably a short-term view that makes them put the highest value on price and opt for the cheapest option available. A new customer has little reason to opt for piped Russian gas when cheaper LNG is available. However, once again, a long-term consideration is enmeshing in the picture. As demand in Europe is expected to grow steadily (IEA 2011), it follows that Europe’s gas import dependency will continue to grow. Europe’s import was 50% of primary gas supply in 2010, and this is expected to rise to 70% in 2035 (IEA 2011, p.33). Since European “shale gas” will not be a ‘game changer’ in the medium term due to impediments like a much more restrictive environmental law than in the US and a generally different geological formation in the “Old continent,” even though the nexus between oil and gas will be loosened in the gas pricing structures, long-term contracts’ supremacy will not be challenged in the medium term. Thus, the only way to enhance competition would be through increasing the shares of LNG in the European market. But again, as we have seen above, for Europe that is not an easy undertaking. Thus, LNG will not change the fundamentals in the future, nor will a 10-bcm diversification pipeline from Central Asia. Further, at the moment the US shale gas seems firmly tied to the American soil, and the European shale reserves are likely, for political reasons, to remain underground. Therefore, although Russia’s market position in Europe has been temporarily weakened as a result of “the gas glut” in the long run dependence on imported Russian pipeline gas will continue to grow, to the depletion of indigenous resources. In sum, Russia should not be avoided or demonized; on the contrary Europe’s gradual path to market-based gas pricing should go through engaging all parties, and certainly its main gas supplier. Lastly, despite the multiple obstacles to LNG that we have seen in this section, diversification remains an inalienable imperative at the EU political level. In order to achieve it, the development of unconventional natural gas exploitation is regarded with keen interest. Some observers believe that it could contribute to the EU’s domestic natural gas production in the future. At the same time, there are many obstacles, such as an unfavorable environmental legislation and a densely populated continent – that render this avenue quite challenging. These potential future scenarios will be analyzed in the following section.

In the words of a Russian energy expert: “It was postponed, postponed and postponed and only when everybody understood that it wouldn’t happen, just then it was announced that Gazprom is postponing it again for an indefinite period of time. The official statement is very unclear; we talked to our partners and and we decided that the project as such is too expensive for now and the FDI won’t be taken until 2014. It can be understood in both ways: whether it was just postponed until 2014 or it was completely terminated. It is a question of understanding”. - Interview with the Author in October 2012

I.e. Nabuco West or TAP (see Chapter 10)

9.5 Unconventional gas: quo vadis Europe?

The energy future is becoming increasingly uncertain. No one can predict the future but there are ways in which we can catch a glimpse of what our energy supply will look like in twenty or thirty years from now. Energy experts agree that energy forecasting is nearly impossible because the uncertainties of the future are so numerous that they cannot be totally integrated into a model. In such a context the scenario approach is privileged and widely used by energy companies, governments and international organizations. Scenarios are neither forecasts nor predictions.\(^{248}\) Rather, they result from brainstorming where people of a given organization try to imagine a small number of ‘possible futures.’ Each scenario provides an image of a possible future at 20, 30 or 50 years into the future. The type of scenario we are most familiar with is the reference scenario of the International Energy Agency (IEA) of the OECD, which assumes the continuation of historical trends into the future and is often referred as business-as-usual. However, some unexpected events, and the way actors observe and react to these events are not very predictable and in those instances, exploratory scenarios might be a preferable option. Another common distinction is between qualitative and quantitative scenarios. The Clingendael International Energy Programme (CIEP) has an extensive background in analyzing gas security using different types of scenarios. For the purposes of this chapter, the recent work of O'Sullivan and Myers Jaffe (2012) represents the most useful example of a consistent examination of the current rapidly changing gas paradigms through a scenario approach. Unlike the reference scenarios based on existing policies, these scenarios were built through a scenario planning exercise and they vary along a grid with two dimensions: low vs. high success in developing unconventional gas (UCG) and low vs. high levels of market liberalization and integration.\(^{249}\) The next chapter will seek to discuss in a qualitative and explanatory manner, whether the shale gas revolution could be replicated in Europe.

9.5.1 Abstract

There is no doubt that in gas one of the biggest transformations of the last decades has been the American “shale gas revolution.” Shale is a type of rock, typically found in a layer above conventional oil and gas deposits. The rock contains natural gas that can be extracted. The dramatic increase in shale gas has been made possible by significant improvements in the technology duo - hydraulic fracturing and horizontal drilling, that created the "shale gale" - the explosive growth in natural gas production from shale rock. US shale gas production has increased from almost nothing in 2000 to a 34% of total U.S. natural gas output in 2011, with some analysts projecting a 50% share by 2035 (CERA, 2010). Shale reserves are also abundant in other parts of the world. This awareness combined with the European increasing dependence on external suppliers has raised the interests in turning some parts of Europe into a “shale” laboratory. However, the situation in Europe is quite different from the American one and there are several obstacles to a real shale boom in Europe. So how worried should Russia be that shale would beat its gas in Europe? In this section we look at the European shale potential and some of the obstacles companies will face in replicating the US shale gas revolution in Europe. Moreover, we discuss whether unconventional gas will represent a real challenge for Gazprom’s business in Europe in the years to come. The main points focus on the challenges that Gazprom faces by encountering potential new competition from shale gas. Then we analyze the potential Russian response in order to avoid unconventional gas outcompeting it in Europe, as well as the potential implications of unconventional gas development for the European gas markets.


9.5.2 Impediments on the Old Continent

Understanding the conditions that have made shale gas exploitation successful in North America is fundamental to an analysis of the potential of shale gas in Europe (Geny, 2010). Energy experts seem to agree that several factors that triggered modern unconventional gas production in the US are hardly replicable in the EU:

- A high level of geological knowledge
- Tax credits
- The technological innovation of "horizontal drilling"
- Favorable environmental legislation
- A strong oil and gas service industry
- Easy access to gas pipelines

In addition there are many operational, regulatory and commercial challenges to the development of unconventional gas resources, which are specific to Europe:

- European shale gas deposits are geologically much harder to extract than those in the US
- Drilling is quite land intensive, and this could be very disruptive in densely populated Europe
- Environmental legislation is much tougher than in the US
- There is no comparable onshore oil and gas service industry to provide drilling rigs and other equipment
- The gas transmission business in Europe is still dominated by giant national gas companies that may not welcome the new sources

Despite the many restrictions, some energy experts believe that Europe’s unconventional gas (UG) reserves could be several times bigger than its conventional gas reserves and that the shale gas boom in the US can be replicated in Europe.250 The US majors – who largely missed out on the first stages of shale growth in their home patch – certainly seem to think so. Exxonmobil, who recently acquired US shale gas producer XTO, is active in Hungary, in Poland and in Germany, and has teamed up with German upstream company Wintershall. Chevron, Conocophillips and marathon are also hunting for shale gas in Europe, particularly in Poland. Also European majors, such as Shell, Eni and OMV are all active in developing potential shale gas plays in Europe. Obstacles in Europe range from local opposition and national policies to the lack of infrastructure and a much greater population density. The main impediments are of political nature though. France already has a moratorium that banned shale gas drilling out of ecological concerns. The Netherlands doesn’t need to bother with shale given they still have Groningen fields. Fostering its ‘Energiewende,’ Germany has ended up splitting its energy mix between lots of wind and even more lignite coal, using Russian gas to fill any residual gaps. In the UK, it is only a handful of Conservative parliamentarians who think shale might offer a British version of the US shale revolution in North West England (Hulbert, 2012). Italy has been oversupplied with Russian and on-going Libyan deliveries. Moreover, as never before the Nimby phenomenon, i.e. “Not in my backyard”, functions perfectly. At last, the EU’s unity was achieved in one thing: no one wants hydraulic fracking and drilling in its backyard. US energy giant Chevron suspended shale gas exploration activities in Bulgaria and Romania following ecological protests.251 A couple of wells in Hungary have been abandoned as unpromising. In Poland, the country considered most promising, only eleven wells have been drilled so far (compared to the

250 See Kuhn and Umbach (2011a) Strategic Perspectives of Unconventional Gas: a game changer with Implication for the EU’s Energy Security, EUCERS, Strategy Paper
Barnett Shale in Texas where 15,000 wells have been drilled). In most of the rest of Western Europe, environmental concerns may make gas extraction impossible irrespective of whether the geology proves suitable. Still the imperatives of diversification will likely fuel the hopes for unconventional gas resources in some parts of Europe – most notably in Poland and Ukraine. In February 2011, Ukraine has become the latest European country to open up its shale gas reserves to exploration, a move that could help to reduce its heavy dependence on increasingly expensive gas imports from its eastern neighbor Russia. However, there might be political troubles here as well. As noted by Hulbert (2012) as quickly as most of American major came in Eastern Europe, many of them have since left. That is probably, as Hulbert puts it: “because Russia is playing hardball with CEE and South East European states. No sooner had Exxon Mobil signed agreements to develop West Siberian tight oil plays in Russia, it pulled the plug on Polish shale exploration. As Shell is no doubt about to find out in Ukraine, developing CEE shale and Russian upstream reserves is not going to be an either/or option. Companies may face a difficult choice: either you do business in Russia or business in CEE – not both.” Moreover, given that so far there has been very little drilling in Europe, enthusiasm that new shale gas supplies will compensate for declining conventional supplies is maybe premature.

Figure 18: Shale Gas exploration sites in Europe

Source: Shale gas in Europe: A revolution in the making? Gas Matters, March 2010

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252“Ukraine opens shale gas reserves to exploration”, Financial Times, By Roman Olearchyk in Kiev and Guy Chazan, February 23, 2012
Only drilling will prove whether significant, commercially viable shale resources exist in Europe. Yet, at present the main obstacles lie “above ground.” Therefore, any estimates of the European shale gas resource base must be speculative. There are many optimistic studies pointing to an enormous potential for shale gas in Europe. An IHS CERA study of 2010 concluded that estimates of the geological potential for shale gas in Europe rival those in North America. Although unconventional gas boom in Europe is not guaranteed at present, the IHS CERA study expects a reasonable minimum level of 60 bcm of an annual production, whereas the also plausible high scenario could reach even 200 bcm shortly after 2025.253

The investment bank JPMorgan has, for example, recently published an analysis which forecasts European shale gas production growing to nearly 30 Bcm/year by 2015 and to four times that figure by 2020.254 But it is still early days, and a great deal of effort will be required to develop such resources. It will also require a vast investment in leadership, imagination and money to make this happen in times when the financial crisis and a stagnating economy in much of the Western world might easily delay action. There is another important difference between the shale revolution in the US and the shale potential in Europe. The US shale gas boom happened at a time when gas prices were rising and most analysts predicted steadily growing gas demand for years ahead. The situation is very different now. At the moment the European market is over-supplied, prices on the ‘spot’ market for short-term gas contracts have fallen significantly, and the medium-term outlook is highly uncertain. But drilling for shale gas is very expensive; “High prices allowed us to make lots of mistakes when building up the US shale gas industry. With depressed prices and demand in Europe, companies have to be profitable straight away,” says one gas expert.255 Because of the smaller scale of production and the dearth of infrastructure and expertise, a higher general cost of doing business compared to the US and an oligopolistic service industry - it will probably cost two to three times as much to produce UG in Europe than in the US (Barysch, 2010). Hence it is not clear when and whether European UG will be able to compete with LNG and pipeline gas. This leads our discussion to the next question: can shale beat Russian gas in Europe? We will tackle this question in the next section.

9.5.3 Can shale beat Russian gas in Europe?

Even if unconventional gas probably won’t be a “game changer” in Europe at least for a decade or more, the “shale gale” in the US has already had a significant indirect impact on the European gas market. The disappearance of the US as a gas importer has released huge amounts of LNG on European and Asian markets. These additional volumes of LNG combined with the recession and slow recovery in Europe, put a downward pressure on all gas prices, and thus have forced pipeline gas suppliers such as Norway’s Statoil256 and Russia’s Gazprom to re-negotiate contracts with their biggest European customers. These events have already forced major adjustments in the Russian gas business plans, its investment priorities, and schedules and negotiating strategies, but fresh challenges lie ahead. The clash of Russian pipeline politics is further unsettled by the potential for a new alternative - unconventional European gas supplies. This multitude of changes—irrespective of whether or not European shale gas would become a game changer—will have a significant impact on the EU-Russian relations, national economies and, ultimately, on consumers. However, if we try to assess more closely whether European shale gas will be able to compete with Russian pipeline gas in the next decade: considering all the obstacles that we mentioned before - the most proximate answer is no. European shale gas will most likely not outcompete Russian gas in the next decades. However, over the past five years we observed

254 Quoted in “Shale gas in Europe: A revolution in the making?” Gas Matters, March 2010 p.4
255 Quoted in Barysch K., Shale gas and EU energy security, Centre for European Reform, June 11, 2010
256 That has already signed supply contracts with Centrica directly linked to UK’s hub prices (Hulbert, 2012)
that regional gas markets are increasingly influenced by developments in different parts of the world. The shale gas revolution in North America, the economic recession in Europe, the Arab Spring and the Fukushima nuclear accident in Japan provide examples of events which have had impacts on gas supply, demand and pricing far beyond their immediate geographical regions (Stern, 2012). Some of these developments put in question the Russian gas trade model and others will contribute to enhance Russian role in the European supply for the years to come. I propose to look at four main factors that will enhance the role of Russian gas despite the potential developments of European UG:

1. Natural gas is an attractive “transition fuel” towards a low-emission global energy mix. Especially in Europe we can expect an expanded role of the “greenest” fossil fuel in the effort to meet European targets for 2050 incorporated in the EU’s Energy Roadmap 2050, which in turn makes the case for an increasing role of Russian natural gas.
2. Following Fukushima, climate targets in Europe are even more ambitious. Angela Merkel’s government phase out of nuclear power will have the end result of much more gas imports and a jump in gas prices.
3. Gas prices are at a historical low, right now. This is not a sustainable level and it will go up. Moreover, after this temporary situation due to the LNG shipments re-routed from the US to Europe, LNG will go to the East where the price is higher.
4. Following the liberalization of the European gas market, the challenging of long-term gas contracts has created more leverage power for the EU. However, the gas transmission business in Europe is still dominated by giant national gas companies that may not welcome new sources such as shale gas, and that have strong interests in maintaining the status quo and protecting the long-term partnerships with Gazprom.

What does all this mean for Gazprom? Regardless of whether the depressed prices and demand in Europe are a temporary phenomenon or a new trend, Gazprom will have to realize that much many options are opening up for Europe in the years ahead and will have to struggle to protect its market share and maximize its long-term revenues. Signs of Moscow’s fear of losing further markets shares in its most important export market have reached the Russian Duma. On April 11, 2012, in his final address to the Duma before he took over as president in May 2012, Vladimir Putin has urged his country’s gas industry to “rise to the challenge” of shale gas as the United States and some European countries forge ahead with developing “the controversial” energy source. Putin said: “US shale gas production may "seriously" restructure supply and demand in the global hydrocarbons market. Our country’s energy companies absolutely have to be ready right now to meet this challenge.”

In the past years, Gazprom has insisted that there was no acceptable alternative to oil-linked pricing and that the gap between long-term contract and spot prices would close by 2012. Putin’s words demonstrate that the Russian government is no longer trying to minimize the importance of the changes in Europe, and is instead focusing on ways how to deal with this external shock that hit Gazprom and that is changing the configuration of global markets. Russia is aware that the tumbling and decoupling of gas prices from oil prices as LNG and shale gas are competing with piped natural gas – might offer an alternative to their long-term contracts and that the increasing “connectedness” of gas markets, has created a market where developments in one region have a worldwide impact. In fact, as noted by Jonathan Stern (2012), Gazprom might need to make uncomfortable choices between volume and pricing of European exports over the next decade. In fact, Russia’s gas export monopoly Gazprom has abandoned plans to increase sales to Europe in 2012, saying that it faced stiffer than expected competition from LNG and lower spot market prices. "Choosing between 154 bcm at a lower price and 150 bcm at a higher price, we choose to export 150 billion," Alexander Medvedev,

Gazprom’s deputy CEO, was quoted as saying by Russian news media. Medvedev stressed that 150 bcm is a minimum level of supply in terms of Gazprom’s long-term contracts. According to Umbach and Kuhn (2011b p.217), European renegotiation and revision of long-term contracts has already caused an average of 15% of Gazprom’s supplies to be delinked from oil-indexation in 2010. Should Poland develop its shale gas resources to allow for export, Gazprom may be forced to cut substantially its prices to remain competitive - but at a cost of potentially jeopardizing investment needed for expanding production and upgrading the obsolete infrastructures, like pipelines and LNG terminals. Therefore, Gazprom will need to diversify as its European export model suffers. It is expected that Gazprom will operate in three distinct markets: (1) the traditional European market; (2) a de-regulated and mixed domestic market; and (3) a new Asian market [Kuhn&Umbach, (2011b), p.220]. Hence, even if unconventional gas does not prove as a pan-European game-changer, it could still have very significant consequences on regional gas dynamics, as even pointed out by the newly re-elected President Putin. However, it should be noted that Gazprom has still a formidable room for price maneuvering. Since the Russian budget remains heavily dependent on incomes from oil and gas exports - Russia will not passively wait to lose its high profit margins on the European gas markets. If needed, its profit margins will allow for substantial price reductions, to slash the competitors out of the game. Moreover, Gazprom will continue its divide and rule policy, negotiating with EU gas majors bilaterally and offering better deals to Russian long-term friends (which explains why Germany pays the lowest prices in Europe). Russian officials and Gazprom could even point to negative environmental implications of unconventional gas production in Europe. In a somewhat conspiracy-minded comment Mikhail Korchemkin, the managing director of Eastern Europe Gas Analysis (EEGAS) suggested: “Russia may inspire the anti-shale movement, including financing heavy-weight politicians in the west to become heads of the clean water movement.” Concluding, gas is likely to become increasingly important at the expense of coal and nuclear power, therefore Russian gas imports will increasingly dominate the European energy mixes. The ‘gas bubble’ will inspire a redefinition of the long-term contracts clauses but Gazprom’s share in Europe will continue to grow. In 2011, Gazprom’s share in the European market grew to 27% from 23% in 2010. The company expects to boost its share up to 30% by 2020. However, the fact that the international gas market is continually re-inventing itself makes forecasts difficult. How the global gas market will develop is uncertain. Nevertheless, in such a situation Europe should concentrate on remaining an attractive market. The Russians will have to include some clauses for renegotiations of the prices, when the ratio between oil and spot gas prices de-links in a considerable way again, but the need for financial security to make investments in upstream projects, will preclude a complete abandoning of long-term relationships. In this complex setup, unconventional gas is to a certain extent “a wild card” for the EU-Russian relationship. Unconventional gas is nowadays the new policy option for European countries, giving buyers more leverage to renegotiate the Russian oil-indexed high gas price demands that are included in long-term contracts. However, Europe will need to guarantee some ‘security of demand,’ otherwise it would not be surprising to see Gazprom more active in the East, focusing on producing easily transportable liquefied natural gas at the Barents Sea deposit, to be shipped for the Asian market, as the company has first mentioned doing in April 2012. If the US shale gas is not exported, if Europe fails to develop indigenous supplies and the gas-thirsty Asia locks-up excess supplies; Europe might find itself in a troublesome position of scrambling for more Russian gas. In fact, for Gazprom, the perception of growing political reluctance in Europe to becoming over-reliant on Russian gas, accompanied with increasing new competition both from LNG, pipelines from Central Asia and shale gas, makes the case that European customers could no longer be relied upon to commit to the huge volumes from new upstream projects, meaning that their commercial

258 “Gazprom cuts European sales target, raises price”, Euractiv, 10 April 2012
259 Natural Gas Europe, April 11, 2012
viability would need to be underpinned by domestic sales to guarantee a minimum rate of return (Henderson, 2011) and by an effective turn towards the Asian markets. In fact, in Russia the need to diversify Russia’s export market, a long-standing idea in the academic and energy industry circles, is gathering more and more momentum. This, finally, links back our discussion to the ‘paradigm shift’ debate. As noted earlier, for a paradigm change to occur, it has to be endorsed by the crucial actors. As the situation is worsening for Gazprom in Europe, it seems that the latter is leading to a fundamental shift in the Russian public perception of the reliability of the European partnership, with more eyes turning towards the Middle Kingdom and the four Asian tigers. That is a risk that could force the EU to rethink its strategies. However, this chapter does not end with this excessively gloomy picture. There is a policy-area, where at least in principle, the political opportunity to align the European and Russian interests exists: the climate change and more broadly, the environmental front. As noted by Goldthau (2012), only in the new millennium the link between climate change and energy was fully recognized. Even Europe that is definitely in the vanguard on environmental issues, both at the regional and the global level, only recently institutionalized the idea that climate and energy should be intertwined in political practice. In fact, in 2009 the “Climate and Energy Policy Package” was the first law that actually acknowledged that climate and energy are increasingly overlapping issues that ought to be dealt together.

Previously, climate change and energy policy were treated separately within the European Union. As climate change is now brought to the forefront in Russia, the EU could provide its skills and set itself as a role model for its Eastern partner, which is increasingly seeking to enhance its R&D in “green” technology. Even more, as the Western role-model and “soft” power were downgraded ever since the 2007 economic crisis, with a growing role-model potential for the Asian economies, at least in the climate change battle Europe can still share its best practices with the world and amendsomewhat for the lost attraction power in the other domains. However, being an example for others does not immediately translate into having negotiating power, as we have seen with the moribund Kyoto Protocol. According to Goldthau (2012 p. 205) the rule-setting power of the future lies in Asia and as a result the next paradigm change will be entirely driven by Asia, by virtue of its sheer impact on energy supply and consumption, climate change policies and energy poverty. In the meantime, the EU can set best practices on how to successfully pursue environmental policy; the most proximate partner for these developments is Russia, as best illustrated by the EU’s invitation in November 2011 that Russian experts take part in developing a European energy strategy until 2050, on which basis the Roadmap of the EU-Russia Energy Cooperation until 2050 was subsequently introduced.

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261 Due to, among other things an anti-trust investigation started by the European Commission on the grounds that Gazprom failed to “unbundle” its activities.


263 Despite of this significant improvement, the actions between the actors within the EC that are supposed to work together are too compartmentalized. These are a Directorate-General (DG) for Energy, a DG for Competition and a DG for the Environment. The latter was split in February 2010, and the departments relating to climate change from the environment, industry and external relations formed the DG Climate Action. Each of these DGs has its own Commissioner with a portfolio. Was the split of the DG Environment really necessary? All of the above mentioned DGs are supposed to work together to tackle the overlapping issues of energy policy and sustainable development and it is uncertain if such a clear separation of activity among competing and often conflicting DGs is the best way to do it.

264 “EU invites Russia to take part in developing energy strategy” Ria Novosti, November 2, 2010
9.6 The role of Technology - A potential chance for the Strategic European-Russian Partnership

While the EU has become increasingly dependent on Russian deliveries, Russia has also become very dependent on European imports of goods and technology. The trade, however, is asymmetrical: Russia imports equipment, consumer goods and high value-added products, while it exports raw materials. As Russia’s main export product, natural gas becomes harder to find and more expensive to produce, Russia’s growing dependence on revenue from raw materials, along with its inefficient and often-corrupt management of the industry, is becoming unsustainable. It is beyond doubt that Russia needs to adopt advanced technological standards, enhance the level of information openness, build a law-governed state, and curb rampant corruption. Considering Europe’s technological revolution in the climate sector, Europe will continue to be Russia’s major partner as regards to the adoption of these new technologies. Russia has recently declared that it aims to create incentives for the “greening” of its economy. Yet, this development will require technology, market development, infrastructure and regulatory structures that will take time to develop. The European Union should offer its strategic partnership to promote R&D in Russia and help the country to set up a regulatory regime in line with its strategy to progressively reduce reliance on coal and oil. Moreover, when offering know-how and technological assistance in the energy sector, the EU should promote active legislation, especially in the climate and investment sectors. Russia's technological decline obliges it to form strategic modernization partnerships, and integration with Europe (and the U.S.), rather than with China is the preferred Kremlin’s way. It is advantageous for the EU to focus on helping Russia to modernize its high-tech industry and research parks. In this respect, conflict between the EU-Russia is not in the cards for the near future and the technology area is more likely to motivate fruitful practical cooperation between the two. This kind of cooperation, created on the basis of shared interests in the field of research and technology, has proven much more successful than a dialogue focused on common values or identities (Barysch, 2011). In the past, Russia has resented the value rhetoric of Europe, which in Russia's perspective was allegedly able to advance its interests under the guise of “values.” Therefore, a more practical and pragmatic cooperation could help to create common ground that responds more closely to the needs of both parties.

9.6.1 Introduction

Technology has a key role in building a sustainable energy future. There is a wide range of new energy technologies and there is also a great potential for using and improving existing technologies in order to enhance the efficiency of energy systems. In trying to meet its ambitious environmental objectives, Europe has developed new “green” infrastructure. Recent additions have been made to the energy mixes by way of renewable energy technologies which include power from the wind - wind turbines, and power from the sun – solar cells, and geothermal – relying on the heat that can be found at varying degrees of depth into the Earth’s surface. Europe is considered in the forefront, both politically and technologically when it comes to addressing the battle against climate change. As noted in a recent report issued by the World Bank, European investments in green technology are forcing producers such as China and Brazil to become “green” in order to satisfy the European consumption.265 Where green technology and technological evolution are

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concerned, Europe has become a standard bearer that voluntarily or involuntarily exports its more stringent standards to the rest of the globalized world. The vanguard role of Europe might spur a redefinition of Russian ties with the European Union, the evolution of which will inevitably influence its own development from a technologically backward country to a more innovative region.

9.6.2 Energy and Green Technology

In 2002 a EU-Russia Technology Centre was created in Moscow, bringing together industry representatives. Since then cooperation has been sporadic and low-profile, gravitating around the four ‘common spaces.’ However, in 2009 Russia itself went through a very painful recession, which turned the post-crisis Russia more humble (Barysch, 2011) and more concerned about its structural dependency on export of raw materials. In fact, over Medvedev’s presidency, the Russian “technology drive” has experienced a positive shift. Medvedev’s foreign policy strategy essentially argued that Russia’s limited foreign policy influence is a direct result of its lack of global competitiveness. All this injected new impetus into the EU-Russia relations and provided a window of opportunity for deepening their bilateral ties. In line with this, Medvedev promoted a number of “modernization alliances” and indeed, at the 25th EU-Russia Summit in May 2010, the EU and Russia officially launched the Partnership for Modernization program. Some observers criticized the EU for supporting Russia’s skewed idea of top-down modernization instead of making a strong case for systemic reform. Controversies aside, bringing most of Russia’s remote resources on-stream is in the interests of both parties. This is opening new perspectives for technological cooperation between European IOCs, Gazprom and other independent natural gas producers operating in Russia. Further, it may increase the European sense of energy security in itself, as Western companies would have a role in preventing technical accidents due to poor maintenance of the gas infrastructure and would provide the needed technological know-how and Western capital to develop new remote oil and gas fields located in East Siberia and the Arctic. In the past the Russian political system remained tuned to maximizing short-term outcomes, while the long-term goals, be it the search for new technologies or doing away with the legacy of Cold War, remained behind the horizon. This has now changed. At the end of January 2012, before the presidential elections, in a lengthy article in Vedomosti, president Putin set out his vision for Russia’s economic development. What came across in the article is that the President is acutely aware of Russia’s technological gap and the need to rebuild Russia’s technological base. According to Putin, Russian firms lack the technology and financial resources to develop the economy on their own and must find Western partners to work with them. In that respect, Putin aims to continue Medvedev’s modernization strategy. Putin has argued that urgent action is needed in Russia to foster implementation of efficiency improvements and energy market reforms that would accelerate the modernization of the Russian economy and thereby loosen its dependency on movements in international commodity prices. The question is whether Russia’s government will pursue a sufficiently good economic policy to attain these otherwise admirable goals. In its conceptualization, Russia 2020 appears more Soviet than market economic. The means for economic growth are problematic. Its emphasis lies on innovation and high technology, but deregulation and improvement of the enterprise environment are ignored. If Russia is to succeed with its growth targets, substantial and comprehensive economic reforms will be needed, but no such major reforms have been elaborated or are intended. The program does not reflect any awareness that Russia’s main

266 EU’s Press Release: EU-Russia Summit Brussels, 11 November 2002
268 Russia’s 2020 economic strategy ‘too optimistic’, RT, 04 October, 2011
problem is its huge, inefficient, and corrupt public sector. In his recent article about the economy, Putin writes: “It is often argued that Russia does not need an industrial policy and that, when choosing priorities and creating preferences, the government often makes mistakes by supporting ineffective players and getting in the way of the innovation that should stem from equal competition. It’s hard to argue with such assertions, but they are valid only if all other conditions remain the same. We went through de-industrialization and the economic structure is severely deformed. Large private capital does not willingly flow into new sectors – in order to avoid higher risks. We will certainly use tax and customs incentives to encourage investors to allocate funds to innovative industries. But this could show its effects several years from now – or not if more attractive investment options emerge in the world. Capital, after all, does not have borders. Are we ready to put Russia’s future at such great risk for the sake of purity of an economic theory?” And moreover later in the same article he claims “The successful economic modernization experience of such countries as Korea and China shows that a push in the right direction from the government is necessary, and that the outcome from such a push outweighs the risk of making a mistake.” These quotes show at least two things: first, Putin is not willing to buy the Western competition storyline and second, he sees an increasing role model in Chinese state capitalism. Today’s Russia is willing to welcome Western know-how and capital, but institutionally is increasingly looking eastwards and is more likely to adopt the “China model.” In any case, if Russia is serious about upgrading and diversifying its economy, the European Union should be open to assist Russia in such endeavors. However, in offering assistance with know-how, technology and energy assets, the EU should make sure that Russia respects its own contracts with the EU energy companies. In the past the EU has often failed to challenge Russia’s disregard for global rules. But before “putting all the eggs into the Russian basket” it should be noted that the EU companies in particular, which turned in healthy profits in spite of their uneasy relations with the Russian state, have been loath to challenge businesses owned by the Russian state. The reason lies in what this study has stressed as the immediate interests of the corporate sector and their reluctance to be locked in legally binding arrangements. Especially for that reason, the EU-Russia ‘partnership for modernization,’ launched at a bilateral summit in mid-2010, could be proof of a EU’s commitment to extending benefits and best practices beyond the straightforward exchange of capital for raw materials. This new ‘partnership for modernization’ aims to harness Western investment and technology in order to develop the Russian economy, reducing its dependence on oil and gas sales while promoting technological innovation. It is notable that to implement this new plan for technological innovation, Russia deliberately relies on investment, know-how and technology from the US and the big EU countries, rather than China. In Mankoff’s (2010) words, “since the West is the principal source of the investment and technology that Russia needs, there is no room for pointless confrontations.” A concerted energy efficiency initiative, where the EU supplies technology and know-how, could help small and medium EU enterprises as well as Russian households and Russian energy exports. A stronger focus on green technologies could depoliticize the energy dialogue on both sides in a healthy way. The European Commission and several European countries have contributed to the World Bank–led Partnership for Market Readiness, which helps countries set up carbon markets - the first round of countries includes China, Turkey, and Ukraine (World Bank, 2012 p.423). Even a country in its own right such as Russia, could participate in such initiatives. The EU will be at the epicenter to pursue what Medvedev has termed “modernization alliances” - in which Russia offers investment opportunities and greater political cooperation in exchange for foreign capital and know-how (Mankoff, 2011). Yet, if Moscow fails to address state meddling in business, widespread corruption and shortcomings in the rule of law, one can hardly expect that Russia will succeed to diversify away from hydrocarbons and minerals. Without the needed reforms of law enforcement and the judiciary and curbs on corruption, Medvedev’s visits to silicon valley will turn out in vain, because Russia will fail to create incentives to attract the capital, technology and expertise needed to take on exploration and development of geologically promising but nonetheless

challenging areas onshore and offshore. In the last years, the continuing lack of clarity about property laws, licensing and tax legislation basically meant that the investment climate has remained unfavorable, especially for foreign firms. A lost opportunity considered that technological advances depend on the availability of financing and innovating capability. As explained incisively by Maugeri (2012), the projections of oil and gas shortage in the first decade of this century were wrong. The apparent shortages were merely the result of meager investments in exploration and development during the 1980s and the 1990s. He explains, not only are fossil fuels known resources still huge but they are also bound to increase over time in step with technological advances and recovery, as the shale gas revolution in America has shown and, in his view, as the tight oil revolution in America is about to demonstrate. Russia, despite sitting on over 30% of global gas supplies and on unconventional reserves that are estimated to be ten times larger than the whole of Europe (Hulbert, 2012), is heavily reliant on Western technology to boost its energy extraction and develop its promising resources. Unless Russia develops domestic know-how, it will fall in a dangerous position where its capacity to hire such services and to purchase required technologies will be highly dependent on the revenues from oil and gas exports and thus, in turn from high levels of oil and gas prices. A combination of binding domestic regulations and an improvement in managerial expertise will be needed to seriously obtain the above-mentioned goals of modernization and diversification of the Russian economy. If such reforms were to happen domestically in Russia, they would make the EU–Russian modernization partnership a more meaningful term.

9.7 Conclusions
This chapter has discussed the most fundamental challenges that the EU and Russia will be facing in light of the changing paradigms in the gas markets, but also in light of the changing paradigms in the global political order. The chapter has argued that the current transition in the natural gas contractual and pricing structures will widen the gap in the immediate interests between the EU’s corporate sector and Gazprom, which will entail even stronger governance challenges and make the multilateralization of the EU-Russian energy relationship unlikely. The companies will operate in rapidly changing and highly uncertain environments and the volatility of the gas markets will enhance their willingness to maintain free hands from multilateralized binding agreements. Currently, the gaps between the Russian immediate interests and the EU’s immediate interests are widening, and in this situation there remains little chance that the EU’s effort to institutionalize the energy relationship through the ECT and/or a new PCA will be successful, because the relationship between the European energy companies and Gazprom is becoming increasingly strained. Besides, the main sentiment inside Russia is that such multilateral comprehensive instruments are of very limited utility and that the actual meetings in the framework of the EU–Russia energy dialogue reflect more a simulation than a genuine effort towards progress.270 It is difficult to make predictions whether a real decoupling of oil and gas prices will happen in the future, in a shorter-term perspective, a hybrid model will be kept and a gradual adaptation of the LTGCs towards more flexibility will be continued. In that situation this thesis emphasizes an appraisal for a new approach, that would entail adopting mid-range agreements, such as the modernization partnership and promote a more efficient and stable cooperation oriented towards concrete goals, that are yet less ambitious on issues like universal values and common views. A growing insecurity in the European gas markets will exacerbate economic and political rivalries among European firms and countries, which will spur a patchwork of state practices at the country level coexisting and even rivaling each other, with the EU Commission-guided approaches trying to subordinate all the others from the top. The private sector approach will fluctuate from somewhat welcoming the EU-level foreign policy

270Authors’s interview with a Russian industry insider, October, 2012
strength in tempering Gazprom, to complaining strongly at specific issues where the national room for maneuver will be constrained by European-level policies. Presently, the logic of the European capitals and the logic of the EU are still far from being aligned. In all, the new gas governance paradigm in the European markets will be characterized by extreme fragmentation and a gradual adaptation to new contractual regimes and new pricing mechanisms. This analysis has examined how certain events can indeed be central to the explanation of paradigm change; in our case the exogenous driver for change that came in the form of the American shale gas revolution, was the crucial event that made the journey towards a more liberalized gas trade possible. This paradigm shift would certainly not have been possible without the European Commission’s regulatory efforts that underpinned, and in the final analysis forced a switch. That in turn made the journey towards a binding multilateral governance institution regulating the EU’s and Russia’s energy relationship even longer and bumpier, giving a symbolic blow to the already troubled EU-Russia’s institutional cooperation. Gazprom and the European energy companies, that are the main drivers in the process of Eurasian energy governance integration or disintegration, will struggle in the years to come on how to narrow the asymmetry pervading their basic interests, which in itself will prevent the creation of a multilateral system regulating the Eurasian gas business.

This chapter has also outlined that within Europe there seem to be a cautious consensus that gas should be “the fuel bridge” that will gradually erode coal’s power, and lead to a more environmentally friendly tomorrow. In fact, in a world where natural gas consumption is growing and by some estimates it may outstrip coal and even oil in a quarter of a century (IEA, 2011) the EU should look for a constructive dialogue with all the producers and particularly with its main supplier. In the current situation of growing gas-to-gas competition in Europe, Russia might feel unfairly discriminated. Thus, it will be crucial for the European Commission to engage Russia in a fruitful dialogue in which the EU should make Moscow feel that its views as a producer are respected as those of an equal partner. As noted earlier, if the US decides to keep its unconventional bonanza at home, the EU for political or economic reasons does not develop its own shale, LNG will not be sufficient to fill the gaps. In that situation, if the EU fails to prove as a reliable customer, in the future it might find itself to compete fiercely for Russian gas with Asia. For these reasons, it is not wise to cut relations with Gazprom. In today’s fragmented and polycentric world, a new challenge will regard incorporating new emerging regions (such as the Asian Pacific) and new global emergencies, such as climate change in a coherent global energy governance system. The question will be whether the new rule-setters, the Asian countries, will want to move to a less cooperative order built on spheres of influence or rather renew and expand today’s system of multilateral governance arrangements. According to Ikenberry (2011), China is increasingly working within, rather than outside of, the Western order. According to this author, China and other emerging great powers do not want to contest the basic rules and principles of the liberal international order; they wish to gain more authority and leadership within it. Regardless of whether this is true or not, the EU and Russia will find themselves together in this new challenge, even more considering that they are both in relative decline, at least compared with the robust and rapid growth of the new Asian centers of power. The common challenges these two blocks will be facing in the coming decades offer, at least in principle, the political opportunity and momentum to align their interests. In sum, the world has emerged to be very much more natural gas prone than oil prone and the state is clearly “back in” in a hybrid model between statism and liberalism, which Goldthau (2012) calls “interventionism.” Energy geopolitics is an integral component on the new system and, as part of it - strategic infrastructure projects are back in the game. If there is a single place in the world where the term energy geopolitics is appropriate, that is Central Asia. The latter is currently the only one region in which all Great Powers are present, albeit some more than others, and is therefore, strategically, the most important region in the world. Geopolitically, the race for Central Asian gas to supply the so-called Southern Gas Corridor from Central Asia symbolizes another chess game that will be examined in the next, and last, case study.
10. The Southern Gas Corridor

10.1 Chapter design

The question of ensuring gas supply security became a growing concern within the EU at the beginning of the 2000s. It was believed that Europe would need much more gas in the future, and that new pipelines were needed to meet this growing demand. In fact, as far as the 1970s the overall strategy of the European gas market was based on the idea of continuous consumption growth. The European efforts to diversify energy corridors and suppliers in order to reduce the dependence from Russia became increasingly important in the late 2000s, setting up many projects driven by political aspirations to reduce the so-called “Russian risk.” The latter is at the heart of the EU’s ‘southern corridor’ strategy, which aims to connect the European energy market to the Caspian gas-rich regions. If Europe is to diversify on the basis of gas from Central Asia and the Caspian it seems essential, from the EU’s perspective, to create a fourth gas pipeline corridor through the Caucasus. At present, three main corridors are used to deliver gas to Europe from Russia, North Africa (mainly Algeria) and the North Sea (Norway and the UK). This new corridor would, not only contribute to diversification of supply sources, but also provide new export routes, which is one of the objectives promoted by both the EU and the USA. At the same time, Russia’s long-standing gas disputes with Ukraine and its willingness to remain a dominant player in the European market stimulate its own preemptive pipeline construction (i.e. South Stream) that would enable Russia to remain a sufficiently large supplier in a position to manipulate somewhat the market value chain. Officially, the only goal of this expensive alternative is to meet, as it was still believed in 2006, the increasing European demand and avoid the “transit risk” that Ukraine has been posing.

The aim of this chapter is to review all the propositions that have been made throughout this study, while devoting attention to the more specific case of the southern gas corridor. This case displays great analytical utility because it encompasses all the conceptual elements that we have seen in the past chapters and in light of the empirical analysis it sets the ground for the concluding comments. The main goal of the chapter is not to discuss descriptively the latest chances of one pipeline to be built vis-à-vis the other, although an up-to-date assessment of the race for the southern corridor will be provided. Rather, the objective is to look at the key research question of this study, that is, why there has been such a shallow institutionalization of the EU-Russian energy interdependence, through the prism of the developments in the Southern Corridor. In that sense, the motivations of the key actors and an evaluation of the stakes that they place on the implementation of their plans will form the core of the analysis. In other words, the case study is embedded in my conceptual framework elaborated in Chapter 5. In light of the empirical evidence collected throughout the research process, this Chapter asks: Why has Nabucco not been realized and it probably won’t be in its original form despite an extraordinary popularity and political backing at the EU (and the US) level? Is South Stream designed as a foil to Nabucco? Who are the winners and who are the losers from the various alternatives to Nabucco and from South Stream? Whose will is indispensable to get these pipelines built? In order to answer these questions we will employ the three-fold analytical task undertaken in the previous chapters, in sum:
1. Identify who are the main actors in the case study under empirical examination

2. Identify what triggers their action: is it the pursuit of profit or rather what they perceive as gas supply security (keeping in mind that decisions made in the gas business have long-term consequences due to the fixed nature of the pipelines and the large scale investments needed to make them happen).

3. Assess the consequences of their decisions

The empirical research has two main orientations. Firstly, to review the Southern Corridor debate from the three lenses of IR theory discussed in this study, to challenge these established assumptions and to place my views within the scholarly debate. Moreover, this chapter aims to make four major analytical points:

1. This study contends that firstly, by framing Central Asian politics in terms of timeless imperial competition, one is unable to disentangle the empirical reality on the ground and falls into simplistic geopolitical judgments. For example, empirical evidence shows that the Central Asian states no longer have passive roles, but are important players in their own right, especially in the energy sector. The ‘race’ between the Nabucco and South Stream pipelines is typically portrayed as the latest episode of the supposed “New Great Game,” or an empire-style competition where the main actors are Russia, the EU and its member states. By conceptualizing the present day energy rivalry over Central Asia and the Caucasus as an epic story of bitter rivalry between the Majors: Russia, the EU, single member states, China and India, whose battlefield can be controlled, co-opted or bought, the roles of the local rulers and governments have been either systematically neglected or relegated to a status of an input.

2. The whole debate about what the European Commission has done thus far and what it ought to do has been muddled and short sighted. The role of the EC is limited by the very peculiar design of the European Union, which prevents the EU to act legitimately as a broker of the “common interest” in foreign policy concerns and illustrates its limits in influencing the will of third countries.

3. In the world of natural gas, given that pipelines are fixed investments, geography matters a great deal. The intersection between geography and politics and the way it influences energy deals matters. However, there are still immutable rules of commerce regulating these energy relationships. Investors look at “risk and return” before embarking in the construction of new pipelines, which are herculean undertakings in terms of money and risk invested. Therefore, popular geopolitical assessments pointing to incursions and sieges, plots and betrayals that are totally divorced of the commercial realities on the ground, are material for intriguing journalistic stories in both Russia and the West, but should not find room in serious academic analyses. In complete acceptance of the argument advanced by Baev&Overland (2010) and contrary to received wisdom, the parties to the pipeline projects are involved neither in a classical geopolitical competition with an energy twist, nor in a straightforward economic competition for profits to be gained from privileged access to the south-eastern quarter of the European energy market.

4. It would not be an over-exaggeration to say that during the last decade the ‘technology factor’ helped transform the energy map of Eurasia. This exogenous factor, compounded with the deep economic recession that hit Europe, reshaped the planned pipeline geography of Europe. However, among most of the key actors, energy experts and those who are in the position to take long-term investment decisions, the impact of technological developments has been treated more as a surprise factor, let alone understood or predicted.
To provide a good illustration of the empirical reality and answer the questions indicated above, over 10 semi-structured qualitative research interviews were conducted with government and non-government energy experts primarily via the phone and with a field trip to Brussels. Secondary source material in English and Russia was also collected from these informers and organizations. Field research allowed for extensive discussions with government and industry energy experts in Brussels. The nature of these interviews was formal and off-the-record for the most part.

10.2 Introduction

The abundance of natural resources, mainly hydrocarbons, in Central Asia and the Caucasus region, immediately after the break-up of the Soviet Union attracted Russia, as the traditional legacy player in the region, but also the United States and Europe, China, India and Pakistan. Since the early 1990s seeking sources of oil and gas not subject to Russian control has been central to the American energy diplomacy, especially during the Clinton administration. The most renowned example of this approach is the active engagement of the United States in the so-called Nabucco project to connect the European energy market to the gas-rich regions in the Caucasus and Central Asia free of Russian intermediation. In the words of an American official: “It was and it is not an ‘anything but Russia’ pipeline policy as much as a ‘pro something-else’ diplomacy.”

Rhetoric aside, the construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the Baku-Tbilisi-Erzurum (BTE) gas pipeline are two notorious examples of this approach, regarded by the Russians as “avoid Russia” energy diplomacy. As noted by Guillet (2011), the BTC from the Caspian Sea to Turkey’s Mediterranean cost is a perfect illustration of how a sustained effort to privilege one project over another can succeed. The oil companies (led by BP) developing the ACG fields in the Caspian Sea near Baku needed a large capacity (1mb/d) export route and had various options, via Russia, Iran or Georgia. Iran was seen as the easiest and most profitable route but was ruled out quickly because of US sanctions. In Yergin’s (2011) words, “There was an option to go south and deliver oil to refineries in northern Iran which would supply Tehran. And then swap the equivalent amount of oil from fields in the south of Iran for export via the Persian Gulf. Hence, it would not be necessary to build a pipeline through Iran. Such a swap was the least cost option in economic terms. But it was wholly unacceptable to the United States and other Western countries, and thus a complete nonstarter.” This case demonstrates that politics can indeed eliminate or promote projects and that diplomatic campaigns do play a role in building or reinforcing the links required in the gas chain, which is not to say that those can amend the lack of a business case for a project, as it will be shown in the Nabucco case. In the BTC case, it was the strong backing of the Clinton administration, with a relatively weak Russia that built the political momentum necessary for the BTC pipeline and the subsequent gas version, the BTE with a roughly parallel route. In Yergin’s words again: “For a time, it seemed that the United States was the most vociferous proponent of all for Baku-Tbilisi-Ceyhan. Its representatives took every opportunity to argue the case, sometimes with a force that surprised and even shocked other participants in the debate. For Washington, the thought that the main export pipeline could possibly go through Russia was unacceptable. The risk was too great.” Subsequently, a second pipeline was built parallel to the BTC, the Baku-Tbilisi–Erzurum pipeline [also known as South Caucasus pipeline (SCP)], to carry gas from the offshore Caspian Shaz Deniz field to Turkey. With these two pipelines, the Russian monopoly over transit of Caspian gas was

271 These interviews were conducted following the general interview guide approach in order that the same general areas of information were collected from each interviewee. Interviews were conducted with, heads of businesses, high officials both in Russia and the EU and influential energy experts. Due to the sensitivity of the information, most of the information obtained during interviews was ‘non-attributable.’

272 Interview with the Author, October 2012, Boston, USA
273 See Belova (2010), Tomberg (2009)
eroded, and the first step of what was dubbed the Southern Corridor running from the Caspian and Central Asia through the Caucasus on to Turkey and the EU, was completed.

Throughout the 1990s Europe showed more timidity than the US in directly challenging Russia in what the EU regarded as an area of Russian privileged interests. The EU’s approach was said to be different, working with rather than against the grain of Russia’s influence in the region (Youngs, 2009). While neo-realist interpretations hold that European timidity is due to its weakness as a geopolitical player, liberal interpretations stress its structural unsoundness and notorious divisiveness. Furthermore, constructivist theories suggesting that identities and interests are interlinked, points to the lack of a common European identity preventing the formation of more coherent practical interests at a European level, and hindering a strengthened perception among old and new member states of a shared risk associated with Russian supplies. Liberals and Constructivists have criticized the EU’s policies in Central Asia and the Caucasus for being too fragmented, project-driven, focusing mostly on technical assistance and being moralistic instead of seeking a more strategic and long-term perspective of cooperation. According to scholars such as Umbach (2011), Barysch (2010) and Marquina (2008) the EU failed to develop a consistent political strategy, especially in the crucial energy domain. These observers have criticized the EU’s policies for being inconsistent and passive, almost to be attributed to the incompetency and the inability of the European diplomats to notice the strategic importance of the area. That is not to say that the EU’s values-based putative engagement in Central Asia and the Caucasus was not hesitant and ambivalent, definitely lagging behind the US engagement despite the latter’s negligible interests in the area’s energy resources (although if one considers the participation of US companies in almost all the major development projects in the area, America’s interests are to a certain extent as dependent as Europeans on a Caucasus route). Yet this chapter stresses that a more nuanced view is needed on these processes. It is hardly a plausible proposition that the EU did not do much to push for its preferences and to some extent beyond of what is its legitimized role as the EU’s executive, with still limited powers in matters of foreign and security policy. In the 1990s, the European Commission created the program of Technical Assistance to the Community of Independent States (TACIS) to support the development of the post-Soviet countries. Two components of this program covered cooperation with Armenia, Azerbaijan and Georgia: TRACECA and INOGATE, which focused on, among other areas, improving the energy transportation network, guaranteeing energy supply and coordinating investment in pipeline projects. In 2004 the EU launched the Baku Initiative, which was focused on European regulation, although the real incentive were the EU’s investments to the Caspian countries in return for energy supplies. However, it was in 2006, following the Russian-Ukrainian gas conflicts that the Nabucco project, which has been in planning since 2002 was put onto the list of priority projects by the EU. At the time of the crisis, roughly 80% of Russian gas exports to Europe transited through Ukraine. The crisis reinforced the European considerations on the importance of strengthening direct relations with Central Asia. The stated goal was to lower the EU’s “dual dependence” on Russia: first on Russian supplies, second on the Russian transit of supplies from the Central Asia region. In 2007, a European strategy for Central Asia was approved and in the spring 2007, the Nabuco project was accorded highest priority as laid down in the guidelines for trans-European energy networks (TEN-E). In fact, a major effort was undertaken at the EU level to diversify both energy corridors and suppliers, in order to reduce dependence on Russia. According to the neo-realist traditional perspective reviewed in this study (Chapter 5), the European Union perceives diversification of supplies almost exclusively as a means to increase energy security, since Russia, allegedly, is not a reliable supplier and one that could use the “energy weapon” against its main customer; thus, Europe’s overdependence on Moscow threatens this security. In more “down-to-earth” realist and liberal versions, this idea goes along with European skepticism about Russia’s ability to provide enough fuel for the growing needs of the EU economy due to Gazprom’s Kremlin-backed risky strategy to secure foreign markets and strategically lock
up reserves, which has apparently pushed the company to its financial limits (Goldthau, 2010; Henderson, 2012). Essentially for these reasons, the Nabucco pipeline became the cornerstone of the EU’s strategy to tackle the impending ‘Russian risk.’ Around the same time, in the Russian view, in response to the EU’s attempts of “pushing Gazprom out of Europe” (Tomberg, 2009) and in order to diminish the “transit risk” given by Russian dependence on ‘unreliable Ukraine’ to deliver its supplies to Europe, Gazprom and the Italian Eni signed a MoU on the construction of an offshore gas pipeline, South Stream in the Black Sea, in addition to their collaboration over Blue Stream. This bilateral agreement received much criticism from several member states, some of which later joined the project, in fact proving that “lone rider” cases are still not exceptions, due to the companies’ incentive to make profits. In 2009 a new Russo-Ukrainian gas dispute exploded in the middle of the winter, in addition to the already controversial 2006-crisis. The dispute this time lasted several weeks and marked the first instance when Gazprom completely halted the flow of gas into Ukraine. Proponents of both Nabucco and South Stream used the crisis as an argument in support of their own project (Abdelal, 2011). Thus, ever since 2009 up to this writing the Nabucco and South Stream projects have provoked a fierce race, which in both projects damaged the normal procedures of preparation, regarding precise calculations on the effectiveness and crucially about acceptable margins of return, leading to a ‘pipeline battle’ that often defied the common sense. In the blunter words of a Russian reputable energy expert: “These projects are more symbolic, they do not make commercial sense. Yet, too many political careers were bet on them. The situation is absolutely symmetrical, both in the case of the Southern Corridor projects and South Stream. For Russia it now becomes more and more obvious that there is no additional demand for gas in Europe and that it will be extremely difficult to market this gas, but too many political announcements were made, too many political offers were involved…So we are left with an ironic situation where actually both parties (the EU and Russia) have to spend several billions of Euros, just to save their faces.”

In the next sections, we will review the stillborn Nabucco project (Finon, 2011) and the herculean South Stream, with a focus on the analytical points evinced at the beginning.

10.3 Synopsis of Nabucco

Nabucco has been in planning since 2002 on the initiative of the Austrian energy company OMV that first identified the opportunity to build a natural gas pipeline across the so-called Southern Corridor to Europe. As documented by Abdelal (2011) the Austrians approached their counterparts at the Turkish energy company Botas with the proposal. Botas and OMV discussed the project with energy companies in the countries along the proposed route: Bulgargaz of Bulgaria, MOL of Hungary, and Transgaz of Romania. Following a feasibility study, the five companies sealed the partnership in June 2004 by formally establishing Nabucco Gas Pipeline International GmbH (NIC), a joint venture with equal national shares headquartered in Vienna. The unusual name of the pipeline was borrowed from the Verdi Opera that the original planners had seen that night at the Viennese Stadt Opera. Nabucco was designed as a 3,900 km pipeline from Turkey to Austria via Bulgaria and Hungary that would carry up to 31 billion cubic meters (bcm) of gas to Europe per year with estimated construction costs of over 7.9 billion Euros. Initially, the 2004 feasibility study estimated the total cost of the Nabucco pipeline to be €5 billion. However, by 2008, the total estimated cost of the pipeline has risen from €5 billion to €7.9 billion as a result of higher prices for steel (Abdelal, 2011). While Nabucco had been planned since 2002 it gained strong political momentum in 2009-10, when in March 2009, against the background of a surging climb in oil prices and the second Russo-Ukrainian ‘gas war,’ the EU breathed new life into Nabucco by allocating $200 million from its own budget to the project. Despite the support of a legion of energy experts, an almost unconditional backing of the European Commission and some

275 Interview with the Author, October 2012
other prominent pro-Nabucco crusaders (i.e. Yoschka Fischer), the project had stumbled over its own inconsistencies, being indeed conceived as a commercial project with an underlying political goal. In the next sections we will review the large number of hurdles that the Nabucco project had to battle, including Turkish transit pricing, unidentified sources of gas to fill the line, no signed purchase contracts, and no secured financing. The greatest uncertainty in terms of price, availability and reliability, that in the final analysis ended up sideling the project was – where would the gas come from to justify such a massive tube?

As noted earlier, in the aftermath of the January 2009 dispute, the EU became a strong proponent of a Southern Gas Corridor independent of Russia. On 8 May 2009 representatives of key Central Asian and Caspian countries, Turkey, and Egypt signed a declaration of support for the Southern Gas Corridor at the Prague Summit. The Prague Summit’s official declaration considered the ‘Southern Gas Corridor’ as part of a ‘New Silk Road’ of transport and energy links between Europe and the Caspian region. In that respect, the Nabucco pipeline project, first proposed in 2002, was expected to play a key role. In July 2009, the governments of the transit countries signed a long-awaited ‘intergovernmental agreement’ (IGA) on the rules that would govern the shipment of gas through Nabucco. By March 2010, all of them had ratified the IGA and some had started the environmental impact assessments required for the project to go ahead. By the end of 2012 all the environmental permits were granted, yet there were non-regulatory, more substantial obstacles that were impassable for Nabucco.

The next section provides an overview of the debate surrounding the Nabucco pipeline, which at this writing, in its original form i.e. a single pipeline from Erzurum in eastern Turkey to European locations, has been superseded and whose fate offers some lessons. Yet, in the blunter, albeit most appropriate, words of Finon (2011, p.65), “An economic fiasco is resulting from the EU stubbornness, from which lessons can be drawn (...) But the lessons could (perhaps) not be drawn because there are too many subjective premises among the European decision-makers and their advisers, which avoid and distort the political and economic reality concerning gas dependence risk.” The next section looks at the Nabucco saga, while keeping in mind the analytical points evinced at the beginning: the role of the local rulers in Central Asia and the Caucasus, the role of the European Commission, whether we observe a preponderance of geopolitical motives or rather something else, the supposed divide between new and old member states and the role of exogenous factors influencing the likelihood of massive investments.

10.3.1 Nabucco’s hurdles

Nabucco encountered several difficulties, the main obstacle boiling down to the question of its resource base. As previously underlined, Nabucco was supposed to attract the gas of Western and Eastern Caspian countries and later on the Middle East gas-rich countries. Neither at the establishment of the Nabucco consortium nor afterwards, long-term contracts have been signed by gas producers and European members of the consortium. As noted by Finon (2011), to be economically viable, the project, which requires a high upfront cost of €8 billion, would have needed an annual flow of at least 20 billion bcm as soon as it started up. At the origin, promoters of the project bet first on the Azeri gas from the existing Shah Deniz I production and the future Shah Deniz II project to be developed in 2011, to be subsequently shipped by the BTE pipeline. Secondly, they were eyeing the Turkmen gas. However, being Azerbaijan the only one country in the Caspian that has largely escaped Russian control, the Nabucco consortium could, in principle, but even that not entirely due to Azeri’s games, only count on Azeri gas. In 2011, the Nabucco shareholders appear to have

presented Shah Deniz II sellers an offer to purchase 21 bcm of gas for shipment through Nabucco. However, Shah Deniz has only 10 bcm to sell. That implies that more than just the Azeri's 10 bcm would be required in order to make the project commercially viable. In theory, the line could draw on a variety of suppliers in an arc going from Russia, the Caspian, Iran, Iraq, and even Egypt. In practice, the problem is that while all of these countries or regions might be able to contribute gas in the long run, a combination of political and practical reasons mean that only Azerbaijan – and perhaps – Turkmenistan – can be considered as Caspian region suppliers in the medium term; it is also the reason why northern Iraq was considered the only significant medium-term Middle East supplier for Nabucco. However, Turkmenistan contracted itself eastwards, leaving the EU in a situation where paradoxically, in the absence of non-Russian resources, the viability and the profitability of the pipeline could be guaranteed only if Gazprom was invited as a partner. However, that would be unacceptable by the Nabucco alliance because the whole point is to diversify away from it. Or in the Russian perspective, as Belova puts it, “to keep the Russian Eastern Corridor and a non-Russian Southern Corridor distinct from one another simply for the sake of conceptual purity.” In addition to the recent and increasingly growing literature on elite opportunism in the countries of Central Asia and the Caucasus (see Junisbai 2009, Cooley 2012), this chapter suggests that Central Asian rulers act as rationally motivated actors, who have learned to play the great powers off one another for their local benefit. For example, even the Azeri government as the most secure of all the above-mentioned supplies to Nabucco, has always refused to provide any guarantees that the Shah Deniz II gas will be available for that particular pipeline. In principle, Azerbaijan has voiced support for Nabucco, although in practice its concern is to ensure it can export its gas to the EU by whatever means seem most attractive, whether it be Nabucco, ITGI (now out of the race), TAP or even as LNG across the Black Sea to Romania. To complicate the situation, Baku and Ankara have been involved in a bilateral dispute about gas prices, volumes and transit fees that has a deeper and more intractable political background, which ended up delaying the coming on stream of the second phase of Shaz Deniz, because companies simply stopped drilling until the dispute was resolved (Barysch, 2010). In the meantime, Azerbaijan committed to sell a 0.5 Bcm of gas a year to Gazprom, in response to the Russian company’s overtures (Abdelal, 2011). What is more, Shah Deniz II was unlikely to produce significant volumes of gas much before 2017 anyway, which meant that Nabucco desperately needed Turkmen gas to fill the gaps and run at full capacity. But Turkmen gas was not available as long as there were no means of transporting it via a pipeline under the Caspian Sea, which would then feed into the Nabucco pipeline (see figure 19).

279 Turkmenistan is currently exporting a remarkable 20 bcm to Iran, and 40 bcm to China (currently 13 bcm). Since the existing export capacity to Russia is more than 65 bcm, Turkmenistan does not have the material capacity for additional exports to Europe. Moreover, it now has a diversified export portfolio and sufficient export capacities.

280 See Belova, M. The Southern Corridor – Not without Russia? In K. Linke and M. Victor (eds.) Beyond Turkey, Friedrich-Ebert-Stiftung, November 2010

281 While that is the only gas in the region that would be readily available to feed the southern corridor.
Since the early 1990s a plan for such a pipeline over the Caspian Sea has been discussed via the proposed Trans-Caspian Pipeline (TCP). In June 1998, a consortium including Amoco, GE Capital and Bechtel Enterprises came together to sponsor the TCP project, which involved a 750-mile new-build pipeline from Turkmenistan through the Caspian Sea to Azerbaijan and onwards to the Turkish BOTAS gas pipeline network. From there, gas was supposed to transit to markets in Europe. TCP enjoyed considerable inter-governmental support among core host governments; Ankara in particular was a keen supporter as was the United States. But when the Shah Deniz Field in the Azerbaijan sector of the Caspian Sea was discovered in 1999, and because of the sustained opposition by Russia, which tried to block the development of the new pipeline from the outset (formally on environmental grounds), the Azeri withdrew their support for TCP. As documented by Yergin (2011), in 1995 the Azeri President Aliyev gave his instructions to the international oil companies operating in Azerbaijan, “nothing should be done that would “alienate” the Russians. It was too risky.” And indeed, in the past twenty years the TCP has been systematically undermined. The project touches a raw nerve not only with Russia, but with Iran as well, with both Iran and Russia insisting that a settlement of the Caspian Sea legal status is required before any such projects are considered. In the words of a Russian influential energy expert: “People have been talking about this project for the last two decades. Still, unless the legal status of the Caspian is settled everybody realizes that is too risky to start any construction. Any attempt at laying pipes across the Caspian Sea, which ignores the interests of other countries, may provoke a harsh reaction – especially from Iran, which would not exclude a forceful response to such attempts. Moreover, Moscow too does not exclude the possibility of using force if anybody started to build around this disputable zone, so I think that no insurance companies and no banks will finance or ensure such a project, unless the government of Iran has changed and nobody knows and how it could happen.” In fact, to strengthen their influence and their consensus of interests in the area, Russia and Iran can simply block the process of defining the legal status of the Caspian Sea. But obstacles do not end here, as they also lie in Turkmenistan itself. While various European energy companies are interested in the country, Turkmenistan only allows international oil companies to own reserves in offshore fields – and these have yet to be fully explored and may take more time to develop. In the words of an American civil servant: “Turkmenistan insists that it can develop its vast gas onshore reserves itself but it is not capable of

282 The exploiting of the ‘environmental card’ became common practice in Russia, especially when the interests of Gazprom are encroached. The Sakhalin-II project saga is telling in this respect.
283 Interview with the Author, October 2012
doing so, there is no viable project on those basis.”

Indeed, China’s CNPC signed the one and only foreign onshore PSA in July 2007 to develop a gas field near the border with Uzbekistan. The gas is now shipped through the new massive pipeline constructed through Uzbekistan and Kazakhstan to China. As noted by Barysch (2010), the reason why China was able to get access to Turkmen gas in just a few years is that it offered Turkmenistan not only to buy a lot of gas for years to come but also to build the pipeline, sort out the transit issues through Kazakhstan and Uzbekistan, help with the development of the gas within Turkmenistan and provide the money needed for all this (which Turkmenistan will repay through the gas it ships to China over the years). However, countries like China (and Russia) can use various form of energy diplomacy to attain their goals, ranging from development assistance and aid to bilateral subsidies and preferential loans. Moreover, Gazprom as a state-owned company may hope to rely on political support to achieve its objectives while maintaining its dominant position in the Russian gas market. In contrast, in a market economy the project must guarantee profit to the shareholders and banks. It has to be economical right from the outset, and not just a geostrategic idea. Political interests alone, convincing as they may appear, rarely drive large energy projects. It is an error to believe that just because the political will and the strategic rationale for a certain project are strong enough the gas will flow. Political will is an important condition for realizing a project, but certainly not a sufficient one (Pflüger, 2012). As even the China and Russia cases reveal, the driving force of (energy-related) foreign policy is not necessarily only the Kremlin or the Chinese presidency but may be also, and especially be (see Chapter 6) the headquarters of Gazprom or CNPC. Yet, given the large geostrategic value of energy deals, political support is a welcome factor when cutting deals. In that respect the EU faces two problems; first, the European Commission has not the legitimate powers to act as a broker of gas supplies. Second, although the EU has long eyed Turkmenistan as a solution to the Southern Corridor dilemma, the European companies have been wary in making huge pipeline investments in a country with such a closed and mercurial leadership. Given Turkmenistan's reluctance to commit to onshore production sharing agreements with international companies (the CNPC agreement being the exception that proves the rule), Western businesses are hesitant to make large investments, as they are not fully convinced of the country’s resource estimates and its real intentions. If we imagine a hypothetical situation where the Trans-Caspian is built without ex ante gas commitment to be shipped, anticipating important Turkmen gas shipments, then Turkmen gas companies which are well advised to let the Trans-Caspian to be built so as to widen their options could well end up choosing to contract with another buyer than European gas companies, all the more because there already exists transportation infrastructure to the markets supplied by this buyer. In fact, President Berdymuhamedov repeatedly said that Turkmen gas should go to the Nabucco pipeline "under the right conditions. The question of the sovereign right to choose the energy resource supply route is directly related to defining prices,” said Berdymuhamedov. This should be read as: Ashgabat is ready to sell its gas to the highest bidder. If the EU does not buy gas at the price that suits Turkmenistan, then Ashgabat is willing to reconsider schemes and conditions of supply more gas to Gazprom. Also, the European companies could be left with a contracted pipeline that runs dry, since if either Gazprom or China is willing to provide better terms, Turkmenistan might have no scruples to look at these alternative directions. These problems touch the heart of the dilemma, which was eloquently brought forward by Finon (2011), “In a complete contradiction with its political nature, the business model of Nabucco (and the Trans-

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284 Interview with the Author, October 2012
285 In 2009 China, for instance, provided $25 billion in financing for the construction of a spur on the Eastern Siberia-Pacific Ocean (ESPO) oil pipeline running from Siberia to the Chinese city of Daqing. In exchange, Beijing locked up a twenty-year supply of Russian oil at concessionary prices, political support on an international level, and even military cooperation and arms sales.
286 Such as Russia and/or China, which would only have to offer a little bit more for Turkmen gas and the Trans-Caspian would then most likely run dry.
287 Quoted in Tomberg (2009).
Caspian line for that matter) is the merchant pipeline, which means that the pipeline will be built only on the basis of anticipated gas flows and revenues emanating from an unregulated shipping price. The owners are not related to gas producers aiming to ship the gas volume from new remote fields. In other words, gas producers, which could export to European markets by Nabucco shipping, are not committed in the project. The owners, which are gas buyers, might not in principle reserve capacities in the regulatory scheme of a merchant line. The merchant model is based upon premises of a textbook market economics and its transposition in mature gas systems for the access of new producer to midstream and downstream buyers and for the development of new infrastructure without \textit{ex ante} contracts. This business model is operatory in a mature gas market but not for a transit pipeline towards new remote gas fields in geopolitically unstable regions.” Thus, the Nabucco project is conceived as if Caspian and Middle East productions and European gas markets were completely integrated within a regulatory jurisdiction of the EU-type market oriented legislation. In such a mature market regime there would be no need for an \textit{ex ante} relation between gas producers and gas suppliers, provided by long-term contracts. But this view ignores the basic economics of gas producer and infrastructure development in a non-mature gas system (i.e. Central Asia). A long-term contract with take-or-play clause and price indexation clause on a competitive commodity market allows sharing the risks of an investment, splitting the price risk (remaining with the producer) and the volume risk (remaining with the consumer). Finon highlights that transaction cost economics (TCE) introduces the dimension of the counterpart’s opportunism, which is a risk endogenous to the relation investor-buyer, the so-called ‘hold-up risk.’ For example, from the consumers’ perspective, the South Stream project will be developed (for its submarine section) under the much less risky ‘ship or pay’ model, in which the gas exporter reserves all the capacity (or a very large part of it) on a long period, given that it must deliver its gas at the gas system frontier of its first geographical buyer (i.e. Bulgaria). In Europe these contractual terms, however, are questioned by the ‘unprecedented prevalence of supply over demand’, so Gazprom is compelled to sell a portion of its export volume at spot-market prices. But traditionally, both the European companies and Gazprom have preferred this way of safeguarding the needed long-term relations, or the so-called Groningen model\textsuperscript{288} of contractual structures, which, as the Kremlin-backed Gazprom is keen to remind these days, was not invented by Russia, but by the Netherlands at the beginning of the last century. Every proposition in this energy security agenda goes directly against the vision adopted by the European Commission, whose third energy package repudiates long-term contracts and oil-indexation. Yet in Finon’s (2011) and Konoplyanik’s (2012) eyes, an important condition for the credibility of the counterpart’s long-term commitment is the existence of contractual guarantees which limits its opportunistic behavior: in upstream gas development, in gas fields and infrastructures, these guarantees are offered by common ownership of assets and/or fixed annual remuneration of the investment which act both as hostages on one hand, and indexed value-based pricing on the other, which means that sellers have no incentive to defer when market values increase (or conversely for buyers when market values decrease sharply). Indeed in Finon’s view, which is shared by this author, Nabucco is a political project built on weak economic foundations because it is conceived along the business model of the merchant line without \textit{ex ante} signed long-term contracts between producers and buyers, strongly believing that it would attract new gas sources by itself. Most long-distance gas pipelines are developed by the producers of the gas or by producers in cooperation with consumers. Hence, the combination of take-or-pay provision in the gas sale agreement and ship-or-pay provision in

\textsuperscript{288}Its major characteristic features are: a) long-term contract, plus pricing formula linked to gas replacement values (prices of gas replacing fuels at the consumer-end within competitive energy market), b) regular price review (including both recalulation of the price level for current period under existing formula, and review procedure of the formula itself), c) net-back to delivery point (which means deduction from end-user gas price of the transportation costs from delivery point to the end-user so contracted gas will be competitive at end-user burner tip), d) minimum delivery and take obligations (take-and/or-pay provision - TOP), e) protection from price arbitrage to the detriment of exporter (so-called “destination clauses”), etc.; Konoplyanik (2012).
the shipping contract is both an insurance mechanism upstream for the producer, an incentive to efficient use of gas downstream for the buyer, and a guarantee for the transit pipeline (or the LNG chain which would be the same case) which should be built in partnership with producers’ and buyers’ commitment. In contrast and oddly, Nabucco was developed without the involvement of the gas producers in the development of the transit capacity, but rather as a system capable of carrying gas from a variety of sources to a variety of customers. That, for the reasons evinced above has proven hardly realistic and therefore the pipeline itself is economically and financially unviable. Finon’s incisive analysis has been proven today, where both Azeri and Turkmen potential sellers have opportunistically preferred to sell to other buyers than to the shareholders of Nabuco. More than having mastered the “New Great Game,” Turkmen and Azeri companies and officials are in many ways in the driver’s seat of the new Eurasian energy projects. For example, the Azeri-led consortium that is developing the Shah Deniz II field (the only gas in the region that would be readily available to feed the southern corridor) had repeatedly postponed the decision on whether to sell the gas to Nabuco, ITGI or TAP – or whether it preferred another option altogether. In 2012 it finally became clear that the winner would become TANAP, a smaller pipeline shipping gas across Turkey, to be connected once again to another small pipeline to Bulgaria, where the race is still open between the so-called Nabucco West, a downscaled version of the original Nabucco and TAP (see section 10.6.2 below). In fact, Baku has always stressed that it is much more interested in the diversification of its export routes, embracing what became a famous slogan, “Happiness is Multiple Pipelines,” and that it would prefer to concentrate on smaller pipeline projects, which could be more profitable. As far as Turkmenistan is concerned, although Ashgabat gave positive signals of supporting the Trans-Caspian and Nabucco pipelines, its utilitarian approach to energy relations, the keynotes of which are pragmatism and expediency, made it become the epicenter of the Central Asian multi-vector geopolitical competition. As noted by Nanay (2009), Turkmen unexpected decision to build a pipeline to Iran and a growing Western interest to build a pipeline under the Caspian Sea, paved the way for a more proactive Russian policy toward the country. Especially since 2004 when prices for gas (and oil) started soaring on the world’s market, Turkmenistan felt confident enough to start demanding higher prices. Moreover, in 2006, in the aftermath of the Russo-Ukrainian gas dispute interest in the Trans-Caspian Gas Pipeline project was rekindled. In March 2006, Turkmen President Niyazov signaled his intention to rejoin possible negotiations on the pipeline. Fearing such intentions, Gazprom increased Turkmenistan’s price for gas it purchased from $44 per 1,000 m3 in 2003–5, to $65 in January 2006. Moreover, on 12 May 2007, an agreement was signed between Russia, Kazakhstan and Turkmenistan providing for Central Asian gas to be exported to Europe through the reconstructed and expanded western branch of the Central Asia-Center gas pipeline system. In December 2007 the deal to build a natural gas pipeline along the Caspian Sea coast was finalized. Construction has, however, not begun and critics question whether the pipeline will ever be built due to a frozen European demand and Turkmen’s orientation towards China. In any event, the 2007 deal also set that Russia’s state-controlled monopoly Gazprom gave in to Turkmen price demands and agreed to pay $130 per 1,000 cubic meters of natural gas in the first half of 2008 and $150 in the second half, raising the price Russian paid for Turkmen gas up to 50 per cent. This was seen as a setback for the realization of

289 On 13 July in Ankara an intergovernmental agreement on the Nabucco project was signed by the leaders of the Governments of Turkey, Austria and Hungary and by the Ministers of Energy of Bulgaria and Romania, which gave formal backing to the project by all involved countries. Significantly, the ceremony was attended only by potential transit countries, but not by suppliers. Uzbekistan, Kazakhstan, Turkmenistan and, most importantly, Iran have not accepted any formal commitments regarding Nabucco.

290 Russia Bows to Turkmen Gas Pricing Demand, Eurasianet. Org, September 5, 2006

291 “Turkmenistan gas price rises 50%”, BBC News, 28 November 2007

292 In sum, in order to retain control of the pipelines as a key component of Gazprom’s leverage over Turkmenistan, the company was forced to agree in early 2008 to start paying Turkmenistan (as well as the other Central Asian gas-producing countries) “European prices” for its gas. This decision proved costly for Gazprom as European demand plummeted during the economic crisis. As noted by Barysch (2011) Russia signed these deals at a time when it did not
the Trans-Caspian Pipeline although Turkmen President Berdumuhamedov said that the Trans-Caspian pipeline project was not canceled. In fact, after the death of the isolationist leader Saparmurat Niyazov, Russia has been prepared to offer sizeable increases in the price paid for Turkmen gas in order to secure gas supplies for the domestic market and to discourage Turkmenistan from non-Russian pipeline projects, especially aiming to head-off any possibility of Turkmenistan committing supplies to the Nabucco line. Meanwhile a Turkmenistan-China pipeline was inaugurated in December 2009 and flowed 3.55 bcm in 2010. By 2013, China is planning to buy up to 65 billion cubic meters of natural gas a year from Turkmenistan, while the Russian-sponsored new pipeline project on the eastern shore of the Caspian Sea from Turkmenistan to Russia, which President Putin announced in May 2007, is going nowhere and will most likely never be built. Thus, despite Russia’s great effort to keep Turkmenistan within its control, the latter is planning to beef up the existing gas accord by exporting 65 billion cubic meters (bcm) a year to China, over half of the 2010 gas consumption of China, “in the near future.” This agreement is a case in point of China’s soaring appetite for gas and increasingly strong position in the geopolitics of the region. In sum, the non-realization of Nabucco will be at little cost for Turkmenistan, which is already fully contracted at least until 2020. As noted by Barysch (2010), Turkmenistan has signed export contracts for a lot more gas than it actually produces. For now, there is no gas available for shipments to Europe, and it is unclear how quickly additional volumes may become available. As regards the Azeri, they favor smaller and possibly cheaper pipelines than to wait for the commercially dubious Nabucco to make headway. These countries have no scruple about looking for other outlets than European markets and, as noted by Finon (2011) are definitively opportunistic. Their political expediency (and lack of credibility) ultimately affected the Nabucco coalition more than South Stream itself. Suffice here to say that in apparent desperation at the lack of progress, the Commission in September 2011 secured an unprecedented decision by the EU’s governing Council, mandating it to negotiate a legally-binding treaty with Turkmenistan and Azerbaijan providing for pipeline construction. In the words of a EU diplomat: “All member states gave a mandate to the EU Commission to negotiate with Turkmenistan and Azerbaijan. Since the end of 2011 the EC has been in negotiation with these two countries. The Commission can only negotiate an agreement if the Council authorizes it to finalize such a legal framework with third countries. This is done exclusively on the basis of negotiating directives approved by the Council.” This was the first time such powers had been given to the Commission with respect to an infrastructure project. The sponsors of the Nabucco project could hardly have asked for a stronger political signal to be sent to the Shah Deniz consortium, which in October 2011 received bids from pipeline consortia for transporting its gas to European destinations. But the energy companies both from the supplier country and from the consumer country, which as significant empirical

293 As outlined in the previous chapters, Russia has so far being successful in blocking European diversification efforts and keeping the status quo in the Caspian region, which essentially means two things: Gazprom buys Central Asian gas at one price, transits it to Europe, and sells it for a higher price. Or, Gazprom buys the cheaper Central Asian gas for domestic Russian consumption and saves its own gas for the future or exports it to Europe for a high price. In fact, Gazprom counts on imports of large volumes of gas from Central Asia as its own production stagnates. For now, there is no gas available for shipments to Europe, and it is unclear how quickly additional volumes may become available. As regards the Azeri, they favor smaller and possibly cheaper pipelines than to wait for the commercially dubious Nabucco to make headway. These countries have no scruple about looking for other outlets than European markets and, as noted by Finon (2011) are definitively opportunistic. Their political expediency (and lack of credibility) ultimately affected the Nabucco coalition more than South Stream itself. Suffice here to say that in apparent desperation at the lack of progress, the Commission in September 2011 secured an unprecedented decision by the EU’s governing Council, mandating it to negotiate a legally-binding treaty with Turkmenistan and Azerbaijan providing for pipeline construction. In the words of a EU diplomat: “All member states gave a mandate to the EU Commission to negotiate with Turkmenistan and Azerbaijan. Since the end of 2011 the EC has been in negotiation with these two countries. The Commission can only negotiate an agreement if the Council authorizes it to finalize such a legal framework with third countries. This is done exclusively on the basis of negotiating directives approved by the Council.”

294 BP 2011, Gas Pipeline Trade sheet

295 Blagov S. Russia labors at neighbors do deals, Asia Times Online, December 17, 2009

296 China, Turkmenistan sign key gas agreement, China Daily, November 24, 2011

297 In fact, with its neighboring location and nearly insatiable appetite for foreign energy, it was China, rather than the West that broke Gazprom’s monopoly over Turkmen gas and set itself, alongside with Russia, as the most important pole of attraction for the Central Asian states.

298 Yet simultaneously, in the words of Herman Van Rampuy, President of the European Council, “Only action at a European level can lead to operational consistency between the different projects which may come to supply the Union with gas from the Caspian and Central Asia.” - The European Files, Security of Energy Supply in Europe: Continuous Adaptation, May-June 2011, n. 22, p. 6
evidence collected in this study demonstrates, are the main actors in the process, did not
weight in by splitting the risks. Thus, the EU’s reinforced efforts to forge an energy
relationship with Turkmenistan, with high-profile visits of Energy Commissioner Oettinger
and Commission President Barroso to Ashgabat turned in vein. A reminder of how difficult
the process is without a serious corporate sector’s motivation came in August 2012 when the
EU Energy Commissioner Gunther Oettinger, having recruited Turkey to the diplomatic
efforts behind the pipeline, visited Ashgabat to discuss this with president
Berdymukhammedov, only to be refused a meeting (Pirani, 2012). In the straightforward
words of an American civil servant: “The EC got a mandate a year ago to negotiate a trilateral
agreement between Azerbaijan, Turkmenistan and the EU. There has been zero progress on that.
Commissioner Oettinger was in Baku and Ashgabat in September 2012, and particularly in Ashgabat no
progress at all. So I don’t think there is anything happening with the Trans-Caspian right now.”
Generally speaking, resource development in the most prolific regions of the world,
including Central Asia, can only proceed with adequate investment mobilized by the gas
companies. What is striking is that Ashgabat appears to have been more open to signing
service contracts for onshore development with companies from Asia and the Gulf states
than with western oil companies (Petersen & Barysch, 2011). As mentioned above, currently
China is connected to Turkmenistan by a gas pipeline that started operating in December
2009 and an oil pipeline to Kazakhstan (since 2006). Caspian producer countries prefer
looking eastward to diversify their consumer base. Unlike much Western assistance, Chinese
credit does not come with any political demands relating to governance and human rights
and criticisms about cooptation and rent-seeking behavior (although ‘buy China’ clauses are
often part of such deals). But what is more, China has deep pockets and a top down
approach that is able to pass the cost on to consumers. To a degree, the high cost of new gas
export routes could have a negative effect on CNPC’s ability to generate profit on the
Chinese market. Therefore, it can be said that Chinese consumers are inevitably paying for
these projects. All that is not possible with the European projects, where investment
decisions based on political calculations (i.e. Nabucco) inevitably tend to fail – because in a
market economy an unsound business proposition simply has troubles finding the needed
financial investment to sustain it. And as stressed in the previous chapters, the EU is not a
geostrategic actor per se, able to further a foreign policy will corresponding to the ‘common
good’ of 27 member states. Thus, it is questionable how far one can go with the Great Game
analogy mainly for two reasons: first, Central Asian states are not passive pawns in a new
‘great game’ (Barysch and Peterson, 2011) but are important players in their own right.
Second, as stressed earlier, the geopolitical reasoning that saturates both expert analysis and
media commentary about Eurasia, tends to ignore some of the underlying economics implicit
in these relationships. In analyzing the empirical content of these dynamics, one should not
overestimate the importance of politics in the development of Central Asia’s resources:
political agreement is only one “instrumental but not decisive” condition for complex
pipeline projects to be realized. A number of other criteria must also be fulfilled: there must
be major dedicated volumes of oil and gas for the pipeline; a large enough company must be
committed to leading the project; and the investor(s) must assess that the pipeline is
economically viable and superior to alternative transport routes. Even for a country like
Russia (and China), efforts are driven by both the government’s strategic considerations and
Gazprom’s commercial motives. Both are deeply intertwined. But as Chapter 6 has discussed
the NOCs and in our case Gazprom, appears to be increasingly “running the show”: the
geopolitical considerations meet, coincide and sometimescollide with the corporate sector’s
calculations, whose final purpose at the end is either to be generally profitable or to enhance
the profit of certain rent-seeking groups within the company, while passing on the cost on
the consumers. We will explore this in more detail in section 10.5, dealing with the possible
rents captured from promoting the herculean South Stream pipeline.

299 American Civil Servant, Interview with the Author, October 12, 2012
300 See Barysch and Petersen (2011), p.44
10.3.2 The New versus Old member states controversy

This section reviews the split between the ‘Old’ and the ‘New’ member states’ interests, that in the past years remained a subject of intense controversy and which therefore requires further clarification. Many liberal energy analysts have criticized the fact that, in practice, the EU’s energy diplomacy is still embryonic while individual EU countries, in particular Germany, France and the UK are pursuing their own bilateral relations with different Caspian and Central Asian states. One particular corollary of this thesis is that the old member states have safeguarded their amicable relationships with Russia, pursuing their own interests regardless of the smaller and more vulnerable states, making a nonsense of the EU’s solidarity and almenting poisoning relations within the EU. It is often argued that countries like Germany and Italy, to everyone’s contempt were letting the East Europeans freeze, while opportunistically enjoying their honeymoons with Russia (see Barysch, 2010). One example of a bilateral agreement that received much criticism from some of the EU members is that between Gazprom and the Italian Eni signed as a 50-50 agreement on South Stream in 2007. Furthermore, there has been a great deal of controversy, when in 2009 the participation of EDF, a French company and in 2011 the German BASF boosted the credentials of South Stream as a European project (Abdelal, 2011). As Finon reminds, the European Treaty and the gas security directive do not create any obligation for partners to be bound by a common foreign gas policy. It includes four member-states (Austria, Hungary, Romania and Bulgaria), with their national gas companies group relying on an alliance with Turkey, which is not bound by any European membership. In fact, the alliance with this particular country over Nabucco has inspired a lot of noise in the Nabucco troubled path (see section 10.3.4). The fragility of the Nabucco coalition, or at least its lack of cohesion, comes from the absence of truly converging interests inside the EU, but more crucially from the dubious economic and financial conditions surrounding Nabucco’s construction, that made an increasing number of political actors and national companies of Eastern Europe eager to jump on the South Stream vessel in the attempt to protect their respective interests. It is important to note that it is not an insufficient political will that killed Nabucco, but rather, the project stumbled and fell over its own deficiencies. A well-known argument advanced by Eastern European countries is that diversification is key in order to thwart dependence on Russian imports. Again, the dichotomy seems to run between countries that aspire for common action in the form of Nabucco to reduce dependency on Russia, while others that already have a relatively diversified energy supply consider the Russia-led South Stream as the more feasible and realistic project to enhance supply security (i.e. Italy, France and Germany). For most Southeast European states options are few and usually involve higher costs, especially if one takes into account that they require the construction of costly infrastructure (pipelines, compressor stations, LNG terminals). For example, in the mid-1990s the Czech republic constructed an oil pipeline connecting the Kralupy and Litvinov refineries with Ingolstadt in Bavaria. The purpose of that investment was to diversify the sources of supply. Yet the plain economic fact remains that the Czech Republic has committed itself to importing oil from Germany, as well as gas from Norway, and that both are more expensive than what Russia was and still is supplying; so in strictly financial terms, the investment in this particular energy infrastructure is a net loss, or at best an expensive insurance (Baev&Overland, 2010). Given the economic logic behind the maintenance of energy relations with Russia, very often, the fierce anti-Russian rhetoric in most of the East European countries amounts to not more than noisy parlor. This empirically significant

301 While it is true that the other players (i.e. China, Russia and to some extent to US) have played in line with its geopolitical realism, in seeking to diminish the others’ influence and securing the largest share of the cake for themselves, the EU on the contrary, has emmeshed itself in a complex mixture of democracy, human rights and energy narrative in dealing with Central Asian states that has been hard to reconcile and whose interplay has only complicated the already complex picture. Yet the difference stems from the fact that the EU does not possess the instruments of a classic state to further its interests, and despite seeming incoherent and disorganized compared to the other, it has even exceeded its legitimate powers while trying to further its interests.
pattern is captured in the way Nabucco’s already fragile alliance crumbled. Actually, it was quite an easy game for Gazprom to deter the interest of Nabucco’s investors; once they realized that South Stream offered not only serious competition but also a more rapid construction schedule and defined supplies of (Russian) gas, all of which Nabucco did not have. As a result, by 2008 all the countries of the Nabucco Consortium were leaning toward South Stream, with Serbia, Slovenia, Austria, Bulgaria and Greece welcoming the project as a significant additional route that would enhance the EU’s energy security, despite their high vulnerability on Russia.\(^{302}\) Between 2007 and 2009 the Russian Federation signed intergovernmental agreements with Bulgaria, Serbia, Hungary, and Greece, also negotiating with Slovenia and Austria, and consulting with Romania. These intergovernmental agreements stipulated establishment of joint ventures on a parity basis between Gazprom and a company designated by the government of each country. The first task of these joint ventures would be to conduct individual feasibility studies for the gas pipeline construction in each country, to be consolidated afterwards so as to make an investment decision on the project. Hungary, a country that initially fully supported the Nabucco line made an impressive U-turn in its foreign policy that exemplifies the complicated set of relations between energy projects, energy firms, governments of former Communist states, Russia, the United States, established European states, and pan-European institutions (Abdelal, 2011). In an illustrative example shown by Abdelal, in February 22, 2008 at their meeting in Moscow with the Hungarian officials, Russian government officials and Gazprom executives pressed for a 51% stake in the joint venture and various tax breaks. The Hungarians refused to acquiesce and left, a move that was applauded by the EC and the disparate camp of Nabucco promoters, including Poland and the Czech Republic that have no material interest in this pipeline, the United States and the UK.\(^{303}\) But when, barely a week later, on February 28, Hungarian and Russian ministers signed the agreement in Moscow, flanked by Prime Minister of Hungary Ferenc Gyurcsány and President of Russia Vladimir Putin, the EC recoiled. By mid-2009 Gazprom has successfully won the support by some of the key governments committed to Nabucco, Bulgaria and Hungary included. Both were committed to the South Stream project, despite the apparent conflict of interests with their Nabucco commitment. In that respect, although the official point of view of both the Russian authorities and Brussels has always been that two pipeline projects are not competitors, at the same time, the accelerating race to see which of the projects would be launched sooner, did not correspond with such a restrained position. Thus, by mid-2009 the most vulnerable East European countries, precisely those for which the Nabucco pipeline was promoted as indispensable i.e. Bulgaria, Hungary and Serbia, all agreed to play an instrumental part in the construction of the South Stream pipeline, further undermining Nabucco. But what made Nabucco an unviável proposition is, contrary to received wisdom, the fact that in the final analysis political factors are of far less importance than business rationale in the construction of a pipeline. While member states frequently couch policy proposals as in the ‘EU interest’ to enlist the support of other member states there is no real indication that a concern for the ‘common EU good’ is driving their national foreign policies. Rather, it appears that member states pursue their national interests by whatever means possible, with both small and large states following their national policy preferences and ‘profit interests’ regarding Russia. And it is an error to unduly charge the European Commission for lack of cohesion or insufficient political commitment as some liberal scholars criticize (see Barysch 2010, Umbach 2011, Marquina, 2008). No amount of European support and backing (which by the way, was already excessive considering the legitimate powers of the EC) would erase the simple fact that the Nabucco pipeline ignored the gas economic fundamentals. It was not a project that would have generated sufficient returns and that entailed a reasonable amount of risk to be seen as justifying the investment. And to say that return has always looked uncertain in the case of the Nabucco project, is an understatement. The western companies backed by their

\(^{302}\) Countries such as Bulgaria, Greece, Slovenia and Hungary all rely on Russia for more than 50% of their gas imports

\(^{303}\) UK’s unusual support for the EC-led endeavors will be discussed in more detail in the next section
respective states, with every justification, have been wary of the European Commission assuming a role in procuring gas supplies in this way. Especially considering that the European Union, until September 2011, did not have a mandate consistent with democratic deliberation to act on behalf of the member states and has very little experience in the energy diplomacy toward third countries. In the more eloquent words of Baev and Overland, “The Commission has tried to define and implement Nabucco as a ‘common good’ project—in an area where it lacks both the means and the necessary experience.” The Nabucco project was backed by an unusual number of crusaders producing a plethora of politicized articles urging the EC at diversifying at any cost, which ended up in what, as it was warned by Finon, “a stubborn carrying out of the project until the very end to show European determination, only to prove the economic fiasco from this intransigence and demonstrating to the world the European geopolitical powerlessness in foreign gas policy.” Most crucially, the Eastern European countries for whom this European diversification policy is supposed to act for, were at the same time enjoying their close relationship with Gazprom over South Stream, showing that the European Commission and the United States were indeed “trying to be more Eastern European than the Eastern Europeans in thinking about the region’s energy security.”

This thesis agrees with those energy experts arguing convincingly that the EU should have refrained itself from naming and promoting (it finally did when the fiasco of its policies was evident to everyone) Nabucco as ‘the flagship project of the diversification efforts of the EU,’ and who are not keen for the EC getting entangled in attempts to strengthen authority over the EU energy business (see Baev&Overland, 2010; Finon, 2011; Van der Linde 2008). Drawing on empirical evidence, this study shows that the legitimate role of the EC has been often overestimated and little understood. We will attempt to examine this complex debate in the next section, in order to understand better what the role of the EC is and what it ought to be.

10.3.3 Role of the European Commission: honest broker?

A large body of scholarship has attributed Nabucco’s failures to the slow dynamics within the European Commission, to the EU’s inconsistent political backing, hesitancy and meager financial support (Barysch 2010, Umbach, 2011). It is this author’s opinion that these assertions require a more nuanced examination: first, the institutional structure of the EU, and of what the latter can legitimately do within its powers. Second, a review of what the EU has done to support Nabucco and third, in light of empirical evidence this section provides an assessment of what the EC ought to do in the future. Despite some progress, at least from the EU’s perspective, on the way to adopt a common energy (foreign) policy as part of the new “External Energy Policy” of 2011, no state was or is still willing to have Brussels dictate the form or type of energy consumed and power generated on a national level. Thus, the external energy policies still remain the prerogatives of the twenty-seven member states.

Within the EU’s multilevel fora each member state, after all, zealously defends its own agenda. To make things more complicated, the above-mentioned cleavage among member states is compounded by the EU’s rivalry with national governments in gaining a larger say regarding the member states’ external energy strategies, which for now, are still tackled in the realm of the CFSP at the European level. However, the European Commission has developed its trilateral approach to energy security that aims to respond to the so-called triangle of competitiveness, environmental protection and security of supplies; that the Commission intends to tackle simultaneously. The basic question of what are the EC’s priorities remains a mystery as equally obscure as the question of how the EC will go about reaching its ambitious goals simultaneously. In any event, there is a core composed by three pillars: diversification, liberalization and sustainable development. It is worth noting, starting with the last, that the environmental policy is by far the most advanced aspect of the EU’s

Paraphrasing the US Special Envoy for Eurasian Energy, Richard Morningstar’s comment in Abdelal (2011)
triangle. It is a policy domain where the EU has been invested full powers, thus the climate and environmental policies are managed fully by the EC’s supranational authority. The same can be said by the liberalization element; here the role of the DG Comp is critical in the forming of the European internal energy market. The DG Competition is one of the several constituent departments of the European Commission. The latter is one of the politically most powerful directorates, which has been largely responsible for drafting the European energy directives packages and promoting the liberalization and the famous unbundling of the internal energy market. That said, it must be admitted that external energy policy still remains a national – rather than EU – competence. Therefore, the EU’s politicized meddling, prior to obtaining a mandate in September 2011, in the attempt to get the Nabucco pipeline on stream was not consistent with democratic deliberation. Therefore, this study disagrees with the number of pro-Nabucco influential experts persistently arguing that Nabucco failed due to insufficient political backing on part of the EU and its passive position adopted with respect to the development of the fourth Caspian corridor (Marquina, 2008). This stance is reflected in the following comment by an inexorable Nabucco proponent: ‘The Europeans should get serious about the political nature of the southern corridor – in which case they should make it clear that Nabucco is a public policy objective as much as a private commercial project (…) There are a number of arguments why Nabucco is more than just another pipeline and therefore warrants political backing and public financial support’ (Barysch, 2010). It is important to note that in spring 2007, the project was accorded highest priority as laid down in the guidelines for trans-European energy networks (TEN-E). Within this system, the European Commission has given significant support for Nabucco in a number of ways. First, the European Commission (based on a mandate from the 27 EU states) was actively involved in the negotiations between the Nabucco consortium and the supplier countries. As result, an intergovernmental agreement lasting 50 years was signed in July 2009 and later ratified by the state governments and the parliaments of the EU members involved in Nabucco, as well as by Azerbaijan and Turkey (Kusznir, 2011). The consortium also received financial support: European banks were willing to contribute 4 billion Euros (2 billion of which came from the European Investment Bank, 1.2 billion from the European Bank for Reconstruction and Development, and 800 million Euros from the International Finance Corporation). Moreover, the project benefitted from the exemption of the third-party access provision for gas infrastructure projects for half the capacity (in Austria, Bulgaria, Hungary, and Romania), for which Nabucco applied and was quickly granted, contrarily to South Stream. In fact, the Commission provided sufficient finance to carry the project through all the preliminary feasibility and detailed engineering study phases (Roberts, 2011). All that, while the official position of the European Commission was shifting into a ‘Nabucco neutral’ position, given the evident difficulty in reaching the initial gas input for the pipeline. Therefore, not only has the European Commission supported the pipeline, both politically and financially, but also in doing so it has stretched well beyond its legitimate powers, while failing to abide by the obvious limitations of its energy diplomacy. Furthermore, the EU has set itself as a leader of a coalition with a distinctively hostile view of Russia. Of the former, notably countries such as Poland and the Baltic states (that rely on Russia for two-thirds to all of their gas consumption but that have no material interest in Nabucco), have seen in Russia a potential threat to their political independence and even territorial sovereignty, and until recently relied on the US approach (that equally, has no material interest in this pipeline) that robustly guards against Russian assertiveness. However, Russia’s traditional customers and “Old” member states have often distanced themselves from such a stance and have sought to work in partnership with Moscow to negotiate access to Central Asian energy. They warned that by promoting engagement with the states of post-Soviet Eurasia largely through integration initiatives that are de facto closed to Russia, the United States and Brussels have (often unintentionally) forced them to make zero-sum choices. Moreover, the Older member states were wary about antagonizing Moscow in situation where, even if Nabucco got built at full 31 bcm capacity, in fact it would have remained a modest project, i.e. it would have served
only 7% of the EU’s demand of around 450 bcm annually, while Russia would continue to deliver 180 bcm. Hence, Nabucco would not much alter the picture of gas import dependence and Russia was, and will remain, by far Europe’s most important gas supplier in the long run. True, some of the East European states suffered badly in the 2006 and 2009 gas crises between Russia and Ukraine. Formally, West European governments declined to take sides and rather apportioned blame to both sides for their shady dealings, insensitivity to European concerns, and downright incompetence (Mankoff, 2011). Yet the 2008-2009 crisis gave fresh impetus to the Southern Corridor initiative with the EC intent to strengthen its authority over the EU external energy business. This increased its long-held aspiration for more devolution in foreign policy, and created tensions between the EC and the member states, that wanted to retain their gate-keeping role. As argued in the previous chapters, when the European Commission acts as the vector for coordination to work out better emergency plans thanks to the development of new interconnectors and reverse flows systems, or by developing crisis prevention mechanisms at the EU level, its action is benign, welcome and within its legitimate competency. In fact, the integrated European energy market is at the very core of the EU energy policy triangle of achieving security of supply, competitiveness, and sustainability because it increases competitiveness of the energy markets on one hand, and strengthens the security of supply through an increased integration of the networks on the other. However, as suggested by Finon (2011) and Baev&Overland (2010), the EU should rather stay in the ‘Soft Power’ vein. The departure of the EU from its traditional ‘Soft Power’ vein in foreign energy policy with its strategy in matters of corridors diversification, which implies intense political competition with Russia, is beyond its powers and would require a fresh transfer of competencies from the European capitals to Brussels. The only time that the EU has been indeed secured an unprecedented decision by the EU’s governing Council, mandating it to negotiate a legally binding treaty with Turkmenistan and Azerbaijan providing for pipeline construction, was in September 2011. This was the first time such powers had been given to the Commission with respect to an infrastructure project. And yet, even with the exceptional efforts of the EU Council, progress towards bringing Turkmen gas across the Caspian had fallen short of what was needed for commitments to be made to build pipelines. There are lessons to be drawn from this process: first criticisms that the EU Commission did not do enough are inappropriate, second, in order for the EC to do more it should be a beneficiary of institutionally enhanced powers obtained by the Council. Interestingly, Barysch (2010) notes the Old member states’ nonchalance, ‘leaving the new member-states literally out in the cold,’ which in her words ‘leaves the UK at the strongest backer of Nabucco among the big member-states.’ Perfectly understandable since the UK is on the path of becoming a net importer of gas, but in stark contradiction with the UK’s traditional Euroscepticism that has consumed, especially the Conservative party for years now. The fact that the UK, as one of the fiercest opponents of the dynamics of ‘deepening’ of the EU, suddenly fully supports the European Commission’s aspiration in acting as a vector for gas supplies and in guiding the EU’s external energy policy more broadly, is astonishing, at least in the opinion of this author. On the other hand, UK’s support for Turkey’s swift accession to the EU as a means of enhancing the EU’s security of supply has been in line with its traditional preference for the ‘widening’ of the EU. Anyhow, the sudden financial and economic crisis that hit Europe most recently, has helped to transform Euroscepticism from being a distinctively British feature, to becoming a well-established trend also in continental Europe. The latter brings us to the observation of how exogenous factors indeed count in our discussion, which we will look in greater detail in section 10.4. To conclude, the debate over the EC’s modest influence and sporadic putative engagement in the development of a ‘Russia-free’ Southern Corridor has generated considerable literature that however fails to acknowledge that the EU’s powers in the foreign policy arena are limited by the member

305 Although Russia has been a reliable energy partner for Europe for many decades and will remain a vital supplier

306 By for example, inciting each member-state to improve its protection and by allocating money to help build some interconnectors in the new member-states, as the EU did in 2009
states’ choices on the import and allocation of energy resources. The most common view holds that the EU has been incoherent and passive in face of a quick and well organized Moscow pushing its own alternative, which in turn undermined Nabucco’s chances. While Moscow’s efforts to secure the largest share of the cake for itself are undeniably in line with its geopolitical realism, the EC has also improvised itself as a politicized broker of direct bilateral initiatives aiming at any cost, to encourage European companies and Caspian governments to reach an agreement over the Southern Corridor; an approach starkly in contrast with its own multilateralism promoted at a EU level. Admittedly, Europe was somewhat forced to adapt to a more tense geopolitical context after 9/11, but in the gas relations towards its main supplier (i.e. Russia) the switch has been quick and sudden; one from an extreme ultra-liberal Washington consensus type of policy to the opposite closure in Fortress Europe - with the EU distancing itself from its own market principles and thus undermining its credibility and legitimacy. The European Commission views itself as a leader in promoting renewable energy and the liberalization of the European internal market. And the latter is, indeed, better placed to promotemarket integration through creating a unified and liberalized energy market.\textsuperscript{307}The most fundamental contribution that the EU can entail is thus to ensure greater solidarity between eastern and western Europe, and between countries that rely on Russian gas and those that do not. Unification of Europe’s gas markets, which would be the single most effective way of decreasing the geopolitical risk of dependence on Russia, can occur by developing rules of solidarity such as the EC Regulation on Gas Supply Security (European Commission, 2009). However, the EU should distance itself from championing politicized projects with a weak economic rationale, because the consequences can be disastrous, as the Nabucco story has shown. Therefore, in this author’s opinion, Commissioner Oettinger should be first committed to the idea of tailoring “a true single market in energy.” In this respect, the EU is legitimated to continue dismantling the national gas ‘bastions’ (Baev\&Overland, 2010), and start, as it has already done, infringement proceedings against EU states for failures to transpose the EU’s third energy package of directives into national electricity and gas legislations, in parallel to prosecuting EU energy companies for breach of the competition rules.\textsuperscript{308} If the Commission succeeds in meeting its goal of the completion of a single internal energy market by 2014, that would already enormously diminish European vulnerability and would optimize its position towards suppliers by creating a “common liquid pool” for gas and electricity. Therefore, the Europeanization of energy powers should proceed step by step, first reaching the objective of a single European energy market. Regarding the external energy policy, the ‘speaking with one voice’ rhetoric, fails to observe that the EC would need additional powers transferred from the member states to legitimately achieve this goal. In the midst of the current existential crisis of the Eurozone and its overwhelmingly nationalresponses,\textsuperscript{309} a unified external energy policy appears a distant goal.

10.3.4 Turkey as an energy hub: to be or not to be?

In the past years, Turkey has had an almost obsessive aspiration to establish itself as an energy hub between Central Asia and the Middle East on the one hand, and Europe on the other. The latter, in Turkey’s official position has been a goal to be realized on top of enhancing the country’s energy security. The main prerequisite for an energy hub is a good physical infrastructure. Turkey has been at pains to remind that in response to the progress

\textsuperscript{307}Although even in these admirable efforts the “third country clause,” often dubbed as “anti-Gazprom clause” paves the way for discriminatory and protectionist treatment as far as foreign investments are concerned despite the Energy Charter Treaty principles.

\textsuperscript{308}Over a dozen major European energy companies were prosecuted including EDF, GDF/Suez, E.ONand RWE. See: E.ON/GDF, Market Allocation in European Gas Markets, Case COMP/39.401; GDF Foreclosure, Case Comp/B-1/39.316; E.ON/GDF, and E.ON Gas Foreclosure, Comp/B-1/39.317; RWE, Gas Foreclosure, COMP/39.402.

\textsuperscript{309}See, for instance: Europe’s leaders stress national politics in New Year greetings, January 02, 2013, Euractiv
of the Nabucco project and Turkey’s reluctance to support Blue Stream II, Gazprom signed a MoU with ENI of Italy in June 2007 to implement the South Stream pipeline project. According to Turkey, the opportunity cost for staying faithful to Nabucco was high, with virtually no rewards. Brussels sees the story differently though. Nabucco has always been planned as part of the Turkey’s natural gas hub. Turkey, however, bargained hard against a straightforward transit role, instead trying to keep the right to resell some of the gas at higher price on its own. The EU objected to this clause, which would allow Turkey to set prices. In the words of a European diplomat: “Turkey intended to take over the role of a hub, which means that it would buy gas arriving within its borders, consume what it needs and sell on the balance at a profit to the consumer. This is incompatible with the role of a transit country as defined in the Energy Charter Treaty ECT, which was ratified by Turkey (...)” The trust between Brussels and Ankara remained low over the stand-off between European preferences (i.e. to have Turkey provide transit service for Central Asian gas en route to the EU’s markets), and Turkey’s “assertiveness” which insisted in buying and re-selling some of those volumes to third parties at a profit to Turkey, which in turn was perceived as a threat to Europe’s future energy security. Russia, by following its classic divide et impera tactics, took advantage of the rising mistrust between the EU and Turkey to drive the latter in its arms. In fact, as a result of Europe’s hesitancy about Turkish EU membership, the support of the Turkish public for it has fallen dramatically in recent years. It is not to be excluded that the next generation in Turkey might not even want to join the EU, even if all the criteria have been fulfilled. On its part, Turkey has used the stake of its eventual European integration to exert pressures on the EU about the transit fee of gas shipment by Nabucco, albeit unsuccessfully. The EU on the other hand, was painfully aware that the non-realization of Nabucco would be at little cost for Turkey in its transit function because it has other opportunities from other transit rents with the completion of the possible 10 Bcm/y TAP project, which could connect Azeri gas to the Italian markets and to a mosaic of existing and developing interconnections to the Balkans. In the recent years, we have actually seen Turkey playing successfully at the Russian table where Gazprom also got Turkey to sign a 30 year supply contract in November 2012,311 further complicating the Southern Corridor transit (and upstream) picture. Moreover, the pipeline project decided to bring Azeri gas to Europe, the TANAP, is entirely in Turkey’s interest. Turkey’s interests are five-fold in seeking to maximize TANAP’s gas flow: to meet the growing internal demand, to reduce dependence on Russian gas supplies, to replace Iran’s overpriced and interruption-prone deliveries, to boost Turkey’s role in the energy corridor to the European Union, and to enhance TANAP’s profitability and investor appeal.312 In 2012, Turkey helped Russian Gazprom to sideline the original Nabucco project. But Turkey’s revisiting of the Southern Gas Corridor to Europe, along with the Azerbaijan-led Trans-Anatolia Pipeline project (TANAP) also helped the southern gas corridor to finally take shape after seemingly endless discussions about various pipeline concepts, their geopolitical implications and economic feasibility. That only confirms Turkey’s crucial in future energy supplies to Europe and evinces the serious blow that the EU suffers from not having integrated this country, a candidate country since 1963, into the EU communities. Many observers in Europe understand the importance of Turkey’s membership for the future of the EU. The EU needs Turkey not only for its energy security, but also for the contribution it would make to the European economy, the European defense system, European neighborhood policy (Caucasus, Central Asia and the Middle East) and the dialogue with the Islamic world.313 Yet the accession talks between Turkey and the EU have been complicated and that in turn influenced their energy cooperation. The EU insisted that Nabucco could only be built if all transit countries agreed to the same rules, and that these rules should be those of the EU.

310 Interview with the Author, May 2012  
311 "Gazprom Seals 30-Year Supply Deal to Turkey,” The Moscow Times, November 26, 2012  
313 Yibingüden Y. EU policy drives Turkey in the arms of Russia, European Energy Review, June 2, 2010
acquis (which means that pipeline owners need to sell access to their pipelines on the open market). The Turks had argued, with some justification, that if the EU wanted Turkey to take over the energy acquis, it should open the accession talks in that particular area. The European Commission, instead of pushing a more swift accession with Turkey, has improvised itself as a vocal broker of Nabucco as a whole (a position that has changed recently amid realization that the illusion of the original Nabucco coming to life could not be protracted any longer). This is not to downplay the significance of the EC and of the ongoing internal liberalization project, but only to illustrate the Commission’s limits in relation to third countries and attribute them the proper weight. In any event, with a secured TANAP, a pipeline stretching from the Georgian-Turkish to the Turkish-Bulgarian border, the only uncertainty left is the “European leg.” Thus, Turkey has almost secured its ambition to become the key hub for transporting Caspian gas westwards. Beyond TANAP, Turkey is indifferent whether it will be TAP or Nabucco West. However, the opening of South Stream in December 2012 in addition to a continued weak gas demand in Europe might put on hold, once again, the development of Shah Deniz II and in turn, Europe’s diversification agenda.

10.3.5 Nabucco’s final act: decline and the race over sober compromise

Despite the multiple hurdles to overcome, Nabucco refused to surrender until BOTAS and SOCAR made known in mid-2012 that they were working on a new Trans-Anatolian Gas Pipeline (TANAP). Until then, the EC had only slightly modified its objectives about Nabucco, being reluctant to leave the ‘southern corridor’ in Russian hands. Numerous high level announcements continued about the usefulness to merge Nabucco with the rival project Interconnector Turkey-Greece-Italy (ITGI), which the Shah Deniz Consortium has now explicitly excluded from the race, or declarations claiming that ‘the project is still alive,’ as shown in the interview with Reinhard Mitschek, managing director of Nabucco Gas Pipeline International, that in November 2011 amidst the clear shrinking chances of Nabucco, declared that the ‘project does not fear recession.’ As we have seen, both the main beneficiaries of the Nabucco project, the South East European countries and potential suppliers, such as Azerbaijan and Turkmenistan, failed to prove loyal to Nabucco and what is more, played an instrumental role in derailing the pipeline project. The Shah Deniz consortium operated strictly on commercial principles, and once Azerbaijan and Turkey had decided to move forward with TANAP, accepted the revised Nabucco bid for a pipeline starting from the western border of Turkey (Pirani, 2012). As far as Turkmenistan is concerned, with the line to China complete, the country will be able to sell up to 125 bcm a year to its present partners. That means that Turkmenistan has the opportunity to sell to the highest bidder, between Russia and China without even bothering to look west yet. Europe undoubtedly remains an attractive potential market, since European customers promise to pay higher prices, but a lack of pipeline connecting Turkmenistan with Azeri’s export infrastructure, makes this impossible in practice. Even if the legal status of the Caspian Sea was finally defined and, potentially, Russia and Iran ceased to oppose the Trans-Caspian pipeline, which is unlikely, that overlooks the naked instrumentalism of Azerbaijani foreign policy. In the words of an American top civil servant: “if you are Azerbaijan, do you really want all this gas from Turkmenistan transiting your country and competing with your own gas in Europe?” The disjunction between high-sounding pro-Nabucco declarations on part of both potential suppliers of Nabucco (such as Azerbaijan and Turkmenistan) and potential consumers (such as Bulgaria, Hungary) and the prosaic realities on the ground, has been striking and has in the

314 See, EU pushes pipeline merger in Southern gas corridor, Euractiv published 18 February 2011, updated 24 February
315 See, CEO: Nabucco project does not fear recession, Euractiv, published 16 November 2011, updated 17 November
316 Interview with the Author, October 2012
final analysis been the key reasons that prevented Nabucco from seeing daylight. Another big spoiler has naturally been the Kremlin-Gazprom duo that with the proposal of its alternative South Stream pipeline has actively (and at last, successfully) tried to undermine Europe’s attempts to build Nabucco and limit the scope of the ‘Russia-free’ gas corridor. South Stream raised a heated debate in Europe on whether its realization would jeopardize or not the Nabucco project. Despite the pervasive belief that the success of the one project would necessarily bring demise to the other, the companies themselves, at least formally, denied competition (Abdelal, 2011). The corporate sector both at the EU and Russian side argued that with regard to the increasing demand for natural gas in Europe, both Nabucco and South Stream may become necessary for the satisfaction of European needs. South Stream would then represent a new export route for Russian gas from its Siberian fields whereas Nabucco would link new gas resources to Europe. The fact that both projects do not hinder each other has been put forward repeatedly by both Russian and Western politicians and experts. For example Mitschek of Nabucco said that, “From a strictly business point of view the two projects are not antithetical. South Stream has no impact on the success of Nabucco.”317 Perfectly symmetrical and florid had been Russia’s rhetoric. At the beginning of July 2009, Vice-Premier Igor Sechin, who supervised the Russian fuel-energy complex, said: “The more opportunities for gas supply provided for consumers, the better.”318 South Stream is clearly intended to serve as a new transit system, for carrying existing supplies to Europe that currently transit through Ukraine and/or Belarus rather than a line that would serve new sources of Russian gas production (at least, until the EU demand recovers). In Roberts (2011) words, “There is also a peculiar double irony in the roles to be performed by Nabucco and South Stream. Nabucco is intended to be a transit line but its creation would actually serve to bring on-line additional gas supplies for producers that, at present either cannot access Europe at all or else have to accept or they can sell gas to the EU only through Russia’s intermediation. As for South Stream, it is a producer’s line that is clearly intended to carry existing, rather than new, gas output.” Although Russian and the EU’s official positions concur in that the projects are not in competition, as acquiescently pointed out by a European diplomat, “There is no competition per se since the South Stream project is mostly promoted to circumvent Ukraine and hence it does not guarantee new sources. Investors though, don’t see it that way. They remain risk averse in the current climate of a global gas glut.” At the same time, moreover, the psychological perception of an accelerating race to see which of the projects will be launched sooner, has triggered a preemption game in order to gain a “first mover advantage” that has not decreased, and has conversely even fastened despite a painful global recession.319 As a result of the declined economic activity, in addition to the effects of the shale gas revolution in the US, the demand for gas in the EU gas plummeted. A rational response would have been to reexamine many large investment projects, due to the fact that earlier estimates about demand levels and price failed to materialize. Instead, a distort perception of the reality concerning gas business had continued and indeed gained fresh impetus, both in Europe as in the Gazprom’s headquarters. For example, when asked if he feared recession, in the midst of the European economic downturn, Nabucco’s managing director Mitschek answered as follows: “No I’m not afraid. I believe that energy demand overall will not increase in Europe but the portfolio will change in favor of gas. Therefore we need more gas and more gas imports. It will for sure be a combination of additional energy capacities, of shale gas in 10 years’ time or so, plus pipelines.” At the other end of the spectrum, in Russia, common sense had been even more openly defied. Despite the company’s financial difficulties, in the aftermath of the second Russian-Ukrainian gas crisis, in mid-2009 the company announced that South Stream’s projected capacity was doubled from 30 bcm to 63 bcm, with the aim to completely chock-off Ukraine’s transit role but also perhaps, as a symbol of Russia’s resilience in the face of the crisis (Baev&Overland, 2010). Gazprom CEO Alexey Miller announced that the change was requested by the Italian side (Abdelal, 2011). That is hardly plausible given that Paolo

317Quoted in Abdelal (2011)
318Quoted in Tomberg (2009).
319Author’s Interview with C. Van Agt (CIEP), January 2012.
Scaroni, chief executive of ENI, certainly alarmed by the greedy, profligate Gazprom's attitude and the impending ‘gas bubble,’ in March 2010 suggested that South Stream and Nabucco should be merged “to combine efforts in a joint cost-cutting drive.” Energy Minister of Russia Sergey Shmatko saying that ‘South Stream is more competitive than Nabucco’ and that ‘Nabucco and South Stream’ are far from being competitors' rejected the merging proposal (Crandall, 2011). As observed by an Italian energy insider: “Scaroni was getting anxious about being entangled in such a politicized project, in a moment when due to exogenous reasons (i.e. the economic crisis and the shale gas revolution in the US) its economic rationale was becoming more and more questionable. Blue Stream at the time had a return of 20%, which cannot be said about South Stream.” For the purposes of this analysis, the exogenous changes and their impact on the viability of these macro-projects is another important and often overlooked analytical point; therefore the next section asks how empirically significant are these changes, especially with regard to the Southern Corridor projects. As noted in Chapter 9, the financial crisis has seriously brought into question the viability of the EU’s future gas demand, and has challenged long-standing terms of trade in the European gas market in light of the availability of new cheaper “spot” priced gas.

10.4 The role of exogenous changes and the ever-increasing globalization of gas markets

Although global gas markets have changed a lot, including an unprecedented availability of unconventional gas from shale; the pipeline-coalitions on both sides have ignored these developments and have proceeded regardless, granting an ever-increasing priority to their preferred projects. Yet, there is a substantial difference in the two coalitions. While Gazprom can afford such policies, due to a unique and symbiotic overlap of Gazprom’s corporate interests with the Kremlin’s goals (see below), Nabucco has to stay profitable right away in order to get built, which makes Nabucco less commercially attractive for private investors. The EU’s economic crisis has translated into political and social unrest that fueled skepticism about European unity within the continent, and bolstered skepticism about Europe’s credibility abroad. Also, it worsened the already stagnating relations between Brussels and the Kremlin, giving new vigor to the Kremlin’s distaste for European norms. At present, there are significant uncertainties surrounding the European gas demand, which irritate the Russian counterparts. For example, one stems from the EU’s ambitious climate change targets: it is not clear how policies for raising energy efficiency, cutting CO2 emissions and shifting from fossil fuels to renewable sources of energy will affect gas demand. Another wild card is the development of unconventional gas in Europe. As observed by Locatelli (2012), before the Fukushima accident, the climate and energy policies of the EU – which were focused principally on energy efficiency and increasing the proportion of renewables in the energy mix – would have led to a reduced demand for natural gas, which would in turn have affected the volumes imported. According to different energy and climate policy hypotheses, there are considerable differences in the gas consumption scenarios for 2030. For example, the difference between the two extreme scenarios represents over 70% of current gas imports in the region. Such uncertainties over a relatively short period of time can raise doubts and upset the long-term investment plans of suppliers outside the EU. In addition, there are other unpredictable factors, given by the sheer growing unpredictability of the gas markets. To everyone’s surprise, under the effect of the American shale gas revolution, the American utilities increasingly shifted to gas, while American coal miners had to look for new markets. They were doing so at a time when slowing Chinese demand was pushing down coal prices, which fell by a third between August 2011 and August 2012, and

320 That in the long run is set to increase again, but how long will the protracted switch from a sellers' to a buyers' market last is yet unclear.
321 See Locatelli and Boussena (2012), p.11
at this writing (January 2013) is below $100 a tonne. These prices made European utilities willing buyers.\footnote{European purchases of American coal rose by a third in the first six months of 2012.} That is due to the fact that many European utilities are tied to Gazprom’s contracted gas, whose price despite a wave of renegotiations stays high. Thus, while renewables are benefiting from subsidies, dirty coal is back from the European energy underworld and increasingly displacing gas. That is, in turn, making a total mockery of the Commission’s environmental standards agreed for 2020.\footnote{The EU aims to reduce carbon emissions to 20% of their 1990 levels by 2020, see http://ec.europa.eu/clima/policies/package/index_en.htm} How can you credibly commit to a much greener energy future while member states are simultaneously switching from gas to coal as fast as they can? This last episode has shown that amid a painful crisis, companies, which are the main drivers of the EU-Russia energy relationship, follow their own logic and strive to stay profitable, even at cost of undermining the EU’s environmental goals. Despite the EU’s undeniable leadership in the environmental battle, coal’s renaissance has shown that the strongest contingent influencing the EU’s energy policy is the companies’ search for profits. Faced with uncertainties, the businesses are turning to the more profitable coal, demonstrating once again the EC’s weakness in energy (and in turn, in environmental) policies as soon as the attainment of profit is jeopardized. On the other end of the spectrum, growing political uncertainties stimulate the Russian gas business to look elsewhere, towards the Asian market.\footnote{The Russian economy relies heavily on the export of energy to the EU. Potential alternative markets, such as China, come nowhere near that level of reliance. Yet this situation might change, as Russian market share in European mature markets decreases, while the Asian market offers significant growth options.} Although the Russian economy still relies heavily on the export of energy to the EU and potential alternative markets, such as China, come nowhere near that level of reliance, Russian appetite to diversify its markets is growing exponentially, in pace with the difficulties in Europe (i.e. EU antitrust and environmental obligations) and thus the European market could find itself competing with the Asian market in the future. As noted by Locatelli (2010 p.969), without doubt, these different scenarios reflect long-term options, given that the necessary infrastructures would have to be put in place, but they can in no way be discounted. Yet, at the moment Gazprom still cares about locking the European market. In that sense, the next section examines Gazprom’s efforts to set up its pipeline project (the South Stream) to compete with Nabucco.

10.5 The South Stream titan: Gazprom retaliates

In order to make Nabucco unlikely to materialize, Gazprom and the Kremlin pressed for a speedy conclusion of all the needed agreements to proceed with their own sponsored alternative, South Stream. The pipeline is destined to cross the Black Sea from Russian compressor station Beregovaya to the Bulgarian coast at Varna and then onwards through the northwestern route to Serbia, Hungary, Slovenia, through the Trans Austrian Gas Pipeline into Northern Italy. The initially proposed southwestern branch leading south to Greece and then through the Ionian Sea to Italy was abandoned (see figure 20).\footnote{See, http://www.south-stream.info/en/pipeline/route/}
South Stream starts at Russia’s Black Sea coast, where the Blue Stream subsea section starts, and continues to Bulgaria as an offshore pipeline. Its offshore section would stretch for 900 km at the depth of up to 2,200 meters (the maximum depth of the Nord Stream pipeline, for example, did not exceed a little more than 200 meters), representing an unprecedented engineering hazard. In the words of an Italian energy security specialist, “I am still uncertain whether this project can be safely completed. Blue Stream, whose depth did not exceed 200 meters, has a pipeline diameter of 3 cm. At this depth, there is an extraordinary level of working pressure, and officially ENI declared that the offshore pipeline would use pipes with a diameter of 32 inches (810 mm). I am still not fully convinced how and if this will work out.” The offshore section of the pipeline was planned to cross the Ukrainian and Romanian sea shelves, which would require these countries’ permission. In the Black Sea, the exclusive economic zones of the two countries directly border each other. Although international maritime law does not give Ukraine and Romania the right to veto South Stream outright, they would have leverage over the project, as they could demand extensive studies of the project’s impact on environment, shipping and maritime safety, and if they considered it necessary, they could demand modifications. Therefore, to avoid Ukrainian exclusive economic zone and also to sweeten Turkey, in 2009 the pipeline was re-routed through the Turkish waters.

In sum, in November 2012 Gazprom has taken the final decision to build South Stream, whose first line should be ready by the end of 2015. Russia’s overall efforts to undermine Nabucco have moved in two directions: first, Russia attempted to remain a key player in the Caspian region and the only vehicle for the transport of the region’s gas to Europe. In that sense, Gazprom has aimed to strategically lock up reserves in the Caspian region by gaining (or regaining) control over pipeline infrastructure. This strategy fulfils a double goal for Gazprom: the lock-up of large part of the exported output allows Gazprom to meet its own domestic and export demand, and in addition it prevents the threatening of its monopoly in delivering pipeline gas to Europe. Second, Russians also introduced South Stream as a direct reaction to Europe’s Nabucco ambitions, as an additional preemptive move to discourage potential intruders from entering its most lucrative export market. While Gazprom restlessly stresses that this pipeline is not meant to outcompete the existing Southern Gas Corridor projects, chiefly Nabucco, its target markets are roughly the same as Nabucco’s. To be sure though, Gazprom’s moves, such as securing markets instead of enhancing product quality or output and marginalizing competitors by controlling market access and infrastructure, fulfill the

326 While with the final investment decision Gazprom has won the battle against the EU for the Southern Corridor, to say that this strategy is expensive would be an understatement. As a consequence of its risky strategy Gazprom may face serious financial limitations in expanding business and tackling demanding projects (i.e. Shtokman, Chayanda), which may put in question its ability to increase supply. For a recent uncompromising analysis on this topic see: Hulbert, M. A Tale of Two Gazproms, European Energy Review, November 29, 2012
criteria of a textbook monopolist rather than point to politicized motives (Goldthau, 2010). In fact, as brought forward very clearly by Baev et al. (2010), in the case of the competition between South Stream and Nabucco, one-dimensional, petro-geopolitical explanations are particularly unsatisfactory, since the parties to this ‘clash of pipelines’ are not vying for control over any particular source of supply or a choke-point. It is a stretch of imagination to interpret Russia’s preference for going underwater and eliminating transit dependency as an evil geopolitical plot aimed at subjugating any particular producers or consumers. In fact, this chapter argues that a crude juxtaposition of economic-commercial interests and geopolitics is not the right one; the parties to the pipeline projects are involved neither in a classical geopolitical competition, nor in a straightforward economic competition for profits to be gained from privileged access to the south-eastern quarter of the European energy market. For example, even the Russian energy policy, which is always under scrutiny for non-commercial objectives, in reality deserves a more nuanced examination. Gazprom’s projects are often dubbed as ‘clash of the pipelines,’ when for the most part they simply aim to neutralize Western European efforts to diversify supply routes. In that, they are a purely rational move by a market actor aiming at exclusive delivery to a profitable market (Goldthau p. 33). Yet, it is clear that the victory of South Stream is possible thanks to a unique symbiosis between Gazprom and the Russian state leadership. But the question is: what are the motivations for conducting this kind of energy policy at such expensive cost? More precisely, whose interest is promoted when diversification in Europe is opposed, Gazprom’s vertical integration is increased and its reach is extended so as to market gas directly to the European consumers? Everything seems pointing to Gazprom. Russia, on the other hand is backing a strong expansion course of its state-owned monopolist, because its own survival depends on the cash that Gazprom is able to gain on foreign markets. Yet, the strategy to seek ownership of downstream assets to ensure outlets for its gas is distinctively Gazprom’s and in the last few years this business strategy has been declared risky even by the Russian government, with stagnating domestic exploration and production projects, which are needed to make up for falling domestic output. However, from Gazprom’s own perspective focused mainly on profit maximization, although risky, the company’s behavior is rational; one designed to guarantee demand security and continued European gas sales. The less clear question is: although Gazprom claims that South Stream will not bring new volumes of gas to the EU but merely seeks to redirect already contracted volumes, it still has to explain why it is prepared to significantly erode the netback value of its gas by paying for a new-build €16 billion project (Pflüger, 2012). Why invest so much money for the shipment of old gas through a new pipeline? According to Guillet (2011), Russia would not build a new pipeline just to replace existing transit through Ukraine: that makes no economic sense, as it would always be cheaper to pay off the Ukrainians (with free gas, for instance). But as demands keeps on growing in Europe, and new capacity is needed, it makes sense to look for alternative routes for additional volumes, because they will then fulfill a real need and cannot be undercut as easily. Guillet’s proposition would make perfect sense, if it weren’t for the ‘gas bubble’ and a consequent depressed demand in Europe, which again puts a question mark over the economic rationale of building 63 bcm of new capacity in addition to the already existing one. Is the opportunity cost given by losing the possibility of eliminating definitively the Ukrainian transit risk, that Gazprom would incur from not building such a costly project, sufficient to justify the investment? It seems more likely that South Stream is mainly designed to undermine the ability of the European Union’s Southern Gas Corridor projects to contribute to a diversification of its gas supplies, besides and in addition to the declared objective of definitively eliminating the Ukrainian ‘transit risk.’ Further, despite its unsoundness from a wider economic, gas market perspective, there could be corporate interests within Gazprom that are still interested in building a macro-project of these dimensions and that, due to the Gazprom-Kremlin mostly symbiotic relationship, managed to sell the story of the necessity of the project to Putin. The costlier the project is, the greater are the potential profits made by insiders. And as noted earlier, the main driving force in
these kind of projects is not only the Kremlin, but also and especially some insiders within the headquarters of Gazprom. The difference both in principle and in substance with the Nabucco project is that the latter has to guarantee an acceptable rate of return from the very beginning in order to get built and contrarily to Gazprom it cannot, transfer the financial burden on the consumers. In the words of Yaroslav Lisovolik, Head of Research and Member of the Management Board, Deutsche Bank Russia “Gas prices keep growing in Russia. But even though they have doubled over the past few years, Gazprom is still operating at a loss on the Russian market. To a degree, the high cost of new gas export routes has a negative effect on Gazprom’s ability to generate profit on the Russian market. Therefore, it can be said that Russian consumers are indirectly paying for these projects.” Western observers have speculated until the very end, due to the prohibitive costs of South Stream, that if the Ukrainians turned over Ukraine’s gas transit system to Gazprom, the latter would probably declared victory and drop the South Stream plans. In the words of an American official: “It is certainly a bargaining leverage with respect to the Ukrainians. It could well be, given the costs and complications of South Stream that if an agreement between Russia and Ukraine was reached Russia may ultimately consider South Stream unnecessary.”

However, that has not happened probably because Yanukovych fears losing some of its political base if he trades the pipelines. Thus, Gazprom has continued with its “transit avoidance” infrastructure, with Ukraine most likely losing its status as a transit country when (and if) all lines of the Nord Stream pipeline, whose design capacity is 55 billion cubic meters, and South Stream, with the capacity of 63 billion cubic meters, are launched and when Gazprom implements its plans to increase gas transit via Belarus, whose pipeline system it owns. In that situation, Ukraine’s bargaining power would be neutralized and the country would only retain its transit status if it accepted the same conditions as Belarus. Yet an influential Russian expert is pessimistic about the opening of the second, third or forth line for South Stream: “I think Gazprom will make this long announced FDI, probably postponing the other lines, so I hope that at least it won’t be 63 bcm but something else, otherwise it is such a huge amount of money, it is too much…but I can hardly imagine a situation where Gazprom is completely pulling out from this project, unfortunately.” In any event, South Stream presents some securities for East European countries against Gazprom’s potential (although unlikely) use of the gas-weapon by withholding deliveries. Since Bulgaria is the first customer on the other side of the Black Sea, in order to reach bigger customers, for example Italy, Gazprom has to guarantee gas for the Southeast European countries “on the way.”

Yet, as an American official readily points out: “There is no guarantee that South Stream would even be approved ultimately. In fact, one of the biggest impediments to South Stream (and challenges to Gazprom) has been the battle with the EU’s energy legislation: both from the competition and the ‘Third Energy Package’ standpoint. The Russian authorities are hoping that the EU will support this project, above all by giving South Stream Trans-European Network (TEN-E) status, which would exempt it from rules on third-party access and the separation of gas trading from gas network operations. They are seeking German, French and Italian help to achieve this (Kusznir, 2011). With their help, Russia is hoping to lobby the European institutions to change the regulation of the EU’s Third Energy Package. However, especially the German government refuses to discuss certain issues directly with Moscow or Gazprom. The Russia-EU format is preferable when discussing issues that touch upon the EU’s direct competencies, such as the competition legislation. So far the EU has proved reluctant to give priority status to the Gazprom-favored pipelines, although Nabucco West, a scaled down version of Nabucco has these permits. The European Commission does not see South Stream as a means to improve the European Union's energy security, mainly because the gas comes from Russia, already its

327 The benefits of South Stream pipeline for Russia,” Valdai Discussion Club, December 26, 2012
328 Also considering the accession to power of a more pro-Russian Ukrainian Yanukovych-government since 2010
329 American official, Interview with the Author, October 2012
330 Which means that Gazprom will be unable to manipulate gas flows to Central and Eastern European members of the European Union (EU) while the more influential Western European members remain unaffected, as some observers feared.
major supplier. In the words of a Russian energy expert: “I understand, with its behavior in the last five months, the EC is demonstrating clearly that it doesn’t want this pipeline, that is a clear message. But Gazprom started buying pipelines and equipment, so it can’t step back completely. It is too late actually.” However, Brussels says that in principle EU members are free to choose their infrastructure priorities, as long as EU energy legislation is respected. In practice however, the South Stream route largely coincides with that of Nabucco West, a planned pipeline that on the contrary has the political support of Brussels and aims to diversify gas supplies from sources other than Russia. In the words of a EU Official: “We are not opposing South Stream. Gazprom can ask for a third party exemption for a limited period of time.” Moreover, on several occasions, the European Commission has indicated that it had not seen any blueprint for the South Stream project, and that it was “not possible” to build pipelines without having conducted a proper environmental impact assessment as required under EU legislation. And yet, save these couple of environmental permits, final investment decisions have been made. Even more, Gazprom has already started the construction of the first stages of the pipeline, amid European Commission’s anti-trust probe. In fact the EC is now warning that attempts to accelerate the Gazprom-sponsored South Stream gas pipeline project will not circumvent EU antitrust and environmental obligations. Recently Oettinger’s spokesperson, Marlene Holzner, stated that EU liberalization rules did provide for a number of exemptions “if certain conditions are met.” This concerns, for example, the third-party access, she said. Russia considers, with some reason, these rules ‘discriminatory’ and is not interested in Europe’s drive to impose its own rules to Gazprom. The EU-Russia summit in December 2012 revealed that Russian-EU relations have cooled, and in fact the summit did not produce any accords. Especially during the press conference the significant deterioration of the EU-Russian relations was more than evident; Putin said, “Open article 34 of our basic treaty with the EU and read for yourselves.” Article 34 of the EU-Russia Partnership and Cooperation Agreement, in force since December 1997, reads: “The Parties shall use their best endeavors to avoid taking any measures or actions which render the conditions for the establishment and operation of each other’s companies more restrictive than the situation existing on the day preceding the date of signature of the Agreement.” This touches upon the very core of the EU-Russian current institutional deadlock; Russia’s aim today is to distance itself from the EU institutional model, and promote a legal framework that is consistent with the country’s institutional environment. For example, Gazprom’s internationalization strategy on the European market is based first and foremost on vertical integration in the downstream segment backed by the national legislation on hydrocarbons that has been amended several times in the last years (see Chapter 6), which goes directly against the vision adopted by the European Commission, based on a competitive system regulated by its acquis communautaire. Locatelli and Boussena (2012) capture well this dynamic; in the 1990s the EU felt reassured by the Russian embrace of the market economy and the rules of the acquis. However, in Russian view, the 1990s neo-liberalism had been a tool of destruction that brought to power baron capitalists with no vision beyond greed. Ever since Putin came to power, Russia had chosen to restructure its gas sector in a way that differs significantly from that advocated by the EU and had refused a relationship essentially based on Russia’s adoption of the acquis communautaire. In fact, that is precisely how the EU wants to manage its relations with its gas suppliers: principally by exporting its acquis communautaires on matters of energy regulation. It all boils down to the different economic interests between consumer and producer countries or in other words their vision of energy security. In fact, as we already discussed energy

331 Interview with the Author, October 2012
332 See, EU puzzled by South Stream acceleration, Euractiv, October 30, 2012
333 See, We are ready to interpret the existing law in a pragmatic way and are engaged in ongoing discussions with the Russian Federation on exemptions foreseen under the third energy package,” she said.
334 See, EU readiness ‘pragmatic’ answer to Putin’s energy agenda, Euractiv, December 18, 2012
335 Russia, EU to foster ‘positive interdependence’, Euractiv, 20 December 2012, updated 10 January 2013
336See, Putin slams Barroso: ‘You know you are wrong, you’re guilty’, Euractiv, December 21, 2012, updated 03 January 2013
security means different things to different countries based on their geographical situation, their political system and their economic disposition. While energy importers want security of supply and low prices, energy exporters seek security of demand—the assurance that their production will be purchased at a fair price over the long term, so that national budgets can anticipate a steady and predictable revenue flow. And especially in the current situation of changing energy paradigms in Europe, Gazprom officials take great pains to remind that energy security is a ‘two way street,’ with Putin himself meeting with European energy executives and officials to discuss possible solutions. Today, the conflict between the two parties is focused principally on the implications of the “Third Energy Package.” According to Gazprom and the Russian government, some of the rules of the third energy package could severely limit its investments in Europe, directly calling into question its industrial strategy. Putin has denounced this legislation because it requires Gazprom to give third-party access to its pipelines and especially to South Stream, while simultaneously granting full political support and these permits to Nabucco West, that aims to diversify gas supplies from sources other than Russia. We will review some of these challenges and how they impact on the EU-Russian institutional cooperation in the concluding remarks. We will also try to suggest some possible solutions, although with the current premises, the author is pessimistic about the prospects of a re-launch of the EU-Russia integration any time soon. But before disentangling the debate that will probably linger on in the coming years, it is necessary to examine the last round of the battle for Azeri (and possibly Caspian) gas through the Southern Corridor.

10.6 The Southern Corridor's last round

10.6.1 Introduction

At this writing the original Nabucco pipeline is officially eliminated. However, the shape of the Southern Gas Corridor is gradually becoming clear, at least as far as the delivery of gas from Azerbaijan to Europe is concerned. In June 2012, the Turkish energy minister Taner Yildiz and his Azeri counterpart Natiq Aliyev signed a deal to build the €5.6-billion Transanatolian pipeline (TANAP) that will span 2,000km from the Georgia-Turkey border to the Turkey–European Union border, parallel to Nabucco’s planned route. Under the project agreement, signed on June 26, Azerbaijan’s State Oil Company (SOCAR) holds 80 percent of TANAP’s shares as well as operating rights; Turkey’s Botas state pipeline company holds 15 percent, and Turkish Petroleum five percent. As a joint venture between Turkey and Azerbaijan, TANAP is expected to initially supply 6 bcm/yr of gas from Azerbaijan’s Shah Deniz field to Turkey, with a further 10 bcm/yr crossing Turkey on its way to Europe. Construction work is expected to start in early 2014. TANAP’s construction costs are planned at $7 billion. The pipeline is planned to carry the first Azerbaijani gas to Europe by 2018, which has long been looking to secure access to new supplies to reduce reliance on Russia, ever since the early 1990s. Speaking at the launch of a State Oil Company of Azerbaijan (SOCAR) representation office in Brussels, Oettinger underscored TANAP’s significance to the EU, in the context of the Southern Corridor to Europe, which Oettinger said the EU supports, despite its earlier support for the Nabucco pipeline. TANAP is designed as a scalable, incremental pipeline, its capacity to be increased in four consecutive phases by adding parallel loops and compressor power, in step with production growth upstream. Baku and Ankara now propose to configure TANAP for an ultimate capacity of 60 billion cubic meters (bcm) per year so as to accommodate future gas

337 Tanap: Pipeline offers security with demand for energy growing, Financial Times, November 21, 2012
338 Sozcor, V. Aliyev, Erdogan Sign Inter-Governmental Agreement on Trans-Anatolia Gas Pipeline to Europe, Eurasia Daily Monitor Volume: 9 Issue: 122, June 27, 2012
339 Oettinger talks up Tanap pipeline, Euractiv, November 15, 2012
flows from both Azerbaijan and Turkmenistan to Europe. The more ambitious target reflects Turkey’s long-standing ambition to set itself as a gas hub for transporting large quantities of Caspian gas westwards and of Azeri-Turkish aspiration to “run the show” in tandem on the Southern Corridor. The EU, that has been instinctively always more sympathetic to importing gas from outside Russia, for reasons of energy security and diversification of supplies, now finds itself subject to the vagaries Baku’s and Ankara’s export intentions. However, the first leg through Turkey that will be controlled by Azerbaijan and Turkey has been decided. The new battlefield where several pipelines have been still fighting is the transit route to Europe starting from the Turkish border. The two finalists are ‘TAP’ and ‘Nabucco West.’ But let us review briefly the battle that lead to the present situation.

Ever since the Shah Deniz consortium led by BP and the Azerbaijani state oil company SOCAR announced in summer 2011 a bid for the Shah Deniz gas, three consortia submitted their comprehensive transportation proposals (ITGI, TAP and Nabucco). However, BP has also announced a plan for its own South East Europe Pipeline (SEEP), which would be able to transport SD2’s post-2017 gas output of 10 bcm per year to Europe. Moreover, during BP’s Annual Forum in Berlin on May 24, 2012 BP Executive Director Iain Conn stated unambiguously that the original Nabucco concept will not be taken into consideration by the Shah Deniz consortium, although there is still a chance for a smaller, scaled down “Nabucco-West” pipeline, which at the moment competes with the Trans Adriatic Pipeline (TAP). There were other two bidders, one for the Northern route, the SEEP, and one for the southern route, the Interconnector Turkey-Greece-Italy (ITGI), both of which have been now excluded from the race. The SEEP, proposed by BP in September 2011, has been the newest addition to the group of competing downstream pipeline projects in the Southern Gas Corridor. Although a serious company with a sound organizational structure promotes it, many of the details are still unclear, a detailed feasibility study has yet not been carried out and there is no concrete cost estimate in the public domain. However, the basic rationale of SEEP seems clear: it looks like a restructured and reduced version of the Nabucco project. But SEEP dramatically avoids the investment costs that Nabucco would incur through the construction of new pipelines by using some of the existing infrastructure in Southeastern Europe. Yet, unlike TAP for example, SEEP is for the time being more of a concept than a fully developed project proposal. Therefore, according to a top American civil servant the SEEP has been now eliminated from consideration. The situation with the ITGI is different. This project, to avoid the transit through Albania, has proposed two sections: a Greek onshore section and IGI-Poseidon, the offshore leg linking the Greek Ionian coast to southern Italy. However, these two projects lack a credible solution to explain how more than 550 km of new-build onshore pipeline will be financed and made available on time to receive Shah Deniz II gas at the Turkish-Greek border and ship it to the Greek-Ionian coast. The assumption was that DESFA, the Greek state natural gas TSO, would construct the pipeline. But the Shah Deniz II consortium and the Azerbaijan government have been closely observing the developments in cash strapped Greece and the induced sell of Greek assets, DEPA included, and not least a possible Gazprom purchase of DEPA. In addition, the fact that the other shareholder of ITGI, Italian Edison is not a deep pocket, rated the execution risks associated with such a solution as too high. Moreover, the IGI-Poseidon offshore section would have constrained scalability and in fact neither of the two IGI-Poseidon shareholders (DEPA and Edison) represented credible buyers or the capability to

341 The second phase has been originally planned to come onstream in 2013-2014 but was delayed because Azerbaijan and Turkey could not agree on the terms of the sale of Azerbaijani gas to Turkey and transit terms for transportation of the gas to the European markets. Yet, trust between Ankara and Baku remains low, the IGA for TANAP still has to be ratified in the Turkish Parliament with the hope that this will happen soon (American diplomat, October 2012)
342Pflüger, F. For Italy it’s a TAP or being left out in the cold, European Energy Review, May 31, 2012
343 Interview with the Author, October 2012
deliver the infrastructure. That leaves us with two finalists, whose features we shall discuss in the next section (see figure 21).

**Figure 21: The "New" Southern Corridor Map**

![Southern Corridor Map](http://www.faz.net/aktuell/wirtschaft/energieversorgung-azerbaidschan-liefert-gas-nach-europa-11802719.html)

10.6.2 The final contest: TAP or Nabucco West?

The Shah Deniz Consortium is currently scrutinizing two remaining routes: a southern route with the TAP, which would transport gas via Greece and Albania, across the Adriatic Sea to southern Italy and further to Western Europe and a Northern route basically from the Turkish-Bulgarian border to Baumgarten in Austria.

10.6.2.1 The TAP: The trans-Adriatic pipeline (TAP) is the Shah Deniz II consortium’s favored southern route for a possible gas link between Turkey, Greece and Italy, this one crossing Albania before it continues under the Adriatic Sea (see figure 22).

**Figure 22: The Trans-Adriatic Pipeline (TAP)**

![Trans-Adriatic Pipeline](http://www.trans-adriatic-pipeline.com/)

According to an influential gas expert: “TAP is the only pipeline built under credible commercial criteria. Its route, across Albania and the Adriatic Sea to Italy, is the shortest one and therefore commercially sensible.” It is backed by Statoil (42.5 percent), E.On Ruhr gas (15 percent), and Elektrizitaet
Gesellschaft Laufenburg (42.5 percent). Indeed, TAP’s main shareholders EON and Statoil represent some of Europe’s most experienced and capable onshore and offshore pipeline construction management and pipeline operators. With these important players and the third large shareholder, Switzerland’s energy utility EGL Group, TAP also has credible financial support behind it. Therefore TAP, not having been in the center of the debate like Nabucco, might nevertheless come out as the winner of the game. In September 2012 the TAP project made a great deal of progress, with the BP-led Shaz Denis Consortium declaring that it looks commercially a better project than the truncated Nabucco West project. In fact, in September 2012 the (TAP) has submitted 99% of the applications needed for its construction, 345 according to a company source, apparently establishing the project as a frontrunner in the race for Azeri gas. Moreover, in the same month an inter-ministerial agreement was signed between Italy, Greece and Albania, which is more a declaration of intent than a real IGA, yet the TAP project made indeed a lot of progress. In the meantime, officially the position of the European Union is neutral. In the words of a EU’s top civil servant: “We do not support any particular pipeline-project. Nabucco didn’t have the access to the needed volumes; hence other alternatives are now discussed. Having said that, we strongly support at least one project, anyone that will be able to satisfy the criteria of capacity requirements, dedicated infrastructure, transparency and scalability. The final decision has to be a commercial one,” he added. A high-ranked American official has reiterated this position: “We are neutral. However, either project must be expandable, either TAP or Nabucco West, and if TAP is chosen we believe that there should also be a South East Europe connection. There is an understanding (not a legally enforceable understanding though) that this would be the case if TAP were chosen.” Both sides of the Atlantic stress the scalability issue with great passion because the EU hopes to pave the way for Turkmen gas to enter the Southern Gas Corridor to Europe sometime in the future. The EU diplomat adds: “The EU has now revised its priority projects. At the moment, the TAP pipeline does not fulfill the criteria of the third party access exemption.” Thus in order to get built, the TAP has to overcome regulatory obstacles that it has been facing for four years now. Also, according to critics, TAP has another flaw in that it primarily targets the Italian gas market, which is already saturated with supplies from Russia, Africa and the Middle East, while the proposed Nabucco West would deliver gas to parts of Central Europe most dependent on Russian gas. TAP claims to be a strategic project that plans to supply not just Italy but the vulnerable Western Balkans countries too. However, as stated by an American diplomat; Nabucco West would have some political advantages because it would ultimately break the stranglehold of Russia over the energy sectors of Central and South East Europe by supply diversification. That is why, politically, all things being equal, prioritizing the Northern route and building Nabucco West first would be a better choice. The race is far from over, and most Western observers at this point would like to see at least some project moving without delays in order to finally get some gas from the Caspian into Europe. Nevertheless, there is much covered hope in Europe for the second contender, the newest version of the Nabucco pipeline project, named Nabucco West.

10.6.2.2 Nabucco West

The EC and the Nabucco Consortium have refused to give up without delivering something. The new alternative is called Nabucco West, a scaled down version of the original Nabucco, named Nabucco West, which aims to link with TANAP to carry 10 bcm, (expandable up to 20 BCM or more), of gas annually to Austria via Romania and Hungary and it is developed by the same Nabucco Consortium. Nabucco West would be nearly half of its original length of 3,900 kilometers (see Figure 23) and a fraction of its 31 bcm/year projected capacity, with the Trans-Anatolian Pipeline replacing the original Nabucco on Turkey’s territory.

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345 TAP scores points in race for Southern Gas Corridor,” Euractiv, September 09, 2011
346 Interview with an American official, October 2012
347 While, at the same time Italian gas consumption is decreasing due to economic turmoil and an increasing usage of renewables.
While the abridged version of Nabucco presents a more practical solution to its more expensive initial plan, the strategic significance of Nabucco West is more limited due to its smaller capacity. In the words of a Russian influential energy specialist: “If you compare this Nabucco “light” version (10 bcm) with the total EU demand you can understand that it is just a small drop in the total consumption. Its meaning is just symbolic, and is not a real alternative to the Russian gas as it was declared initially.” However the EU (and the US) officials see the debate in slightly different terms; “Certainly 10 bcm is a drop in the bucket, so my argument to the Russians, why worry about it? At least there would be alternative competition, which could, if nothing else, have an effect on the price (certainly in some of the East European countries), and some room of maneuver in the negotiations over price is certainly better than no room at all. Increasing the EU’s options in terms of sourcing, duration of contracts and price also enhances competition – and that is welcome news. And he concludes; “I think that is the real concern of the Russians, and they also worry about more gas being available later.” Certainly this proposition seems plausible, which is probably why Gazprom has moved quickly to finalize the necessary agreements for the construction of South Stream, whose goal, despite denial of the Kremlin-Gazprom duo is as much to outcompete the existing Southern Gas Corridor projects, as it is to avoid Ukraine. The final decision to build South Stream, a 63 bcm, multibillion-dollar uneconomic infrastructure investment, in a moment when ‘market fundamentals’ don’t support any new pipeline construction into Europe, seems to bolster this conclusion. All of these factors reveal the riskiness of Gazprom’s business strategy and its eagerness to secure the European market and marginalize potential intruders, rather than focusing on upstream investment and diversification of exports towards the East. As far as the EU is concerned, after years of twists and turns, it has to be admitted that Gazprom has won the race to, if nothing else, seriously jeopardize the EU’s efforts to establish direct links to Central Asian producers. It seems that the political value of transit risk reduction, plus the economic value of remaining the only pipeline supplier to Europe, compounded with the profit motive of some Gazprom’s insiders (interested in promoting a huge project, whose cost would be then passed on to consumers) were seen as justifying the investment. As regards the Southern gas corridor, the transportation of the gas from Turkey’s western border will be taken either to central Europe via the Nabucco West pipeline, or to Italy via the Trans Adriatic Pipeline (TAP). But we have entered the final stages in the decision making process and Europe’s Southern Gas Corridor project is gaining traction. The Shah Deniz Consortium needs to take the final decision on Azerbaijan’s giant Shah Deniz II field,
along with the selection between either a southern route (TAP) or a northern route (Nabucco West), by June 2013. Nevertheless, virtually zero increase in gas demand in addition to a continued economic recession in Europe may cause a re-assessment of the Shah Deniz II consortium’s options and a new impasse in the EU’s plans. As noted by Hulbert (2012) the Shah Deniz II consortium would not have any ideological problem monetizing their gas through LNG rather than piped gas. In fact, the consortium has repeatedly postponed the decision on whether to sell the gas to Nabucco West or TAP – or whether it prefers another option altogether. Thus, the prospects for the southern corridor – and thus for EU-Central Asian direct energy relations – remain uncertain. But it is equally important to ask what these developments mean for the EU-Russian relations. We have seen that the strongest contender in the overall battle has been the titanic South Stream. Whatever will be its end-result, the story offers the possibility to take a second look on the EU-Russia relationship and some lessons about the main dynamics in place, essentially to avoid conceptual confusion, may be drawn. That will be attempted in the concluding thoughts of the last case study, which will also set the ground for a broader, all-encompassing conclusion of this dissertation.

10.7 Summary of the Findings

This section highlights the key role that the race for the Southern Corridor has played in the weakening and ultimately, the deterioration of the institutional ties between the EU and Russia. First, we address the implications of the patterns identified above in light of the analytical objectives outlined at the outset of the chapter. Second, we specify how the identified patterns affected the worsening of the EU-Russia energy relationship.

This chapter demonstrates that realist approaches incessantly framing the rivalry over the strategic environment in Central Asia as the latest iteration of the great game are reductive and foster a zero-sum mentality. The current competition for power and influence in Central Asia is an infinitely more complex and sophisticated phenomenon (Lo 2008, Cooley 2012) than the 19th-century contest between the Russian and the British Empires. Moreover, this chapter has emphasized through a number of examples that Central Asian states no longer have passive roles, but are important players in their own right, especially in the energy sector. Empirical evidence has shown that the countries of the region do not have any scruple about looking for other outlets than the European markets in the pursuit of the best deals, whose final goal is merely the maximization of profit. Moreover, this chapter has demonstrated that despite strong political efforts of some actors to get Caspian gas to Europe, the logic of economic return cannot and should not be discounted. This study agrees with Baev & Overland’s (2010) observation that despite the popularity of geopolitical interpretations depicting Central Asia as a Grand Chessboard (Brzezinski, 1998) in which a new Caspian derby (Yergin, 2011) is taking place, by framing Central Asian politics in terms of timeless imperial competition, one is unable to disentangle the empirical reality on the ground from geopolitically charged judgments. One is therefore likely to fall into, as claimed by Baev and Overland, “an inherent and irreducible oversimplification in the underlying assumptions about power balances.” Furthermore, the skepticism of Realists toward the private element of self-interest, but also toward institutional goals and collective identities as driving forces in international politics, may disclose important nuances and hinder institutional solutions to the EU-Russian predicament. As Nabucco’s misfortune has shown: subjective preferences for one project over another count and can build a strong (and sometime unstoppable) momentum, which definitely makes the case for partial political interpretations. Yet, in the final analysis, who laid siege to Nabucco was not the political rival South Stream but the smaller, commercially sounder TANAP. That occurred not because of insufficient political will and unity, which was on the contrary unprecedented for an infrastructure project, but rather because of Nabucco’s irreparable economic flaws. In summary, if there is no business rationale at all, (in the South Stream case the rent seeking motive might play a role in an
influential albeit small elite of insiders\textsuperscript{348}, the project will not see the “light at the end of the pipeline.” Even in Russia, the fact that South Stream will get built, is more a symptom of Gazprom’s opaque and corrupt practices, motivated indeed by individual profit-seeking, rather than of a grand design type of project. This highlights an important finding: the project has to be compatible and consistent with the economic interests of those ruling elites, who are in position to decide about it. Since in Europe, which aims to be a liquid and competitive market for gas, the cost of pipelines cannot be passed further on to consumers, Nabucco had troubles explaining its economic rationale. The situation is different in Russia: first, the project will not be developed as a merchant line and second, its cost will be inevitably passed on to consumers. However, the over-emphasis of the ‘political factor’ in the Eurasian energy relations is shortsighted.

This chapter also suggested that constant liberal-style denunciations that Nabucco’s geopolitical disaster is due to an incoherent and nonchalant approach on part of the EU, should take into consideration the limiting factors that affect the EU-related foreign policy and to a certain extent predetermine the outcomes of its diversification efforts. The European Commission’s efforts to broker a gas pipeline over another, are certainly not consistent with its own norms of democratic delegation, accountability and representativeness, since the latter has not legitimate powers to act as a foreign policy vector on behalf of the member states. The EC is perhaps better placed to support the ECT and other aspects of rules-based multilateralism, rather than attempting to enhance the EU’s energy security through politicized bilateral deals with third countries (i.e. as a moderator of the Nabucco deal), which, at least until the 2011 mandate from the Council, was not even within the realm of its competency. In an attempt to fudge these inconsistencies, starting from 2010, the Commission suggested its ‘neutral’ position on the Southern Corridor-related matters.

The chapter also took into consideration the broader impact of external factors, such as technological developments and the economic recession, on the gas business in Europe, and by consequence on the EU-Russia energy relationship. Looking back, this research indicates that the impact of exogenous factors has been little understood or predicted. For example, neither the effects of the economic recession (which in large part explains the overly generous permits to pollute in Europe) nor the groundbreaking technological developments in shale gas exploration were foreseen. Therefore, more research on the aspects regarding technological breakthroughs and more broadly, exogenous factors (such as economic downturns) and how they impact the Eurasian gas business, is certainly worthwhile.

Most importantly, the battle over the pipelines in the Southern Corridor, illustrates that the EU and Russia have not yet overcome the zero-sum philosophy and mentality, in which one party’s gains result only from equivalent losses or concessions by another party. In that respect, the chapter finds an inverse relationship between the intensifying of the ‘pipelines battle’ and the likelihood for the EU and Russia to form a multilateral rules-based relationship. This finding, in turn, raises another fundamental question of this project: on whose rules and values should the relationship be based? The study has not fully answered this first-order question, but it has offered some proposals on how to placate both parts and move forward by adapting the existing institutions for exchange in a way respectful of the legitimate concerns and interests of both sides. These points will be covered again in the next, concluding chapter. Nevertheless, the question has important theoretical and policy implications and therefore, it deserves much more future scholarly attention. One could

\textsuperscript{348} And is an epitome of Russia’s risky strategy to invest more in the construction of strategic pipelines than in its own infrastructure or storage capacity. And in fact, recent studies suggest the possibility that Gazprom, which is becoming more reliant on production from remote and relatively high cost fields, may soon find itself at a competitive disadvantage and facing the possibility that it may fail to meet its own production targets (see Goldthau, 2010; Hulbert, 2012).
argue that if Russia accepted the ECT and its controversial Transit Protocol, the whole debate about the Southern Corridor would have become superfluous and the EU-Russia energy predicament would have been solved with less cash and political battling. Yet, instead of multilateral cooperation, Russia’s business model primarily lies on bilateral relations, in which it can prevail over weaker partners and reward friends. Like many other producer countries, Russia thus makes frequent use of its economic means, especially in the energy sphere where it stands strong, to promote its economic interests. In fact, the latter has not denied that energy might be an important part of its foreign relations, although it responded vehemently to accusations that it uses energy as a foreign policy tool.

When Moscow speaks about cooperation, it envisages a ‘quid pro quo’ exchange on equal terms, in line with its vision of sovereignty and non-interference in other states’ affairs. Yet, the findings of this study strongly support the fact that key member states were, until recently, equally eager to engage in asset swaps to secure their access to supply sources in Russia. One good example of these is the share swap and cooperation that the German giant BASF finalized with Gazprom in November 2012, amid the EU’s antitrust probes against Gazprom, which is thus subject to a great deal of controversy and complaint. In February 2012 Europe underwent another energy crisis as Russia had troubles delivering the unusually (albeit contracted) high volumes in the midst of a cold spell. Among other things, this difficulty demonstrated the lack of resilience of the delivery systems partly due to the current sensitive transitional phase in the gas sector (Westphal, 2012). In Italy, for an anxious few days, as energy use surged to record levels, questions were being asked about the country’s ability to meet that demand and keep its citizens safe, warm and dry. Though the country was much better prepared than in 2006 for example, thanks to strategic storage capacities, new interconnectors, and reverse flows, some industries were briefly forced to suspend their operations. Many observers took the crisis as another wake up call and were contemplating whether Italy would soon learn the needed lessons from it. Indeed, reputable energy analysts (i.e. Pflüger) urged the country to take a stronger stance for the TAP line, which offers a sound diversification option for Italy’s currently not very liquid market. In such a situation, any additional supplies coming to the country, in particular from a new, non-Russian source, would support increased competition. It is widely known that in the past Silvio Berlusconi prioritized and supported bilateral relations with Russia. Yet, in July 2012, Italy’s new technocrat Prime Minister, Mario Monti, also visited Moscow to refresh ties that were typically warm under his predecessor and to discuss plans for the upcoming South Stream launching. This example indicates that, as already identified by Goldthau (2010), there is a strong path dependency in mutual gas relations, which is hard (and costly) to leave. Moreover, this chapter sheds light on the two level relationship between Europe and Russia: one level involves the fruitful business alliances with gas giants from three key states—France, Germany and Italy, and a second level involves a mostly ineffective working relationship between Russia and the EU. Two of the schools of thought being represented in this study (liberalism and constructivism) argue that the stasis between Russia and the EU involves a clash in values, in which the EU vision based on its et quid and a competitive

349 Such a contradiction in narratives and interests is once again, visible in the most recent Syrian crisis. Regarding Syria, Russia’s decision to support Assad’s regime is in line with its geopolitical realism that opposes any interference in other states’ domestic matters and in line with its economic interests in Syria (i.e. arms sales). Russia is perhaps also motivated by the interest to claim that it has reestablished itself as a great power and to discuss plans for the upcoming South Stream launching. This example indicates that, as already identified by Goldthau (2010), there is a strong path dependency in mutual gas relations, which is hard (and costly) to leave. Moreover, this chapter sheds light on the two level relationship between Europe and Russia: one level involves the fruitful business alliances with gas giants from three key states—France, Germany and Italy, and a second level involves a mostly ineffective working relationship between Russia and the EU. Two of the schools of thought being represented in this study (liberalism and constructivism) argue that the stasis between Russia and the EU involves a clash in values, in which the EU vision based on its et quid and a competitive

350 Such deals would be prohibited under the so-called ‘third energy package’ approved by the European Parliament and the EU Council in mid-2009.

351 “BASF and Gazprom agree on asset swap” Kyiv Post, November 14, 2012

352 The sudden spike in demand followed a long phase of falling demand and exposed the inertia of the system.

353 Italy, alongside with Poland and Greece, declared major supply disruptions under the EU directive on security of gas supply.

354 “Italy’s Monti in Russia to boost energy cooperation,” Kyiv Post, July 23, 2012
market is not easily compatible with Russia’s norms and values. Yet this quite overlooks the fact that for forty years Russia has not been alone in promoting vertically integrated business alliances and asset swaps, but fully supported and in accordance with the interests of the European ‘champions’ such as Gaz de France ENI or E.ON. The wave of renegotiations and the mutual discontent regarding gas prices and volumes in the last few years, has slightly shaken the forty-years long honeymoon between Gazprom and these gas giants; nevertheless, it would be mistaken to infer from this evidence that the latter ones are satisfied with the European Commission acquiring increasing powers also in external energy policy. These companies are still fiercely competing for the “best deals” with energy producers, especially Russia, which in itself is not a bad thing, and is consistent with the competition logic that the EU seems to promote. On the other hand, to conceptualize and promote ‘common good’ projects such as Nabucco, even before the competency for such action is obtained, is not consistent with the procedural rules of accountability and democratic delegation. By reviewing the Southern Corridor debate, this chapter has also attempted to demonstrate that the stand-off between the EU and Russia is not the outcome of a lack of shared norms in turn preventing the actors to reconcile interests, as the Constructivist reading suggests. Closer analysis of data and recent events indicate that it is more a problem of different economic interests between consumer and producer countries and the challenge in harmonizing rules, with the underlying risk of imposing ill-fitting rules on both parties. Whose standards should prevail, the European or the Russian ones? Do we have an argument to claim, a priori, that the acquis is indeed better for Russia, considering its domestic institutional environment and legitimate interests, and therefore should be exported? As Finon and Locatelli (2008) put it: Russia sees itself as a sovereign power and has no plans to become part of a European common political and economic space; consequently, it has no immediate interest in bringing its regulations in line with European legislation. This refusal also means that Russia’s reasoning on gas issues is as much political as it is economic.” In addition, it is important to underline that the tension between the EU’s values and interests and the Russian ones is a subtle one. In order to fully implement its liberalization agenda, Brussels will need to overcome not only Gazprom’s resistance, but also the hindrance of key European energy firms, which indeed are the main and most shrewd lobbyists within the EU, also opposing higher levels of institutional integration with Russia and fearing to be institutionally locked into interdependence. These crucial actors, alongside with Gazprom, have benefitted from the status quo. Thus, to say that the EU is a unitary actor promoting a certain organizational model that is resolutely rejected only by Gazprom is not a valid criticism per se. Essentially, the conflict stems from the fact that the high-energy interdependence between Russia and the EU asks for regulatory and procedural answers on how to organize it, but the satisfaction of this goal might restrict the domestic and fairly represented articulation of interests and legal practices on both sides. No comprehensive and definitive answers to these questions are offered, yet only in context of this dilemma can we understand the lingering challenges moving forward. With this in mind, we now turn to the conclusions.
Part V
Conclusion
11. Conclusions

11.1 Introduction

The institutional landscape of the EU-Russian energy relationship is constantly evolving and at the time when I am finishing this dissertation, the weight of mutual suspicion has reached a painful but by no means unprecedented low point. At the writing of the last section of this study, the 30th biannual EU-Russia summit has come to its unsuccessful conclusion.\textsuperscript{355} In fact, even the Russian Ambassador to the EU, Vladimir Chizhov, who in the past had pressed for the speedy conclusion of a new basic treaty between Russia and the EU, in the midst of these negotiations declared that the negotiations had reached “a technical pause.”\textsuperscript{356} But the more prosaic reality behind such a euphemism is that in fact, relations have worsened and the European Third Energy Package is the epicenter of the controversy that has hampered cooperation. Yet compared to the past the economic stakes of such an impasse are higher and ever rising, due to the recently sharply increased globalization of the gas markets. This last chapter aims to provide a good illustrative summary of the empirical evidence that was collected in order to better understand the research question that guided this inquiry. The central question of this study has been stated as: Why, given the high degree of mutual dependency, to date, the EU and Russia lack legally binding instruments ruling their energy relationship?

The empirical analysis was based on the data detailed at length in section 5.5, in addition to the application of the conceptual framework based on three levels of analysis; starting with the identification of the main actors, a subsequent the discussion of their interests, and finally, the consequences of their interest formation (over time and given the dynamic market circumstances) on the degree of institutionalization of the EU-Russia energy relationship (see figure 7).

The application of this theoretical framework has yielded to a number of findings about the centrality of the business sector, the interesting dynamics between the multi-level and multi-actor private-public partnerships in the gas sector and how these apply to the energy governance case between the EU and Russia. This dissertation demonstrates that there are numerous opportunities to learn from the role of firms in international politics and, counter to conventional wisdom, argues that their interest formation affects the level of integration in the energy governance between states. Unfortunately, policymakers, as well as scholars, often miss such opportunities because of the tendency to overwhelmingly focus on the ‘geopolitical’ type of narrative that places states and their pursuit of power at the center of empirical evaluation. While it is undisputable that states are still crucial players in world politics, this lens on its own is not sufficient to understand the complex interplay in the (energy) business-government relations within and across nations. As a result of an overwhelming geopolitical reading of the gas business, we know very little about business-government dynamics in the natural gas sector and especially how the interests of key-business actors influence the institutional harmonization of the relationships under examination.

\textsuperscript{355} The 30th European Union-Russia Summit took place in Brussels on Thursday 20 and Friday 21 December 2012. The President of the European Council, Herman Van Rompuy, and the President of the European Commission, José Manuel Barroso, represented The EU. President Vladimir Putin represented Russia.

\textsuperscript{356} Euractiv, Russia, EU to foster ‘positive interdependence,’December 20, 2012
This study was devoted to the EU-Russia case, but the author believes that the findings summarized below can be applied to other cases where interdependence is proved to be a source of conflict. For example, the financial interconnectedness between China and the United States, amid very different institutional landscapes, in the final analysis leads to contested patterns of economic interdependence. That said, one should be always cautious with analogies, because each case has its specificities, which deserve in-depth inquiry. Finally, in the next section we review how the theoretical framework, combined with the empirical analysis based on four large case studies, is applied in order to provide an answer to my research question.

11.2 Main Findings and Final Thoughts

The evidence that we have surveyed indicates that contrary to conventional wisdom holding that high and ever-increasing levels of economic interdependence lead to agreed institutional frameworks of exchange, under certain conditions a high degree of balanced interdependence can instead lead to conflicting patterns. In a situation where a multitude of disputed interests are converging with high stakes for everyone, interdependence can lead to conflict. For example, it is true that most fundamentally, consumers’ quest for security is matched by producers’ quest for demand security. In principle, a secured flow of natural gas in the Eurasian network is a shared interest by all actors, both on the EU and the Russian side. In practice however, whereas this general interest is shared, other more specific interests and the way the two sides perceive energy security are in competition and hence, the relationship is a source of friction. Normatively, the EU and Russia are two exceptionally distant environments. According to the liberal neo-institutional approach, the tension stems from the fact that each side tries to impose its own social order, with the comprising sets of rules, values and practices, to the other side. The EU has attempted to managed its relationship with Russia by exporting the *acquis communautaires*, which would in fact enable the EU to ensure the security of its gas supply by giving its gas companies the possibility of obtaining access to the hydrocarbon resources of the producer countries (i.e. Russia). The latter is blatantly not interested either in the EU’s ‘norm entrepreneurship’ or in “importing” those rules that considers discriminating (Tomberg, 2009) and attempts to maintain an organizational model more consistent with its own institutional environment. The question thus is: whose institutional system should prevail at the “international” level, or in other words, when the two blocs attempt to cooperate whose “domestic” order should be chosen?

To say that answers to this dilemma are challenging, would be an understatement. Participants in the EU-Russian energy trade frequently claim to be seeking a level-playing field. However, as Chapter 4 (see table 5) has shown, there is a counterpoint to this assertion; if national tastes or conditions lead to different laws, the playing field of international cooperation will not, and should not, be level. For example, by seeking cooperation (and economic competition) that works internally and externally to ensure a level-playing field between EU and non-EU companies, the EU risks harmonizing rules at the cost of imposing ill-fitting rules on all. The core question is: do we have the elements, to claim *a priori*, that the EU’s institutional framework would, when and if, transposed to the Russian context, respond better to this country’s social, economic and cultural needs? What this thesis had tried to demonstrate is that there are no jurisdictional level right for all types of governance. The optimal decision-making is the one that can better accommodate diversity in national preferences and conditions, and that is consistent with governmental accountability and the practices of democratic delegation. For example, as this dissertation has discussed, the

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357 This approach has been developed by scholars such as D. North, J. Wallis and B. Weingast (2010). This group is a very eclectic grouping comprised of individuals supportive and trusting of multilateral institutions. It consists of individuals adhering both to “Liberal Institutionalism” and “Constructivism” as well as the English Realist School. This group is ideational and normative in orientation. They put their faith in diplomacy and pan-regional partnerships.
European Commission should refrain itself from taking advantage of the EU’s multi-scalar confusion to promote itself as an honest broker of the EU’s common energy interests.

Chapter 10 in particular, makes the case for return to reality by a sober understanding of the limits of the EU’s foreign policy weight. But most importantly, it is undemocratic for an elite multilateral institution, cosmopolitan and working in what its members consider the good of all, to override repeated demonstrations of informed, rights-regarding, fairly represented popular will. This could be benign technocracy, perhaps, but not democracy (Keohane et al., p. 15, 2009). That being said, the EU’s benign action in deepening the integration of the internal gas market, which is consistent with its legitimate powers, has been praised in this study (see Chapter 6). That allows the policing of opportunistic national actors when they distort fair competition by supporting their “national” champions. However, when their competition is consistent with the rules of the internal market, there is nothing inherently bad in not “speaking with one voice,” because that is what the companies do, they compete. A ‘common speaking’ strategic vision is only possible if the Commission is able to make a convincing case on how member states’ interests will be protected even if they relinquish their national oriented policies. The EU wants to manage the growing gas dependence of its member states; yet at the moment it lacks the institutional and geopolitical means of a joint foreign policy. However, a much closer and integrated approach is indeed possible if the Commission proves able to take a more flexible role. Ironically, the traditionally more Eurosceptic British private sector has shifted its position notably in favor of strengthening Community powers, as a result of the UK moving towards being an energy importer (Chapter 10). Nevertheless, ultimately, the EU energy policy still relies on decisions made in EU capitals.

Returning to the EU-Russia governance issue, some form of institutionalized exchange given the high level of interdependence is necessary and requires trade-offs among conflicting goals. There are no clear-cut answers. As noted by Locatelli (2012), the question as to whether the international standards generated by the EU through the Energy Charter Treaty (ECT) are consistent with Russia’s institutional environment is a key one. In fact, as noted by Kuchins & Zevelev (2012), on a broader level, the central debate today and going back at least two hundred years revolves around the West: to what extent Western liberalism is an appropriate model for Russia and how closely Moscow should ally with the West, or certain partners in the West, to achieve its goals. However, in contrast to Locatelli’s European versus Russian institutional dichotomy, empirical findings detailed at length in Chapter 6, suggest a more nuanced picture. The crude juxtaposition of the European system of governance based on a competitive economy itself framed by the rule of law as opposed to the Russian system fond of asset swapping is not the right one because there is an area of overlap, constituted by the shared interests of the corporate sector on both sides. As this dissertation has shown, until recently, the European corporate sector has favored asset swapping and bilateral relations as much as the Russian counterpart. In fact, here lies a sizeable paradox which deserves to be highlighted: presenting it as a dichotomy between the large system of values and interests of the EU on one side, and Russian normative ‘package’ on the other, does not do justice to the two-level dynamics happening within the EU. Therefore we need a more subtle differentiation. The battle until recently, has been chiefly between the interests of both Gazprom and the big gas giants within the EU versus the EU’s liberalization agenda. More recently, these firms starting to suffer huge losses, have partially changed their view, but have not repudiated long-term contracts as such (see Chapter 9). This has been possible despite the European Commission’s regulatory might due to the fact that the European companies are indeed the key actors in the European energy policy

358 See, for instance, the very recent controversial asset swap between Gazprom and the German chemical company BASF in November 2012, despite the rules of the EU’s Third Energy Package. For more information: “BASF and Gazprom agree on asset swap” Kyiv Post, November 14, 2012
integration and disintegration. Locatelli (2012) noted that the problems of defining new gas trading relations between the EU and Russia stem primarily from a clash of values and from Russia’s rejection of the EU’s power to enact rules regarding the organization of gas industries and markets. While the author agrees with the importance of the value gap, this study argues that the conflict stems primarily from the two levels tension between the interests of:

1. The European Commission vs. Russia
2. The European Commission vs. Europe’s national gas giants (backed by their respective governments) and Gazprom (backed by the Kremlin).

Generally, the second conflict stems from the fact that member states do not tolerate their energy sovereignty compromised and do not want to share power or even transfer the control over their national energy path. Thus, most of the states simply continue to conceive energy security as a state-led responsibility.

As demonstrated in the previous chapters, the EU national governments still strongly guard their energy policies and give political support to their energy companies when cutting deals, which is perceived as a welcome factor especially when dealing with giant counterparts such as Gazprom (and Russia). An in-depth analysis through different case studies illustrates that the main actors’ overall objectives in the EU-Russia energy cooperation are the maximization of national welfare and private profit. Among the two, the results of this analysis showed that the maximization of private profit is the strongest force. Moreover, while these two objectives often go hand in hand they do not always converge. Nevertheless, there is an important point of convergence; both member states and the energy firms are reluctant to the idea of ceding energy sovereignty to Brussels. Companies, which are the key actors, are wary of the European Commission assuming a role in managing external energy policy. Contestation stems from their fear to be “locked-in” an institutional design with Russia that would limit their current room to maneuver in negotiations over price and volumes of natural gas, but also over investment in crucial infrastructure. Therefore, for the reasons described in detail in the previous chapters, the European Commission is challenged not only by the Russian reluctance to adhere to its rules and norms, but also and most importantly, resistance appears to stem from internal dynamics inherent in Europe, i.e. the energy firms as well as individual countries that benefit from the status quo. At the EU-Russia level, according to Locatelli (2012), Bressand (2010), De Jong (2012) and several other sensible energy experts who defy narrow partisan judgments, it is clear that the rules of the ‘third energy package,’ which are at the heart of the current controversy, should be re-examined with suppliers. With Russia, the consumer only nature of the EU processes (i.e. ECT and PCA) is an impediment to in-depth cooperation. An alternative approach, would take into consideration the Russian proposal to develop *sui generis* institutions to balance producer and consumer interests. For example, so far the EU has shown no interest in discussing the new ‘conceptual approach’ to energy cooperation advanced by ex-President Dmitri Medvedev, and most probably it will ignore Russia’s new proposal of a general EU-Russia agreement on infrastructure. In all, and not surprisingly, the current institutions designed to set rules and standards in the EU-Russia energy trade tend to be contested and also appear to be ineffective in terms of compliance management. Laws are one thing, enforcement quite another, especially in cases when laws are contested. Overall, my research

359 See for instance, the internal conflict between Gazprom and the Russian government over the ‘dual pricing’ of natural gas, which is sold at a much lower price to domestic consumers (and some CIS countries) than on the export market. Gazprom is constantly lobbying to raise these domestic prices, but the government is cautious due to its use of natural gas as a “social shock absorber.”

360 See: EU reads ‘pragmatic’ answer to Putin’s energy agenda, December 18, 2012, Euractiv
finds that contrary to neo-liberal theories holding that high levels of balanced interdependence enhance the need for multilateral organizations with the role of providing predictable rules and standards and lowering the transition costs of cooperating, when a plethora of interests on both sides are in conflict, mutual dependence causes serious impasse, rather than cooperation. My conclusion is that some causal linkages seem to exist between high levels of economic interdependence and the establishment of ‘international regimes’ in order to reduce uncertainty, however, these linkages are not as direct and uncomplicated as the liberal institutional theories would suggest. That being said, I argue that it would be misleading to see the clash between Russia and the EU either only through narrow realist geopolitical lenses or attributing it solely to an institutional diversity or a value or identity gap of the broad families of institutional liberal and constructivist traditions of thought (see Chapter 5); the misunderstandings and conflicts derive predominantly from conflicting interests in the pursuit and maximization of private profit.

11.3 Future directions and policy recommendations

The big question in the coming years will be whether the EU-Russia energy cooperation can adapt towards more inclusive schemes, with acceptable solutions for both sides. The institutional frameworks of exchange the EU promotes today are narrow and biased toward supply-side solutions. From Gazprom’s perspective, given the volatility of the contemporary international environment in addition to growing uncertainties in the European gas markets, Gazprom is exasperated by an interlocutor unable to promise security. From the standpoint of Moscow, a EU that oscillates from seeking ‘positive interdependence,’ to diversifying at any cost away from its main supplier, to again fostering ever-changing environmental targets, raises doubts about the stability of its partnership. Therefore, Gazprom is increasingly wary about committing itself to a Union whose long-term intention remains a mystery. For that reason, in the future we could see the Gazprom-Kremlin tandem increasingly eager to diversify towards the East, with some potentially damaging consequences for the EU. On the other hand, from the EU’s perspective, Gazprom stayed aloof from these regulatory efforts politically supported by Putin’s intransigence in refusing to give “third parties” access to its pipelines and especially to South Stream. The inauguration of South Stream is the blatant epitome of Gazprom’s energy policy and its eagerness to remain the key player in the European gas market and the only vehicle (for the time being) for transporting Caspian gas to Europe. Gazprom’s strategy to increase its vertical integration and to market its gas directly to the consumers is sensible and perfectly in line with a monopolist behavior. The EU fears that as Russia gains interests in downstream assets as well as controls upstream supplies, its market power grows at the expense of its consumers. In the words of a EU official: The gas pricing is something that Gazprom has to adapt. Russia says the EU rules were discouraging Gazprom from investing in pipelines and gas storage facilities as they would grant others access to its infrastructure. Some legitimate concerns regarding investment protection will be examined. However, when operating within the EU’s jurisdiction, Gazprom and the Russian government will have to respect the EU laws.”

Yet adjusting the rules to match both sides is a fertile source of political tension between the EU and Russia. Solutions are out of sight and the number of thorny questions is multiplying, keeping pace with the growing interconnectedness and the spillovers of the globalized gas market. In any event, this study holds that the current design of the ECT and the PCA is biased toward supply side solutions; hence in order to unblock the current impasse the EU-Russia governance should adopt more effective rules and standards, respectful of the interests on both sides. For example, this study considers the cooperation within the context of the Partnership for Modernization

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361 Russia still supplies around a quarter of Europe’s gas imports and despite the current ‘gas glut’ in the long run gas imports are projected to grow (see Chapter 9)

362 European Commission’s DG Energy top civil servant – Interview with the author, May 2012, Brussels
launched in 2010 as a good germ from where to start a more balanced cooperation. Unlike the PCA, the Partnership for Modernization is not split in two because of dragging negotiations over the energy issues. Instead, it has thus far enhanced co-operation in innovation, research and development and promoted economic restructuring to the mutual benefit of both European and Russian enterprises. Thus, the latter could be seen as a ‘win-win framework’ for distributing the cooperation benefit. Furthermore, as explained in Chapter 8, ‘grandiose plans’ and solemn declarations perhaps are not the most efficient way to increase cooperation and mutual understanding between the two players. Fostering bottom-up cooperation in peripheral, albeit crucial, ‘contact zones’ such as Southeast Europe, by promoting small-scale people-to-people links could bring about benefits and positive spillovers into the ‘wider’ picture.

Ultimately, this study has sought to demonstrate that Russia needs the European market at least as much as (but in reality much more)363 than the latter needs its gas. Given this strong energy connection the EU should if anything, try to agree on a common analysis of Russia: is Russia a partner or a threat? According to Luciani, “It would be an exaggeration to view Russia as a threat to the EU’s energy security, but neither should it be viewed as a preferred supplier.” In this context, it is not obscure that like many other energy producers, Russia favors bilateral approaches and makes frequent use of economic means to promote its interests. The EU, on its part should make sure that Gazprom respects the rules of its competitive gas market when operating within the EU. As long as the Europeans fail, among themselves, to deliver at least a basic common stance on Russia, the EU-Russia institutional cooperation will inevitably remain a very divisive issue. However, this is not to say that in this author’s opinion a ‘one voice’ Europe in external energy policy presided by the European Commission is the way to go. At the EU level it would be wise to reinforce the idea of a balanced partnership with Russia. In the medium term, neither of the two parties should be interested in limiting discussions only to energy exchanges. Taking a wider look, in the context of a rapidly changing world, the EU and Russia could find synergies in coping together with the “rise of the rest.” The extraordinary economic growth of China and the relative decline of both Russia and the EU, at least in principle, could raise common concerns and make cooperation more desirable. [According to the Liberal Realist Barry Buzan, rather than unipolarity or globalization the world is moving towards multipolarity and regionalism in an economic sense as well. In the years to come we should expect a more regionalized, i.e. decentred globalist world in which the West is in relative decline and no country is able to maintain a power differential due to the slow rise of all the others. As this inequality diminishes, the most likely scenario for world politics is decentred globalism, in which there will be no superpowers, only great powers.364 Regardless of whether such an analysis proves correct or not, in a context of power diffusion and rapid growth of new centers, Russia and Europe could, in principle, find ‘common ground’ in coping with the rise of the others. As Harvard’s Joseph Nye puts it, a ‘smart power’ narrative for the twenty-first century is not about maximizing power or preserving hegemony. It is about finding ways to combine resources into successful strategies in the new context of power diffusion and “rise of the rest.”365 Considering the formidable growth of China, but also of emerging countries such as Brazil and India, Europe and Russia could use their long diplomatic experience to strengthen a positive alliance. In a context of a more regionalized world and low-trust globalization, the combination of

363 Simply put, the Russian budget and by consequence the sheer survival of the Russian state depends heavily on the export of energy to the EU, much more than any of the EU-27 states depends on Russian gas.


365 Smart power is the combination of the hard power of coercion and payment with the soft power of persuasion and attraction, Nye (2011).

geographic proximity, cultural similarity and common challenges make EU and Russia well placed to seek constructive dialogue in the future.

Yet in practice there is a much more negative side to the issue; despite high levels of EU-Russian energy interdependence there is persistent institutional diversity, which raises doubts whether closer integration could be achieved in such a way to absorb the more immediate, albeit currently conflicting, legitimate interests of both sides. Despite the acknowledgement of both (at least officially) of the importance of agreeing on common rules governing energy trade and investment, the above-discussed issues make negotiations of such binding rules very difficult. This dissertation has attempted to illustrate the complex tension arising from attempts to harmonize the EU and Russian norms and practices on the one hand, and keep the “domestic difference” on the other.

The core puzzle is whether, and if so how, the EU-Russian partnership can adapt and prosper in an ever more globalized gas market. Despite their obvious interdependence, the more immediate interests of the two blocs differ significantly, and finding common ground will be challenging. In light of the empirical analysis and the critical points presented in this dissertation, I would like to conclude presenting three “possible futures” on how the energy relationship between Russia and the EU could evolve:

1. Ever-increasing energy interdependence framed by some form of legally binding and commonly accepted institutions, or in other words the reaching of a compromise and therefore a positive outcome.
2. Less energy interdependence and more diversification on both sides as a result of an inability to work out commonly acceptable rules regulating the natural gas trade, ultimately leading to a shallow and more fragmented institutional landscape underpinned by decreasing economic interdependence; a negative outcome but leading to a relaxing of the current stand-off.
3. Ever-increasing energy interdependence, yet itself framed by an increasing fragmentation of the institutional landscape, or in other words a preservation of the status quo in the legal space and a rising fragmentation in the EU-Russian political ties.

Given the current difficulties, this author believes that it is hard to imagine the positive outcome of the first proposition any time soon; yet in the longer-term the two actors will have to strive towards an institutionalized form of exchange. Therefore, this optimistic scenario is not completely out of question, yet it remains a distant prospect. Regarding the second proposition: talk about Russia diverting gas exports to Asia is not relevant in this context. Russia will obviously diversify its export markets, but Europe will always be the one market that offers the best netbacks. In the same vein, although Europe will try to develop alternative export routes, Russia is, and will remain, by far Europe’s most important gas supplier. Yet, as noted in Chapter 9, as Gazprom’s position in Europe weakens, Asia will become an increasingly attractive market, still promising significant growth opportunities. The third scenario is in many respects the most plausible. The emergence of a hybrid or even fragmented environment in the European gas market is already a reality (Goldthau; 2012), which is somewhere between state dirigisme and market liberalism on one hand, and a hybrid combination of oil-indexed and ‘spot’ pricing, on the other. Uncertainties are growing and at the moment re-launching and saving the EU-Russian moribund institutional cooperation is neither a priority on the European nor on the Russian side. Finally, regarding future developments, it will be a challenge for both policy-makers and businesses to navigate
with skill in this increasingly uncertain regional gas market environment dominated by hybrid private-public partnerships.

11.4 Contributions and Significance of the Study

Building on the inspirational work of Abdelal (2011), this dissertation has endeavored to disentangle the complex, sophisticated and multi-level dynamics between:

(i) The bilateral and multilateral cooperation between the EU and Russia
(ii) The role of the European national businesses and governmental relations with Gazprom and the Russian government respectively
(iii) The internal dynamics between the European governments and gas firms on one side, and the EU on the other

The interdisciplinary, multi-level and multi-actor approach adopted in this study was extremely useful in the analysis of the above-indicated relationships and their impacts on the EU-Russia energy governance. A narrow focus on nation-states level or looking solely on the supranational, EU level vis-à-vis Russia would have not revealed this variegated and interlinked web of relationships. This study also highlights that a focus on actors ‘below the state’ such as sub-state actors can help to enhance regional synergies through bottom-up energy cooperation, and thus compensate somewhat for the deadlock at the macro-level (Chapter 8). In addition, it emphasizes that in both the EU and Russia the key drivers of action are large gas firms. The results of this analysis indicate that the maximization of profit for its own sake is the main driving motivation, undermining the more traditional view of Eurasian energy relations, which often over-emphasizes the ‘political’ factor in the domain of energy relations.

In this sense, the dissertation has critiqued neo-realism for being too dismissive of the profit motive, which indeed is driving the dynamic multi-level context of the EU-Russia energy relationship. The study has also addressed the limitations of the neo-liberal institutional agenda in the energy sector, which sees the deadlock in the current cooperation as a result of the inability of the EU to ‘speak with one voice’ and/or the unsoundness of the Putin’s regime. Obviously, there are structural differences in the way the two actors define their goals, however it would be mistaken to attribute the failure of binding governance to these, primarily. Through different case studies (Chapter 7 through 10), this study has demonstrated that commercial considerations made by corporate actors are the main obstacles to binding governance frameworks. In sum, this dissertation has, through an interdisciplinary analytical framework, detailed the limits of the narrow geopolitical lens and the reductive explanatory power of the broad family of neo-liberal explanations. Theoretically, it responded to an analytical gap in the IR literature and a weakness in the IPE literature by primarily building on the work of Abdelal, who invoked the scholarship of Raymond Vernon. This has re-launched an interesting strand of analytical thinking within IPE by taking into consideration the variety of business-government relations that prevail in international politics. I hope to place my work within this recent and increasingly growing IPE literature and its novel conceptualization of energy governance as well as to more general studies that focus on impediments to cooperation in situations of high economic interdependence. This dissertation has revealed a number of political narratives and values, while simultaneously showing that economic interests often take over. It has sought to contribute to the often-partisan debate on the EU-Russian relations and every effort was made to add to our knowledge without subjectivity bias. I hope that this dissertation has

Abdelal proposes that the field of IPE revisit and systematize the insights of a previous generation of scholarship, such as the work of Vernon, that took more seriously the role of firms and business-government relations within and across nations
helped to entice curiosity for more theoretically informed studies on the nexus between the interests of energy firms and the outcomes of energy governance within and across nations, which at the moment is a growing, but still under-researched field of study. Ultimately, as this thesis had demonstrated, unpacking the empirical reality from normative judgments is never easy, and hence requires more in-depth inquiry and scholarly attention.
Selected Bibliography

This bibliography indicates the list of works cited and related published materials. It consists of books, chapters in books, academic journals, policy papers, reports and annuals, official governmental publications, and authored newspaper and web-based articles. Additional website references, where they may be helpful to the reader, appear in the footnotes of the individual chapters, although online resources are often temporary by nature. The resources are arranged in alphabetical order primarily by author’s name and secondarily by date. Where an author has more than one article in the bibliography they are shown in order of date of publication.

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