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***THE LIMITS OF THE EU REGULATORY  
STATE:  
POWER, POLITICS AND PRAGMATISM  
IN EUROPEAN GAS MARKETS***

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Panel: Reconsidering the Regulatory State in Europe

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**Paper:**

**THE LIMITS OF THE EU REGULATORY STATE:  
POWER, POLITICS AND PRAGMATISM IN EUROPEAN GAS MARKETS**

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Since Giandomenico Majone coined the term, the idea that Europeans are living in the age of the regulatory state has dominated one branch of the study of public policy in the European Union and its member states in general, and the study of the utilities sectors in particular.<sup>1</sup> The European Commission's continuous drive to expand the Single Market has been a free-market and rule-oriented project, driven by regulatory politics rather than policies that involve direct public expenditure. The dynamics of European integration are rooted in three central concepts: free trade, multilateral rules, and supranational cooperation. Both the integration theory literature (intergovernmentalist and institutionalist alike) and literature on the emergence of the EU as a 'regulatory state' assumed that this was primarily a matter of policy *making*: once agreement had been reached to liberalise the utilities markets a relatively homogeneous process would follow. The regulatory state model fit the original common market blueprint better the old industrial policy approaches. On the other hand, sector-specific studies continue to reveal a less than fully homogeneous internal market. The EU has undergone momentous changes in the last two decades, which have rendered the notion of a homogeneous single market somewhat unrealistic. Recent research shows that the de-politicised, homogeneous Single Market that long informed much of the political and academic debate is at best an exaggeration, and more probably misleading. Mutual adaptation between the EU and the member states and between the EU and the outside world is generating several different patterns of European integration. Differentiated integration and regulatory variation is becoming the norm, even when there is broad agreement on liberal market principles. This paper asks whether these developments are changing the nature of the regulatory state in Europe, or even whether the EU is going beyond the regulatory state.

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<sup>1</sup> G. Majone, "The Rise of the Regulatory State in Europe", *West European Politics*, 17:3 (1994), 77-101; F. McGowan & H. Wallace, "Towards a European Regulatory State", *Journal of European Public Policy*, 3:4 (1996), 560-576; M. Lodge, "Regulation, the Regulatory State and European Politics", *West European Politics*, 31:1-2, 2008, 280-301.

The regulatory state in Europe faces three broad challenges. The first is related to the very nature of the regulatory state, and to the political context in which it emerged. Both at the national level and the EU level the regulatory state is gradually being changed though its own internal dynamics: the accumulation of regulatory tasks, multiple conflicting priorities, new and unanticipated challenges, and even organised opposition may undermine the regulatory state. Whereas the foundations for the regulatory state regime were laid in the early 1990s in a context of considerable optimism about the Single European Market at rule-based, non-interventionist governance, the late 2000s are seeing a degree of re-politicisation of the single market. The financial crisis of 2008 has only strengthened these tendencies. Moreover, the last decade has seen the consolidation of large European gas companies' strong (and sometimes dominant) position in the market, often with the open enthusiasm and support of national governments.

Second, although the principle of homogeneous integration has long dominated the EU single market, in practice a number of different practices are maintained. EU has become more heterogeneous as well as more integrated over the last decade. It has widened to 27 member states; the authority of its institutions has been strengthened; and its scope has expanded. It has become a colourful and heterogeneous family of states. This expansion in width, breadth and depth poses challenges for further integration of the Single Market. Common policies increasingly go hand in hand with differentiation and re-politicisation of Single Market regulation at the national level; the Lisbon process has formalised the EU's practice of 'soft law' and policy coordination into the Open Method of Coordination (OMC); and in some cases countries have opted out of policies or have yet to qualify for full participation. It may therefore make more sense to speak of several different patterns of market integration, if not "differentiated integration." Although the idea of liberalisation has become the new paradigm in the energy sector, the reality in the EU gas market is far from a single liberalised market. At the policy level the Commission continues to push for a more integrated homogeneous market, yet the legislative compromises leave considerable room for diversity. At the organisational level the structure, mandate, competences and resources of National Regulatory Agencies vary considerably. Unsurprisingly, so does implementation.

Third, at the international level the changing geopolitical environment represent a challenge for the EU's multilateral, rule-oriented approach to international trade. The EU's external environment is changing, particularly its relationship with the other big European power, Russia. The EU now faces an increasingly self confident Russia, which is challenging the EU's core principles of multilateralism and open markets. Russia is increasingly oriented towards bilateral arrangements and direct deals, bypassing the political and economic structures of EU. The interplay between internal developments and the EU's capacity to act in a unified way on the international scene shapes the development of the Single Market. Russian strategies affect the core interest of the European Union, its member states and those of the European Economic Area (notably Norway). Here the gas sector provides a somewhat atypical case, because of the regional nature of gas markets. However, because its brings the relationship between the EU and Russia to the centre stage, it provides a particularly good test of the EU's ability to

projects its rule-based institutionalist approach beyond its own boundaries and the difficulties in coordinating national and EU policy.

The paper focuses on the single market for gas to explore these three factors. The energy sector is one of the core interests of the EU and its member states. Liberalisation is progressing slowly, and the regulatory frameworks at both national and EU level are subject to continuing reform; at the same time as Russia's more assertive energy policy, its bilateral approach to many member states, and Gazprom's activities in the EU market represents a challenge for collective action in the EU.

### **1. The Regulatory Politics Dimension – Re-politicisation?**

The central tenet in the regulatory state argument is that most EU (and EEA) states have replaced direct interventionist industrial policy with indirect regulation. Whereas the old industrial policy regimes were characterised by protectionism, direct state intervention, active industrial policy, widespread state ownership, and state aid to industry; the regulatory state relies more on indirect rule through rules regulations. The state's central goals are no longer directly to support or protect industry, but rather to ensure that competition operated as it should. The regulatory state therefore involves a change in the central policy instruments of the state: a shift from industrial policy to competition policy. Independent competition authorities and regulatory agencies play increasingly important roles, and the role of government ministries of industry, energy, telecommunications etc. play a more indirect role at arm's length from the industry. Rules and legal authority are the principal tools that governments use to regulate industry, in contrast to the importance of direct state expenditure and ownership in the old industrial policy regimes. In the 1990s, this was extended to the telecoms, electricity and gas sector, by a combination of national reforms and EU-driven liberalisation.

From a late 2000s perspective, the regulatory state in Europe looks very robust. It is anchored in the WTO regime, the Single European Market and in public policy reforms at the national level. Yet in many policy sectors, nationally and in the EU, privatisation and liberalisation have proven to be somewhat more complicated processes than initially assumed, and the regulatory state has therefore developed into a far more complex set of policy regimes than the term 'de-regulation' might suggest.<sup>2</sup> All public policy regimes tend to engender new problems and challenges, often of fairly predictable type, and the regulatory state is no exception.<sup>3</sup> Although these problems of challenges of the regulatory state could be detected before the recent global financial crisis, developments over the last two years have added a certain urgency to the debates about the regulatory state. Not only are most governments considering how much intervention is warranted in each sector to counteract the effects of the financial crisis, but the very notion that markets

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<sup>2</sup> D. Levi-Faur, "Europe and the New Global Order of Regulatory Capitalism", in J. From & N. Sitter, *Europe's Nascent State: Public Policy in the European Union*, Oslo, Gyldendal, 2006.

<sup>3</sup> Hood, C. (1991), "A Public Management for All Seasons?", *Public Administration*, 69, 3-19; Dunleavy, P. & C. Hood (1994), "From Old Public Administration to New Public Management", *Public Money and Management*, July-September, 9-16; Hood, C. (2000), *The Art of the State: Culture, Rhetoric and Public Management*, (Oxford: Oxford University Press).

tend toward equilibrium is increasingly challenged. In the energy sector, these internal challenges to the regulators state fall into four categories.

1. A revision of the balance between the three aspects of EU energy policy – the internal market, security of supply and environment policy.

- EU energy policy has always been linked to other policy areas, most notable competition policy, the internal market, industrial policy, security of supply and the environment.
- In the 1990s, it looked as if competition policy would gradually gain the upper hand. By 2009 the threat of man-made climate change had moved to the top of the agenda. It is too early to say much about the effect of this on the single market for gas. However, it seems likely that much political attention will be diverted from the internal market and resource-neutral competition to regulation of emissions and the use of renewable energy resources.
- Throughout the liberalisation process, several member states have continued to argue against further liberalisation and to maintain an element of industrial policy in EU energy policy.
- The Commission is about to reorganise itself to establish one single Directorate General to integrate energy and environment policy, with a view to implementing the new arrangements in the autumn of 2009.
- Several national governments have commented that the present financial crisis provides an opportunity to ensure that growth is both financially and environmentally sustainable. The Czech Presidency's statement of policy priorities focussed on the integration of security of supply and the environment dimension.

2. A review of the balance between competition policy and industrial policy at the state level, and substantial government commitment to interventionist energy policy.

- The single market initiative, both in the energy sector and elsewhere, was grounded in an effort to achieve a market based on general principles of competition that would reduce the space for industry- and sector-specific industrial policy.
- A number of policy problems have been settled rather than resolved, allowing some actors to circumvent rules. The accumulation of unresolved problems undermines the legitimacy (and robustness) of the regulatory regime.
- Until the financial crisis and the Russia-Ukraine gas supply disputes it looked as if the Commission's drive for a liberalised gas market was gradually being accepted as inevitable by both companies and governments. However, the concern for security of supply and Gazprom's influence on EU markets lent legitimacy for traditional energy policy concerns; and the global financial crisis has brought traditional industrial policy concerns such as full employment to the fore.

3. The strengthening of larger energy companies in the gas sector, whether through mergers and acquisitions, joint ventures, or government support for national champions.

- The big EU member states, particularly Germany, Spain, Italy and France have sought to protect and support their former monopoly incumbent companies.

- Two developments go against the grain of the EU liberalisation initiatives. First, a series of mergers and acquisitions have brought about big horizontal EU-wide companies, as protected incumbents buy companies in smaller states. Consequently, there are now pan-European energy companies (EDF, RWE, E.ON), which operate in several segmented national markets. Second, a number of mergers and acquisitions across the electricity and gas divide have taken place (E.ON – Rhurgas; GDF – Suez). Integrated companies become dominant across the energy sector.
- Unbundling has been delayed, and indirect ownership forms circumvent such measures. Recent Commission proposals seek to deal with this.

4. The prevalence of long-term (take-or-pay) contracts in the gas sector, often linked to non-EU companies.

- The key characteristics of the energy sectors are related to historical experiences and perceptions of market failures as well as to political and industrial policy objectives. Important energy resources are concentrated in a few countries outside the EU (Russia, Norway and Algeria). This had led to concern for supply and price stability.<sup>4</sup>
- Although take-or-pay contracts should in principle be eliminated, recent gas price volatility (linked to oil price volatility) and reduced short-term demand (causing liquidity problems) has generated so much uncertainty over revenue from gas that take-or-pay contracts are likely to remain an attractive means of financing new gas developments (especially if they involve long-distance transport of gas).

#### **4. The EU Dimension - Differentiated Integration?**

The EU is changing radically along three dimensions: deepening, widening and broadening. Integration is ‘deeper’, the authority of the EU institutions has been strengthened and the decision making processes have become more supranational. These changes raise new questions about the development of European integration, particularly with respect to the Single Market, and therefore warrant new thinking about the types and patterns of European integration.

The first question concerns exemptions (opt-outs) from EU initiatives: should all states participate in all policy sectors in the same way? Not all member states are equally eager, let alone able, to participate in all aspects of integration. The ‘opt-outs’ of the 1990s (e.g. from EMU and Schengen) were seen primarily as temporary and exceptional.<sup>5</sup> By 2007,

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<sup>4</sup> Estrada, Javier, Helge O. Bergesen, Arild More & Anne K Sydnes (eds 1998): *Natural Gas In Europe* (London: Pinter Publisher); Arentsen, Maarten (2004), “Politics and regulation of gas in Europe”, in Dominique Finon and Atle Midttun (eds) *Reshaping European Gas and Electricity Industry: Regulation, Markets and Business Strategies* (Oxford, Elsevier 2004); G. Ferman, (ed). *Political Economy of Energy in Europe*, Berliner Wissenschaft-Verlag, 2009.

<sup>5</sup> A. C. Stubb, (1996), “A Categorization of Differentiated Integration”, *Journal of Common Market Studies*, 34:2, 283-295; A. Kölliker, (2001) “Bringing Together or Driving Apart the Union? Toward a Theory of Differentiated Integration”, *West European Politics*, 24:4, 125-151.

such arrangements have become more common, and in some cases they seem semi-permanent.

The second question concerns the impact of EU policies at the national level: what are the effects of the discretionary power and competence the member states enjoy when transposing EU rules into national legislation? Expansion into new policy areas and to states with widely different institutional traditions and capacities has come at the price of heterogeneity. The considerable variation in national adaptation reflects the different context and trajectories of integration, as captured in the literature on Europeanization.<sup>6</sup>

Much of the debate about European integration – both political and academic – has been based on the unrealistic assumption that once an agreement is reached at the EU level, it is implemented in a fairly homogeneous way across the EU. *However, developments in European integration over the last decade suggest that, in fact, such homogeneous integration may be the exception rather than the rule.* Two research agendas have begun to treat integration as an independent variable, and explore the impact of integration at the national level. The literature on ‘Europeanization’ explores the plenitude of variation in EU policy, often based on case- or sector-specific explanations.<sup>7</sup> The *institutionalist turn* in EU studies offers a set of explanatory mechanisms to account for such variations.<sup>8</sup>

We argue that there are two principal sources of variation in the links between policy-making at one level and implementation at another. First, the hierarchical relationship between the EU and the national level ranges from tight to loose. EU-level decision-making involves political compromises that often lead to general or ambiguous policy formulations. Second, member state institutions vary, as does their capacity for policy implementation. The member states’ institutions are rarely all equally compatible with any given EU directive. Pressure for de-coupling from EU requirements may therefore be the product of institutions that shape local identities, norms and even preferences.<sup>9</sup>

### *Major Types of Integration*

In reality these two dimensions are of course linked: strong resistance to strict EU-rules by a number of member states usually leads to watered-down directives at the EU-level. The four patterns (or types) of integration are therefore not equally likely.

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<sup>6</sup> S. Bulmer, (2005) “Theory on Europeanization”, in *Europeanization: A Handbook for a New Research Agenda*, (London, Palgrave Macmillan).

<sup>7</sup> J. P. Olsen (2002) “The Many Faces of Europeanization”, *Journal of Common Market Studies* 40:5, 921-952; see also K. Goetz & Hix, S. (eds 2000) *Europeanized Politics? European integration and Political Systems*, (London, Frank Cass); A. Dimitrova, & B. Steunenbergh (2000) “The search for convergence in national policies in the European Union”, *European Union Politics* 1:2, 201-226.

<sup>8</sup> S. Bulmer (1993) “The Governance of the European Union: A New Institutional Approach”, *JPP*, 13:4, 351-380; M. Aspinwall & G. Schneider (eds 2001) *The Rules of Integration: The Institutional Approach to European Studies*, (Manchester, Manchester University Press).

<sup>9</sup> S. S. Andersen (2004) “The Mosaic of Europeanization: An Organizational Perspective on National Re-Contextualization”, Oslo, ARENA Working Paper 11/2004; S. S. Andersen & N. Sitter, “Differentiated Integration: What Is It and How Much Can the EU Accommodate?”, *Journal of European Integration*, 28:4 (2006), 313-330.

*Homogeneous integration* is the ideal-type, and is based on the assumption that EU-level rules are clearly defined with precise organisational requirements, that these are implemented more or less uniformly by states, and subject to effective supervision and evaluation. Competition policy comes close to this ideal type, though Eyre & Lodge provide a detailed account of the Europeanization of competition law as reform processes, and describe the tension between convergence and divergence as countries are increasingly playing a 'European melody', but with distinct 'national tunes'.<sup>10</sup>

In a number of policy sectors, EU rules are more loosely defined, but several states share the same general interests as those expressed in an EU directive, and therefore proceed according to the spirit of the law even if this is not strictly speaking required. *Aligned integration* relies on mutually reinforcing overlap of state and EU-level interest, and is fairly common. OMC success is based on this.

Perhaps the most common pattern is one in which a number of governments object to strict EU rules, and directives are therefore vague on a number of points. *Autonomous integration* takes place in situations where the central demands for particular organisational and behavioural patterns are weak, and local pressure to maintain existing practices is strong. OMC sometimes results in this.

The last type, *deviant integration*, is less common. Whereas the other three types of integration are consistent with legal requirements, what we call deviant integration is in principle an illegal circumvention of EU law. This situation features strict EU legal requirements and expectations about loyal national implementation, but at the same time strong local resistance. In theory this may be because a government has lost a vote in the Council of Ministers, in practice it is more likely to reflect unsuccessful attempts to influence a decision (for example on the part of new and inexperienced EU countries, or EEA-countries).

Our starting point was that in the EU public policy is normally made and implemented at different levels and by different actors or organisations. The 'implementation gaps' that result from this are also well documented in national public policy studies. The central point here is not that public policy is seldom implemented exactly as planned, but rather that the heterogeneity of the EU system makes for considerable variation. Even where common directives are faithfully transposed into national law, the impact of integration is not necessarily uniform. In short: differentiated integration has brought about more room for manoeuvre for the member state governments, and a degree of re-politicisation of the Single Market. In the gas sector, this has implications at three levels – in terms of legislation, organisation and implementation.

1. Although the concept of liberalisation has become the new paradigm in the EU gas market, EU legislation on the single market remains a very gradual process that has yielded compromises that leave considerable room for national variation.

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<sup>10</sup> S. Eyre & M. Lodge (2000) "National Tunes and a European Melody? Competition Law Reform in the UK and Germany", *Journal of European Public Policy*, 7:1, 63-79.



- Until the early 1990s, energy was generally considered a major policy failure for the EU.<sup>11</sup> The Commission's 1988 green paper on the Internal Energy Market concluded that the main obstacles to this goal lay in structures and practices associated with member state energy markets that protected the industry from competition.<sup>12</sup>
- The introduction of a new EU policy paradigm, in a directive proposal on the liberalisation of EU natural gas markets, challenged key elements in the existing system. Stern: "Many of the established actors in European gas industries [...] regarded the introduction of liberalization as the equivalent of the end of civilization".<sup>13</sup>
- The central question for gas liberalisation was third-party access to networks. Agreement on gas liberalisation came in December 1997. The compromise promised limited and gradual market opening with some scope for temporary derogations and Member State discretion in implementation. Its key points included states defining the 'eligible costumers' (but all gas-fired power generators and consumers of more than 25 mcm/y must qualify, reduced to 5 mcm/y by 2008); initial opening of 20% of Member State markets, rising to 28% 2003 and 33% in 2008; market access based on negotiated or regulated TPA; and accounts were to be unbundled, as in the electricity directive. Within this framework it allowed temporary derogations over take-or-pay contracts, upon decisions by states or their regulatory authorities subject to established guidelines and possible amendment by the Commission, as well as temporary derogations for emergent markets or markets with only one external supplier.
- Two of the most important battles, determination of tariff methodologies and regulatory provisions for enforcing competition and third party access at the EU-level, had been defeated in 1994, before the first attempts to find agreement in the Council. As Stern (1998: xviii) concluded: "The value of the directive, therefore, lies not so much in its specific provisions, which are likely to be rapidly overtaken by events, but rather in the fact that it established both the principle of access to (pipeline) networks, and the assurance that opponents of competition and liberalisation cannot indefinitely procrastinate in the opening up of their gas markets."
- The heterogeneity of the EU gas market increased considerably with enlargements of 2004 and 2007, as did the differences among the member states as to how to address the security of supply issues raised by Russia's role as the supplier for 25 percent of the EU's gas consumption.

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<sup>11</sup> Usherwood, Simon (1998), "Energy policy" in Glocker, Gabriel, Lie Junius, Simon Usherwood and Julian Vassallo, *Guide to EU policies* (London: Blackstone Press), Andersen, Svein.S. (2000) "Towards a Common EU Energy Policy", in Svein S. Andersen & Kjell A. Eliassen (eds.) *Making Policy in Europe*, second edition, (London, Sage)

<sup>12</sup> Commission of the European Communities (1998), *The Internal Energy Market*, COM (88) 238

<sup>13</sup> Stern, Jonathan P. (1998), *Competition and Liberalization in the European Gas Market. A Diversity Model* (London: The Royal Institute of International Affairs)

2. The organisation of gas market regulation in the EU still reveals considerable gas between member states in terms of the mandate, resources and competences of national regulators.

- National regulatory regimes and the big companies' market strategies became important in providing the content and pace of market liberalisation. The member states were committed to bring the laws, regulations and administrative provisions necessary to comply with the gas directive into force no later than in 2000. As expected, some countries (like France and Germany) only partially transposed the directive into national law. Others (Portugal and Greece) were granted ten-year derogations because of the emerging status of their gas industry. Italy and Spain went further than required; the UK went further than all the rest. Although the basic rules of the game had changed, the overall picture was mixed and reflected different national concerns. This meant that the further elaboration of the new policy paradigm shifted from the EU-level to member state level. The implementation process faced the challenge of balancing three important aspects: i) clarifying the implications of the directive in various national setting, ii) the degree of flexibility with respect to the speed of reform and specific organisational solutions, and iii) ensuring that the national solutions were compatible with the directive and EU competition law. National solutions varied considerably: only three states chose negotiated TPA, although all expect Portugal had established some kind of TPA regime by 2002.
- The member states differ widely in the extent to which they permit or encourage large energy companies to use market rules to consolidate and strengthen dominant market positions regional and national markets. Big states like Germany, France, Italy and Spain support their national champions. The EU directives aimed at unbundling the different vertical functions of the industry. While this is happening to some degree, there is a trend towards horizontal integration across different types of energy industries, like gas and electricity. This happened first in Germany and France, and later in smaller countries like Belgium.

3. It is therefore hardly surprising that the Commission reports considerable problems with the implementation of the internal market in gas.

- A further gas directive was adopted in 2003, to address the shortcomings of the present liberalisation process. This directive requires that all states adopt a 'regulated' access tariff, and establish an independent regulator for the gas industry. In addition non-discriminatory third party access should be developed through legal unbundling of gas transport from trading services. At the time, only one of the then fifteen member states was judged to have completed market opening in the gas sector: the UK.
- In a 2005 report, the Commission concluded that "the provisions of the previous Directives have not been adequate to achieve the objective of competition, even for larger users." The same report also noted that the "development of the internal market has [...] been constrained by the continued existence of long term reservations of transmission capacity. The lack of coherence between the charging

structure of individual transmissions system operators has also prevented competition in some areas”.<sup>14</sup>

- The 2007 Third Energy Package focuses on three elements: i) ownership unbundling, 2) an alternative in the form of an independent systems operator, and 3) strengthening national regulators and establishing a new EU regulatory agency. In 2009 the main challenge still remains the ability of incumbents to limit access to segmented energy markets. The introduction of a new regulator is an attempt to deal with the heterogeneity of national markets and political goals.

### 3. The External Dimension of the Single Market – Geopolitics?

The EU’s effort to establish and extend the Single Market fits into a broader pattern of international market- and institution-building in the late 1980s and 1990s. At the national level, many states embarked on programmes of liberalisation and/or privatisation. At the EU level, this provided the backdrop for the Single Market. At the international level, and particularly after the collapse of communism in the Soviet bloc, general market-based rules were the order of the day as optimistic prophesies about the ‘end of history’ and ‘triumph of globalisation’ abound. This was the height of what Correljé & van der Linde call the “*Markets and Institutions*” approach to international economic and political cooperation: an integrated, multilateral world with effective institutions and markets.

However, recent developments in international economic relations point to an alternative pattern of “*Regions and Empires*”. This involves “a world broken up in rival political and economic blocs, competing for resources and markets via political, economic and military power.”<sup>15</sup> In terms of international relations theory this comes close to the neo-realist paradigm (as opposed to the neo-liberal “market and institutions” approach). It is no coincidence that Correljé and van der Linde’s analysis of the EU focuses on the energy sector: the most important single sector for two of the EU’s neighbours – Russia and Norway. This illustrates how the present Single Market integration is affected by broader international trends and the actions of key neighbour countries.

The EU’s international role has hitherto been cast very much in line with neo-liberal theories of international relations – and the *Markets and Institutions* narrative – based on assumptions that the possibility of mutual gains from trade warrants market-based institutional arrangements. Although the EU has not shied away from confrontations with the USA over specific issues in the WTO, the general approach both within the EU and vis-à-vis the rest of the world has been to proceed from the assumption that international trade is a positive-sum game. With a few exceptions, such as negotiations over fisheries policy, the EU’s relationship with the EFTA states is based on the same principles.<sup>16</sup>

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<sup>14</sup> Commission of the European Communities (2004), *Annual Report on the Implementation of the Gas and Electricity Internal Market*, COM (2004) 863, p. 3 and 7.

<sup>15</sup> A. Correljé & C. van der Linde (2006) “European Supply Security and Geopolitics: A European Perspective”, *Energy Policy*, 34:5, 532-543, p.532.

<sup>16</sup> S. S. Andersen, (2000) “Norway: Insider AND Outsider”, ARENA Working Paper 4/2000; M. Emerson, M. Vahl & S. Woolcock (2002) *Navigating by the Stars: Norway, the European Economic Area and the European Union*, (CEPS); K. A. Eliassen & N. Sitter (2003) “Ever Closer Co-operation? The Limits of the

The EU's present relationship with Russia is developing more as neo-realist theories would predict: increasing politicisation and, at least on the part of the Russian government, a quest for bi-lateral arrangements rather than universal market rules. Particularly in the energy sector, the Russian government follows a strategy that corresponds to the 'realpolitik' *Regions and Empires* narrative, rather than the *Markets and Institutions* approach associated with the Energy Charter Treaty.<sup>17</sup> Trade is part of the broader geo-political security game, and relative gains are more significant than absolute gains. Moscow's more assertive posture places different demands on the EU as an external actor, different from the immediate post-cold war world. *In short: the EU's role as an external political actor is brought back to centre stage.* The Russian gas question provides an almost ideal case for the study of the nexus between trade, internal market and foreign policy in the EU in the 2000s. This question has two dimensions – the dynamics of Russian policy making and the question of how the EU and its member states respond to this.

1. Although there is no shortage of evidence that the Russian government is prepared to link gas and foreign policy, there is more controversy as to whether it is actually in a position to do so.

- Russian strategies affect the core interest of the European Union and its member states, and under Vladimir Putin's presidency and prime ministership Russia has turned increasingly away from multilateral, rule-based engagement with the EU and adopted a more bi-lateral and politicised approach to EU energy markets. There is little sign that the new Russian leadership will change this Russian policy.<sup>18</sup>
- The EU now faces an increasingly self-confident Russia, which is challenging the EU's core principles of multilateralism and open markets. Russia is increasingly oriented towards bi-lateral arrangements and direct deals, bypassing the political and economic structures of EU.<sup>19</sup>
- Gazprom has signed long-term supply deals and/or bought into distribution companies in a number of EU states (including Italy, the UK, Denmark, Germany, Austria, Spain, Bulgaria, Hungary and France), and many of these deals involve trading long-term supply for access to distribution networks. With Gazprom's deal with EON and BASF over the NordStream pipeline, and the Shtockman field expanding its production capacity, the overall picture is one in which Gazprom is emerging as a major player on the EU market.
- Gazprom has signed long-term supply deals and/or bought into distribution companies in a number of EU states (including Italy, the UK, Denmark, Germany,

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'Norwegian Method' of European Integration", *Scandinavian Political Studies*, 26:2, 125-144; S. S. Andersen (2006) 'Kampen om energimarkedene i EU' *MAGMA* 9:5-6, 40-48.

<sup>17</sup> For strong proponents of this view see particularly, E. Lucas, *The New Cold War: How the Kremlin Menaces both Russia and the West*, London, Bloomsbury, 2008.

<sup>18</sup> Aalto, Pami (2008), "The EU-Russian Energy Dialogue and the Future of European Integration", in Pami Aalto (ed.) *The EU-Russian Energy Dialogue*, (London: Ashgate); Romanova, Tatiana (2007), *EU-Russian Relations through the Prism of International Relations' and Integration Theories: Reflections on a Wider Europe and Beyond. Norms, Rights and Interests* (St. Petersburg: St. Petersburg State University).

<sup>19</sup> Stern, Jonathan P. (2005), *The Future of Russian Gas and Gazprom* (Oxford: Oxford University Press)

- Austria, Spain, Bulgaria, Hungary and France), and many of these deals involve trading long-term supply for access to distribution networks. With Gazprom's deal with EON and BASF over the North European Gas Pipeline adding pipeline capacity, and the Shtockman field expanding its production capacity, the overall picture is one in which Gazprom is emerging as a major player on the EU market.
- However, the gas disputes with the Ukraine in 2006 and 2009 involved both a political and a business dimension. Gazprom's price rises hit Russia's neighbours irrespective of their political relations with Moscow. The extent to which these disputes should be taken to demonstrate Moscow's capacity to use energy supplies as a foreign policy tool is therefore contested.<sup>20</sup>
  - In the 2001 to 2008 period, when oil and gas prices increased dramatically, Russian politicians and companies grew increasingly self-confident. They came to see the EU as dependent on Russian energy, and Russian actors could play a divide-and-rule game in the EU. The NordStream (agreed October 2006) and SouthStream (agreed April 2008 – seen as a rival to the EU-sponsored Nabucco pipeline) pipeline projects are a case in point: both have caused serious divisions in the EU. However, the global economic crisis has made it abundantly clear both that gas revenue is uncertain and that Russia depends as much on the EU as the EU depends on it.<sup>21</sup>
  - The Russian government, the Russian economy and Russian energy companies all depend heavily on participation in EU markets. The Russian budget is based on a 60-dollar oil price and a 25-Rouble exchange rate; the decline in both threatens the government's capacity to modernise the economy and address with its social problems. Both the government and the economy depend on closer integration into EU markets. With today's revenues, Russian energy companies require access to EU companies' investment and finance to maintain its production, transport and export capacity. Recent cases such as BP – TNK and the Telenor – Vimplecom have done much to raise scepticism among potential EU investors.

2. The second main factor in the external dimension of the gas market is how the EU and its member states respond to Russian government and company strategy.

- The change towards a new international economic policy paradigm for energy in the 1990s reflected the general political climate, but also changes in the international supply situation that had been 'normalised' after more than a decade of turbulence. The change in the dominant political-economic perspective on energy was partly formalised by the Energy Charter Treaty during the early 1990s.<sup>22</sup> The original vision of this treaty was that cooperation in the energy sector would pave the way for broader economic cooperation. However, in its

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<sup>20</sup> A. Goldthau & J. M. Witte, "back to the Future or Forward to the past? Strengthening markets and rules for effective global energy governance", *International Affairs*, 85:2, 2009, 373-390; A. Goldthau, "Rhetoric versus reality: Russia's threats to European Energy Supply", *Energy Policy*, 26 (2008), 686-692.

<sup>21</sup> M. G. Salameth, *Russia: An Aspiring Energy Superpower With Feet of Clay*, USAEE WP 09-018 February 2009.

<sup>22</sup> Dore, Julia & Robert De Bauw (1995) *The European Energy Charter. Origins, Aims and Prospects*, London: The Royal Institute of International Affairs; S. Mayer, "Path Dependence and Commission Activism in the Evolution of the European Union's External Energy Policy", OGEL, September 2008.

- original version, the treaty was more an extension of EU thinking than an attempt to reconcile EU and Russian interests.
- The main challenge is only partly the Russian government and companies' effort to by-pass the Commission and deal directly with member states and companies on a bilateral basis (as recently as the March 2009 deal between Russia and Spain). A large part of the problem for the Commission is the propensity of individual member states to seek to control their own energy policy and deal directly with Russia and Gazprom. The EU treaty does not provide the Commission with the kind of competences in this regard that it does for competition policy.
  - Gazprom's active policy for acquisitions of shares in energy companies across the board in EU member state and transit countries. EU governments and analysis are divide on whether this should be seen a political move to exploit market dominance for political ends, or simply a matter of company strategy. Some see the Ukrainian dispute as evidence that Russia is willing to use gas for political purposes, and consequently argue that import of Russian gas and Gazprom's access to the EU market should be limited. Alternatively, the dispute can be seen as part of a commercial strategy to increase gas prices in the Ukraine toward the international market level. In any case, some (e.g. the French government) argue that allowing Russian companies full access to EU markets will created interdependencies and thereby in the longer run reduce the room for Russian political influence. Moreover, it opens for extending EU competition and energy policy rules to Russia, and therefore also to from foreign investment in Russia. One option would be a European Economic Area-type agreement, which in the energy sector would actually come closer to the aims of the Energy Charter Threat than the current arrangements.
  - One of the Commission's more prominent initiatives has been its continued support for the Nabucco pipeline, as an alternative to Russian-dominated pipelines. The EU summit in October 2008 endorsed the French presidency's report that called for diversification of supply routes and energy sources. This was echoed by Czech presidency, which also added stronger emphasis on the need for a common energy policy.

### **Concluding remarks**

The single market was conceived – and largely implemented – in an era that was neatly summer up by Fukuyama's *The End of History* observation that market liberalism had triumphed in the ideological contest of the Twentieth Century. The challenge was to create multilateral institutional arrangements that would support economic development, liberal democracy and the globalisation of markets (both globally and in Europe). Much of the debate on the single market and the regulatory state – an indeed on European integration as such – took this as a basic premise. Even in this favourable context, European gas markets proved sufficiently diverse – and politicised – to render liberalisation a very difficult project. Nevertheless, by the late 1990s the liberal paradigm seemed to have gained a secure foothold, even if the liberalisation process was

painstakingly slow and the Commission's original aims had been watered down. The following decade saw a focus on implementation in the form of further liberalisation (including some new directives) and the Commission's legal follow-up of its directives.

Effective regulation – and indeed the success of the regulatory state – depends on a degree of de-politicisation. It requires a degree of consensus on political goals, a relatively stable and predictable context, and a clear understanding of the rights and obligations of the industry. If these factors change, politicisation is likely to ensue. Three developments have brought about this kind of change: the dynamics of regulation in the EU energy market, the enlargement of the EU, and external shocks related to climate change, Russia politics and the global economic crisis. The development of the EU regulatory regime for gas pushed a number of controversial questions into the future or down to the national level. Eastern enlargement brought in a series of member states with very different energy profiles, let alone institutional capacity to operate the EU regulatory regime. The recent prioritising of mitigating climate change, securing stable gas supplies and dealing with energy challenges in the context of recession has fundamentally altered the environment in which the EU regulatory regime operated. Even if some of these questions might be resolved in the medium term, they have reintroduced the spectre of volatility into EU energy policy.

The regulatory state has proven relatively robust, at least compared to alternatives such as *dirigiste* industrial policy. However, this paper points to two important qualifications. First, even in the most favourable circumstances the gas sector features a range of characteristics that render depoliticised regulatory decision making difficult. Second, in any sector the combination of accumulated unresolved problems and new issues is likely at some point to prompt some actors to demand revision of the rules or seek to circumvent them. The national regulatory state can draw on more than the regulatory toolkit to try to handle such challenges. The question is whether the EU regulatory state can match this. Regulatory politics – like all politics – is indeed the art of the possible.