

Chapter Three

Common Rules without Strategy: EU Energy Policy and Russia

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The European Union's (EU's) energy policy toward Russia—or, to put it more precisely—the absence of a coherent policy, is a hotly debated topic in academic and policy circles. The overall message is clear and has been reiterated for many years: As long as the EU does not act in a (vertically) coherent way it cannot be externally effective. But coherence would require that Member States limit their individual sovereignty over decisions for the sake of a greater autonomy at the community level. This has proven to be especially problematic with regard to energy policy, which may be regarded as a domain of “high politics” in external relations and is subject to politicized debates internally as well. Historically, energy policy has been regarded as a national prerogative, strongly linked with national security and public service. Also, a common external policy needs an agreement on what it is about: Should energy policy toward Russia concentrate mainly on maintaining energy security or should it be seen as the core of the overall foreign policy toward Russia? As energy is an important aspect both for the EU and Russia, a conflation between external energy policy and foreign policy in general can easily occur. This makes it even harder to arrive at a common position, as there are far more possible objectives in general foreign policy than in energy policy. In addition, foreign energy policy does not only involve state actors, but also big economic actors that control the economic processes underlying energy policy.

This chapter evaluates the EU's external energy policy toward Russia according to the general criteria of energy security policy. After giving an overview over the challenges Russia poses to EU energy security, the chapter will examine the policy measures the EU has taken vis-à-vis Russia. When evaluating the success of the actions taken, special emphasis will be on the goals of the various actors in

the EU. The account of the EU's energy policy toward Russia focuses on the following three levels: External initiatives, aimed at enhancing energy security via a reduction of risks effected by Russian detrimental behavior; external initiatives, aimed at increasing resilience by diversifying energy supply routes; and internal initiatives in the gas market, which have direct effects on Russia. Specific attention will be given to the natural gas sector, as it has been in the focus of the EU-Russia energy relationship. This is due to its high capital intensity and the rigid grid-bound transportation needs, which bind suppliers and consumers closely together in a long-term relationship. This necessitates a much higher degree of coordination than the oil or coal markets. In addition, Russia's reserves of natural gas are much bigger than its oil reserves.

The Russian Challenge to EU Energy Security

Declining indigenous production of the EU and substantial Russian gas reserves result in a mutual interest of the EU in Russian gas supplies and of Russia in the EU gas market. However, notwithstanding this mutual interest, the goals of the actors diverge substantially. With some simplification, the challenge to the EU is most often described as being the result of a Russian worldview and corresponding priorities that fundamentally differ from those of the EU (Finon and Locatelli 2008, 424). Whereas the EU adheres to a "markets and institutions" approach envisaging strong and binding rules allowing markets to allocate value, Russia pursues a realist "regions and empires" strategy, focused on establishing the state as the prime decision-maker, presiding over the economy. This goes along with a fuzzy boundary between economic and political goals.¹

Thus, current Russian energy policy is based on the conception of oil and gas resources as strategic goods, requiring the reliance on direct influence of state actors rather than on market forces to regulate their extraction and distribution. Increasing state influence and regulation of the sector by manipulation of laws is partly a consciously planned policy in order to be able to use oil and gas corporations, especially the gas monopoly Gazprom, as domestic and foreign policy tools in the absence of other attractive instruments (ideological, institutional etc.) and partly the result of spontaneous processes of property redistribution to the bureaucracy and security services (Easter 2008; Treisman 2007; Zudin 2006).

In this context, several challenges have been discussed:

- Some have argued that the renationalization of the oil and gas sector and the resulting deinstitutionalization of the sector led to underinvestment in exploration and production in Russia. This was seen as a possible threat to future gas export possibilities.² However, substantial room remains for reducing gas demand inside Russia, which is Gazprom's biggest market from a volume, but not from a revenue perspective. Meanwhile, more than 60 percent of Gazprom's revenues are generated on the EU market (Grätz 2009, 67). Thus, because of the attractiveness of the EU market for Gazprom, a supply shortfall is not very likely. Rather, it makes sense for Gazprom to foster the perception of resource scarcity by upholding information scarcity on investments, in order to obtain more price-setting power by simultaneously driving a strategy of high market penetration (Christie 2009, 10).
- Gazprom drives an expansion strategy to the EU's downstream markets striving to enlarge its market share and profits. As the highest profits can be obtained by rising barriers toward possible competitors, Gazprom has a vested interest in segmenting Member States' markets (Noel 2008). Thus, Gazprom tries to use the opportunities of gas market liberalization in order to monopolize markets and thereby to undercut the EU's liberalization and market homogenization agenda. What is more, in an effort to monopolize the EU market, it tries to obstruct the EU's diversification strategies by launching competing pipeline projects and co-opting potential independent suppliers from Central Asia (Milov 2008, 6; Götz 2008). As this increases Gazprom's market power it endangers energy security by hampering supplier diversification and imposing artificially high prices on consumers.
- This economic strategy goes along with a strategy to harvest the political gains that go along with economic dependence (Liuhto 2010). In the "near abroad," Gazprom traditionally used the dependence of Central Asian countries on export routes through Russia, relieving it from the pressure to invest in drilling and exploration at home and achieving the additional goal of binding these states to Russia politically (Christophe 1998; Westphal 2003; Vahtra 2005). As a new development, Gazprom and state-owned Transneft' were used as foreign policy tools against "unfriendly" neighbors such as Ukraine, Georgia, or Lithuania (Milov 2008, 7f; Finon and Locatelli 2008). Thus, Russia aims

at reaping the “double dividend” of revenue flows and political influence generated by market power (Christie 2009, 12).

External Initiatives toward Russia

The EU’s external energy policy toward Russia can be traced back to the beginning of the 1990s. Since the last days of the Soviet Union, the European Commission’s (hereafter: the Commission) approach was not to limit dependence on Russian energy imports per se, but to use structural power by involvement of capital from the EU in Russia’s energy sector and, most important, by protecting these investments not on the basis of personal deals but on the basis of institutionalized rules agreed at the international level. Such an international regime would have limited the potential of political actors to interfere with commercial transactions in an unforeseeable way and thus would have limited the security of supply risk of arbitrary behavior by Russia. As these efforts failed, the Commission consistently tried to develop new formats for promoting its vision. But Member States were not helpful in the Commission’s efforts, as they established their own bilateral cooperation schemes and could deliver on Russian demands far more effectively.

The Energy Charter Treaty

The first major tool was the Energy Charter, which evolved into a multilateral treaty. The Charter process was started in June 1990 by Dutch prime minister Ruud Lubbers, who surprised other heads of state when he distributed his proposal at the European Council summit in Dublin. The basic idea was to export European rules to Eastern Europe and the Soviet space in order not only to solve the problem of property rights protection, but also to spur the transition to a market economy and to stabilize the European neighborhood macroeconomically (Balmaceda 2002: 22; Kemner 1996: 210; Konoplyanik 1992). This idea was then packed with symbolic meaning by comparing the plan to the European Coal and Steel Community that started the EU integration process back in 1952. So, not only were energy policy goals strived for but also wider goals of foreign policy, such as the stabilization and ultimately the integration of Russia into a European rules-based order. Institutionally, the plan not only foresaw the guarantee of property rights for investors, but it should also be able to

regulate transportation, market access, and constant access to all hydrocarbon reserves.³

The plan reflected several structural conditions present at that time. First of these is the decrepit situation of the Soviet energy sector and the Soviet economy in general that was in desperate need of capital injections; second, low energy prices with oil hovering between \$15–20 per barrel, resulting in low investment levels; third, the need of Western and Eastern Europe for energy imports and possible vulnerabilities arising from excessive reliance on oil imports from the Middle East; and finally the capital and technological resources Western Europe had to offer. At the same time, a historical situation was seen to be present which could result in an integration process between the Soviet space and Europe on the EU’s own terms.

The proposal met the approval of the other heads of state and the European Council mandated the Commission to elaborate on the basic principles of an Energy Charter. The Commission started to work immediately and won the approval of Soviet diplomats already in the beginning of July, who claimed that it was in accord with the Soviet “vision of the solution to Europe’s energy problems.”⁴ Momentum was added due to the unraveling Gulf War and plunging Soviet oil production. The Commission was especially interested in the proposal, as it fit in perfectly with its internal goals of energy market liberalization that were worked upon at the same time (Matlár, 1997). More specifically, the Energy Charter could be used to support competition on the production level that was sought after as a useful complement for the liberalized internal market (EC - COM(91) 548 final: 25). The proposal crafted by the Commission contained much more liberal provisions than the original Lubbers proposal—for example it postulated the free access to known and future energy resources and to their extraction, as well as a free energy market (EC-COM(91) 36 final: 9). The Council granted negotiation rights to the Commission in April 1991.⁵ Notwithstanding the August coup and the breakup process of the Soviet Union, the political declaration initiating the Energy Charter process was signed on schedule in December 1991 with both the Soviet Union and the Soviet Republic as signatories.⁶ The Charter contained the political commitment to work on a binding multilateral treaty that would regulate energy investments, transport, trade, and innovation. It was opened to all interested parties; the signatories included Japan and the United States. The treaty would contain a basic agreement and several issue-specific protocols.

The negotiations that followed proved to be much more difficult, as negotiated provisions were to be made binding. The basic principle

of the Energy Charter Treaty (ECT) is the extension of GATT principles to energy trade and investment, specifically most-favored-nation treatment and national treatment.⁷ But the negotiation process of the ECT was delayed substantially not because of the resistance from Russia but because of the disunity on approaches to regulatory policy in the EU and the Organisation for Economic Co-operation and Development (OECD) camp in general. As the Charter foresaw a far-reaching liberalization of transport networks, some Member States feared losing their grip over the energy sector. As a result, the proposal for mandatory third-party access (TPA) to export and transit pipelines put forward by the Commission and supported by the United Kingdom (UK), was dismissed by France and other Member States. This resulted in a watering down of the provision, which now provides only for negotiable access.⁸ The same disagreements came to the forefront regarding foreign direct investment, where notably France and Norway resisted the mandatory national treatment principle of foreign investors, which as a result was made nonbinding (Doré 1996, 142; Liesen 2004, 52). These disagreements revealed the lack of consensus on gas and electricity market liberalization in the EU and substantially delayed the negotiation process.⁹

Further delays occurred because of a lack of competence on the side of diplomats and experts from the former Council for Mutual Economic Assistance (Comecon) states, which had to familiarize themselves with capitalist treaty provisions. But in contrast to the internal divisions of the OECD camp, these delays did not reflect a disagreement with ECT principles on the Russian side. The only caveat from the Russian side was a temporary exemption from certain rules for transition countries, to allow for relevant laws to be adopted. The Russian negotiating team was reform-oriented and favored a quick negotiation process, as the energy sector was still weakly organized and domestic opposition to the treaty had not yet been voiced (Doré 1996, 147; Wälde 1996, 316). In this context, the Russian side, aware of possible future difficulties, wanted to use its “window of opportunity” of a certain autonomy vis-à-vis certain domestic pressure groups to agree on an international accord that would then limit the influence of these groups. But the negotiations stalled again in 1993, this time due to opposition voiced by the United States, who found that provisions on investment were lagging behind other bilateral treaties it had concluded with different producer countries.¹⁰ This led to a delay of one year, with the basic ECT being signed in December 1994, without the United States. At that time, one of the Russian negotiators already spoke of possible

resistance in the Duma and oil-extracting Russian republics.¹¹ As a result, a crucial window of opportunity may have been missed by the West in drawing out negotiations on the treaty. Thus, the EU itself established disincentives for Russia to ratify the treaty by its disunity and its incoherent approach to the ECT. This is not to claim that Russia would definitely have ratified the treaty if Member States had acted in a coherent way. But this is a recurrent problem, which will be explained later in the chapter.

While the ECT was still promoted by the Russian government in the 1990s, it was more and more seen as an infringement on sovereignty, especially in the Duma, which at that time still constituted a force of its own. Leftist factions viewed the ECT as a threat to the Russian national interest because it would spur energy exports, would represent a “sell-out of the homeland,” and weaken the position of domestic capital.¹² They were reportedly supported by Gazprom who feared obligations to open up its pipeline network to third parties and to grant transit rights to Central Asian countries, which would have weakened its power (Balmaceda 2002, 23). So, ratification was stalled in the Duma committees from 1996 to 1998, and an attempt at ratification failed in 1998. As time went by, it became increasingly obvious that Russia would not ratify the treaty. In the meantime, as it had signed the treaty, Russia was obliged to apply the ECT provisionally, as foreseen in Article 45. This gave some investment protection to corporations of Member States and led to an arbitration case by YUKOS (Yuganskneftegas Kuibyshevnefte OrgSintez) shareholders. But in August 2009, Prime Minister Vladimir Putin signed a decree to withdraw Russia’s signature from the treaty.

The EU-Russia Energy Dialogue

As the failure of the ECT became more and more evident, the president of the Commission, Romano Prodi, launched the bilateral “Energy Dialogue” with Russia in 2000 to at least communicate with Russia about planned steps in energy market liberalization and to promote energy market harmonization. The Energy Dialogue was established in October 2000 on a bilateral basis. The Dialogue was based on the Partnership and Cooperation Agreement signed between Russia and the EU in 1994. Both the Commission and the Kremlin appointed “single interlocutors,” who are responsible for the process of cooperation. Apart from normal intergovernmental negotiations the interlocutors organized some “round tables,” where all relevant stakeholders

from European and Russian energy business met with government officials to discuss their positions and to agree on issues of common interest (EC-COM (2004) 777 final). At the outset, four issue areas were identified: the implications of the internal energy market for the EU-Russia relationship, the sustainable use of energy, security of supply and the harmonization of markets. The policy content stayed the same: “establish predictable trade rules, improve networks and encourage investments by promoting a more stable and transparent legal framework.”¹³

In the beginning, the Commission tried to use the Energy Dialogue to promote the ratification of the ECT. But this was fruitless, as energy prices had recovered, alleviating Russia’s need for FDI. The central Russian political elite now strived for achieving as much control as possible over the energy sector. The central task for them was now to curb the autonomy of private capital and the regions. New foreign investors would only be detrimental to this process.

In connection with the first issue area the Commission also wanted to tackle the problem of long-term delivery contracts for gas, including destination clauses.¹⁴ But attempts were not too successful. No overall agreement prohibiting destination clauses has been reached, only a renegotiation of contracts to eliminate such clauses on a case-by-case basis could be agreed upon.

Since the mid-2000s, the Energy Dialogue has been used by the EU mainly as a device to keep some contact to the Russian side and to try to exchange information on energy issues. But even these attempts are often jeopardized by the Russian side: Some of the subgroups do not meet due to a lack of interest by Russia, which often refuses to appoint representatives or agree on schedules. Recently, progress has been reported mainly on the energy efficiency topic, most likely due to the reason that an amount of 5 million euro in EU funds was allocated to promote energy efficiency in Russia in 2009 (EC 2010b, 22f).

Observers of the Energy Dialogue point to the fact, that Russia was able to “monopolize” the dialogue several times for its own purposes, playing on its bargaining power as a major energy supplier (Westphal 2005, 18). This is not only due to structural issues such as growing energy demand, tighter markets, and high prices that were present from 2002 until 2008, which resulted in a “new energy paradigm,” as some argued (Helm 2007; Spanjer 2007). These structural conditions cannot fully explain the lack of attention given by Russia to the EU level—especially not after the abrupt drop in energy prices in mid-2008. What is more, the EU does not possess the necessary institutional and structural features to act coherently in the energy

sphere, as Member States followed their own interests and cooperation projects with regard to Russia (Barysch 2004, 53f; Westphal 2008). As a result, Russia was not interested in the EU level, but oriented its efforts toward Member States. A sufficient explanation must therefore be sought from a more detailed examination of the Member State’s strategies toward Russia.

The Member State Agenda: Fostering National Champions

The Western European gas industry traditionally operated on the basis of national or regional distribution monopolies, which negotiated with the suppliers, mainly Algeria, the Netherlands, Norway, and Russia (Finon 2004, 185; Wybrew-Bond 1999). The monopolies could keep the balance between supply and demand via their function as “gatekeepers.” They were controlling market access and concluded accompanying long-term, take-or-pay contracts based on rigid oil product-based pricing formulae. Competition only took place between fuels and to a very limited extent between gas producers when new contracts were negotiated. The pricing formula ensured the “competitive” pricing of gas in every market situation and for every consumer group and thus guaranteed margins for distributors. For suppliers, this arrangement meant that gas could only be sold at the border to the monopolies, a condition they were willing to tolerate as it guaranteed them substantial long-term stability of demand (IEA 1998, 32; Stern 1998).

Privatization and liberalization of the EU’s gas market, which began in the early 1990s, began to threaten this order and at the same time opened up new possibilities for the national monopolies and suppliers. The easier entry of competitors was threatening their position at the same time as they could become competitors in other markets as well. Therefore, they tried to keep their traditional position in their home market to the largest extent possible, at the same time trying to penetrate other markets. Substantial vertical and horizontal integration took place (Finon and Midttun 2004), supported by national politics, in order to form “national champions,” which would be able to compete on a European scale without falling prey to a hostile takeover. The companies argued that big national champions were needed in order to counterbalance the power of suppliers (Bergmann 2005, 3). Thus, as liberalization moved on, incumbents and national politicians formed an alliance to protect their vested interests—the

former fearing a deterioration of their position and the latter a loss of control over energy policy. This led to a joint “beggar-thy-neighbor” strategy of Member States and market incumbents, which were on the one side eager to exploit the new possibilities opened up by liberalization in other markets, whereas they strived to limit competition in their own market as far as possible.

This strategy of strengthening national capital was also played out in external relations. While claiming to enhance the EU’s security of supply, especially German and Italian politicians would offer their national incumbents concrete support in gaining access to Russian upstream assets by providing and sustaining an undisturbed political environment, as well as facilitating asset swaps and granting exemptions from national regulations.

At least in Germany, this policy was pursued with a general frame of reference that went beyond energy security goals: A general policy of integration very much in line with the initial motivations of the Energy Charter process was pursued, but this time in absence of the common framework the Charter wanted to provide. This policy was justified within a renewed “Ostpolitik” framework, claiming that integration of Russian and German-cum-European capital would eventually contribute to political rapprochement, peace, and integration (Rahr 2007; Steinmeier 2007; Whist 2009, 179). Former German chancellor Gerhard Schröder, who is now working for Russia’s Gazprom, has added geopolitical reasoning to this German strategy and “uploads” it to the EU: he claims that the EU needs to pursue integration with Russia in order to compete economically, politically, and culturally against the United States and rising Asian powers such as China (Schröder 2006; 2010). The policy that follows from this agenda is opposed to a policy that would result by focusing on energy security, where reduction of dependence on a particular supplier and not its increase would be in order. Needless to say, this foreign policy orientation did not reflect the goals of central Eastern European nations, which adopted an Atlantic orientation and wanted to integrate with the West, but not with Russia.

The German example shows that a policy that is problematic from an energy security viewpoint was deliberately taken out of this policy domain and justified with the wider rationale of contributing to economic and eventually political integration. However, even if the goal of political integration between Russia and Germany (or, for that case, the EU) is accepted as a legitimate and achievable goal, it is difficult to comprehend how integration of energy sectors could contribute to political integration, as the Russian energy sector is marked by deep

politicization and subjected to strategic goals of the Russian political elite (Liuhto 2010).

These bilateral deals that are pursued by Member States were to the detriment of the EU’s policy of promoting a common framework. These deals rendered it very cheap for the Russian side not to respond to demands made by the EU. On the contrary, “gatekeepers” to the Russian market such as Gazprom could gain high yields from their control of the rules and resources. They could use this control, as well as the readiness of European companies to compete with each other, for advancing their own projects through asset swaps.

In addition, the national strategies contributed to suboptimal outcomes for the internal energy policy from a community point of view. For example, transit avoidance pipelines such as Nord Stream are not only more costly than onshore pipelines but also bypass several EU member countries that could have benefited from the additional supplies. Other cases in point are exemptions from EU competition regulations, granted for new projects by national authorities in order to make investments more profitable.¹⁵

Facilitating Dependence Reduction: Promoting Supplier Diversification

Apart from trying to limit the risks of dependence on Russia by promoting common rules, the Commission tried to promote alternative supply projects, such as LNG regasification terminals and import pipelines. Here, the Commission mainly proposed to act as a coordinator and facilitator of projects already proposed by the industry. It started in 1996, when the Council adopted two decisions on trans-European energy networks of “common interest,” later termed TEN-E projects (EC-96/391/EC, 1996; EC-1254/96/EC 1996). Priority was given to electricity, specifically to interconnections in the internal market, and on connecting isolated energy networks to the EU-wide grid. Besides, it included also gas interconnection and supply projects. With these decisions the Commission got awarded relatively wide-ranging competencies: Apart from the task to facilitate cooperation between Member States, it could also decide on granting financial assistance to the designated projects. Nevertheless, all measures had to be agreed upon in regulatory comitology procedure by a qualified majority of the committee’s Member State representatives. The Commission acted swiftly, first, by granting funds for feasibility studies for several projects and then even by co-financing the capital costs

of two electricity undersea cables in 1998, linking Sweden and Poland as well as Norway and the Netherlands (EC Energy 1998). It also proposed to broaden the list of projects several times and obtained the approval from the EP and the Council. However, except for granting priority status to some LNG terminals, no efforts were made to diversify away from traditional gas suppliers.

In the early 2000s, external gas infrastructure was given specific attention, in line with rising energy prices and the first Commission Green Paper on the security of energy supply. The Green Paper explicitly mentioned new supply routes from the Caspian Sea basin and southern Mediterranean as remedies for insecurities associated with growing import dependency (EC - COM (2000) 769 final: 73). In 2002, the Commission proposed to create a new category for dedicated "Priority Projects," which should form a special subset of "common interest" projects. Such projects should be "very important" for realizing competition in the internal market or the strengthening of security of supply (EC - COM (2001) 775 final: 42). They should be entitled to receive as much as 20 percent of estimated total investment costs from the community budget (EC - COM (2001) 775 final: 23). The Commission also identified three "priority axes," including two pipelines from Algeria, one northern corridor from Russia to the U.K., now being realized with the Nord Stream and BBL pipelines, and one southern corridor from the Caspian Basin via Turkey and Greece to the Central European grid, now known as the partly competing Nabucco, Interconnection Turkey Greece Italy (ITGI) and Trans-Adriatic Pipeline (TAP) projects. These proposals were adopted in mid-2003 with no major changes (EC - 1229/2003/EC 2003). From now on, the bulk of the community funding was allocated to gas projects, predominantly in the Mediterranean region, where gas markets were still in their infancy. The Nabucco project and associated pipelines received the largest portion of financial support, amounting to 11.4 million euro (EC - COM(2006) 443 final: 31).

Already at the end of 2003, the Commission submitted a new proposal on improving the gas network development together with other proposals aimed at improving network access and energy efficiency. This was mainly in order to broaden the scope of priorities of network development toward meeting the needs of accession countries (EC - COM(2003) 743 final). In addition, the Commission proposed to add a third category of projects that would receive highest priority. This was due to the fact that the Commission was dissatisfied with the lengthy authorization procedures new projects encountered in many Member States. For these "projects of European interest"

the Commission proposed to appoint a coordinator in consultation with Member States in case of difficulties. In case of severe delays the Commission also foresaw the right to withdraw the attribute "European interest" from the concerned project. The new category was deleted entirely in the Council's first reading and substantially watered down after its reinsertion by the Commission. Neither did the Commission receive the right to appoint a coordinator on its own, nor to withdraw the attribute "European interest" from the project in the decision adopted in 2006. The list of projects of European interest was mainly composed of those projects that were termed "priority projects" before (EC - 1364/2006/EC). In 2007, four project coordinators have been appointed by the Commission, three of them for electricity projects internal to the EU and one for the coordination of gas supplies from the Caspian basin (Nabucco). The coordinators have produced reports and recommendations to the Commission based on their findings and seem to act mainly as an additional external source of information for the Commission.¹⁶

The budget allocated to TEN-E energy projects has been minimal—about 20 million euros annually. Thus, the EU could only contribute small amounts to each of the projects. This situation has changed in 2009, when the Council approved a "European Economic Recovery Package" as an extraordinary measure to smoothen the impact of the 2008 economic crisis (EC - COM(2010a) 203 final). Consequently, 1,39 billion euros were granted to gas pipeline projects, in order to avoid bottlenecks when demand would pick up in line with an anticipated economic recovery and to avoid a drain in skills in the construction sector. Under the package, 200 million euros were approved to the Nabucco project and a further 100 million euros to the ITGI pipeline (EC 2010a). These projects would eventually contribute to diversification away from traditional European suppliers.

In sum, the success of the EU's policy on diversification in the gas sector is not overwhelming, despite considerable Commission activity in providing assistance. As many factors and players are involved it is hard to judge the impact precisely. However, no clear interrelationship between funds granted and progress of a "priority project" seems to exist. This is especially true for the northern European region, where out of six priority projects four received EU funding, three of which were postponed indefinitely (Skandled, Baltic Pipe, and Yamal II). In contrast, the Nord Stream pipeline, which received no EU funding but is backed by Gazprom as a powerful supplier and by distribution companies, began construction work in 2010. In the Mediterranean, more projects that received EU funding have been completed or made

steps forward, but others like the Greenstream pipeline from Libya to Italy have been completed without such funding (EC - COM(2010b) 203 final).

Three conclusions can be drawn from the EU's attempts at supplier diversification: First of all, the EU does not pay sufficient attention to the interests of the various players involved when selecting strategic projects. It is implicitly assumed that the actors involved would act in the interest of the common market and help to further the EU goals of security of supply, sustainability, and competitiveness. As a result, possible pitfalls and drawbacks of certain projects are not properly analyzed, at least not in public. A proper analysis of the actors involved in pipeline projects and their strategies would also help to focus EU funding on projects that would not go ahead otherwise. This leads to the second conclusion: The EU is good at throwing money at many different "priority" projects, but not at making strategic decisions on which projects to support. As a result, the EU has assigned the status of "European interest" to projects that are competing for the same supplies and markets and not diversifying suppliers, as exemplified by the Nord Stream and Yamal II projects. This is again due to a lack of common vision of Member States: They tend to advocate projects that can be promoted as being favorable from a European viewpoint but at the same time maximize their own benefit or the benefit of their "national champion." In order to bring the majority behind the list of European priority projects, more and more projects have to be added to the list. The Commission's effort to design additional subcategories for "top-priority" projects in order to concentrate efforts did not work out, as Member States then strived for to get their respective projects onto this list. But this is not an appropriate approach for decision-making on capital-intensive supply lines with significant long-term implications for energy security. Third, in line with the disregard for different actor interests pointed out above, regulatory issues are de-emphasized. This leads to the implicit assumption that pipeline infrastructure would always fulfill a public goods function, that is that it could be used to the benefit of the EU's economy. This would be the case if the pipeline were governed according to rules mandating TPA, which ensure equal access of all prospective customers. But this may not be the case. Indeed, most new infrastructure projects do not fall under EU or ECT jurisdiction or are exempted from TPA rules despite EU funding. In addition, it makes a substantial difference if an infrastructure is governed by effective rules mandating TPA and thus stressing the public goods function of infrastructure, or if it is regarded to be a private investment undertaken by incumbents. The

latter version of investment may lead to substantial limitations regarding the usage of the asset, which in that case tends to be used for furthering the interests of market incumbents and suppliers. Thus, more attention has to be paid to the issue of pipeline governance *before* assigning priority status to a gas supply project.

Aggregating Market Power: The Internal Market

The internal market for energy is the most important field for community action but not the most visible in external relations, although it has an important impact on the relationship toward suppliers. The Commission's approach to energy policy has widened over time—it began with gas and electricity market liberalization as a measure to enhance economic competitiveness and was extended in line with climate policies to overall demand management measures such as energy efficiency and the promotion of renewables. This section only concern with market liberalization policy and accompanying measures as they have the most direct impact on the relationship with Russia.

Implications for Suppliers and Consumers

The Commission has pursued gas market liberalization since the late 1980s, according to the principle of "completion of the internal market" agreed upon in the Single European Act (EC - COM(91) 548 final). The overall goal of the liberalization was to facilitate competition in the grid-bound internal energy market, in order to reduce energy prices and to increase energy security by easing investments in interconnections between Member States. This, in turn, would increase global competitiveness of the EU's internal market. The attention thus shifted from supply security and the public service character of the energy industry to their overall contribution to economic competitiveness in a globalized world. Due to space constraints, readers unfamiliar with the EU's policies on energy market liberalization should refer to the detailed analysis on energy market liberalization by Per Ove Eikeland in chapter 1 of this volume.

The most important implication of the liberal model for gas supply security is that it erodes the gatekeeper function of the big national

energy transport companies. Therefore, it needs two preconditions to function for the benefit of consumers: (1) Sufficient supplies are, or can be made, available (liquidity); and (2) some diversity of suppliers (no monopoly).

This implies that liberalization policies contain some new opportunities for suppliers with high market power. As the pricing principle is changed from long-term indexation with oil products to a supply-demand based pricing model, suppliers may be encouraged to foster the perception of scarcity in order to push up gas prices. Thus, traditional long-term contracts may be a useful tool for consumers also in a liberalized market, if liquidity is lacking (Finon 2008). In addition, the erosion of the gatekeeper function of utilities and ensuing competition induces powerful suppliers to play importers off against each other. Suppliers may now engage in strategic bargaining with different companies supplying to the same market, which may result in substantial concessions of the latter. Also, the possibilities for downstream expansion of suppliers increase. This may have negative externalities for the EU's energy security, if suppliers with high market power acquire downstream assets in order to segment markets and influence demand. These problems have to be addressed by liberalization policies.

As a result, the core debate with regard to liberalization centered on the problem of market power and ensuing market distortions. The question was, whether the power of national incumbents should be curtailed by the state (the EU) in order to reduce their market power or instead be tolerated, enabling the companies to ensure national security of supply by aggregating demand and buffering markets from direct producer influence, while surcharging consumers for this service. Whereas the former results in greater control by state and the EU's institutions and passes on some of the risks to them, the latter leaves more control and risks to "national champions," implying a lower burden for state actors, better realization of national goals and less transfer of authority to the EU level. On the downside, of course, unchecked market power sustains fragmentation of markets, higher prices, and leads to substantial political control by corporations (Finon and Glachant 2004, 269f).

Safeguards Toward New Threats

As a safeguard toward the first problem of increased domination by a consolidated supplier as a possible ironic outcome of market

liberalization, the Commission foresaw a "reciprocity clause" directed toward investors from third countries. The clause foresaw that unless a bilateral agreement between the EU and the investor country on mutual market access and third party access to pipelines in the investor's country of origin concluded, they would be completely banned from controlling transmission assets in the EU (van Hoorn 2009, 57). In effect, the Commission proposed to use the attractiveness of the EU's market for achieving a favorable outcome in third countries by altering the rules for market entry. If applied, two outcomes could have been possible: (1) a suboptimal outcome, where Gazprom would refrain from further investments in transmission assets in the EU and sell gas at the border; (2) a preferred outcome where Russia would alter the rules for access to upstream assets and pipeline infrastructure and would then invest into the EU's gas sector. This is tantamount to a ratification of the ECT and would also have contributed to supplier diversity and market liquidity. A third outcome that was widely discussed (van Hoorn 2009) but is unlikely due to the attractiveness of the EU's market, is the cessation of supplies by Gazprom to the EU.

But the clause met the fierce resistance by some Member States. As a result to resistance led by Germany, where Gazprom already possesses significant infrastructure assets and which regards the presence of Russian capital as a sign of "integration," the clause was completely scrapped during the Energy Council in October 2008. The underlying fear was that incumbents could no longer engage in asset swaps with Gazprom, which would further curtail their ability to bargain with suppliers. Now, investors from third countries face the same restrictions on vertical integration as domestic companies. Hence, Gazprom will have to prove the compliance of its subsidiaries with the unbundling regulations to the national regulator from 2011 onward (van Hoorn 2009, 58). In addition, the risk for security of supply of the EU has to be considered before the regulator approves an investment and the Commission has to be consulted prior to granting the approval. However, the Commission's opinion is nonbinding. In countries that opted for full ownership unbundling, subsidiaries of Gazprom or other corporations, representing the interests of Gazprom, cannot acquire transmission operators. But inherent problems with the approval procedure for foreign investors exist: The gathering of information about foreign investors by the regulatory body is difficult and the quality of information provided by the investor is likely to be low, as the body does not possess the intelligence or effective instruments to prove their accuracy. Office raids, which as an ultimate threat may back up demands of disclosure by the regulator, can be carried out

only with great difficulty. This problem is severe especially in case of Gazprom's investments, who are often carried out by letterbox- and offshore-companies (Globalwitness 2009; Smith 2008). Ultimately, the momentum of a better exploitation of market power is lost, as Gazprom will have ample possibility to agree with Member States and national regulators on conditions for market entry on a bilateral basis. This way, the opportunity to reaggregate the EU's market power as a logical consequence of the liberalization process has been missed. This reflects the conflict between the models of integration based on corporate power and integration based on common rules outlined above. Here, corporate power has been privileged over regulatory coherence. This may move the liberalized gas market into an oligopolistic direction.

For the second complex of problems induced by liberalization—a weakened bargaining position of the EU's market players toward an oligopoly of suppliers, as well as demand uncertainty—no legislative solution has been proposed at all. When regional monopolies were intact, importers often negotiated as a consortium with suppliers, enabling the former to achieve favorable conditions and a balance between supply and demand. This is no longer possible in a competitive market. Some governments and researchers therefore suggested to re-monopolize demand by forming a “gas purchasing group” that would act as an interface between supply and demand and thereby aggregate demand toward suppliers (Andoura et al. 2010; Christie 2010). It could begin with European companies forming national, regional or EU-wide purchasing groups for gas that would negotiate with suppliers. Another possibility would be to establish an EU-wide purchasing agency. This public entity would negotiate all contracts for imported gas with the producers and could then sell the contracted volumes to buyers in the EU (De Jong 2008, 17). This would indeed be a logical development in view of demand insecurities and increased market power of suppliers, but it has not been scrutinized as to how such a mechanism could be put to work in a liberalized market.

The forming of gas purchasing groups implies a return to the earlier practice of purchasing consortia and would only be possible if substantial distortions to competition exist, under which the participating companies would not be able to sell in each other's markets. Otherwise, no incentives to cooperate exist. It would also mean that some market players would have to give up their special relationship to specific suppliers, guaranteeing them lower gas prices than competitors. This would be rather difficult to achieve, given the experience of substantial resistance even to more modest proposals (Finon

and Locatelli 2008, 438). The establishment of a public purchasing agency would be a more reliable variant. However, it would have to temporarily take over the volume risk, as it would have to guarantee the purchasing of contracted volumes toward producers until gas volumes have been sold off internally. In any case, some solution toward demand aggregation has to be found if the power of suppliers should again pick up due to increased gas scarcity and/or supplier coordination.

In sum, the EU could not use gas market liberalization to play out the substantial power of a big market toward suppliers so far. The different goals of Member States have prevented such a solution. Instead of regulatory integration, utilities are integrating European markets on a corporate basis. This is also a form of market integration which could eventually lead to a more European orientation of Member State interests (De Jong 2008, 17). It is more compatible to the Russian institutional setup and does not necessitate adaptations on the Russian side. At the same time, it is not the form of integration envisioned by the Commission, as it serves to aggregate market power, which may be detrimental to energy security by distorting the market. At the same time, a possible transformative impact on Russian institutions is lost. In order to reduce the mismatch between corporate power and EU market liberalization rules, the EU should apply competition regulation in a proper way, as well as elaborate on new legislative proposals to alleviate the new risks induced by market liberalization.

Conclusions

As has been argued, the EU's external energy policy toward Russia as well as internal measures with external implications failed to a great extent. In energy policy terms, whereas the Commission promoted an external and internal liberalization policy that aims to redistribute power away from corporate actors toward regulatory agencies and from the national to the EU level, big continental Member States backed their incumbents, which were seen as the most appropriate tool to ensure national energy security. This was mirrored in external relations, where deals were made between incumbents and suppliers that traditionally had established tense relations. The deals were backed and facilitated by national foreign policies. There was thus no need for Russia to attach importance to the European level, as a positive payoff to current policies was provided by Member State initiatives,

whereas the EU's policy would have involved costly changes to existing institutions and behavioral scripts in Russia. Here, the EU's problem arose from the refusal of Member States to confer the necessary decision-making authority to the EU level and to change their internal economic rules.

The difficulty to arrive at a common energy policy toward Russia was exacerbated by the fundamentally differing perceptions and accompanying goals of policies toward Russia, held by the Member States. Thus, whereas the Commission together with smaller and new Member States from central eastern Europe advocated an external energy policy concentrating on safeguarding security of supply, older Member States such as Germany discounted supply security and infused energy policy with the greater vision of binding Russia closer to Germany and/or the EU by integrating energy sectors. As a result, a common energy policy was complicated by the disagreement about what this policy should be about: energy policy or "integration" by default in order to reach wider goals. This problem has to be solved in order to make sure that "integration" policies toward Russia pursued by particular Member States rely on an internal consensus and do not contribute to a disintegration of the "ever closer Union."

Notes

1. In this context, it has been argued that the EU approach of market liberalization is deficient in a world of increasing resource scarcity and high commodity prices, giving rise to a "new energy paradigm," see Helm (2007); Spanjer (2009). However, market developments are not so unidirectional and clear to allow such a wide-ranging conclusion. See: Paillard (2007: 12ff); Peters (2003: 22ff); Riley (2006); Milov (2008); Noel (2008: 5f).
2. See: Paillard (2007: 12ff); Peters (2003: 22ff); Riley (2006); Milov (2008); Noel (2008: 5f).
3. See: Dutch Prime Minister suggests first step toward Soviet integration. *The Guardian*, June 26, 1990: 9.
4. Brussels and Moscow agree energy plan. *Financial Times*, July 6, 1990, International : 3.
5. See: *Energy Charter Progress Delayed despite Strong Soviet Support*. In European Energy Report, May 1991, S1.
6. See Soviet Republics Sign International Energy Exchange Accord, *Associated Press*, December 17, 1991. Eventually, this was the first official recognition of Soviet Republics as separate entities and three days later the Soviet Union was dissolved.

7. See Art. 29 II a) ECT.
8. Vgl. Final Charter Treaty text sent out to all participants. *EC Energy Monthly*, September 1994: 1. Matlárý (1997, 48).
9. When agreement could be finally reached in 1994 the United States did not sign the treaty, as it did not encompass the liberal rules once envisaged. On the negotiation process in general see Dor (1996); Matlárý (1997); *Energy Charter Progress Delayed despite Strong Soviet Support*. In European Energy Report, May 1991, S1.
10. EC and US Clash over Charter. *EC Energy Monthly*. December 1993: 9.
11. See: Mixed reception awaits Energy Charter in Russia, *East European Energy Report*, 25. November 1994: 5.
12. See: U energetičeskoj chartii v Rossii malo storonnikov. *Segodnja*. No. 31, 18.2.1997; Ėnergetičeskaja chartija pod perekrestnym ognem. *Segodnja*. No. 123, 18.6.1997; Zylakov (1998).
13. COM/2004/777 final: 9.
14. Destination clauses prohibit the reselling of energy resources to other states than the contracting partner and are therefore in conflict with the internal energy market of the EU.
15. A good case in point are the Ostsee Pipeline Anschluss-Leitung (Opal) and Norddeutsche Erdgas Leitung (NEL) pipelines built by German Gazprom/Wintershall joint venture Wingas, which shall be connected to the Nord Stream pipeline in order to transport gas to Southern and Western Europe: Wingas applied for an exemption from competition rules for the new pipelines. See: OPAL NEL TRANSPORT GmbH beantragt Ausnahme von Regulierung, WINGAS PM, 28.07.2008, <http://www.wingas.de>; Opal will allein glänzen, in: *Der Spiegel*, 45/2008. November 3, 2008: 80.
16. See: Energy infrastructure—European Coordinators. http://ec.europa.eu/energy/infrastructure/tent_e/coordinators_en.htm (accessed May 18, 2010).

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Chapter Four

EU Emissions Trading: Achievements and Challenges

Jørgen Wettestad

The European Union Emissions Trading Scheme (EU ETS) is based on an EU Directive that was adopted in 2003 and started functioning in 2005 (Skjærseth and Wettestad 2008).¹ It caps industrial emissions and allows trade of emission rights (hereafter: “allowances”).² EU officials refer to the ETS as both the “cornerstone” and the “flagship” of EU climate policy.³ As it represents something completely new for the EU, analysts have called the ETS the “new grand experiment” (Kruger and Pizer 2004).

The ETS has now been functioning for five years. To what extent is a big celebration warranted? According to EU environment commissioner Stavros Dimas, “the EU has a well-functioning trading system, with a robust cap, a clear price signal and a liquid market, which is helping us to cut emissions cost-effectively” (EurActiv 2009b). Point Carbon reports a relatively thriving market, apparently only moderately affected by the current financial crisis, and see the ETS as a substantial driver for emissions reductions (Point Carbon 2009a). However, some highly critical reports can certainly be noted. For instance, climate-policy analyst Dieter Helm has claimed that the EU has “landed itself with a complex and relatively inefficient tradable permits system” (Helm 2009, 11). Furthermore, the British environmental organization Sandbag has warned that the ETS at present is “a blunt tool” (Sandbag 2009).

This chapter seeks to take stock of the main achievements so far, in terms of institution building and ultimate effects on corporate practices. As further elaborated in the section “Achievements So Far: Mostly Mixed?” there are both strengths and weaknesses to be noted. In the section “Explaining Mixed Achievements: “Grand Experiment”—And Grand Uncertainty?” some key explanations are discussed, organized according to the main actors and