EU - Russia Energy Relations and Political - Economic Ideology

by

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A thesis submitted to the Faculty of Graduate and Postdoctoral Affairs in
partial fulfillment of the requirements for the degree of

Master of Arts

in

European, Russian and Eurasian Studies

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Ottawa, Ontario

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Abstract

Russia and the European Union cannot reach a conclusive agreement on major issues in energy relations. Russian and EU economic policymaking from the 1970s onwards developed mutually incompatible ideological foundations. The EU adopted a neoliberal market framework with some social market characteristics, while Russia functions along economic nationalist ideas. These ideological influences informed the development of energy policy in each respective party. The EU insists that Russia deal with the internal European Energy market through a free market framework, while Russia prefers to do business with the EU without modifying its economic model in the energy industry. This has resulted in disagreements in negotiations for Partnership and Cooperation Agreement, the Energy Charter Treaty, and the Third Energy Package. Both Russia and the EU would benefit from cooperation due to energy interdependence, but each party needs to recognize and acknowledge their counterparts' interests for achievable long-term progress.

Acknowledgements

This thesis would not have been completed without the guidance of the committee members, support from fellow students, and moral support from my family.

I would first like to give my deepest thanks and gratitude to Professor Joan DeBardeleben for advising and supervising this MA thesis, and for providing crucial guidance and encouragement throughout the entire process. Her unwavering patience and enthusiasm gave me the confidence and inspiration to bring this thesis to fruition. Her support and advice has made me a better researcher and thinker. I would also like to express my thanks to Professor Crina Viju for being the second reader of this MA thesis. Her valuable criticism and insightful comments were indispensable and extremely helpful throughout the research process.

A sincere and grateful thanks to the members of the defence committee: Simon Power, David Long, Crina Viju, and Joan DeBardeleben. They provided insightful comments and suggestions, and I am grateful for devoting their time to read and comment on this thesis.

I would also like to thank all the academic and administrative staff, and fellow students of the EURUS Institute. All of you offered your professional and moral support without question. Your advice and encouragement kept me going in the most difficult times.

A special thanks to my parents, Athanasios and Maria, and my sister, Dimitra. Their constant encouragement and understanding made the writing of this thesis all the much more enjoyable.

Finally, I would like to thank my fiancée, Dina Tsitouras. Many times the temptation to surrender to frustration and self-doubt was dispelled by her unfaltering support and wise words. Despite spending countless late nights researching and writing, and often letting exhaustion and self-doubt get the better of me, she always encouraged me to push on to the very end. I am forever in her debt.

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Chapter 1: Introduction

Research Problem

Energy security is a foremost concern among the EU and its member states over the last two decades since the fall of the Soviet Union. European energy demands in natural gas and oil have steadily increased over the same period, and are projected to continue doing so into the near future. Since at least 1995, Russia has steadily become Europe's largest source of oil and natural gas supplies; in 2010, Russia's energy exports to Europe (180,654 thousand tonnes) were nearly equivalent to the combined export volumes of the next four largest suppliers to Europe (Norway, Libya, Saudi Arabia, and Kazakhstan).¹ Ever since 1991, the EU and Russia have attempted to lay down a framework to establish a stable, predictable supply of energy from Russia to Europe. Some of the most notable attempts have been the Partnership and Cooperation Agreement, the Energy Charter Treaty (ECT), and the Transit Protocol and the Third Energy Package, the latter of which, although is not directed at Russia, has an impact on the latter's energy interests in Europe. To date, neither of these agreements have come to fruition or led to any substantive outcome. Russia initially signed on to the ECT, but has since withdrawn; Russia refuses to ratify the Transit Protocol, and continues to criticize the Third Energy Package.

¹ European Commission, *EU Energy in Figures Statistical Pocketbook 2012*. 2012, p. 64. http://ec.europa.eu/energy/publications/doc/2012_energy_figures.pdf (Accessed July 1, 2013). Weights of non-liquid and non-solid energy products are converted into tons according to their calorific content relative to oil (see *EU Energy in Figures Statistical Pocketbook 2012*, Appendix 6. No. 2). All subsequent measurements follow this methodology.

This thesis attempts to answer the following research question: Why have Russia and the European Union been unable to conclude a major agreement on energy security over the last two decades?

Hypothesis

The hypothesis of this thesis is that Russia and the European Union have failed to reach a major agreement on energy security due to a problem stemming from economic ideology: the EU and Russia have incompatible ideologies concerning political economy. The EU follows an economic liberal ideology, while Russia adheres to an economic nationalist ideology. This results in the inability of both parties to reach conclusive and substantive agreements in their relations concerning energy security.

Ideology is argued to be the prime factor in explaining the outcome of energy agreement negotiations, as it is assumed that ideology motivates the imperatives and goals of each party. In other words, ideology informs the coordinates of what is a rational or irrational decision for the interests of the respective party. Thus, the instances of disagreement that will be discussed (the Energy Charter Treaty and Third Energy Package) will be analyzed to conclude whether ideology is the cause of the disagreements concerning these events, and how ideology plays out in sabotaging cooperative behaviour. Evidence that would support the hypothesis would be policies or strategies that demonstrate ideas or values that correspond to an economic ideology, and lead to policy outcomes that follow the ideas and values of the respective ideology of the unit of analysis. Evidence refuting the hypothesis would be policies or strategies that

demonstrate ideas or values, or lead to policy outcomes, that do not correspond to the assumed ideology of the unit of analysis. Refuting evidence also includes policies or strategies that correspond to the assumed ideology of the unit of analysis, but are never put into practice.

The hypothesis of this thesis will be juxtaposed with alternative explanations for disagreement in EU - Russia energy relations. This consists of analyses based in realist IR theory, and explanations based in legal norms and structural economic factors. These explanations will first be addressed in the existing literature, then during the empirical section of the thesis, where the two major disputes of EU - Russia energy relations will be analyzed. In the final chapter, the arguments of each approach will be considered along with the hypothesis of this thesis to determine which approach, or combination of approaches, best explains the dynamic of the disagreements in EU - Russia energy relations.

Variables

The independent variable is the ideology of political economy of each respective party. The dependent variable is the acceptance or refusal of agreement on energy security. The relationship between these variables is measured by the conflicts and events related to energy supply that have taken place over the last two decades. An example of observing this relationship would resemble the following example:

Russia refuses to sign the Energy Charter Treaty (dependent variable). This is because the ECT embodies priorities and ideas of liberal economic ideology (independent

variable), and these elements contradict the nationalist nature of Russia's political and economic policies. The assumption behind this hypothesis is that if Russia were more liberal economically, it would be more willing to reach agreements with the EU on energy security.

The nature of the research question is qualitative. As such, it would be useless from an empirical standpoint to attempt to define the dependent variable by degrees of willingness to accept or refuse an agreement. Attempts to define "willingness" is too open to errors of interpretation and inaccuracies.

The research question is focused on the notion of "agreement." An agreement is to be understood as any formal treaty or legal framework encompassing a set of rules, norms and/or provisions that both parties agree to accept *and* enact. Thus, it is not enough to simply sign on to the agreement; the parties must also enact whatever measures the treaty or framework calls for to qualify it as a case of a successful agreement.

Corollary to this, *acceptance* and *enactment* must be operationalized as well. Acceptance is evidence of a party's *consent* to respect or adopt rules or norms in an agreement, whereas *enactment* is when a party takes concrete measures to fulfill its obligations in the agreement. For example, if Russia and the EU drew up a treaty that limited the maximum market share of any European or Russian energy company to 20 percent of the total European energy market, signing the treaty would be considered *acceptance* of the terms and rules. Once both parties take the measures to ensure that this limit is respected and enforced, then the treaty is considered to be *enacted*. Thus the treaty can be qualified as an instance of a successful agreement. If it were a case that both

parties *accept* the treaty in principle, but either both or one side omits to take any action to meet the terms of the treaty, then this would be considered a failed agreement.

Thesis Outline

Chapter 2 discusses the methodology of the study and the literature review. Chapter 3 deals with the historical development of Russia's and the EU's economic ideologies since the collapse of the Soviet Union, and lays the case for the existence of an ideological conflict between Russia and the EU. Chapter 4 is devoted to the analysis of EU and Russian energy policy, respectively, and how each policy embodies their respective ideological values. Chapter 5 discusses the areas of conflict in EU - Russia energy security, showing how the combination of each party's historical ideological development and the subsequent effect on their energy policies have led to the disagreements and conflicts between them from 1991 to 2013. Chapter 6 concludes with a discussion of alternative explanations, a summary of the findings, and avenues for further research.

Chapter 2: Methodology and Literature Review

Conceptual Framework

This thesis argues that political - economic ideology is the prime factor explaining the discord between Russia and the European Union on energy security. Thus, the literature review hinges upon works concerning energy security and ideologies of political economy. This thesis brings the two topics together by focusing on a specific unit, 'energy,' that is often subsumed in the larger rubric of economy in the existing literature.

The independent variable is the ideology that informs the political economy priorities of each side. The dependent variable is the outcome of attempts to reach agreements on energy security. Thus, the units of analysis are political economy ideology, the energy policy of Russia and the EU, energy related agreements between Russia and the EU, and statements and policies of individuals or groups of policymakers or policy-influencers.

This thesis employs qualitative methods to address the research problem. Content analysis is deployed to analyze energy policy documents and energy treaties between Russia and the EU. Discourse analysis will be used on speeches and documents released by individuals or groups that influence or determine energy policy decisions in Russia and the EU. Quantitative methods are used in a secondary role to buttress the qualitative analysis, using statistics from private and governmental statistical authorities.

The hypothesis was generated from the review of the theoretical literature on economic liberalism and nationalism, and on works of energy security. There is a strong

trend in the literature of realist IR theory-based approaches to analyzing energy relations between Russia and the EU. Explanations using domestic-level analyses are less frequent. Ideology as a factor is not addressed in any significant manner. The hypothesis and theoretical framework of this thesis rests on the assumption that ideology a) does exist as a factor and, b) it informs priorities in energy negotiations between Russia and the European Union. Therefore, the review will discuss the literature with the context of this paper's hypothesis in mind.

Multi-Case Study

The multi-case study method will be used to analyze two specific cases related to politico-economic ideology and energy agreements: the Energy Charter Treaty and the Third Energy Package. These cases are used to gather the empirical evidence to support or refute the hypothesis and alternative explanations.

Disciplinary Approach

History, specifically political history, is used to gather empirical data to ground the assumption that the EU and Russia have organized their economies according to specific ideologies. This is a nomological type of history, since the objective is to uncover and pinpoint the existence of structures that have led to the foundation for the ideological bent of EU and Russian economic policy in energy matters, and what the impact of these structures are on concluding energy agreements.

Political economy serves to ground the paper in the theoretical component. The concept of ideologies of political economy is drawn from this discipline as well. The

research question is answered by attempting to understand the interplay between the political economy aspect of energy relations between Russia and the EU. Political economy, which deals precisely with that interplay, is best suited for the task.

Sources

Data are a combination of primary and secondary resources. Primary sources consist of policy papers, reports, government documents and memoranda. Secondary sources are existing documents; academic articles and books, statistical data from governments and energy authorities such as Eurostat, EIA, state statistics agencies, and reports released by energy companies. Secondary sources will be used to build on existing academic work in the fields of energy security, energy trade, international relations theory, and energy dependence between Russia and Europe.

Scope

The scope of the paper is limited chronologically to data and historical events dating between January 1991 - February 2014. Future energy sources, such as shale gas and future energy technologies, will not be considered since their effectiveness and feasibility have yet to be conclusively determined. Oil, natural gas and currently existing renewable energy sources will be the main focus of this study. Geographically, the paper will include Eurasia and EU member-states.

Theoretical Framework

The theoretical framework underpins the sources reviewed for the literature and frames the variables to be observed in the collected data. For this study, the theoretical framework is based on constructivist IR theory, but applied in the sub-discipline of International Political Economy. From this theory, the ideologies of economic liberalism and economic nationalism are deployed as the independent variables to the research question. These ideologies have varying theoretical definitions and interpretations in the theoretical literature, depending on the context they are used in. Let us explore this further.

For this thesis, the notion of “ideology” is borrowed from the Shared Mental Model (SMM) framework developed by Arthur Denzau and Douglass North.¹ The Shared Mental Model framework is constructivist in nature and is a refinement of rational choice theory and its tendency to oversimplify understandings of economy.² Contrary to rational choice theory, constructivists such as Goldstein and Keohane argue ‘utility’ is realized through a set of ideas and beliefs of what furthers or hinders a subject’s interest.³ Denzau and North build on this logic and argue that, “mental models are the internal representations that individual cognitive systems create to interpret the environment.”⁴ Ideologies, then, “are the shared framework of mental models that groups of individuals

¹ A.T. Denzau and D.C. North, “Shared Mental Models: Ideologies and Institutions.” *Kyklos*, vol. 47, no. 1 (1994): 3 - 31 (Accessed January 16, 2014).

² Ravi K. Roy, Arthur T. Denzau, and Thomas D. Willett, “Neoliberalism as a Shared Mental Model” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 3 - 14 (New York: Routledge, 2007). p. 5.

³ J. Goldstein and R.O. Keohane. *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change* (Ithaca: Cornell University Press, 1993).

⁴ Denzau and North, “Shared Mental Models,” p. 4.

possess that provide both an interpretation of the environment and a prescription as to how that environment should be structured.”⁵

The SMM informs the constructivist literature on economic nationalism and economic liberalism. Let us further examine this. As far as economic nationalism is concerned, there are two conceptual traditions: nationalism as ‘the state’ (statist) or as ‘the nation’ (nationalist).⁶ The statist position falls into realist theory, while the nationalist position stems from constructivism. Robert Gilpin’s conception of economic nationalism sums up the realist, statist position. Gilpin argues that economic nationalism is conceptually akin to mercantilism, statism, protectionism, and the German Historical School.⁷ The core of economic nationalism is the notion that economic activities are subordinate to state building and the interests of the state.⁸ Economic nationalists consider industrialization to be a key concern for the state. They believe that industrialization produces externalities that encourage overall economic development. Possession of a strong industrial base is equated with self-sufficiency and political independence, and a source of military strength and national security.⁹ In short, this is a state-centric, rationalist and materialist understanding of economic nationalism.

Rawi Abdelal’s criticizes Gilpin’s conception of economic nationalism, claiming that this approach wrongly conflates nationalism with statism. Similarly, Smith, El-Anis and Farrands argue that the realist position is flawed because it ignores the objective

⁵ Denzau and North, “Shared Mental Models,” p. 4.

⁶ George T. Crane, “Economic Nationalism: Bringing the Nation Back in.” *Millennium Journal of International Studies*, 27:55 (1998): 57 - 75. p. 55 (Accessed on January 15, 2014).

⁷ Robert Gilpin, *The Political Economy of International Relations* (Princeton, N.J.: Princeton University Press, 1987). p. 31.

⁸ Gilpin, *Political Economy*, p. 31.

⁹ Ibid, p. 33 - 34.

nature of national interests. Policies initially presented as favoring the national interests could, for example, simply be presented as such by domestic groups that would directly benefit from these policies.¹⁰

These criticisms represent the “nationalist” tradition of economic nationalism. The nationalist tradition is constructivist; it focuses on the social construct that is national identity and domestic influences on international economic relations.¹¹ National identities, according to this tradition, are social constructs with varying contents and contestations; the content of these identities specify the direction and social purposes of economic policies. Shared national identities increase the time horizons of a society and build the political will required for economic sacrifices.¹²

Abdelal’s provides persuasive empirical evidence to support the nationalist position. Abdelal deploys the case of Ukraine and its erratic stance towards Russia in the post-Soviet period, despite Ukraine being the second most powerful state in the Eurasian region in military and economic capabilities. Abdelal explains this outcome due to the convoluted nature of Ukrainian national identity and regional economic divisions; the eastern and southern portion of Ukraine is not anti-Russian, while Western Ukraine is more openly pro-Western and Europe oriented. Contrary to realist expectations, the Ukrainian state responded to these pressures by varying its stance over time as domestic pressure dictated.¹³

¹⁰ Roy Smith, Imad El-Anis & Christopher Farrands. *International Political Economy in the 21st Century: Contemporary Issues and Analyses* (Longman, 2011). p. 5.

¹¹ Rawi Abdelal, “Nationalism and International Political Economy in Eurasia” in *Economic Nationalism in a Globalizing World*, ed. Eric Helleiner and Andreas Pickel, 21 - 43 (Ithaca; London: Cornell University Press, 2005). p. 26 - 27.

¹² Abdelal, “Nationalism and International Political Economy,” p. 25 - 26.

¹³ Ibid, p. 32 - 34.

Abdelal's approach follows Helleiner's understanding of economic nationalism as the interplay between national identities and nationalism, and the impact on economic processes and policymaking.¹⁴ Crane reaches a similar conclusion when asserting that economics and economic policy decisions, as much as history or culture, are subject to interpretation and reinterpretation to serve collective identification.¹⁵ All these constructivist positions on economic nationalism fit into Denzau and North's Shared Mental Model framework.

The same observations can be made in the literature concerning economic liberalism. Gilpin assumes that, under economic liberal ideology, markets should appear organically to satisfy human needs and work according to its own internal logic once it begins to operate. Humans are economic beings and markets naturally evolve without need for central direction. A market system improves human welfare by increasing economic efficiency, and maximizing economic growth. Although economic activity also improves the power and security of a state, the prime objective of economic activity is concerned with the benefit of individual consumers; free trade widens the range of good and services for consumers.¹⁶ At the state level, liberals believe that free trade leads to peaceful, cooperative relations between states due to the mutual benefits of commerce and the interdependence of national economies.¹⁷ Under an economic system of free

¹⁴ Eric Helleiner, "The Meaning and Contemporary Significance of Economic Nationalism" in *Economic Nationalism in a Globalizing World*, ed. Eric Helleiner and Andreas Pickel, 220 - 234 (Ithaca; London: Cornell University Press, 2005). p. 220.

¹⁵ Crane, "Economic Nationalism," p. 56.

¹⁶ Gilpin, "Political Economy," p. 27-28.

¹⁷ Ibid, p. 30-31.

exchange, ‘everyone’ is better off in absolute terms, but the gains in wealth are unevenly spread.

Nancy Auerbach argues that Gilpin’s use of economic liberalism is deployed as “a paradigmatic model set up against realism in the international relations context, or perhaps Marxism in the political economy context.”¹⁸ Auerbach posits that neoliberalism can rather be understood as a renewed form of economic liberalism; both concepts share core market-oriented ideas and directives and represent a “shared mental model,” of classical liberalism.¹⁹ States that are neoliberal may differ in the extent to which they pursue neoliberal policies (different mental models of liberalism), but they share core values that fall into the “neoliberal family,” i.e the Shared Mental Model of neoliberalism.²⁰ Hay defines neoliberalism according to eight specific characteristics:

1. Confidence in the market as an efficient mechanism for allocating scarce resources;
2. Belief in the desirability of a global regime of free trade and free movement of capital;
3. Belief in the desirability, “all things being equal,” of a noninterventionist state with a limited role;
4. Conceive the state as a “facilitator and custodian” for market mechanisms, rather than a substitute for them;
5. Defending individual liberty;
6. Commitment to removing welfare benefits that may discourage market participation.

¹⁸ Nancy Neiman Auerbach, “The Meanings of Neoliberalism” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 26 - 50 (New York: Routledge, 2007). p. 27.

¹⁹ Auerbach, “Meanings of Neoliberalism,” p. 27.

²⁰ Roy, Denzau, and Willett, “Neoliberalism as a Shared Mental Model,” p. 9.

7. Defence of labor-market flexibility and promoting and fostering cost competitiveness.
8. Confidence in using private finance for public projects and, in general, in the allocative efficiency of market and quasi-market mechanisms for providing public goods.²¹

Although Hay uses this definition of neoliberalism to understand the ideology in the context of U.S. and UK politics and economy, it is equally relevant in the European context. Parsons argues that the European Union is commonly viewed as a victory of the neoliberal shared mental model. Despite “protectionist agricultural policies, rigid regulations, and onerous bureaucracies,” Parsons claims that these elements are secondary components of a “fundamentally neoliberal enterprise” that is the EU.²² The establishment of the Single Market in 1992 and monetary union, Europe has been oriented to more closely embody neoliberal principles of “competition, price arbitrage, and public policies that favour background economic stability over active intervention in markets.”²³

²¹ Colin Hay, “The Genealogy of Neoliberalism” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 51 - 70 (New York: Routledge, 2007). p. 54.

²² Craig Parsons, “Neoliberalism isn’t Enough: On the Interaction of the Neoliberal and Europeanist Shared Mental Models in the European Union” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 160 - 184 (New York: Routledge, 2007). p. 160.

²³ Parsons, “Neoliberalism isn’t Enough,” p. 160.

Literature Review

There are two distinct focuses within the reviewed literature on EU - Russia energy relations. The first, and major, focus is the dichotomy of energy dependence/interdependence between Russia and Europe, while the second and more minor focus is Russia's energy industry and Russian foreign energy policy. The literature review will discuss these two elements, and then place this thesis in the context of the reviewed literature.

Energy Dependency versus Interdependency

The first “trend” to review is the debate concerning energy dependence versus interdependence. Baev and Morales posit that Russia is using its energy reserves to increase its political influence in Europe.²⁴ Goldman puts forth a similar conclusion, but argues that energy has successfully granted Russia more power over Europe than it had during the Tsarist and Soviet eras.²⁵ Blank argues that Russia uses energy exports as a multi-pronged policy weapon.²⁶ Kevin C. Smith also argues that Russia uses energy wealth for political and economic influence in Europe.²⁷ These scholars sum up the “dependence camp” and adopt a realist approach to their analyses.

²⁴ Pavel K. Baev, *Russian Energy Policy and Military Power: Putin's Quest for Greatness* (New York, NY: Routledge, 2008); Javier Morales, “Russia as an Energy Great Power: Consequences for EU Energy Security” in *Energy Security: Visions from Asia and Europe*, ed. Antonio Marquina, 24 - 33 (New York, NY: Palgrave Macmillan, 2008).

²⁵ Marshall I. Goldman, *Petrostate: Putin, Power and the New Russia* (New York: Oxford University Press, 2010).

²⁶ Stephen Blank, “Russian Energy and Russian Security,” *The Whitehead Journal of Diplomacy and International Relations*, Vol. 12, No. 1 (Winter 2011): 173 -186 (Accessed on July 4, 2013).

²⁷ Kevin C. Smith, *Russian and European Energy Security: Divide and Dominate*, (Center for Strategic & International Studies: October 2008). http://csis.org/files/media/csis/pubs/081024_smith_russiaeuroenergy_web.pdf

However, other scholars disagree that Europe is the weaker partner in its energy dealings with Europe. Pierre Noël, for instance, argues that energy dependency is an overblown issue. Noël posits that the real issue concerns the EU's goal to depoliticize gas relations; Russia refuses to play along with the EU as politicized gas relations are part of Russian energy strategy.²⁸ Closson argues that there is a strong energy interdependency between Russia and Europe that will likely persist into the future, and the relationship favors cooperation over confrontation. Closson makes the case that Western perceptions of aggressive Russian behavior are more a result of Russia's growing physical presence in the energy markets and Russian posturing rather than actual aggressive intentions.²⁹ Aalto also concludes that Europe and Russia are mutually dependent in energy, but, like Noël, points out that the dependency varies between member states. Aalto argues that the EU has been promoting policies based on the three principles of "open, free and competitive markets; reliability and security of energy supply; and sustainability in the exploration and exploitation of energy resources."³⁰ The EU has been attempting since the early 1990s to make its relations with Russia dependent on adopting these principles. However, each EU member state has implemented these principles selectively; each state had an existing energy relationship with Russia before the institutionalization of EU energy principles took place.³¹

²⁸ Pierre Noël, "Beyond Dependence: How to Deal With Russian Gas," *European Council on Foreign Relations, ECFR/09, November 2008*, http://ecfr.eu/content/entry/russia_gas_policy_brief (Accessed on July 6, 2013).

²⁹ Stacy Closson, "Russia's Key Customer: Europe" in *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*, ed. Jeronim Perovic, Robert W. Orttung & Andreas Wenger, 89-108 (New York: Routledge, 2009).

³⁰ Pami Aalto, "European Perspectives for Managing Dependence" in *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*, ed. Jeronim Perovic, Robert W. Orttung & Andreas Wenger, 157 - 180. p. 157.

³¹ Aalto, "European Perspectives," p. 157.

Alongside the argument that energy dependency is not a significant, or even actual problem, some scholars argue that the focus should be on EU coordination in energy policy to protect the EU from energy dependency. Kusku argues that EU policymaking in energy remains intergovernmental due to the absence of a common EU policy. This will remain the case as long as the energy security interests of member states do not converge.³² Gawdat Bahgat, examining European policy in the realm of energy security, concludes that an increasing reliance on energy has amplified the importance of energy security in Europe since the EU-27 receives a significant share of its natural gas from Russia.³³ Anderson argues that dependency on Russia will increase if European states implement energy policies that involve phasing out nuclear power and reducing coal consumption, but EU policy has not paid attention to security threats in energy. Dependence already affects freedom of actions of certain European states and will damage European sovereignty over time.³⁴ Russian scholars such as Safonova make a similar argument, specifically that the EU will not be able to achieve any significant progress in energy sector development unless EU energy policy can be consolidated and member states are able to speak with one voice on the world stage.³⁵

³² Eda Kusku, "Enforceability of Common Energy Supply Security Policy in the EU: An Intergovernmentalist Assessment," *Caucasian Review of International Affairs*, Vol. 4, 2 (Spring 2010): 145 - 158. Accessed through Jstor on July 20, 2013.

³³ Gawdat Bahgat, "Europe's Energy Security: Challenges and Opportunities," *International Affairs (Royal Institute of International Affairs 1944-)* 82, No. 5 (September 2006): 961-975. Accessed through Jstor on July 20, 2013.

³⁴ Richard J. Anderson, "Europe's Dependence on Russian Natural Gas: Perspectives and Recommendations for a Long-term Strategy," *George C. Marshall European Center for Security Studies*, No. 19 (September 2008) <http://oai.dtic.mil/oai/oai?verb=getRecord&metadataPrefix=html&identifier=ADA488295> (Accessed July 13, 2013).

³⁵ Iu. A. Safonova, "Energeticheskaya politika Evropeiskogo soiuza i natsional'nye interesy Rossii." *Gosudarstvennost' Rossii v XXI veke*, 4 sektiia (January 2013): 833 - 849, http://www.journal.esco.co.ua/industry/2013_1/art228.pdf (Accessed on March 18, 2014.). p. 847 - 849.

Conversely, Goldthau and Söderbergh, Jakobsson and Aleklett focus on the danger of Russia *failing to meet* Russian European energy demand in the near future as the real threat to European energy security.³⁶ In the same vein, Mert Bilgin, using a geo-economic framework, argues that Russia is simply seeking profits from the energy trade, not political dominance.³⁷ The more mutual energy interdependence there is between Europe and Russia, the less likely conflict will break out. Dimitri Trenin reaches the same conclusion, but argues that a ‘geopolitics of energy’ is nonexistent, and, similarly to Goldthau and Söderbergh, Jakobsson and Aleklett, the threat to Europe does not lie in geopolitics, but in the lack of investment in the Russian upstream sector. Higher energy prices, better energy efficiency and non-Gazprom production would alleviate the problem.³⁸ Price argues that the long term production capacity of Gazprom is a concern domestically and internationally. Subsidized domestic prices will not allow Gazprom to cover costs in developing new fields to guarantee domestic and export supplies. A program of domestic gas price deregulation will help EU energy security by encouraging new development through protection against losses in the domestic market and driving down domestic demand.³⁹

³⁶ Andreas Goldthau, “Rhetoric vs. Reality: Russian Threats to European Energy Supply,” *Energy Policy*, 36 (2008): 686 - 692 (Accessed on July 25, 2013); Bengt Söderbergh, Kristofer Jakobsson, Kjell Aleklett, “European Energy Security: An Analysis of Future Russian Natural Gas Production and Exports,” *Energy Policy*, 38, (2010): 7827 - 7843 (Accessed on July 25, 2013).

³⁷ Mert Bilgin, “Geo-Economics of European Gas Security: Trade, Geography and International Politics,” *Insight Turkey*, Vol. 12, No. 4 (2010): 185-209 (Accessed on July 24, 2013).

³⁸ Dimitri Trenin, “Energy geopolitics in Russia - EU relations” in *Pipelines, Politics and Power: the Future of EU - Russia Energy Relations*. Ed. Katinka Barysch, 15 - 24 (Centre for European Studies) http://www.cer.org.uk/sites/default/files/publications/attachments/pdf/2011/rp_851-271.pdf (Accessed on May 17, 2013).

³⁹ Robert F. Price, “Energy Reform in Russia and the Implications for European Energy Security,” *Demokratizatsiya* (2007): 391-407 (Accessed through Jstor on May 30, 2013).

In a similar vein to Price, Ehrstedt and Vahtra's work addresses global investment of Russia's leading energy companies. These companies have shown willingness to challenge global energy majors. State control of the Russian energy sector with international expansion carries strong political and economic significance, but Europe and Russia clash on this issue, mainly on competing infrastructure projects and reciprocal investment restrictions in the energy sector.⁴⁰ A reliable energy policy should integrate concerns of all actors involved. Ehrstedt and Vahtra argue that the regulatory environments of the EU and Russia have many similar features, and the differences are explained by the nature of the energy industries in the EU and Russia, not by political or value choices made in Brussels. Predictability, they argue, is only possible in a regulatory framework that aggregates the interests of all stakeholders and provides a fair distribution of risks, obligations and revenues.⁴¹

Contrary to Ehrstedt and Vahtra, Evert Faber Van Der Meulen argues that the EU's energy policy towards Russia harms security of supply because it ignores the aims of Russia and Gazprom. The EU Commission seeks interdependence due to its inclination for liberal markets, but Russia prefers a policy that involves suboptimal state control of resources. A more pragmatic EU approach to security of supply would be more optimal, while the adopting of liberal energy markets should be a long term goal. There is a persistent lack of understanding between both sides and difficulty in reaching an

⁴⁰ Stefan Ehrstedt and Peeter Vahtra, *Russian Energy Investments in Europe* (Electronic Publications of Pan-European Institute: April 2008) <http://www.tse.fi/pei> (Accessed on June 3, 2013).

⁴¹ Nikolay Kaveshnikov, "The Issue of Energy Security in Relations between Russia and the European Union," *European Security*, Vol. 19, no. 4 (December 2010): 585-605 (Accessed through Jstor on July 20, 2013).

agreement on an energy partnership.⁴² Van Der Meulen's analysis ties into the problem of a mismatch between supply and demand guarantee in EU - Russia energy relations. Boussena and Locatelli point out that while the EU desires supply security, Russia prefers a guarantee of gas demand to make the financial investments needed to expand Russian energy export capacity. Boussena and Locatelli argue that this dispute stems from a clash of values and the EU's inability to define a common energy policy towards Russia.⁴³

On the topic of a common EU energy policy, Umbach posits that global traditional energy security concepts and domestic and regional political stability require new thinking regarding energy security and foreign and security policies. The 2006 Russia-Ukraine gas dispute brought energy security back into relevance, but the EU-27 have failed so far to create coherent energy security and foreign policy strategy ever since. Umbach believes that by reducing and freezing EU energy consumption and diversifying supply, Russia will be dissuaded from using energy as a weapon.⁴⁴ This conclusion fits with the conclusions of scholars that believe Russia is using energy for aggressive political purposes against the EU. However, as other scholars persuasively argue, Russia and Europe are mutually dependent in energy; it is unclear how monolithic energy policy priorities are in Russia, and Russian export capacity is already on a downward trend, which makes it seem unlikely that Russia is capable of using energy as an offensive political weapon. Such an argument ignores the possibility that, as

⁴² Evert Faber Van Der Meulen, "Gas Supply and EU-Russia Relations," *Europe-Asia Studies*, Vol. 61, no. 5 (July 2009): 833-856 (Accessed through Jstor on July 20, 2013).

⁴³ Sadek Boussena and Catherine Locatelli, "Gas Market Developments and their Effect on Relations between Russia and the EU," *Opec Energy Review* (March 2011): 27 - 46 (Accessed through Jstor on July 6, 2013).

⁴⁴ Frank Umbach, "Global Energy Security and the Implications for the EU," *Energy Policy*, 38, (2010): 1229-1240.

arguments of interdependence show, the problem boils down more to a mismatch of economic and political values or EU common energy policy, not hostile Russian intent.

Energy pipelines are a focus within the literature on energy dependence/interdependence. Ziegler argues that energy pipelines tie nations into beneficial interdependence, but this also involves vulnerability. Ziegler criticizes rationalist approaches on this issue, arguing that a focus on interests and reciprocity is not enough; analyses must be supplemented by a concept of trust based on normative factors. Ziegler cites political disputes with transit and consumer states, competing norms, and the legacy of mistrust from the Cold War as elements that have formed a uniquely toxic relationship in energy matters between Russia and the EU.⁴⁵ Schmidt-Felzmann and Pointvogl provide similar analyses and conclusions. According to Schmidt-Felzmann, EU member state' choices are informed by assessments of geopolitical reality and expected effect on national energy security. This is informed by perceived vulnerabilities stemming from geographic location, historical experience and bargaining position vis-à-vis Russia. Calls in the EU for "solidarity" in security of gas supply covers pursuits of individual interests, but fails to address collective EU interests.⁴⁶ Pointvogl concludes that the main driver in an integration of European energy policy is member state perception of energy security, with a significant role for energy business; these factors influence member states' willingness to integrate and define realities of implementation of existing measures. For efficient integration of European energy policies, Pointvogl argues that it is crucial to

⁴⁵ Charles E. Zeigler, "Energy Pipeline Networks and Trust: The European Union and Russia in Comparative Perspective," *International Relations*, Vol. 27, No. 1 (2012): 3 - 29 (Accessed through Jstor on July 26, 2013).

⁴⁶ Anke Schmidt-Felzmann, "EU Member-States' Energy Relations with Russia: Conflicting Approaches to Securing Natural Gas Supplies," *Geopolitics*, 16:3 (August 2011): 574-599 (Accessed through Jstor on July 25, 2013).

successfully accommodate different preferences of energy security and consider the effects of EU integration upon them.⁴⁷ Baran and Noël, akin to Schmidt-Felzmann and Pointvogl, argue that disunity among EU member state energy policies is a source of weakness. Russia has taken advantage of this situation to seal favorable energy deals and increase customers' dependence, essentially pursuing a divide and conquer strategy. Russia has stopped European attempts to build Caspian and Central Asian pipelines that circumvent its own networks. Baran argues that Cooperation among EU member states on energy security is critical to stand up to Russian pressure.⁴⁸ The August 2008 Georgia-Russia war has increased the urgency to search for a better policy to deal with Russia. Russia's leadership pursues a rational set of political and economic goals in its foreign energy policy, but is limited by the options available. Russia's use of pipelines and buying up assets in foreign countries as a foreign policy strategy has increased over time.⁴⁹

There is no substantial focus on ideology of political economy in the reviewed literature. Realism, geo-economics, and geopolitical approaches are dominant, and although some scholars have focused on normative values and economic ideologies, none have attempted to draw a causal link between the political and economic ideologies of Russia and the EU and their effects on energy agreements (or lack thereof) between both sides. Essentially, this thesis provides a better explanation by attempting to isolate the

⁴⁷ Andreas Pointvogl, "Perceptions, Realities, Concession - What is Driving the Integration of European Energy Policies," *Energy Policy*, 37 (2009): 5704 - 5716.

⁴⁸ Zeyno Baran, "EU Energy Security: Time to End Russian Leverage," *The Washington Quarterly*, Vol. 30, No. 4 (Autumn 2007): 131-144 (Accessed through Jstor on July 29, 2013).

⁴⁹ Robert W. Orttung, Indra Overland, "A Limited Toolbox: Explaining the Constraints on Russia's Foreign Energy Policy," *Journal of Eurasian Studies*, 2 (2011): 74-85 (Accessed through Jstor on June 30, 2013).

overarching, prime factor that explains disagreement on energy between Russia and EU, not simply focusing on the “symptoms” and main elements of disagreement.

Russia’s Energy Industry and Russian Foreign Energy Policy

The second focus within the reviewed literature in EU - Russia energy relations is the relationship between Russia’s energy industry, industry reform and Russian foreign energy policy. Pleines argues that the EU is Russia’s most important trading partner in foreign economic activities; after the 2004 enlargement, Russia now supplies two-thirds of EU gas demand and one-third of its oil. Pleines makes the case that Russian business interests only effectively influences policy towards CIS countries. Russian energy policy preferences towards the rest of the world are beyond the influence of the Russian business elite.⁵⁰ However, Michael Fredholm makes the convincing argument that although Russia’s energy policy until mid-2003 was determined by different actors within the state and the private sector, Putin has since centralized energy policy under his control. Energy company executives no longer take part in the decision-making processes at the government level. Russia’s leaders are aware of the strategic needs regarding the energy industry and this is reflected in Russian energy strategy. Additionally, like Noël, Fredholm isolates natural gas as the deciding factor; Russian oil companies are privatized, but the Russian government can still use gas and electricity companies as policy tools since they remain under state control. However, these companies are

⁵⁰ Heiko Pleines, “Russian Energy Companies and the Enlarged European Union” in *Russian Business Power: The Role of Russian Business in Foreign and Security Relations*, ed. Andreas Wenger, Jeronim Perović, and Robert W. Orttung. Routledge: 47 - 66 (New York: Routledge, 2008).

inefficient and infrastructure development projects lack funding.⁵¹ Li-Chen Sim, using rational choice institutionalism, argues that Russia's current drive to maintain a largely state-controlled oil and gas sector is in line with past policy during the tsarist and Soviet eras.⁵²

Philip Hanson argues that Russian economic growth is vulnerable to falling oil prices, and investment in the energy sector has been insufficient due to state control, complicating future Russian export capacity to meet European demand.⁵³ Kazantsev and Gustafson also press on the issue of falling export capacity,⁵⁴ but the latter posits that oil in particular is important for Russian growth and prosperity.⁵⁵ This may be true from an economic standpoint, but, as mentioned above, Noël and Fredholm's findings indicate that natural gas, not oil, is a more pressing concern for current and future Russian political interests in Europe, since gas infrastructure is more costly and more difficult to displace.⁵⁶

Heinrich posits the existence of two factors that determine Russia's attitude towards foreign investment in the oil and gas industry: the short-term financial needs of the energy industry and state budget, and the balance of power between different state

⁵¹ Michael Fredholm, "The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?" *Conflict Studies Research Centre*, 5, 41, (September 2005) [www.da.mod.uk/CSRC/documents/Russian/05\(41\)-MF.pdf](http://www.da.mod.uk/CSRC/documents/Russian/05(41)-MF.pdf) (Accessed on August 3, 2013).

⁵² Li-Chen Sim, *The Rise and Fall of Privatization in the Russian Oil Industry* (New York: Palgrave Macmillan, 2008).

⁵³ Phillip Hanson, "The Sustainability of Russia's Energy Power: Implications for the Russian Economy" in *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*. eds. Jeronim Perovic, Robert W. Orttung, and Andreas Wenger, 23-50 (London; New York: Routledge, 2009).

⁵⁴ Andrey Kazantsev, "The Crisis of Gazprom as the Crisis of Russia's 'Energy Super-State' Policy towards Europe and the Former Soviet Union," *Caucasian Review of International Affairs*, Vol. 4, no. 3 (Summer 2010): 271-284 (Accessed through Jstor on August 8, 2013); Thane Gustafson, *Wheel of Fortune: The Battle for Oil and Power in Russia* (Cambridge, Mass.: Belknap Press of Harvard University Press, 2012).

⁵⁵ Gustafson, "Wheel of Fortune."

⁵⁶ Noël, "Beyond Dependence"; Fredholm, "The Russian Energy Strategy."

actors involved in the energy industry. Both factors changed during the 1990s, resulting in an ambivalent and unpredictable attitude towards foreign investment.⁵⁷ Larsson argues that Russia's political reliability as an energy supplier depends on a time perspective, the customer and political context. The use of energy as a policy tool will likely be aimed at former Soviet states to maintain influence over the CIS, but Europe could be affected as well. Russian coercive energy policy should be understood through a long-term geopolitical and strategic context (political, economic and market drivers together). International competition for Russia's resources are also a critical future factor. Negative democratic trends combined with structural instability and policy unpredictability underscore uncertainties in development that are more significant than they seem at first glance.⁵⁸

Robert W. Orttung argues that oil revenue in Russia enables authoritarian tendencies to survive by enabling the political elite to control property and financial resources in society. State control over the energy sector frames how energy resources are managed and developed. Orttung concludes that Russian energy resources have been squandered by bolstering authoritarian rule. The concentration of political power in few hands and the muzzling of the media stymies the development of policies and ideas that can encourage structural changes in government. Russia, in short, is a victim of the resource curse; high energy revenues encourage a short-term outlook on economic

⁵⁷ Andreas Heinrich, Julia Kuszniir & Heiko Pleines, "Foreign Investment and National Interests in the Russian Oil and Gas Industry," *Post-Communist Economies*, 14:4 (2002): 495-507 <http://www.tandfonline.com/doi/abs/10.1080/1463137022000032709> (Accessed on August 10, 2013).

⁵⁸ Robert L. Larsson, *Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier* (Swedish Defence Research Agency: March 2006) <http://storage.globalcitizen.net/data/topic/knowledge/uploads/20110731213514705.pdf> (Accessed on August 2, 2013).

development.⁵⁹ Pleines argues that privatization does not necessarily lead to efficient companies, evidenced by the poor performance of Russian companies during the privatization drive of the 1990s. What matters is the market environment: if the market has clear rules and secure property rights, companies are more likely to operate more efficiently and will feel secure enough to engage in long-term investment strategies. In Russia's case, Putin's government has failed to create a market environment conducive to growth and investment due to selective law enforcement and insecure property rights.⁶⁰

Tkachenko argues, akin to arguments made by Orttung and Pleines, that the Russian presidential administration has played a leading role in shaping national energy policy and that energy is the most effective policy tool for Russia in the international arena.⁶¹

Kennedy argues that power sector reform is one of the key policy issues facing Russia. Lack of reform means inefficient performance will worsen. If reforms do succeed, Russian finance will be able to support the development of an efficient and high-quality power supply. Price and regulatory reform is central to the success of market liberalization.⁶² However, reforming the Russian electricity industry is difficult as it is a key economic sector with political connotations. In concordance with Pleines' analysis, Engoian warns that free-market doctrine could endanger the Russian economy by

⁵⁹ Robert W. Orttung, "Energy and State - Society Relations: Socio-Political Aspects of Russia's Energy Wealth" in *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*, ed. Jeronim Perovic, Robert W. Orttung, and Andreas Wenger: 51-70 (London; New York: Routledge, 2009).

⁶⁰ Heiko Pleines, "Developing Russia's Oil and Gas Industry: What Role for the State?" in *Russian Energy Power and Foreign Relations: Implications for Conflict and Cooperation*, ed. Jeronim Perovic, Robert W. Orttung, and Andreas Wenger, 71-88 (London; New York: Routledge, 2009).

⁶¹ Stanislav L. Tkachenko, "Actors in Russia's Energy Policy towards the EU" in *EU - Russian Energy Dialogue: Europe's Future Energy Security*, ed. Pami Aalto, 163 - 192 (Abingdon, UK: Ashgate Publishing Group, 2007).

⁶² David Kennedy, "Liberalisation of the Russian Power Sector," *Energy Policy*, 31 (2003) 745-758.

threatening the basis of the economy and electricity generation through privatization.⁶³ Boute also addresses the electricity sector and Russia's attempts to engage in liberalization since 2003, and makes a similar argument to Kennedy in that the Russian electricity sector is hampered by a clash of political considerations for subsidized prices for consumers and the long-term demands of investors.⁶⁴ While the Russian government ostensibly began liberalizing the energy sector in 2003, it still maintains a considerable presence in the sector through control of certain companies.⁶⁵

There is no discussion of political-economic ideological factors to explain Russian energy policy objectives and preferences in the literature, at least not in any significant way. The literature still leaves an important question unanswered, which is why the Russian state pursues a protectionist energy policy vis-a-vis the EU and tightly controls its energy sector *despite* the damage such an economic policy is inflicting on Russian export capacity and, consequently, Russian state revenues and economic growth in the long term. This question can be juxtaposed with the short-term benefits of the strategy, which are maintaining a strong presence in the European energy market and more control over the direction of the country's economic development and modernization. Additionally, while the literature does address the EU's free market approach to organizing the energy sector, there is a disproportionate focus on explaining Russia's unwillingness to understand, adopt or work with European economic ideas, and

⁶³ Alda Engoian, "Industrial and Institutional Restructuring of the Russian Electricity Sector: Status and Issues," *Energy Policy*, 34 (2006): 3233-3244.

⁶⁴ Anatole Boute, "The Russian Electricity Market Reform: Towards the Re-Regulation of the Liberalized Market?" in *Evolution of Global Electricity Markets*. ed. F. Sioshansi (Elsevier, 2013). Chapter provided by the author.

⁶⁵ Boute, "The Russian Electricity Market."

very little discussion of the reverse situation. The hypothesis of this thesis attempts to answer these questions, but without a disproportionate focus on one party of the EU - Russia energy relationship. By focusing on ideology as the independent variable, the analysis will attempt to explain the dynamic of the EU - Russia energy relationship outside of the realist IR paradigm and other alternative approaches, therefore adding a new analytical dimension to the topic of EU - Russia energy relations.

Chapter 3: Ideological Foundations

The objective of this chapter is to situate the ideological influences behind EU and Russian energy policy by examining the historical evolution of the ideologies themselves. In Europe, neoliberal ideology gradually became the guiding principle of economic and energy policy throughout the 1980s and 1990s and became an integral part of the European integration process. Russia, meanwhile, briefly experimented with neoliberalism from 1985 to 2000, but suffered a catastrophic economic and national collapse as a result of that experiment, and became reliant on its energy industry for economic and national survival.

Europe and Economic Liberalism

The origins of neoliberalism in the EU stem from the mid-1950s, during the era of Keynesian dominance of macroeconomic policy in the Western world. From the post-WWII era until the 1970s, the Keynesian economic model reigned supreme on both sides of the Atlantic: the Keynesian welfare state, a response to the Great Depression, provided governments with the tools to respond to dropping levels of aggregate consumer demand in the 1930s. In the post-WWII era, the welfare state model was expanded to boost the spending power of the poor (who were more likely to buy domestically produced products instead of luxury imports) during economic downturns to stave off collapses in demand.¹

¹ Colin Hay, “The Genealogy of Neoliberalism” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 51 - 70 (New York: Routledge, 2007). p. 57.

In the 1970s, Western liberal democracies began experiencing stagflation: rising inflation coupled with increasing and elevated levels of unemployment. The Keynesian paradigm “or shared mental model,” as Hay puts it, that underpinned the intellectual rationale during the boom period of the 1950s - 1970s was unable to offer a solution to stagflation.² In response, right-wing politicians in the West filled the gap by arguing for neoliberal policies as an escape from stagflation. This is best exemplified in the Thatcherite / ‘Reaganomics’ revolutions of the late 1970s - early 1980s in the UK and the US respectively. Monetarist and supply side economic policies, the cornerstones of neoliberalism, were deployed in the US and UK to enact welfare reform, the denationalization of state industries, prioritization of cost competitiveness, anti-union legislation, and labor-market flexibility.³ The assumptions behind these measures were:

1. Capital is best informed as to where it can secure the best net return on investment;
2. Markets for goods and services are completely integrated in the global economy, therefore national economies must be internationally competitive to survive;
3. Capital is perfectly mobile and has no exit costs;
4. Capital will secure the greatest return on investment by minimizing labor costs in flexible labor markets, and by moving its productive activities to economies with low corporate tax rates;
5. The welfare state is lost capital to mobile asset holders and lacks positive externalities for the competitiveness and productivity of the national economy.⁴

² Hay, “The Genealogy of Neoliberalism,” p. 57.

³ Ibid, p. 61.

⁴ Ibid, p. 66.

Interestingly, although these ideas came into popular political discourse in the 1970s and 1980s and adopted by governments, there were already hints of these neoliberal assumptions germinating in Western Europe in the 1950s, when the foundations for economic and monetary union were beginning to be laid down. Indeed, the idea of a single European market was already being discussed among liberal circles soon after the Second World War, particularly among members of the neoliberal Mont Pèlerin Society.* However, memories of the Great Depression and the unrestricted capitalism of the time were still strong; thus the post-WW2 years were a time of economic planning and coordination. Even the Schuman Plan and the foundation of the European Coal and Steel Community (ECSC) were driven by notions of cooperation and coordination, not market competition.⁵

It was only after the June 1955 Messina Conference and the May 1956 Venice Conference that neoliberal ideas began to appear in European economic policy. Based on these conferences, the Spaak report was released in April 1956. This report became the blueprint for a single West-European market and contained three specific goals: establishing normal standards of competition by removing protective barriers; discouraging state intervention and monopolies; and enacting measures to stop distortion of economic competition, including the use of harmonization of legislation at the European level.⁶ The report argues that economic integration would enable Europe to

* The Mont Pèlerin Society was a group of intellectuals in favor of neoliberal economic policies. Friedrich Hayek, Karl Popper, Ludwig von Mises, George Stigler and Milton Friedman were members.

⁵ Christoph Hermann, "Neoliberalism in the European Union," *Studies in Political Economy*, 79 (Spring 2007): 61 - 90. <http://spe.library.utoronto.ca/index.php/spe/article/view/5196/2060> (Accessed on February 14, 2014). p. 69.

⁶ Michelle Egan, "The Single Market" in *European Union Politics*, ed. Michelle Cini, 2nd ed (New York: Oxford University Press, 2007). p. 254.

avoid obstacles to economic growth from, among other things, insufficient *energy resources*.⁸ Indeed, the report concedes that energy resources, especially petroleum based sources, were almost completely imported into Europe. Additionally, the report points out that investment in the energy sector is expensive and of a long-term nature. In the 1950s West European states jealously protected their own energy needs and accorded differing degrees of priority to security of supply, increasing the financial and time costs of investment. Consequently, as the report contends, competition within Europe in energy suffered and weakened the ability of European energy companies to compete with other states.⁹ European energy policy, then, was beginning to be linked with the common European market.

Following the Spaak report, the Treaty of Rome in 1957 established the objectives for constructing a common market within Europe. Within this common market, a customs union would be the main focus. The common market included trade liberalization measures such as the free movement of labor, goods, services and capital (otherwise known as the ‘Four Freedoms.’)¹⁰ These freedoms led to a debate in the 1980s between proponents of neoliberal and interventionist economic ideologies in the EC. In the neoliberal camp, one could find the British Conservative party, heads of British and European multinational corporations, industrial associations such as UNICE (European Confederation of National Employers’ Associations), financial interests, pressure groups, think tanks, pro-business factions in the German CDU-CSU and FDP, liberal and

⁸ EU Commission, *Rapport des Chefs de Délégation aux Ministres des Affaires Etrangères*, p. 10. April 21, 1956, http://aei.pitt.edu/996/1/Spaak_report_french.pdf (Accessed on February 3, 2014).

⁹ *Rapport des Chefs de Délégation*, p. 126 - 127.

¹⁰ Egan, *The Single Market*, p. 255.

conservative parties on the European continent, and “opinion leaders” such as *The Economist*.¹¹

The European Commission also hosted neoliberals in its ranks. During Jacques Delors’ presidency the commission was ideologically split between the president and right-wingers led by Sir Leon Brittan, commissioner for competition and later commissioner for external trade. When Brittan was appointed in 1988, Thatcher hoped that Brittan, a “liberal crusader” would help liberalize national and EU-level industrial policy.¹² The Directorate-Generals of the Commission, especially the Directorate-General for competition (DG IV) that implemented the internal market, also supported the neoliberal agenda. This was in part due to the recruitment of market supporters in the 1980s and a parallel growth in the profile of competition policy during the establishment of the internal market. According to a senior official in the DG in 1995, “there is no question that the balance has changed, and that there is much greater emphasis on greater [market] opportunities rather than giving out money.”¹³

As mentioned previously, in the late 1970s and early 1980s the Western world was experiencing an economic slowdown that called into question Keynesian economic policy. EC member states were not immune to these effects. As a response to stagflation, member states attempted to maintain protective economic barriers, but these measures did not close the competitiveness gap growing between Europe, and Japan and the U.S.¹⁴

¹¹ Liesbet Hooghe and Gary Marks, “The Making of a Polity: The Struggle Over European Integration,” *European Integration online Papers* (EIoP), Vol. 1, no. 004 (1997) <http://eiop.or.at/eiop/texte/1997-004a.htm> (Accessed on February 3, 2014), p. 9.

¹² Hooghe and Marks, “The Making of a Polity,” p. 10.

¹³ Interview quoted in Hooghe and Marks, “The Making of a Polity,” p. 10.

¹⁴ Egan, *The Single Market*, p. 259.

Debates over which approach (neoliberalism or regulated capitalism) would work best to solve these problems led to the Single European Act (SEA) of 1986, followed by the establishment of the Single Market in 1992, which institutionalized reforms that changed EU economies along neoliberal lines.¹⁵

The main objective of the SEA was to “add new momentum to the process of the European construction so as to complete the internal market.”¹⁶ This was to be achieved by easing the establishment of the internal market by raising the number of cases where the European Council could take decisions through Qualified Majority Voting (QMV) instead of unanimity. This would ostensibly ease the decision-making process by removing the delays caused by the need for unanimous agreement.¹⁷ The establishment of the SEA in 1985 set the stage for the 1992 Single Market, also known as the 1992 Programme.¹⁸ Under Jacques Delors’ presidency in the Commission, and with the neoliberal Internal Market Commissioner Lord Cockfield, the Commission released a White Paper entitled *Completing the Internal Market*, which became the basis for the 1992 Programme.¹⁹

The White Paper discusses the protectionist measures put in place by member states to safeguard their economies during the recessionary era of the late 1970s and early 1980s, noting that these actions were in contravention of the EEC Treaty provision that

¹⁵ Craig Parsons, “Neoliberalism isn’t Enough: On the Interaction of the Neoliberal and Europeanist Shared Mental Models in the European Union” in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 160 - 184 (New York: Routledge, 2007). p. 163.

¹⁶ European Union, *The Single European Act*, http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_singleact_en.htm (Accessed on February 4, 2014).

¹⁷ *The Single European Act*.

¹⁸ Egan, *The Single Market*, p. 261.

¹⁹ *Ibid*, p. 261.

called for the gradual abolishment of restrictions on the freedom to provide services during the transition to a common market.²⁰ Setting a timetable for completion by 1992, the paper set out three specific objectives: the removal of physical, technical and fiscal barriers.²¹ These measures were intended to not only fuse the markets of the member states, but also to ensure that the single market “is also an expanding market - not static but growing” and to ensure that the market is “flexible so that resources, both of people and materials, and of capital and investment, flow into the areas of greatest economic advantage.”²² All these measures would help Europe become more competitive. As Egan notes, the White Paper “constitutes a radical break with Europe’s interventionist tradition, emphasizing the merits of economic liberalism.”²³

This had direct implications for services such as gas and electricity; these sectors have traditionally been considered nationally important and were given exemptions from competition rules in the Single Market. However, pressure to liberalize, coupled with technological pressures that allowed new entrants to the market to circumvent public networks, undermined the interventionist rationale behind this scheme. Pressure to open up the gas markets, among other things, “resulted in the Commission forcing the liberalization of these basic services through its competition powers.”²⁴ Indeed, as Nadine Haase points out, the Single European Act “was the precondition for the creation of a

²⁰ European Commission, *Completing the Internal Market*, (1985) http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf (Accessed on February 4, 2014), p. 5.

²¹ *Completing the Internal Market*, p. 6.

²² *Ibid*, p. 5.

²³ Egan, *The Single Market*, p. 262.

²⁴ *Ibid*, p. 262.

common European internal market, *a goal of the energy market reforms* [my italics].”²⁵

This follows the argument Parsons makes that neoliberal ideas of political economy have become indispensable to the EU project because “they benefited from a fortuitous political connection to the distinct project of Europeanist institution-building.”²⁶ Integration and neoliberalism were complimentary ideas.

The point to note in the evolution of the common market and the adoption of neoliberal economic policies, as far as energy is concerned, is that although energy was considered a critical component in promoting European economic growth and competitiveness, it was no longer a given that state control was the best option for the energy industry. The idea that the market is the best guarantor of economic growth, and that the fewer economic barriers the better, was applied to the European energy sector. In 1995, the Competitiveness Advisory Group (CAG) called for deregulating and privatizing the public sector, especially in the area of energy.²⁷ Indeed, by the 1990s liberalization was considered a fundamental tool to strengthen European business and to benefits consumers by discouraging the formation of monopolies and oligopolies.²⁸

Furthermore, unlike in early post-Soviet Russia, neoliberal ideas and policies had decades to be implemented and fine-tuned in Europe. There was no crash reform program or a political collapse. While the Soviet Union was disintegrating and Russian nationalism was resurgent in the 1990s, Europe in the same era was moving in the

²⁵ Nadine Haase, *Regulation for Competition in European Gas Markets: The Impact of European Law and Facilitating Factors* (ECPR Standing Group on Regulatory Governance, 2008) <http://regulation.upf.edu/utrecht-08-papers/nhaase.pdf> (Accessed on February 4, 2014), p. 2.

²⁶ Parsons, “Neoliberalism,” p. 179.

²⁷ Hermann, “Neoliberalism in the European Union,” p. 76.

²⁸ Ibid, p. 74.

opposite direction, experiencing steady economic growth among EU member states and gradually moving closer to supranationalism. Questions of economy never became tied up with notions of national power, prestige or even survival, not only because the EU itself is supranational by nature, but it is also in the ideological camp that survived the Cold War. Laissez-faire capitalism outlasted the Soviet model of a centrally planned economy. There is no real or perceived mortal economic or political threat to Europe stemming from Russia since the Soviet collapse, and therefore no pressure or incentive to even consider the economic nationalist model of political economy.

Russia and Economic Nationalism

Political-economic ideology under the Soviet Union mandated that the economy never stray far from state control. Once the USSR collapsed in 1991, however, Russia's elite attempted to reform the economy through neoliberal economic policies. Russia's brief experiment with neoliberalism, however, did not lead to positive economic outcomes, especially in the energy sector. The economic damage caused by neoliberalism convinced Russia's leaders in the post-Yeltsin era that key economic sectors, energy being one of them, were better off under state control to rebuild both the economy and the Russian nation.

The appearance of neoliberal ideas in Russian political discourse took place in the 1980s, but the roots of those ideas are traceable as far back as the 1960s. Under Leonid Brezhnev's neo-Stalinist regime, liberal minded Soviet elites disdained what they perceived was a misguided socioeconomic policy of privileging the interests of the

working class over the scientific-technical intelligentsia.²⁹ This view was pioneered by men such as the academician Oleg Shkaratan. During the reform debates of the 1960s, Shkaratan argued that the scientific-technical intelligentsia, not the working class, should be relied upon to lead the Soviet Union into a second industrial revolution and avoid economic stagnation. Brezhnev, in response, demoted Shkaratan along with an official party reprimand and disciplined any other academics that shared Shkaratan's views.³⁰

In the 1970s and 1980s, liberal sociologists radicalized Shkaratan's ideas, claiming that genetic justifications, akin to Social Darwinist theories of innate genetic superiority, could be used to explain and justify social inequality and hierarchy. This reflected concerns among sections of the Soviet elite that opportunities for social promotion among the working class were growing scarcer and that the *nomenklatura* was becoming a self-replicating social stratum that was sealing itself off from the rest of society.³¹ Flaherty argues that although these Social Darwinist ideas and the debates surrounding them were obscure and somewhat ludicrous, they were "the first trickles of the neo-liberal intellectual current which has moved into the mainstream reform debate of the nineties."³² These sociological debates became the political vehicle for restructuring social class in post-Soviet Russia³³ by providing a non-communist, but still elite-driven, mental model for reforming society through radical economic reform. The neoliberal reform process was driven from above by the Soviet elite while the population remained

²⁹ Patrick Flaherty, "Perestroika and the Neo-liberal Project" In *Communist Regimes: The Aftermath*, ed. Ralph Miliband and Leo Panitch, 128 - 168 (London: Merlin, 1991) <http://socialistregister.com/index.php/srv/article/view/5593/2491> (Accessed on February 12, 2014).

³⁰ Flaherty, "Perestroika," p. 132 - 133.

³¹ Ibid, p. 133 - 134.

³² Ibid, p. 134.

³³ Ibid, p. 134.

a passive observer.³⁴ Even though the Social Darwinist element never came to fruition, the idea that an ‘enlightened’ class could transform Russia’s economy survived.

This factor played a crucial role in the development, demise, and rejection of neoliberalism in Russia, as we shall see. Also, it must be noted that even though the European and Russian versions of neoliberalism developed from different starting points, they share similar ideological characteristics. Both versions share a vision of a minimized state that interferes minimally in market activity, and that market forces are better determinants of where capital should be allocated in the economy. The only difference is in the manner in which these ideas became acceptable in political discourse.

By the mid-1980s a small scale, private black market in the USSR had arisen and was treated as semi-legal by the Soviet state. This market was very limited in size, and foreign trade, banking and finance remained under state control. Gorbachev’s perestroika reform in 1985 created more legal space for private business, encouraging growth in retail, services and small-scale production. In the late 1980s and early 1990s, private enterprise began to breach its prescribed limits. Komsomol members started experimenting with privatized foreign trade and private banking; these elite-driven capitalist ventures, protected by the state and benefiting from influential social connections, were one of the most successful and profitable private capitalist ventures in the final years of the Soviet Union. As a result, these elite businesses amassed substantial capital within a short period³⁵ and, as Tikhomirov aptly points out, it was “in this environment of the crumbling state hold of the [Soviet] economy and the growing formal

³⁴ Vladimir Tikhomirov, *The Political Economy of Post-Soviet Russia* (New York: Palgrave, 2000). p. 225.

³⁵ Tikhomirov, *Political Economy*, p. 226.

and informal private sector that the Russian economy reform was launched at the start of 1992.”³⁶

In September 1990, a working group formed through the joint decision of Gorbachev and Boris Yeltsin, and headed by S.S. Shatalin, published the *Transition to the Market: Concept and Program*, otherwise known as the 500-Day Programme.³⁷ This program outlined the plan and measures to convert Russia from a centrally planned economy to a fully functioning free market neoliberal economy in 500 days. According to Shatalin, this program is a natural outgrowth of the perestroika era.³⁸ Shatalin argues, in line with neoliberal ideology, that only by considerably downsizing the state and handing over its resources to the people can the country ensure a more effective use of resources and dampen the negative effects of the transition to the market economy.³⁹ Nationalism is also appealed to:

And only when all the possibilities and resources, devoured today by the giant state machine, will be turned over to the needs of the people and when they are aware of this; only then is the nation’s leadership justified to turn to the people with an appeal to exercise patience, *to endure eventual hardships in the name of the Motherland, in the name of their own future and the future of their children* [my emphasis] (vynesti vozmozhnye tiagoty vo imia Rodiny, vo imia budushchego svoego i svoikh detei).⁴⁰

The program weighs three options for the economy: a return to Stalinist economics, gradual reform to a market system, or a radical reform to a market system. The first

³⁶ Tikhomirov, *Political Economy*, p. 226.

³⁷ EPItsentr, *Perekhod k Rynku: Konseptsii i Programma (Rabochnaia grupp, obrazovannaia sovместnym resheniem M.S. Gorbacheva i B.N. Yeltsina)*, Moskva 1990 <http://www.yabloko.ru/Publ/500/500-days.pdf> (Accessed on February 12, 2014).

³⁸ *Perekhod k Rynku*, p. 8.

³⁹ Ibid, p. 8

⁴⁰ Ibid, p. 8.

option is rejected due to the need for political repression to make it function, and the second option is viewed as unable to stop economic and national disintegration. Yet, the third option, radical reform, is posited as the best option simply since “[t]he need to transition to *an alternate model of social structure* is dictated by *universal laws of economic and social development in general*. Attempts to seek a unique path, for one country, that defy *the logic of historical development* are doomed to fail [my italics].”⁴¹ This project was clearly ideological in character, assuming the neoliberal option was the natural answer according to a historicist view of economic and social development. This option would be implemented by the elite, with the populace standing by to bear the inevitable burdens of economic transition for the sake of the nation. Although the program was never adopted, the actual reforms carried out were the same; the only difference was the timing of the reforms outlined between the enacted reforms and those in the 500 Days plan.

Economic reform took place as the Soviet Union collapsed economically and politically through Russian and Ukrainian defection from the Union. As Rutland argues, this meant that not only did Russian leaders have to now rebuild the economy, but they also had to create a new Russian nation and build new democratic reforms at a time of imperial collapse. The logic was that by establishing a functioning free market, Russians would have a national objective they could rally around as a uniting force and legitimize the rule of the Russian elite in the process.⁴² Indeed, nationalism was closely tied to

⁴¹ Ibid, p. 28.

⁴² Peter Rutland, “Mission Impossible? The IMF and the Failure of the Market Transition in Russia,” *Review of International Studies*, Vol. 25, The Interregnum: Controversies in World Politics 1989 - 1999 (Dec., 1999): 183 - 200, <http://www.jstor.org/stable/20097645> (Accessed January 23, 2014). p. 186.

Russia's drive to neoliberalism. During the *perestroika* era, Yeltsin was a champion of radical economic reforms as a key element for Russian sovereignty.⁴³ He played upon ethnic Russians' distaste of non-Slavic nationalities, whom they perceived as backwards, foreign, and as a financial burden due to the beneficial treatment they received within the Soviet system.⁴⁴ Before being elected president, Yeltsin suggested establishing a Council of Economic Advisers to plan a transition to a market economy, along with a law on Russian sovereignty, a new Russian constitution, and a convertible ruble.⁴⁵ By the turn of the 1990s, Yeltsin was dead set on market reform as Russian economists kept pressing for a free market. This sat well with both ordinary Russians and the party elite: for the former, market reform was envisioned as the solution to shortages in shops and the key to fair access to any stores and goods regardless of class background; for the elite, reform would mean the end of relying on patronage from one's superiors and one's place in the *nomenklatura* hierarchy in order to have access to luxury goods.⁴⁶ Yeltsin was prepared to destroy the Soviet Union in the process, but not solely for nationalist reasons: Yeltsin's use of nationalism justified and created the conditions for drastically restructuring the Russian economy.

In the Soviet economy, the energy industry was entirely controlled by the state. However, after the collapse of the USSR in 1991, the energy industry fell under the neoliberal experiment along with the rest of the economy. Oil and natural gas resources

⁴³ Maya Eichler, "Explaining Postcommunist Transformations: Economic Nationalism in Ukraine and Russia" in *Economic Nationalism in a Globalizing World*, ed. Eric Helleiner and Andreas Pickel, 69 - 90 (Ithaca; London: Cornell University Press, 2005). p. 75.

⁴⁴ David M. Kotz & Fred Weir, *Russia's Path from Gorbachev to Putin: The Demise of the Soviet System and the New Russia* (New York: Routledge, 2007). p. 128.

⁴⁵ Jonathan Steele, *Eternal Russia: Yeltsin, Gorbachev, and the Mirage of Democracy* (Cambridge: Harvard University Press, 1994). p. 245.

⁴⁶ Kotz and Weir, *Russia's Path*, p. 128.

under the USSR were managed by the Ministry of Petroleum and the Ministry of the Gas Industry, respectively. Initially after the 1991 collapse, the Ministry of the Gas Industry remained under state control; senior state officials within the ministry managed in 1989 to tie up all its assets before the collapse and transformed the ministry into Gazprom. The Ministry of Petroleum, however, had its production fields, refineries and pipelines sold off into private hands:⁴⁷ On November 1992, Yeltsin signed Decree No. 1403 into law, which regulated the privatization of the Russian oil sector.⁴⁸ The Russian state did sell some of its shares in Gazprom, but retained the majority of them, effectively maintaining state control; Viktor Chernomyrdin, minister of the Soviet-era Gas Industry, appointed himself as president and CEO of Gazprom.⁴⁹ Once Boris Yeltsin appointed Chernomyrdin as deputy prime minister in May 1992, the latter promoted Rem Vyakhirev from vice chairman of Gazprom to chairman and CEO of the corporation. Under Vyakhirev, Gazprom was no longer closely regulated by the state.⁵⁰ The company paid little in taxes or shareholder dividends, and assets such as wells, pipelines and distributions entities were sold off unrestrictedly to executives' family members or transferred offshore.⁵¹

The chaos in the energy industry is an example of the fatal flaw in Russia's post-Soviet reforms: no strong foundations existed for a workable market economy. True, as we saw before, there was already a semi-legal private market since 1985, but its most

⁴⁷ Marshall I. Goldman, *Petrostate: Putin, Power and the New Russia* (New York: Oxford University Press, 2010.) p. 59.

⁴⁸ Government of the Russian Federation, *Decree Concerning Privatization and Restructuring of Public Enterprises into Corporations for Industrial and Scientific - Production Associations of Oil, Petroleum and Petroleum Industries* (November 1992), <http://www.transneft.ru/files/2012-11/HsQ3lB5jCdM0VeL.pdf> (Accessed on February 12, 2014).

⁴⁹ Goldman, *Petrostate*, p. 59.

⁵⁰ Ibid, p. 60 - 61.

⁵¹ Ibid, p. 60 - 61.

successful elements were limited to a small, elite section of society. A significant portion of the ex-USSR economy was heavily militarized; 25 to 40 percent of it was earmarked for defense alone. Infrastructure was lacking and a significant proportion of Soviet defense related industry was situated in peripheral geographic regions that favored national security concerns but defied economic rationality. For instance, three million Soviet citizens lived north of the Arctic circle and worked in towns dedicated to military and mining facilities producing single items such as tanks or nuclear missiles. Reallocating all this labor and capital would cause substantial economic disruption.⁵²

Nevertheless, despite these problems, neoliberalism was expected to pull through and cure Russia's ills through monetary stabilization, liberalization and privatization (known ever since by critics as "shock therapy").⁵³ Monetary stabilization consisted of introducing a stable currency to prevent hyperinflation and easily measure price levels and money supply (the cornerstones of monetary and supply side economics as we saw above). Liberalization entailed lifting restrictions on domestic and international business activities: price controls and subsidies would be dropped, as well as restrictions on new business formation. Private enterprises would be given free access to foreign trade. Quotas and export duties would also be abolished, and import tariffs would be reduced. These measures were ostensibly designed to encourage the necessary import competition to push Russian monopoly suppliers to become competitive or succumb to the pressures of the market. Additionally, free trade would enable resources to place themselves into economic sectors that offered the best return on investment.⁵⁴ Privatization, by

⁵² Rutland, "Mission Impossible?" p. 187 - 188.

⁵³ Rutland, "Mission Impossible?" p. 190; Eichler, "Explaining Postcommunist Transformations," p. 75.

⁵⁴ Rutland, "Mission Impossible?" p. 190.

transferring economic assets from state to private ownership, would encourage entrepreneurship and foster competitive markets. State assets were sold off to anyone willing to buy them.⁵⁵ Although these reforms applied to specific sectors of the Russian economy, they involved fundamentally restructuring an economy that was geared for heavy industry and defence into a Western style economy focused on consumer goods production. Thus even industries and sectors not targeted by the reforms were affected by the changes.

However, in Russia, there were no domestic private actors with the required capital to buy newly privatized assets, apart from the early adopters of capitalism as mentioned previously. This meant that either foreigners would buy these companies, or they would have to be sold to domestic purchasers at a discount. The latter took place, with the consequence that “the privatization process essentially became a vehicle for the legitimization of the seizure of state assets by the more energetic members of the old communist-industrialist nomenklatura.”⁵⁶ This is exactly what happened with the energy industry, and Chernomyrdin’s takeover of Gazprom is the perfect example:⁵⁷ Chernomyrdin, the former head of Gazprom and then deputy prime-minister, had spent the early part of his career working in the Orsk refinery near the Urals and worked for the Communist Party in Orsk until 1973 until becoming an engineer for a natural gas processing plant in Orenburg. He became director of the plant in 1978, and later worked his way up in Moscow as an instructor for the Central Committee of the Communist

⁵⁵ Rutland, “Mission Impossible?” p. 190.

⁵⁶ Ibid, p. 191.

⁵⁷ David M. Kotz, “Is Russia Becoming Capitalist?” *Science & Society*, Vol. 65, no. 2 (Summer 2001): 157 - 181, <http://www.jstor.org/stable/40403894> (Accessed on February 6, 2014). p. 165.

Party. This set him up to take on the role of deputy minister of the Ministry of the Gas Industry in 1982, then minister in 1985.⁵⁸ Vyakhirev, Chernomyrdin's replacement as Gazprom chief, also hailed from the energy industry as a natural gas and petroleum specialist.⁵⁹

It was the privatization element of “shock therapy” most of all that tipped the scales towards economic and national disaster in Russia. While privatization initiatives in EC countries were carried out with some difficulty as mentioned above, they did not result in catastrophic economic disruptions. Western Europe already had market mechanisms in place before adopting neoliberalism. In contrast, privatization in Russia, according to Roy Medvedev:

[i]n its goals, its scale, and its time frame it has no precedent in world history. It was proposed that over a period of two or three years the greater part of the publicly owned enterprises and property that had been accumulated in Russia, not just in the Soviet era but ever since industrialization began in Russia in the 1870s - all this was to be sold or auctioned off or somehow distributed among the citizens of our country.⁶⁰

Consequent to this rush to privatize, David M. Kotz argues that the result in Russia was not a development of capitalism, but a “non-capitalist ‘predatory/extractive system’.”⁶¹ Russian workers in the pre-Putin era were not paid regularly. Wages were too low for a worker to survive on alone and had to be supplemented from activities outside of the workplace (e.g. farming small private plots of land, petty production and trade). Additionally, Russia's *nouveaux riches* did not derive their income from employing wage

⁵⁸ Goldman, *Petrostate*, p. 59 - 60.

⁵⁹ Ibid, p. 60 - 61.

⁶⁰ Roy Medvedev, *Post-Soviet Russia: A Journey Through the Yeltsin Era.*, trans. & ed. George Shriver (New York: Columbia University Press, 2000). p. 86 - 87.

⁶¹ Kotz, “Is Russia Becoming Capitalist?” p. 159.

labors to produce goods for sale on the market; rather, income was gained through speculation, lending, extortion, and asset stripping. This specifically included the oil and gas industries of Russia.⁶² As Kotz states, the new oil and gas producers acquired assets created by the previous state socialist system; through the privatization program, they essentially bought those assets for a fraction of their real value. As a result, it made more sense for these new energy industry owners to simply export oil and gas without reinvesting profits into production capacity, refining or infrastructure.⁶³ The energy industry, oil in particular, was as a result vulnerable to fluctuations in the international economic environment. While Russia was able to export 100 - 110 million tons of oil annually from 1995 - 1997 and bring in 40 - 50 percent of the profits in hard currency for the state, between January and March 1998, oil prices dropped, costing the Russian treasury US\$1.5 billion in lost revenue.

Data drawn from U.S Energy Information Administration. <http://www.eia.gov/countries/country-data.cfm?fips=RS&trk=m>

⁶² Ibid, p. 164 - 165.

⁶³ Ibid, p. 166 - 168.

To properly explain the extent of the damage done to the oil and gas industry, graph 1.0 illustrates total oil production between 1992 and 2008. Total production declined by 22 percent from 1992 (7,818 thousand barrels) to 1998 (6,069 thousand barrels). Production only recovered to 1992 levels after 2002, *a whole decade later*. The 1998 east Asian financial crisis showed how vulnerable the oil sector was to a currency shock. If we look at total natural gas production over the same period, a similar picture emerges:

Data drawn from U.S Energy Information Administration. <http://www.eia.gov/countries/country-data.cfm?fips=RS&trk=m>

In the case of natural gas, production decreased by 16 percent over the 1992 - 1997 period, from 22,615 billion cubic feet in 1992 to 18,900 billion cubic feet in 1997. Production slightly recovered in 1998 (19,553 billion cubic feet), but production never recovered to 1992 levels until after 2008.

Economic damage to the energy industry aside, the Russian population was politically and economically traumatized by the effects of neoliberal policies. People withdrew from political engagement and lost trust in a weak state to defend them from the vagaries of the market.⁶⁴ From 1992 to 1993 real wages were diminished by 41 percent and another 14 percent by the end of 1995. The average workers' wage declined 55 percent by 1995. Poverty became rampant; by 1995 the average wage was only 1.8 times higher than the poverty threshold, while in 1992 it was three times higher.⁶⁵

Thus, as the neoliberal reforms eroded the income of the population, the growth of domestic production and consumption was crippled. Without public spending to make up for low consumer demand, production for export became the only viable option for economic growth.⁶⁶ Hence, the Russian state became dependent on revenue from oil and natural gas exports to remain financially solvent.

As the end of the 1990s approached, a change in ideology took place with Vladimir Putin's entry into the presidency. The neoliberals (led by Yegor Gaidar and Anatoly Chubais) and Yeltsin's administration in general were discredited by their failure to reform the economy.⁶⁷ Putin hailed from a *siloviki* background, a loose group of individuals who served in the 'power ministries' of the former Soviet Union and modern Russia, mainly military, intelligence and security services.* Putin himself was director of

⁶⁴ Bertram Silverman and Murray Yanowitch, *New Rich, New Poor, New Russia: Winners and Losers on the Russian Road to Capitalism* (New York: M.E. Sharpe, 1997). p. 7.

⁶⁵ Silverman & Yanowitch, *New Rich, New Poor, New Russia*, p. 18.

⁶⁶ Kotz and Weir, *Russia's Path*, p. 252 - 253.

⁶⁷ Liliia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington, DC: Carnegie Endowment for International Peace, c2007). p. 114.

* The main ministries are: the Ministry of Defense (MO), Ministry of Internal Affairs (MVD), Federal Security Service (FSB), Ministry of Civil Defense and Emergency Situations (MChS), Federal Customs Service (FTS), Procuracy, Federal Service for Control of the Narcotics Trade (FSKN), and the Federal Guard Service (FSO). Brian D. Taylor, *State Building in Putin's Russia: Policing and Coercion after Communism*. New York: Cambridge University Press, 2010, p. 36.

the St. Petersburg FSB just before his nomination to the presidency. The *siloviki* believe that a strong state is necessary to serve as the foundation of society. The state should run the economy at least in economic sectors that are considered strategically valuable: they consider Russia's vast natural resources to be the property of the state and oppose the economic privatization undertaken in Russia during the 1990s.⁶⁹ In 1997, two years before Putin became president, he defended a PhD thesis in economics that displayed these very ideas; his thesis was the leading article in the 1999 annual edition of the St. Petersburg Mining Institute journal.⁷⁰

Putin's thesis argues that sustainable development of Russia's economy for the short-term must be based on systematic growth of 'developed sectors,' specifically in mineral resources. Developing a reliable resource base to meet current and future economic needs would guarantee the economic security of the country. The thesis offers six conclusions based on an analysis of the country's raw material resources, but one stands out in particular: "The main reserve to, in the near future, make Russia a great economic power with a high living standard for the majority of the population is maximum support for the fatherland's processing industry based on the extractive complex."⁷¹ The thesis pointed out that natural gas and oil made up 47.9 percent of Russia's potential mineral reserves and were worth US\$13.6 trillion (in 1997 US

⁶⁹ Jørgen Staun, *Siloviki Versus Liberal-Technocrats: The Fight for Russia and its Foreign Policy* (DIIS Report, 2007:9), <http://subweb.diis.dk/graphics/Publications/Reports%202007/diisreport-2007-9.til%20web.pdf> (Accessed on June 19, 2013). p. 29.

⁷⁰ Harley Balzer, "Vladimir Putin's Academic Writings and Russian Natural Resource Policy," *Problems of Post-Communism*, vol. 53, no. 1 (January/February 2006): 48-54. p. 48.

⁷¹ Vladimir V. Putin, "Mineral Natural Resources in the Strategy for Development of the Russian Economy." 2006 Translation from the Russian 1999 original St. Petersburg State Mining Institute, "Mineralno-syrevye resursy v strategii razvitiia Rossiiskoi ekonomiki," *Zapiski Gornogo Instituta* 144 (1999): 3 - 9. Translation by Harley Balzer.

dollars).⁷² Raw minerals provided more than half of GDP and 70 percent of the state budget, were the basis for military modernization, and were providers of social stability: most of the companies directly or indirectly involved in raw materials have cities dedicated solely to the companies.⁷³ The thesis also argues that allowing market forces to handle the economy will not solve problems; rather, regulating the use of resources will provide better results, “regardless of the prevailing form of land and subsoil property or the type of economy.”⁷⁴ This is to be done in conjunction with a “high degree of [state] responsibility” in decision-making concerning foreign and domestic economic policy designed to promote Russia’s geopolitical interests and ensure national security.⁷⁵

Have these ideas been borne out in practice in the oil and gas industry? As of December 31, 2012, the Russian state still holds more than 50 percent of the shares in Gazprom.⁷⁶ On July 1, 2013, the Russian government released a ‘Memorandum of Intent’ to make clear that it would not divest any of its shares in the company until at least 2016.⁷⁷ Although the rest of the economy remains privatized, the energy industry remains under state control, as it is considered the key tool for rebuilding Russia’s economy and encouraging the socioeconomic development of the country. In the oil sector, the oil pipeline network is controlled by the state through Transneft; all the company’s voting

⁷² Putin, “Mineral Natural Resources,” p. 50.

⁷³ Ibid, p. 51.

⁷⁴ Ibid, p. 53.

⁷⁵ Ibid, p. 53.

⁷⁶ Gazprom, “Investors,” <http://www.gazprom.com/investors/stock/> (Accessed February 28, 2014).

⁷⁷ Gazprom, “Memorandum of Intent of the Russian Federation as a major shareholder of JSC ‘Gazprom’,” <http://www.gazprom.com/f/posts/62/158052/memorandum-of-intent-en.pdf> (Accessed on February 28, 2014).

stock is held by the Russian government.⁷⁸ Private oil companies do operate in Russia: LUKoil, a privately owned company, is the second-largest holder of Russian oil reserves.⁷⁹ However, all of Russian exported oil must pass through Transneft's pipeline monopoly, and Rosneft, which is state owned, occupies the top spot in oil production.⁸⁰ In 2012, Rosneft produced 23.7 percent of total oil production; LUKoil produced 16.2 percent.⁸¹ Technically, the electricity sector has been liberalized since 2003, but in 2008 the Russian government increased its role in the sector, especially in the sale of strategically important assets, thus the electricity sector is still not free from government intervention along the neoliberal model.⁸² This is the key difference between Russian and EU perceptions of the role energy should play in the economy; for the EU, a liberalized energy market is a critical element in fostering overall economic growth and providing more consumer choice; for Russia, the energy industry is instrumental in the survival of Russia as a state and as a people.

⁷⁸ Komori Goichi, "Issues Involved in the Russian Crude Oil Transportation System and the Role of the State-Owned Pipeline Company, Transneft." *The Institute of Energy Economics, Japan*. August 2005. <http://eneken.ieej.or.jp/en/data/pdf/292.pdf> (Accessed on April 17, 2014). p. 1 - 2.

⁷⁹ U.S. Energy Information Administration (EIA), "Russia." March 12, 2014. <http://www.eia.gov/countries/analysisbriefs/Russia/russia.pdf> (Accessed on April 17, 2014).

⁸⁰ U.S. EIA.

⁸¹ U.S. EIA.

⁸² Anatole Boute, "The Russian Electricity Market Reform: Towards the Re-Regulation of the Liberalized Market?" in *Evolution of Global Electricity Markets*, ed. F. Sioshani (Elsevier, 2013). p. 11. Chapter provided by the author.

Chapter 4: EU and Russian Energy Policy

EU Energy Policy

This chapter analyzes the energy policies of the European Union and the Russian Federation. The goal of this chapter is to determine whether the ideological values of both parties are visible in the goals and objectives of these energy policies. This will allow us to establish whether there is empirical evidence of a link between general ideological priorities of political economy and energy policy priorities. Consequent to this, we will examine in Chapter 5 whether these influences have had an effect in practice on issues concerning major energy agreements between Russia and the European Union.

The European Community in the 1990s lacked a concrete supranational energy policy; efforts were mostly spent setting up the foundations of an internal energy market through directives aimed at liberalizing and unbundling energy companies. In the 1990s the EC began laying down legislation for gas and electricity market pricing. Directive 90/377/EEC of the European Council stipulates that energy price transparency is key to reinforcing competitiveness in the common market and achieving a stable functioning internal energy market.¹ The directive references the Treaty of Rome, which set out to provide the conditions for establishing a common market and customs union,² thus the directive is in line with those goals. Indeed, building an internal market for energy is, for

¹ Official Journal of the European Communities, *Council Directive of June 29 1990 Concerning a Community Procedure to Improve the Transparency of Gas and Electricity Prices Charged to Industrial End-Users (90/377/EEC)*, No L 185/16, June 1990, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31990L0377:en:HTML> (Accessed on February 19, 2014).

² European Community, *Traité instituant la Communauté Économique Européenne et documents annexes*, March 1957, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:11957E/TXT:FR:PDF> (Accessed on February 19, 2014). Articles 2 and 3.

the EU, an integral element of establishing a proper single market as Directive 91/296/EEC clearly shows.³ Notably, gas is of more concern than oil, and this is reflected in all subsequent legislation leading up to the establishment of the EU's first common energy policy. This is in line with Noël's analysis that argues natural gas is a more pressing concern for the EU than oil.⁴ In June 1998, the European Council and Parliament released a directive that made the first mention of 'unbundling' for natural gas companies. According to Article 13, paragraph 3:

Integrated natural gas undertakings shall, in their internal accounting, keep separate accounts for their natural gas transmission, distribution and storage activities, and, where appropriate, consolidated accounts for non-gas activities, as they would be required to do if the activities in question were carried out by separate undertakings, with a view to avoiding discrimination, cross-subsidisation and distortion of competition. These internal accounts shall include a balance sheet and a profit and loss account for each activity.⁵

The unbundling principle is a central component of the market liberalization goal of the EU's internal energy market as it prevents companies from acquiring and consolidating enough assets to block potential competitors from entering the market. A June 2003 directive reinforced the unbundling principle by emphasizing that, in the interest of "efficient and non-discriminatory network access," transmission and distribution systems

³ European Council, *Council Directive 91/296.EEC of 31 May 1991 on the Transit of Natural Gas Through Grids*," Official Journal L 147, 12/06/1991 P. 0037 - 0040, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31991L0296:EN:HTML> (Accessed on February 19, 2014).

⁴ Pierre Noël, "Beyond Dependence: How to Deal With Russian Gas," *European Council on Foreign Relations, ECFR/09, November 2008*, http://ecfr.eu/content/entry/russia_gas_policy_brief (Accessed on July 6, 2013).

⁵ European Council, *Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 Concerning Common Rules for the Internal Market in Natural Gas*," L 204, July 1998, P. 0001 - 0012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998L0030:EN:HTML> (Accessed on February 19, 2014). Art. 13, Par. 3.

in gas networks have to be operated through *legally separate* entities in cases where operations are vertically integrated.⁶ Articles 9, 13, and 15 stipulate the minimum criteria for ensuring the independence of transmission systems, distribution systems, and combined operators, respectively; article 17 stipulates the conditions for unbundling accounts of natural gas undertakings.⁷

Concerns over energy security existed in the EC during the same period, but they were not brought to the fore or given a clear priority over market considerations until as late as April 2004, when an EC directive dealing specifically with measures for protecting the supply of natural gas was released. Article 3 of the directive, however, stipulates that although member states must define roles and responsibilities to ensure sufficient levels of security of gas supply, they must still take the necessary actions “to ensure that the measures referred to in this directive do not place an unreasonable and disproportionate burden on gas market players and are compatible with the requirements of a *competitive internal gas market*.”⁸ Five years later, this emphasis on unbundling was expanded: Directive 2009/73/EC addresses the issue of the rules on legal and functional unbundling in Directive 2003/55/EC which failed to achieve “effective unbundling of the transmission system operators.”⁹ It is in this directive where the link between

⁶ European Parliament and Council, *Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 Concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC*, Official Journal of the European Union, L 176/57, June 2003, <http://www.energy-community.org/pls/portal/docs/36278.PDF> (Accessed on February 19, 2014). Point 10.

⁷ European Parliament and Council, *Directive 2003/55/EC*.

⁸ European Council, *Council Directive 2004/67/EC of 26 April 2004 Concerning Measures to Safeguard Security of Natural Gas Supply*, Official Journal of the European Union, L 127/92, April 2004, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:127:0092:0096:EN:PDF> (Accessed on February 19, 2014). Article 3.

⁹ European Parliament and Council, *Directive 2009/73/EC of the European Parliament and of the Council Concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 2003/55/EC*, Official Journal of the European Union, L 211/94, August 2009, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:en:PDF> (Accessed on February 19, 2014).

competitiveness and security of supply is made most evident: “[o]nly the removal of the incentive for vertically integrated undertakings to discriminate against competitors as regards network access and investment can ensure effective unbundling. Ownership unbundling...is clearly an effective and stable way to solve the inherent conflict of interests and to ensure security of supply.”¹⁰ Common rules were established for transmission, distribution, supply and storage of natural gas, with a deadline of March 3, 2012, for member states to separate assets of production and supply.¹¹

The previous directive makes a direct reference to the January 2007 ‘An Energy Policy for Europe’ policy document.¹² This policy argues that, through the establishment of an open internal energy market, Europe will benefit from increased economic activity and greater supply security. However, there is no explicit mention of security taking priority over economic concerns, nor any mention of government involvement in regulating the energy market in any way to protect it from foreign competition. Indeed, even in a section devoted to the problem of security of supply, the focus is on ensuring security strictly for economic concerns, that is to allow “the necessary long term investments to take place and for user prices to be competitive.”¹³ Indeed, if one looks at the strategic objectives of the 2007 policy, there are three specific goals that very much reveal what the EU’s energy policy priorities are: dealing with climate change, limiting external vulnerability to imported hydrocarbons, and encouraging growth and jobs to

¹⁰ European Parliament and Council, *Directive 2009/73/EC*.

¹¹ *Ibid*, *Directive 2009/73/EC*.

¹² *Ibid*, *Directive 2009/73/EC*.

¹³ Commission of the European Communities, *Communication from the Commission to the European Council and the European Parliament: An Energy Policy for Europe*, COM(2007) 1 final, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52007DC0001&from=EN> (Accessed on November 10, 2013). p. 3 - 4.

provide secure and affordable energy for consumers.¹⁴ Energy security is to be achieved through the competitiveness that the implementation of an internal energy market will ostensibly nurture.¹⁵

EU enlargement has partly achieved this goal by expanding the area in which internal EU market rules apply. Russia, however, remains outside this area, and this is of utmost concern for the EU; the EU was aware from as early as 2000 that the continent's dependency on Russian fossil fuels, and natural gas in particular, was a potential energy security risk.¹⁶ The "Green Paper: Towards a European Strategy for the Security of Energy Supply" drawn up in 2000 presented an outline for a long-term energy strategy. The paper was more of a jump-starter for debate on the issue of energy supply than an actual strategic plan, but nonetheless it encapsulated the priorities of the EU at the time. The main goals of the paper were rebalancing EU supply policy in favour of a demand policy, and a change in consumer behaviour through taxation measures or parafiscal levies. Concerning supply, the paper called for a priority focus on mitigating global warming, diversifying import routes for oil and gas, and implementing more robust mechanisms for building up strategic stocks of supply.¹⁷

The paper also addressed the issue of external energy supplies. The paper stated that "the European Union must use its political and economic influence to ensure flexible and reliable external supply conditions."¹⁸ In relations with producer countries, a need

¹⁴ Commission of the European Communities, *An Energy Policy for Europe*, p. 5.

¹⁵ Ibid, p. 6.

¹⁶ European Commission, *Green Paper: Towards a European Strategy for the Security of Energy Supply*, 2000, http://ec.europa.eu/energy/green-paper-energy-supply/doc/green_paper_energy_supply_en.pdf (Accessed on October 1, 2013). p. 2.

¹⁷ European Commission, *Green Paper*, p. 3-4.

¹⁸ Ibid, p. 73.

existed for establishing an “ongoing dialogue” with producer countries on a regular basis, not solely in response to changes in the market. The Energy Dialogue is mentioned in its infancy stage as an energy partnership with Russia, but no detail is given on how the Dialogue fits into the overall strategy.¹⁹ While Russia would prepare itself to improve the EU’s long term supply security, Europe would provide investments in transport and production in the energy sector. All measures would be finalized “within the framework of a cooperation and partnership agreement between the European Union and Russia.”²⁰ The relationship between the two political entities, at least in this document, was framed as a straightforward partnership devoid of any normative conditions or demands. The Green Paper also outlined plans for stronger supply networks with security guarantees. At the time, 90 percent of the EU’s oil was imported by sea; a “supply balance” would be restored by shifting emphasis onto oil pipelines. Using new pipeline networks would increase the diversity of supply by making it possible to tap into supplies from the Caspian Sea, the southern Mediterranean, Azerbaijan, Kazakhstan and Turkmenistan. The plan insists that the EU must ensure the provisions of the Energy Charter Treaty and the transit protocol are swiftly implemented by applicant countries and the NIS.²¹

In 2006 another green paper on energy was released, “A European Strategy for Sustainable, Competitive and Secure Energy.” The paper expanded on the earlier paper’s points by identifying six key areas that were considered crucial for the challenges facing Europe in the energy sector: competitiveness and the internal energy market; diversification of the energy mix; solidarity; sustainable development; innovation and

¹⁹ Ibid, p. 73 - 74.

²⁰ Ibid, p. 73 - 74.

²¹ Ibid, p. 73 - 74.

technology; and external policy.²² The 2006 version includes an external energy policy, but with more detailed objectives, arguing that the effectiveness and coherence of the EU's external energy policy is contingent upon internal policies and, more specifically, the establishment of an *internal energy market*. By following these steps, one of the goals that could be achieved is the improvement of dialogues with major energy producers; indeed, the paper highlights the special opportunity this initiative may have with Russia, “the EU's most important energy supplier.”²³ A “true” partnership would provide the security and predictability to enable long-term investments in new capacity. This ideal partnership would entail “fair and reciprocal access to markets and infrastructure including in particular third party access to pipelines.”²⁴ In other words, Russia would have to follow EU energy market rules.

The 2007 “An Energy Policy for Europe” is based on the 2000 and 2006 green papers. Predictably enough, the three main goals of the policy are sustainability, security of supply, and competitiveness.²⁵ The internal energy market is presented as ‘essential’ for the success of these three goals, and, interestingly enough all these goals involve encouraging and ensuring economic growth through competition. Sustainability, for instance, would encourage the development of energy-efficient technologies and push smaller companies and consumers to choose non-conventional energy supplies. Security of supply, by separating electricity and gas networks, will, the policy argues, incentivize

²² European Commission, *Green Paper: A European Strategy for Sustainable, Competitive and Secure Energy*, 2006, http://europa.eu/documents/comm/green_papers/pdf/com2006_105_en.pdf (Accessed on October 1, 2013) p. 4-5.

²³ European Commission, *European Strategy*, p. 15.

²⁴ *Ibid*, p. 15.

²⁵ Commission of the European Communities, *Energy Policy for Europe*, p. 3 - 4.

companies to invest in infrastructure, inter-connection capacity, and new generation capacity.²⁶ Unbundling networks is still considered crucial to the success of the internal energy market.²⁷

Three years later, The “Energy 2020: A Strategy for Competitive, Sustainable and Secure Energy” green paper was released. It builds upon the points addressed in the 2007 policy: by 2010 the goals of security of supply, competitiveness and sustainability were incorporated into the Lisbon Treaty.²⁸ The paper mentions “serious gas supply crises that have acted as a wake-up call, exposing Europe’s vulnerability,”²⁹ a reference to the Ukraine - Russia gas disputes of 2006 and 2009. The paper reflects the growing fear in the EU of supply dependency in oil and natural gas and the need for a common EU external policy to address this problem in the Europe 2020 strategy.³⁰ The 2020 Strategy explicitly calls for a formalization of the principle in which Member States “act in the benefit of the EU as a whole in bilateral energy relations with key partners and in global discussions.”³¹ Yet again, the creation of the internal market and the unbundling principle remains essential to European energy security.

European energy policy over the last two decades has maintained market liberalization and minimal state interference at the core of its principles and objectives. Establishing a regulatory framework for an energy market and raising taxes or parafiscal levies to influence consumer behavior may seem to contradict the spirit of neoliberalism,

²⁶ Ibid, p. 6.

²⁷ Ibid, p. 7.

²⁸ European Commission, *Energy 2020: A Strategy for Competitive, Sustainable and Secure Energy*, 2010, <http://www.eib.org/epcc/ee/documents/energy-2020.pdf> (Accessed on November 18, 2013) p. 2.

²⁹ European Commission, *Energy 2020*, p. 3.

³⁰ Ibid, p. 3-4

³¹ Ibid, p. 17.

but that is not necessarily the case. The EU endorses an idiosyncratic variant of neoliberalism that is different from the US variant, the latter of which is relatively more anti-regulation and anti-federal in comparison. However, the regulatory elements of the EU's energy market are designed to remove impediments to the competitive entry of firms into the market and ensuring, for the benefit of consumers, that monopolies are prevented from forming, or that they are dismantled if they already exist. Furthermore, although security of supply is a pressing concern for the EU, it is not given priority over establishing and maintaining a competitive free market in European energy. In fact, a free market, not state intervention, is considered crucial to security of supply. Additionally, if we take the Washington Consensus, which is considered the baseline for evaluating what is or is not neoliberal,³² as a litmus test, EU energy policy does follow neoliberal principles.

With the above in mind, one can begin to see where Russian and European energy policy differ most. As mentioned above, the European internal market inevitably affects Russia, as it is the main supplier of natural gas and a major supplier of oil to Europe. EU energy import dependency has steadily increased between 1995-2010. In 1995, overall energy imports stood at 43.2 percent. Imports hit a peak of 54.6 percent in 2008, then dropped down to 52.7 percent in 2010.³³

³² Nancy Neiman Auerbach, "The Meanings of Neoliberalism" in *Neoliberalism: National and Regional Experiments with Global Ideas*, ed. Ravi K. Roy, Arthur T. Denzau and Thomas D. Willett, 26 - 50 (New York: Routledge, 2007). p. 36 - 37.

³³ European Commission, *EU Energy in Figures Statistical Pocketbook 2012*. 2012, p. 64. http://ec.europa.eu/energy/publications/doc/2012_energy_figures.pdf (Accessed on July 1, 2013). p. 64.

Table 1.1 : Percentage of EU - 27 Energy Import Dependency, All Fuels³⁴

	1995	2000	2005	2008	2009	2010
EU - 27	43.2	46.7	52.5	54.6	53.7	52.7

Table 1.2 : Percentage of EU - 27 Energy Import Dependency, Petroleum Fuel³⁵

	1995	2000	2005	2008	2009	2010
EU - 27	74.3	75.7	82.3	84.2	83.1	84.3

Table 1.3 : Percentage of EU - 27 Energy Import Dependency, Natural Gas³⁶

	1995	2000	2005	2008	2009	2010
EU - 27	43.5	48.9	57.7	62.3	64.3	62.4

Table 1.2 and 1.3 demonstrate the differing degrees of dependency between oil and natural gas. As Table 1.2 shows, oil dependency has remained elevated, rising by 10 percent from 1995 to 2010. Natural gas dependency, however, has risen by almost 20 percent over the same period, as Table 1.3 shows.

Tables 2.1 and 2.2 illustrate the variation in Russian exports of crude oil, NGL and natural gas to the EU-27 from 1995 to 2010, compared to the next four largest exporters (three for natural gas):

³⁴ European Commission, *EU Energy in Figures*, p. 64.

³⁵ Ibid, p. 67.

³⁶ Ibid, p. 69.

Table 2.1 : EU - 27 Imports of Crude Oil & NGL by 2010 Volume, Thousands of Tonnes³⁷

Thousands of tonnes	1995	2000	2005	2008	2009	2010
Russia	76,319	118,229	188,079	179,061	173,519	180,654
Norway	102,203	115,904	97,610	86,713	80,042	73,078
Libya	47,978	45,542	50,601	57,404	48,108	53,754
Saudi Arabia	82,419	65,143	60,748	38,912	29,809	30,774
Kazakhstan	78	9,915	26,386	28,563	28,522	29,705

Table 2.2. EU - 27 Imports of Natural Gas by 2010 Volume, Millions of Cubic Meters³⁸

Millions cubic meters	1995	2000	2005	2008	2009	2010
Russia	111,541	119,363	134,609	135,017	137,335	130,421
Norway	28,914	47,774	78,157	99,679	103,637	100,477
Algeria	33,698	55,607	57,075	50,591	47,072	50,342
Qatar	0	309	4,859	7,449	15,127	29,960

As Table 2.1. shows, over a 15-year period Russian exports of crude oil and NGL to the EU have increased to the point where in 2010, they were double the amount of the closest competitor, Norway. In fact, Russia exports more crude oil and NGL than the three next exporters combined. As for natural gas, Russia does not have as strong a lead; the amount of imports have remained relatively stable over the 15-year period. However, Norway's production of natural gas is expected to decline in the coming years, thus

³⁷ Ibid, p. 62.

³⁸ Ibid, p. 63.

Russia will maintain a healthy lead over its competitors. Since the EU is highly dependent on a limited number of external suppliers, Russia being the foremost supplier of oil and natural gas to Europe, liberalization of the EU energy sector is only really possible if Russia liberalizes its own energy assets in Europe through the unbundling principle.³⁹ The issue however is that Russia has a different idea of what its energy policy should accomplish and how it should go about reaching its goals.

Russian Energy Policy

Contrary to the EU, Russia's energy policy emphasizes security concerns over competitiveness and liberalization; energy is an element of Russia's national economic survival and socioeconomic development.

Russia's energy policy after the Yeltsin era abandoned neoliberal policies (privatization in particular) in exchange for an economic nationalist policy under Putin's administration. While the EU proceeded through legal means to embed energy in the liberal market framework of the Single Market, Russia's administration under Putin used the power of the state to consolidated its control over the oil and gas sectors of the economy, pushing out any private business rivals that could challenge the new policy.

Until mid-2003, Russian energy policy was determined by a multitude of actors within the structures of the state and the private sector. During the era of Yeltsin's presidency and the privatization drive of the economy, energy company executives had some degree of influence in the decision making process at the government level. Under

³⁹ Tatiana Romanova, "Legal Approximation in Energy: A New Approach for the European Union and Russia" in *Dynamics of Energy Governance in Europe and Russia*, ed. Caroline Kuzemko, Andrei Belyi, Andreas Goldthau and Michael F. Keating, 23 - 44 (UK: Palgrave Macmillan, 2012). p. 34.

Putin's leadership however, the state has taken the reins at the expense of private business interests. Putin has placed loyal men as chairmen and chief executive officers in key energy companies.⁴⁰ In parallel with these developments, the Russian state under Putin began formulating its domestic and foreign energy policy. As we saw in Chapter 3, Putin, before taking up office, outlined his vision of Russia's natural resource development being controlled by the state.

Soon after the collapse of the Soviet Union, the Russian government began writing up a new energy policy. In September 1992, the government assented to drawing up the main provisions of the 'Concept for Energy Policy under New Economic Conditions.' The Concept was deemed applicable until 2010 and was to provide Russia with a reliable supply of energy, ensure independence and security, and support Russia's energy export potential. The policy also emphasized the need for developing a raw materials base, efficiency, and renewable energy resources. In November 1994, the Ministry of Fuel and Energy designed the "Energy Strategy of Russia." It was approved a month later by the Russian government as the "Energy Strategy of Russia (Major Provisions)."⁴¹ From May 1995 to August 1997, the first post-Soviet Russian energy strategy was drawn up along with amendments to address natural monopolies, structural reconstruction and privatization.⁴²

Under Vladimir Putin's presidency, Russia's Energy Strategy to 2020 was created and given legal status on May 23, 2003 and confirmed on August 28, 2003. This

⁴⁰ Michael Fredholm, "The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?" *Conflict Studies Research Centre*, 5, 41, (September 2005) [www.da.mod.uk/CSRC/documents/Russian/05\(41\)-ME.pdf](http://www.da.mod.uk/CSRC/documents/Russian/05(41)-ME.pdf) (Accessed on August 3, 2013). p. 9 - 10.

⁴¹ Fredholm, "The Russian Energy Strategy," p. 2-3.

⁴² Fredholm, p. 3.

document “explains much of what goes on within the Russian energy sector” under Putin’s administration.⁴³

In the “Energy Strategy of Russia for the Period of up to 2020,” energy policy is defined as the means “to make [the] most effective use of the natural fuel and energy resources and of the potential of [the] energy sector for economic growth and improvement of life quality.”⁴⁴ Concerning external policy, the goal is to transform Russia from a supplier of raw resources into an important member of the world energy market. Over two decades, Russia will have to “realize the export abilities of [the] Russian fuel energy complex and secure the economic safety of the country,” and remain a “stable and reliable partner for the European countries and for the whole world community.”⁴⁵ There is no specific mention, however, of working within the framework of the EU’s internal energy market. Indeed, Russia prefers to deal with Europe through bilateral or intergovernmental negotiations and cooperation. Russia does aim to have a dialogue with both producers and consumers, taking part in international energy conferences, cooperating with developed countries “on the basis of declaration [of] cooperation with [the] IEA and in the framework of [the] G8,” and cooperating with leading OPEC and non-OPEC exporters of oil to provide fair energy resource prices.⁴⁶

For Russia, “energy security is one of the most important components of...national security.”⁴⁷ Energy security is determined by three factors: resource

⁴³ Fredholm, p. 3.

⁴⁴ Ministry of Energy of the Russian Federation, *The Summary of the Energy Strategy of Russia for the Period of up to 2020*, August 2003, http://ec.europa.eu/energy/russia/events/doc/2003_strategy_2020_en.pdf (Accessed on January 8, 2014). p. 2.

⁴⁵ Ministry of Energy, *Energy Strategy of Russia 2020*, p. 12.

⁴⁶ Ibid, p. 12.

⁴⁷ Ministry of Energy of the Russian Federation, *Energy Strategy of Russia for the Period up to 2030*, 2010, [http://www.energystrategy.ru/projects/docs/ES-2030_\(Eng\).pdf](http://www.energystrategy.ru/projects/docs/ES-2030_(Eng).pdf) (Accessed on October 29, 2013). p. 28.

sufficiency, that is “the physical possibility of [a] deficit-free supply of energy resources to the economy and population;” economic availability, which “determines the profitability of such supply at appropriate market prices;” and ecological and technological acceptability, which “determines the possibility of extraction, production and consumption of energy resources within the existing technological and ecological limitations determining [operational] safety for energy facilities at various phases.”⁴⁸ This is similar to the EU’s three goals of security of supply, sustainability and competitiveness, but competitiveness in the Russian context concerns the external energy market; the energy industry should be able to compete against foreign companies outside the Russian market. Russian concerns of competitiveness are more about Russian energy companies being competitive vis-à-vis non-Russian companies, not so much about competitiveness between Russian firms.

The strategy states that Russia’s energy policy is to be solidified with a continuous development of the normative and legal base of the policy. This will be used to regulate activities of the energy sector by use of “direct action” and legislation to provide stability.⁴⁹ Russian legislation has been adapted to reinforce this aspect of the policy. On April 29, 2008, one year before the 2030 Energy Strategy was enacted, the Russian government enacted ‘Federal Decree no. 57-F3 g. Order Concerning Foreign Investment in Corporations of Strategic Importance for National Defence and State Security.’⁵⁰ This

⁴⁸ Ministry of Energy of the Russian Federation, *Energy Strategy 2030*, p. 28.

⁴⁹ Ministry of Energy of the Russian Federation, *Energy Strategy of Russia 2020*, p. 3.

⁵⁰ Government of the Russian Federation, *Federal’nyii zakon ot 29 apreliia 2008 goda N 57-F3 g. Moskva O poriadke osushchestvleniia inostrannykh investitsii v khoziaistvennye obshchestva, imeiushchie strategicheskoe znachenie dlia obespecheniia oborony strany i bezopasnosti gosudarstva*, Priniat Gosudarstvennoi Dumoi 2 apreliia 2008 goda. Odobren Sovetom Federatsii 16 apreliia 2008 goda, <http://www.rg.ru/2008/05/07/investicii-fz-dok.html> (Accessed on January 10, 2014).

law set a limit (25 percent control of shares or stock of a business entity) on the extent of control foreign investors are allowed in any business entities that are considered to be of strategic value for national and state security. NGOs, state or state related organizations, even those based or created in the territory of the Russian federation, are not entitled to make any deal that allows them to breach the share or stock limit in any business entity that is of strategic importance for national defence and state security.⁵¹ Gazprom, the giant state gas monopoly, is not scheduled to be open to private control anytime soon either. In October 2013, the government sent a letter to Gazprom, informing the company that it would not divest any of shares for the 2014-2016 period.⁵² The Russian government currently holds more than half of all stock in Gazprom.⁵³

In November 2009 the Energy Strategy to 2020 was replaced with the “Energy Strategy of Russia for the Period up to 2030.” The new strategy reflects the post-2008 economic context Russia faces. Russia’s 2030 strategy was a product of state and non-state actors, the latter of whom included: the Chamber of Commerce, the Russian Union of Industrialists and Entrepreneurs, and the Institute of Energy Strategy.⁵⁴ It is noteworthy how much importance the state attaches to its energy industry. Energy policy is expected to defend citizens’ and businesses’ rights and legal interests, guarantee state defense and security, properly manage state property, and “achieve a new qualitative state for the energy sector.” The main strategic guidelines for the long-term are defined as: energy

⁵¹ Government of the Russian Federation, *Federal’nyii zakon ot 29 apreliia 2008 goda N 57-F3 g.*

⁵² Gazprom, “Memorandum of Intent of the Russian Federation as a major shareholder of JSC ‘Gazprom’,” <http://www.gazprom.com/f/posts/62/158052/memorandum-of-intent-en.pdf> (Accessed on February 28, 2014).

⁵³ Gazprom, “Investors,” <http://www.gazprom.com/investors/stock/> (Accessed February 28, 2014).

⁵⁴ Ministry of Energy of the Russian Federation, *Energy Strategy 2030*, p. 5.

security; energy efficiency of the economy; budget efficiency of the energy sector; and environmental safety of the energy sector. Again, these goals are similar to the EU's energy policy, but competitiveness in the domestic Russian market is not a focus in the policy. The 2030 goals are to be achieved through a "favorable economic environment for the operation of the fuel and energy complex (including coordinated tariff, tax, customs, antimonopoly regulations and institutional reforms in the fuel and energy complex);" implementing technical regulations, national standards and norms to improve and stimulate the implementation of critical priorities and guidelines for energy development; stimulating and assisting businesses and their strategic initiatives in investment, innovation, energy-saving, environmental and other areas; and improving the managing efficiency of state property in the fuel and energy sector.⁵⁵

As far as state control over the industry is concerned, the policy mentions that, if economic events develop according to expectations, direct state participation will slowly decline, but will be replaced with 'various forms' of public-private partnerships. How much control the state would relinquish the policy does not make clear, but the general inclination of the policy is for the state to play a major role in ensuring the Russian energy industry becomes and remains influential in world energy markets.

If one only considers Russia's energy policies, the impression is that priorities are chosen strictly along rationalist concerns. Is this really the case? By taking a look at some of the annual speeches Putin has made to the Federal Assembly, we can gain some insight to answer that question. These speeches represent the official stance of the Russian

⁵⁵ Ibid, p. 24-25.

government and are worked on by Kremlin analysts and officials, and are thus representative of official Kremlin discourse.

In his 2001 annual presidential address, Putin stated that “[Russia] can no longer tolerate the lack of financial transparency in [electricity, gas supplies, railways and communications industries], rising costs and ineffective management.”⁵⁶ Although Putin stated that state subsidies to these industries would need to be dropped, he advised caution in the matter as “it is precisely these monopolies [in the aforementioned sectors] that form the foundation of our economy, today at least.”⁵⁷ Putin acknowledges that energy is central to the economic survival of the Russian federation,⁵⁸ in 2002, he spoke of Russia’s loss of its global market share in oil as a “period of weakness - of our weakness.”⁵⁹ Indeed, in most of his speeches, Putin makes similar references to ideas of ‘national strength’ or ‘national weakness’. In his 2003 annual address, Putin argues that “[Russia’s] entire historical experience shows that a country like Russia can live within its existing borders only if it is a strong nation. All the periods during which Russia has been weakened, whether politically or economically, have always and inexorably brought to the fore the threat of the country’s collapse.”⁶⁰ Putin later stated in the speech that without the Russian people rallying around basic national values and objectives, Russia

⁵⁶ Prezident Rossii, *Poslanie Federal’nomu Sobraniuu Rossiiskoi Federatsii, 3 apreliia 2001 goda*. Moskva, Kreml’, http://archive.kremlin.ru/appears/2001/04/03/0000_type63372type63374type82634_28514.shtml (Accessed on February 5, 2014).

⁵⁷ Prezident Rossii, *Poslanie Federal’nomu Sobraniuu, 3 apreliia 2001 goda*.

⁵⁸ Prezident Rossii, *Poslanie Federal’nomu Sobraniuu Rossiiskoi Federatsii, 26 mai, 2004 goda*. Moskva, Kreml’, http://archive.kremlin.ru/eng/text/speeches/2004/05/26/1309_type70029type82912_71650.shtml (Accessed on February 5, 2014).

⁵⁹ Prezident Rossii, *Poslanie Federal’nomu Sobraniuu Rossiiskoi Federatsii, 18 apreliia 2002. goda*. Moskva, Kreml’, http://archive.kremlin.ru/eng/text/speeches/2002/04/18/0000_type70029type82912_70662.shtml (Accessed on February 5, 2014).

⁶⁰ Prezident Rossii, *Poslanie Federal’nomu Sobraniuu Rossiiskoi Federatsii, 16 mai 2003 goda*. Moskva, Kreml’, http://archive.kremlin.ru/eng/text/speeches/2003/05/16/0000_type70029type82912_44692.shtml (Accessed on February 4, 2013).

will not be able to stand up to economic and political threats. Referring to Russia's historical feats and the sacrifices as Russia's "historic fate," he reminds his audience not to forget these points as Russia rises to the challenges it faces.⁶¹ Energy, specifically improving the infrastructure network of the oil and gas sector is equated with ensuring the unity of the country, "whether people feel they are citizens of a united, large nation, and whether they can make use of its advantages."⁶² In 2007, Putin stated:

The spiritual unity of the people and the moral values that unite us are just as important a factor for development as political and economic stability. It is my conviction that a society can set and achieve ambitious national goals only if it has a common system of moral guidelines. We will be able to achieve our goals only if we maintain respect for our native language, for our unique cultural values, for the memory of our forebears and for each page of our country's history.

This national treasure is the foundation for strengthening our country's unity and sovereignty. It is the foundation for our everyday life and the basis on which we can build our economic and political relations.⁶³

As the quoted passage demonstrates, national values and political-economic interests intersect, thus it is no stretch to posit that the Russian energy industry is critical to the Kremlin's nationalistic goals. This is noticeable in the planning structure of the 2030 policy, which is set up as three distinct phases, since it demonstrates how dependent overall economic development is on the development of the energy industry. The first phase consists of recovering from the 2008 financial crisis and quickly laying down the foundation for a new type of economy. This is to be done by developing and updating

⁶¹ Prezident Rossii, *Poslanie Federal'nomu Sobraniuu 16 mai 2003 goda*.

⁶² Prezident Rossii, *Poslanie Federal'nomu Sobraniuu 26 mai 2004 goda*.

⁶³ Prezident Rossii, *Poslanie Federal'nomu Sobraniuu Rossiiskoi Federatsii, 26 apreliia 2007 goda. Moskva, Kreml'*, http://archive.kremlin.ru/eng/text/speeches/2007/04/26/1209_type70029type82912_125670.shtml (Accessed on February 5, 2014).

basic production assets and energy infrastructure, and removing any major domestic or foreign barriers that impede a rapid implementation of the energy policy. The Russian economy suffered a beating during the crisis as demand for energy products decreased, so Russia is quite aware of how dependent the economy is on the energy sector. This phase is expected to end sometime between 2013 - 2015.⁶⁴

The second phase is the transition process into “innovative development and construction of the infrastructure of a new economy.”⁶⁵ Energy efficiency in the fuel and energy complex will be improved in parallel with the overall economy through modernization of production assets, regulatory and institutional reforms, and “innovative” and new capital-intensive energy projects from the first phase in Eastern Siberia, the Far East, the continental shelf of the Arctic seas, and the Yamal peninsula. All of these measures are expected to be implemented in the first phase for the second phase to succeed, in combination with technology, materials and equipment obtained through related industries and “international cooperation.”⁶⁶ Once the world energy market is stable, Russia will switch to a “new technological wave associated with a wide use of non-hydrocarbon energy in the economy.”⁶⁷ The economy and the budget will gradually reduce their dependence on revenues from the energy sector, and the latter will have its leading position in the economy replaced by “new innovative sources of growth based on manufacturing and high-technology science-intensive services.”⁶⁸ Additionally, state involvement in the energy sector will gradually *decrease*, contrary to current fears and

⁶⁴ Ministry of Energy of the Russian Federation, *Energy Strategy 2030*, p. 25-26.

⁶⁵ Ibid, p. 26.

⁶⁶ Ibid, p. 27.

⁶⁷ Ibid, p. 27.

⁶⁸ Ibid, p. 27.

expectations. Different forms of public-private partnerships will become the new norm, especially in the construction and modernization of energy infrastructure, and innovation development. The state will still play an important role by reinforcing its regulatory presence in improvements and optimizations of the energy sector's institutional environment.”⁶⁹

The third and final phase is the development of “an innovative economy.”⁷⁰ At this stage, the energy sector will be a mix of highly efficient hydrocarbon energy sources and new, non-hydrocarbon energy and technology. The main challenge in successfully completing this phase lies in Russia's ability to weather a significant decrease of the energy sector's size in the economy and substituting it with “non-energy sources of innovative economic growth.”⁷¹ By 2030, primary consumption of natural gas is expected to drop from 52 percent in 2005 to 46-47 percent in 2030. The share of non-fuel based energy in primary consumption will rise, from 11 percent to 13-14 percent in 2030. Energy intensity will be significantly cut by a factor of 2.1-2.3, combined with slowed growth in domestic consumption (1.4-1.6), export (1.1-1.2), and production (1.3-1.4).⁷² This phase is expected to be complete by 2030. The state will still have a role in the energy sector during this phase. It will consist of supporting new developments in the energy sector, such as non-fuel based sources, and providing and regulating a “sustainable institutional environment for [the] effective functioning of the energy sector.”⁷³

⁶⁹ Ibid, p. 27.

⁷⁰ Ibid, p. 27.

⁷¹ Ibid, p. 27.

⁷² Ibid, p. 59.

⁷³ Ibid, p. 28.

Now, what does all this have to do with ideological influences in Russia's energy policy? The point to note is that, under Putin's administration, power and nationalism are linked; they are not values isolated from each other, they are considered to be complementary. Additionally, as the Russian energy policy shows since the early 2000s, energy is envisioned as critical to the socioeconomic well being of the Russian population and the power and influence of the Russian state in the international political and economic system. This is not strictly about rationalist calculations of what will maximize the power of the Russian state. Putin's appeals to nationalism and connecting it with economic power pays homage to Yeltsin's strategy of tying Russian nationalism with reforming and strengthening the economy in a crisis: upon taking office, Putin had to restore order and public trust in the Russian state while rebuilding Russia's prestige that was lost in the post-Soviet transition stage. Of course, Putin never directly associates oil and natural gas resources with the idea of national survival; that would be nonsensical. The point is that energy is an important element, but one among other economic elements that are critical in being able to rally the Russian "nation" around the objectives of the state.

Chapter 5: Two Cases of Disagreement in Russia - EU Energy Relations: The Energy Charter Treaty and the Third Energy Package

This chapter analyzes two cases of disagreement between the European Union and the Russian Federation in energy relations: The Energy Charter Treaty and the Third Energy Package. These cases were selected due to their duration and their significance; both of the cases have been ongoing for several years, thus there is more room for observing variation over time in the variables, which offers a more evenly distributed sample of data (reducing the overrepresentation of outliers) compared to a more chronologically limited case. These cases also involve major issues in EU - Russia energy relations, therefore focusing on these cases provides more insight into the dynamics of EU - Russia compared to minor cases that are more limited in chronological scope or political and economic importance. By looking at these two cases, this chapter will attempt to falsify the hypothesis that the EU prefers establishing energy cooperation with Russia through free-market neoliberal norms, but Russia prefers to run its energy relations Russia along economic nationalist lines.

Before tackling these cases, a discussion of the legal foundation of EU - Russia energy relations (the Partnership and Cooperation Agreement - PCA) is required. The legal structure of the relationship provides an insight into the basic ideas and objectives of each party. It is the point of reference for negotiations on energy relations and, from an analytical perspective, could provide an alternative explanation for the source of disagreements.

Partnership and Cooperation Agreement (PCA)

The Partnership and Cooperation Agreement established the basic parameters of EU - Russia energy relations and frames the options and debates in subsequent energy agreements, as it is the basis of economic cooperation between Russia and Europe. The treaty came into force in 1997 as a formal codification of relations between both sides.¹

The objectives of this partnership are to:

1. Provide a framework for political dialogue between the parties to develop closer relations;
2. Promote trade and investment, and stable economic relations based on the principles of a market economy;
3. Strengthen economic and political freedoms;
4. Support Russian efforts to “consolidate its democracy and to develop its economy and to complete the transition into a market economy”;
5. Create the condition for establishing a free trade area between Russia and the European Community;
6. Provide the framework for gradual integration between Russia and “A wider area of cooperation in Europe”;
7. Promote activities of joint interest;

¹ Amelia Hadfield, “EU - Russia Energy Relations: Aggregation and Aggravation,” *Journal of Contemporary European Studies*, Vol. 16, No. 2 (August 2008): 231 - 248. p. 233.

8. Provide a basis for economic, social, financial and cultural cooperation.²

Article 65 of the agreement lays out the areas of cooperation in the field of energy. Cooperation is understood to take place “within the principles of the *market economy* and the *European Energy Charter*, against a background of the progressive *integration of the energy markets in Europe* [my italics].”³ There are nine specific areas of cooperation in energy, the most relevant being: the formulation of energy policy, improving the management and regulation of the energy sector to fit with a market economy, the modernization of energy infrastructure, and improvement of the quality and security of energy supply in an economically and environmentally sound fashion.⁴ What stands out in Article 65 is the notion that cooperation is based around the EU’s normative values: Russia is expected to cooperate through the principles of a free market economy.⁵ As a result, the PCA has been criticized by some as a fatally limited treaty that fails to establish any real ground for common interests, since it does not include Russia’s normative values.⁶

² European Union, *Agreement on Partnership and Cooperation Establishing a Partnership between the European Communities and their Member States, of one Part, and the Russian Federation, of the other Part - Protocol 1 on the Establishment of a Coal and Steel Contact Group - Protocol 2 on Mutual Administrative Assistance for the Correct Application of Customs Legislation - Final Act - Exchanges of Letters - Minutes of Signing*, Official Journal L 327, November 1997, P. 0003 - 0069. <http://ec.europa.eu/world/agreements/prepareCreateTreatiesWorkspace/treatiesGeneralData.do?step=0&redirect=true&treatyId=201> (Accessed on March 25, 2014).

³ European Union, *Agreement on Partnership*.

⁴ Ibid.

⁵ Hadfield, “EU - Russia Energy Relations,” p. 234.

⁶ Ibid, p. 234.

Common Strategy on Russia

Is the above criticism warranted? If we examine the Common Strategy on Russia (CS), adopted by the EU on June 4, 1999, (scheduled to last four years), the criticism seems to be validated. The Common Strategy builds upon the PCA; it considers the PCA to be “the core of the relationship” between Russia and the European Union. The Common Strategy, however, is a unilateral foreign policy instrument created to clarify the European Council’s vision and execute its objectives. The CS sketched out limited goals through which EU - Russia partnership could evolve into a strategic reality. Javier Solana, the High Representative for the EU Common Foreign and Security Policy (CFSP) at the time, stated that “to develop the partnership with Russia is the most important, the most urgent and the most challenging task that the Union faces at the beginning of the twenty-first century.”⁷

The Common Strategy posits that the EU and Russia have a common interest in developing their respective energy policies “in such a way as to improve the exploitation and management of resources and security of supply in Russia and in Europe.”⁸ Yet there are no concrete measures laid out in the strategy to achieve these goals, only vague references to providing support in energy and energy related fields for Russia. What is more important though, is that the CS insists on Russia signing the Energy Charter Treaty and recommends pursuing consultations on enhancing cooperation between Russia and its neighbors over pipeline access. Most of the strategy is concerned, like the PCA, with

⁷ Abellan in Hadfield, “EU - Russia Energy Relations,” p. 234.

⁸ European Council, *Common Strategy of the European Union of June 4 1999 on Russia*, June 4, 1999, http://trade.ec.europa.eu/doclib/docs/2003/november/tradoc_114137.pdf (Accessed on January 15, 2014). Part One, Principle Objectives, No. 4.

normative economic values set by the EU. Energy was bundled up with general cooperation and norm-setting,⁹ and was not perceived to be an issue involving security or external policy.¹⁰

Russia's Medium Term Strategy

However, the goals of the Common Strategy clashed with Russia's vision of cooperation with Europe, which was fundamentally different from the EU perspective outlined in the Common Strategy. In 1999, Russia released the "Medium-Term Strategy (MTS) for the Development of Relations between the Russian Federation and the EU (2000-2010)." This strategy outlines the priorities of Russia's foreign policy towards the EU. The MTS was presented to Brussels in the same year by Vladimir Putin, at the time Prime Minister of Russia. The strategy argues that Russia is a great power that should maintain and use its freedom to decide and implement domestic and foreign policies. Relations with the EU should be conducted in line with ensuring the national interest and defending Russia's right to safeguard sectors of its economy, even if any measures contravene the terms of the 1997 Partnership and Cooperation Agreement.¹¹ "In sum, the strategy enshrines Russia's refusal to allow Brussels to interfere in its sovereign affairs."¹² Already from 1999, the foundation of EU - Russia energy cooperation was being challenged by Russia.¹³

⁹ European Council, *Common Strategy*, Part Two, Area of Action No. 2.

¹⁰ Hadfield, "EU - Russia Energy Relations," p. 235.

¹¹ Federaln'aia antimonopol'naia sluzhba, *Strategia razvitiia otnoshenii Rossiiskoi Federatsii s Evropeiskim Soiuzom na srednesrochnuiu perspektivu 2000 - 2010 gg.* 1999, http://www.fas.gov.ru/legislative-acts/legislative-acts_3810.html (Accessed on April 20, 2014).

¹² Dov Lynch, "Russia's Strategic Partnership with Europe," *Institute for Security Studies*, 2004, <http://www.iss.europa.eu/uploads/media/analy077.pdf> (Accessed on October 9, 2013) p. 103.

¹³ Lynch, "Russia's Strategic Partnership with Europe," p. 103.

In 2007, Russia and the EU decided to pursue talks on a new agreement to replace the PCA. Both parties continue to agree that energy is a strategically important matter for cooperation and that it would remain a substantive element of a new agreement, but to date no new agreement has been reached to replace the PCA. The EU maintains its insistence on applying free market principles in its energy relations with Russia. This approach is entirely in line with the EU's energy policy, which, as we saw in Chapter 4, is geared for establishing an internal energy market based on competitiveness and limited state intervention or control in the energy industry. For Russia, this arrangement does not sit well with its economic ideological values; the Russian energy industry is too valuable to Russian economic and national survival and unity to be left to private actors in the market. As such, the PCA has not led to any substantive agreement in energy relations between Russia and the EU.

Energy Charter Treaty

The Energy Charter Treaty (ECT) is the first case where EU - Russia energy relations have foundered due to disagreements inherent in their respective economic ideologies. Much like the PCA, the ECT attempts to establish energy cooperation between Russia and Europe according to free market principles as interpreted by the European Union.

Signed in 1994 and modeled on EU energy market rules dating from the early 1990s, the Energy Charter Treaty established conditions for trade, investment and transit of all energy products and cooperation in energy efficiency. The treaty is the brainchild of

former Dutch Prime Minister Ruud Lubbers in 1990; it is based on his suggestion that cooperation in the European energy field would kickstart an economic recovery in Eastern Europe and the USSR. The ECT would help promote closer interaction between western and eastern Europe, and by extension promote European integration through greater intra-European trade and investment, strengthening the European Union in the process.¹⁴

The political foundation of the 1994 Energy Charter Treaty is based on the 1991 European Energy Charter. The 1991 Charter bases energy cooperation within a market economy framework, including fair energy market access and energy trade liberalization.¹⁵ Thus, the basic concept of the ECT is to “catalyze economic growth by means of measures to liberalize investment and trade in energy” having regard to, among other issues, “competition rules concerning mergers, monopolies, anti-competitive practices and abuse of dominant position.”¹⁶ Article 6 of the treaty calls for contracting parties to “alleviate” distortions and barriers to competitions in “Economic Activity in the Energy Sector”^{*} and enforce the necessary laws to address “unilateral and concerted anti-competitive conduct in Economic Activity in the Energy Sector.”¹⁷

In the aftermath of the fall of the USSR, the ex-communist states stood to benefit tremendously from the hard currency they could earn in exchange for their fossil fuel

¹⁴ Regina S. Axelrod. “The European Energy Charter Treaty: Reality or Illusion?” *Energy Policy*, Vol. 24, No. 6, 1996: 497-505. p. 497.

¹⁵ Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents*, 2004, http://www.encharter.org/fileadmin/user_upload/document/EN.pdf (Accessed on December 2, 2014). p. 213; 217.

¹⁶ Energy Charter Secretariat, *Energy Charter Treaty*, p. 39 - 40.

^{*} The treaty defines Economic Activity in the Energy Sector as “an economic activity concerning the exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, or sale of Energy Materials and Products except those included in Annex NI, or concerning the distribution of heat to multiple premises” (p. 41).

¹⁷ Energy Charter Secretariat, *Energy Charter Treaty*, p. 46.

resources. However, these states lacked the legal framework necessary to guarantee that companies, regardless of their national origins, would receive fair treatment, and trade barriers in trade products and materials would be removed. Legislation was therefore necessary to reduce discrimination and encourage investment, and this is exactly what the ECT sets out to do according to Article 2 of the ECT.¹⁹ The ECT also assumes that Western actions would affect domestic politics in Eastern Europe through the growth of trade and investment in energy.²⁰

Russian membership is critical to the success of the ECT. Russia is the only large energy producer that originally signed the ECT in 1994 and provisionally applied it before withdrawing from the treaty.²¹ Excluding Russia from the ECT would render the treaty meaningless for Europe; Europe does, after all, import close to half of all its energy from Russia.²² Without Russia, the long-term success of the EU internal energy market is uncertain. Unfortunately for the EU, Russia is unsatisfied with the ECT and refuses to sign the treaty. The dissatisfaction stems from one of the provisions of the ECT; The Transit Protocol.

Transit Protocol

By the end of the 1990s, the issue of transit became a critical area of contention for Russia in its energy relations with the EU, making resolution of this problem a

¹⁹ Ibid, Article 2 p. 44.

²⁰ Axelrod, "European Energy Charter," p. 497-498

²¹ Kirsten Westphal, "The Energy Charter Treaty Revisited," *Stiftung Wissenschaft und Politik* (German Institute for International and Security Affairs), March 2011, http://www.swp-berlin.org/fileadmin/contents/products/comments/2011C08_wep_ks.pdf (Accessed on September 10, 2013). p. 1.

²² European Commission, *EU Energy in Figures Statistical Pocketbook 2012*. 2012, p. 64. http://ec.europa.eu/energy/publications/doc/2012_energy_figures.pdf (Accessed on July 1, 2013). p. 64.

condition for ratification of the ECT. Article 7 of the treaty in particular was disputed;²³ this article establishes the principle of free transit:

Each Contracting Party shall take the necessary measures to facilitate the Transit of Energy Materials and Products consistent with the principle of freedom of transit and without distinction as to the origin, destination or ownership of such Energy Materials and Products or discrimination as to pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges.²⁴

In 2000, The Charter Conference decided to establish more specific rules on energy transit; this became the Transit Protocol. The goal of negotiations on the Protocol are:

- to ensure secure, efficient, uninterrupted and unimpeded transit;
- to promote more efficient use of transit infrastructure;
- to facilitate the construction or modification of transit infrastructure.²⁵

The negotiations were concerned with the issues of tariffs, access, and availability of volumes in transit pipelines. Russia is worried about the possibility of long-term contracts not matching with transit contracts under the rules of the Transit Protocol. Gazprom, Russia's state gas monopoly, wants the protocol to include the right of first refusal through which exporters, whose transit contracts are due to expire, would maintain priority over competitors in concluding new contracts for an identical transport volume. From the start of negotiations, the Russian energy giant lobbied against ratification of the ECT because of the Protocol. Gazprom buys and resells Central Asian

²³ Westphal, "Energy Charter Treaty Revisited," p. 2.

²⁴ Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents*, Article 7.

²⁵ Energy Charter Secretariat, "Transit Protocol," <http://www.encharter.org/index.php?id=37>

natural gas along with providing transit services; the company is worried about losing its strategic position as Europe's gateway to Central Asian gas supplies. Gazprom's powerful position as Europe's gas supplier rests on its ability to buy Central Asian gas at favorable prices with variable volumes depending on European demand. With the rise of China and its growing demand for Central Asian gas, and the EU's efforts to secure gas from the Southern Gas Corridor, Russia's payments for Central Asian gas have become more expensive. However, Russia passes on the costs to the European market.²⁶ If Gazprom did not have the degree of control over Central Asian gas that it had at the time (and still does), Russia may have fared much worse in the post-2008 financial crisis period when the price of oil collapsed. The Transit Protocol would also force Gazprom to open up its transit networks to other companies, effectively displacing it from its monopoly position in the European gas market.

Due to the aforementioned disputes and the inability to reach an agreement on energy cooperation, Russia and the EU viewed the ECT as a failed mechanism in the first half of the 2000s. In 2006, EU member states and the European Commission brought the ECT back onto the table due to the 2006 Ukraine-Russia gas dispute,²⁷ and it was again put in the spotlight in the 2009 gas dispute. In 2009, Russia used legal arguments to justify cutting gas supplies to Ukraine based on national law and customs regulations, while simultaneously complaining about the ineffectiveness of the ECT in not preventing these situations. The provisional application of the ECT is void when its provisions are

²⁶ Westphal, "Energy Charter Treaty Revisited," p. 3.

²⁷ Tatiana Romanova, "The Russian Perspective on the Energy Dialogue," *Journal of Contemporary European Studies*, Vol. 16, No. 2 (August 2008): 219 - 230. p. 223.

inconsistent with national laws, regulations or constitutions;²⁸ Russia argued that provisional application of ECT Article 45 does not apply to Russia. This has had a detrimental effect for the Energy Charter Treaty and the Russian engagement in the process. As previously mentioned, Russia provisionally applied the ECT back in 1994; by refusing to abide by Article 45, Russia essentially declared that it could apply the provisions of the Treaty at its own discretion. Such a move in effect challenges the legitimacy and relevance of the ECT if a provisional signatory refuses to respect its terms. Russia has been keeping a low profile in ECT Process meetings since 2009 and has not positioned itself in the modernization process, although it still provides the Deputy Secretary General.²⁹

Negotiations concerning the Transit Protocol also involved Article 10, Article 8.4, and, most importantly, Article 20, known as the Regional Integration Organization (REIO) clause. Article 20 exempts EU member states from obligatory execution of Transit Protocol provisions on their territory, since “the rules of a Regional Economic Integration Organization [i.e. the EU] shall provide an overall standard at least equivalent to that resulting from the provisions of this Protocol.”³⁰ In other words, the rules of the Protocol would not apply to energy flows within the European Union.³¹

This exception was based on the EU’s insistence to be recognized as an economically integrated region. This would give the EU the option to implement the

²⁸ Energy Charter Secretariat, *Energy Charter Treaty*, Article 45 “Provisional Application,” Paragraph 1, p. 89.

²⁹ Westphal, “Energy Charter Treaty Revisited,” p. 3.

³⁰ Energy Charter Secretariat, *Energy Charter Protocol on Transit, Article 20, Regional Economic Integration Organization*. Annex 1 to the Final Act., October 2003 <http://www.encharter.org/index.php?id=37> (Accessed on January 6, 2014).

³¹ Energy Charter Secretariat, “Energy Charter: Transit Protocol,” <http://www.encharter.org/index.php?id=37> (Accessed on December 4, 2013).

stricter rules of the EU single market for transport within its territory, rather than the rules of the Energy Charter Treaty. This would affect Russia, for instance, on the Polish portion of the Yamal-Europe pipeline insofar as transit contracts would be enacted in significantly shorter intervals than existing long-term contracts.³² This discouraged Russian advocates from endorsing the ECT's ratification, and for similar reasons Russia refused to sign the Transit Protocol in December 2003, effectively suspending negotiations.³³

The REIO clause is also problematic due to the expansion of the EU and the expansion of the internal energy market. As discussed in chapters 3 and 4, in the early 1990s the European Community was establishing an internal energy market. To establish this market, state subsidies for corporations would be gradually removed and replaced with common standards and price transparencies. For the gas and electric sectors, it was paramount that third party access was possible through another state or industry transmission line. It comes as no surprise then that the EU was the main influence behind the establishment of the ECT, "whose primary thrust was to create a wider energy market facilitating much needed investment by the private sector in countries east of the EU."³⁴ The problem with this is that EU enlargement has diminished the relevance of the ECT within the EU. Since Russia's signing of the ECT in 1994, the EU has gone through several enlargements, decreasing the ECT's area of application. Ex-communist states that initially made up the majority of the ECT signatories now abide by the EU's internal

³² Westphal, "Energy Charter Treaty Revisited," p. 2.

³³ Vladimir Milov, "Russia - EU Energy Dialog: Filling a Vacuum," *Russia in Global Affairs*, Vol. 5, No. 4 (October - December 2007), http://eng.globalaffairs.ru/number/n_9785 (Accessed on March 25, 2014). p. 135.

³⁴ Axelrod, "European Energy Charter," p. 502.

market rules.³⁵ Essentially, Russia is not only in a position where it has no flexibility to negotiate on the norms of an agreement with the EU (norms it had no say in to begin with),³⁶ the REIO clause would effectively apply over most of Europe, Russia's largest consumer of its energy exports. Russia is essentially forced to deal with an ever-expanding free energy trade zone that actively legislates anti-monopoly measures.

In 2009, President Dmitry Medvedev proposed a "Conceptual Approach to the New Legal Foundation for International Cooperation in Energy (Goals and Principles)." This is Russia's own version of an Energy Charter Treaty.³⁷ This was the beginning of Russia's attempts to draft, into legal terms, an alternative to the Energy Charter Treaty. The legal draft was released a year later (Draft Convention on Ensuring International Energy Security), but with no concrete outcome or decisions stemming from it. In April 2009, Medvedev made it clear that the draft document was designed to replace the Energy Charter Treaty.³⁸ The document reflects Russia's most pronounced stances on international energy security, trade, investment, and transit, thereby also revealing the effects of its economic ideology on its normative preferences in energy agreements.

Five points in particular stand out. The first is energy security supply as demand security:³⁹ Russian energy policy has attempted to redefine energy security as security of supply and predictability of demand. However, demand is tied to the sum of consumer decisions and can be only indirectly influenced by the state. Demand trends in Europe are

³⁵ Milov, "Russia - EU Energy Dialog," p. 134.

³⁶ Tatiana Romanova, "Legal Approximation in Energy: A New Approach for the European Union and Russia" in *Dynamics of Energy Governance in Europe and Russia*, ed. Caroline Kuzemko, Andrei Belyi, Andreas Goldthau and Michael F. Keating, 23 - 44 (UK: Palgrave Macmillan, 2012). p. 27.

³⁷ Westphal, "Energy Charter Treaty Revisited," p. 3-4.

³⁸ *Ibid.*, p. 3-4.

³⁹ *Draft Convention on Ensuring International Energy Security*, p. 8. <http://ua-energy.org/upload/files/Convention-engl1.pdf> (Accessed on March 25, 2014).

uncertain and applying such a principle is difficult in practice.⁴⁰ Predictable demand guarantees would suit Russia's energy industry due to its monopolistic structure: the lack of domestic market competition reduces energy firms' incentives for investment in more efficient input processing and output production. As of spring 2012, the level of Russian investment per barrel of extracted oil is between US\$9 and US\$10. The average investment value per barrel for large international oil firms is between US\$15 and US\$20, a 50 percent to 100 percent difference. Aggregate investment in Russian companies did increase over the five years leading to 2012, but is still insufficient. In 2000, annual Russian investment was US\$4-5 billion, and by 2011 investment reached US\$25 billion. By comparison, Exxonmobil invested US\$32 billion in 2011, even though it produces less oil than Rosneft. Exxonmobil's investment level alone exceeded the total aggregate level of investment of all Russian energy companies combined.⁴¹

The second issue is balancing of diverse interests. As the Draft Convention states, "each Party...shall notify the depositary in writing whether it is predominantly a producer of Energy Materials and Products...or it is predominantly a consumer of Energy Materials and Products."⁴² The goal is to stabilize price levels, earnings, and revenues from energy exports. European consumers and producers were very sensitive to the \$100 price drop in oil between November and July 2008, and this clause of the draft is trying to address this issue by establishing more stability.⁴³

⁴⁰ Westphal, "Energy Charter Treaty Revisited," p. 8.

⁴¹ Wojciech Konończuk, "Russia's Best Ally: The Situation of the Russian Oil Sector and Forecasts for its Future," *OSW Studies*, No. 39, Warsaw, (April 2012), http://www.osw.waw.pl/sites/default/files/prace_39_en_0.pdf (Accessed on March 25, 2014). p. 48.

⁴² *Draft Convention*, p 22.

⁴³ Westphal, "Energy Charter Treaty Revisited," p. 8.

The third is national sovereignty: Article II.4 states that the “Convention shall not infringe upon the national legislation of the Parties, which governs the system of property rights over energy resources.”⁴⁴ Each party would hold indisputable rights within its own territory for defining areas of exploration, levels and rates of production, taxes, financial payments, regulation of environmental protection and exploration safety, and participation in exploration and operations.⁴⁵ This leaves open the possibility for the state expropriating a company, and is a fundamental mismatch with the EU’s interpretation of investment protection and national sovereignty under the logic of the Energy Charter Treaty.⁴⁶

Fourth is dispute settlement through bilateral channels, either in a state court where the investment is located, or under the UN Commission on International Trade Law or the International Centre for Settlement of Investment Disputes. “This demonstrates the sovereign and far-reaching role that Russia designates to the state in the energy sector.”⁴⁷ The draft proposes that companies exchange assets as a way to guarantee access to markets and infrastructure. However, there is no indication that this type of agreement is reciprocal, i.e. if this rule applies to the Russian energy market and access to its pipelines. According to Kirsten Westphal, this is a way for Russia to get around the EU’s internal market, and that these types of exclusive deals are incompatible with the EU’s free market rules.⁴⁸

⁴⁴ *Draft Convention*, p. 9.

⁴⁵ *Ibid*, p. 9.

⁴⁶ Westphal, “Energy Charter Treaty Revisited,” p. 8.

⁴⁷ *Ibid*, p. 5.

⁴⁸ *Ibid*, p. 5.

Fifth is the issue of long-term contracts and transport. This element is partly influenced by Russia's desire to spread risk among parties involved: the European gas market is rapidly changing and the oil-indexed long-term gas contracts with take-or-pay clauses are being challenged by the EU. Russia's opposition to the EU Third Liberalization Package is also another factor (also known as the Third Energy Package, more on this below), which calls for a separation of electricity and gas production from supply. Russia does not want to be limited to selling gas only at EU borders. Russia desires to claim and profit from the supply chain and in the process limit potential competition from possible rivals in the gas supply. Concerning transit provisions, the draft proposes replacing the Transit Protocol of the ECT with application of the Draft Convention within REIO and its member states. However, there is not much more detail on the issue, despite having been a central point in Russia's refusal to ratify the ECT.⁴⁹ Westphal argues that Russia wishes to control the supply chain of energy to Europe and prevent newcomers from supplying gas by using long-term contracts, but this argument does not take into account Russia's need for stable export demand to justify the expensive investments necessary for increasing production and transit capacity.

The draft version states that the Convention enters into force after ratification in only three countries, which is anathema to European conceptions of multinational institutions and legally binding treaties.⁵⁰ Unhappy with the state of negotiations on the ECT and the Draft Convention, in July 2009 the Russian government took the decision to withdraw from the ECT. The decision became official in October of the same year. Russia

⁴⁹ Ibid, p. 5-6.

⁵⁰ Ibid, p. 6.

still plays a part in the treaty by providing the Deputy Secretary General, but does not commit itself to the rules or the modernization process of the treaty.⁵¹ The Transit Protocol also remains unsigned, but this will be discussed further later on.

The ECT's main use is its provisions on transit and investment protection (which are lacking in WTO rules), but these provisions have rarely been used in practice. Investment protection norms have only acquired legal force in countries that have ratified the ECT, but these are states that lack substantial energy assets or that already have stable and favourable investment environments that do not discriminate against investors.⁵² In December 2009, the Charter Group mandated a restart of negotiations on the Protocol. However, in October 2009 the EU put forth a new position on the negotiations. The EU argued that due to changes in the international energy situation, "developments in the Energy Charter Constituency," and the lack of progress on Transit Protocol negotiations, negotiations needed to be reset based on a "new document reflecting the common views of the constituency."⁵³ In response, the Charter Conference repealed the 2009 mandate in November 2011 and consultations were launched, but no agreements have been reached as of this time.⁵⁴

The Energy Charter Treaty failed to establish any energy trade agreement between Russia and the EU due to the conflicting normative economic values of each party. The creation of ECT was spurred by the EU first, and its goals reflect those of the EU's internal energy market. As such, the treaty advocates adopting a free-market framework

⁵¹ Ibid, p. 3; 6

⁵² Milov, "EU - Russia Energy Dialog," p. 135.

⁵³ Energy Charter Secretariat, "Transit Protocol."

⁵⁴ Ibid.

in trading energy products between its members, a framework that is incompatible with Russia's energy strategy and the economic nationalist ideology that underpins it.

At least, that is one way of looking at the problem. If we discount ideology, and instead look at legal norms, one could draw the conclusion that Russia is hamstrung in its energy dealings with Europe due to legal asymmetries in the relationship. The REIO clause of the Transit Protocol gives the EU the ability to put the rules of the *acquis communautaire* on the same level of hierarchy as international law, at least in energy matters. For Russia, and Gazprom in particular, this means that it would be difficult to turn to investment protection or dispute settlement within the confines of international treaties outside of EU rules. As Konoplyanik argues, in this state of affairs the highest dispute settlement authority for the EU would be the European Court of Justice. Not only that, but since 2009 the combination of the EU's decarbonization policy, slower overall economic growth in Europe since the 2007 financial crisis, and the growth of U.S. LNG supply through the shale gas boom, means the EU is moving through an oversupplied market of energy.⁵⁵ Gazprom and the Russian government are not even able to adopt a hardline negotiating position as they are losing their competitive edge in the European market and confronting the inevitability of having to adapt to changing market conditions.⁵⁶ As such, it seems understandable that Russia has issues with ECT and the Transit Protocol. Thus, while ideology is a factor to some extent, legal considerations also play a role that cannot be ignored.

⁵⁵ A.A. Konoplyanik, "European Commission vs. Gazprom: How to Find a Balance (Between Demand for Immediate Competition From the First & Justified Economic Consideration from the Latter)," *Oil, Gas & Energy Law Intelligence*, OGEL 5 (2013) <http://www.ogel.org/article.asp?key=3384> (Accessed March 19, 2014), p. 10.

⁵⁶ Konoplyanik, "European Commission vs. Gazprom," p. 10 - 11.

Third Energy Package

The Energy Charter Treaty sought reliability, security and predictability of energy relations through the establishment of a legal framework for a common free market in energy and transparency in Europe. Energy transit, infrastructure and investment are key components in achieving these objectives, and not only is this the case for the ECT. The ECT and the Transit Protocol share similar or complementary objectives to the Third Energy Package. Indeed, it may even appear that the EU has been launching several initiatives that, although they may seem different from one another at first glance, are in reality trying to achieve the same goals. This peculiarity is even more apparent when one observes the EU Third Energy Package, the second case of disagreement in EU - Russia energy relations.

Although the Package is directed at the EU's internal energy market, it does affect the EU's energy relations with Russia. As recently as August 2013, Russian Foreign Minister Sergei Lavrov stated that the European Union could achieve closer energy ties with Russia, but the Third Energy Package is halting any progress on this issue. Russia contends that the unbundling of ownership of natural gas production and supply lines, an integral element of the Package, violates the 1994 Russia-EU Partnership and Cooperation Agreement and other bilateral investment agreements.⁵⁷ Before discussing the impact of the Package on EU - Russia energy relations, we first need to analyze the Package itself.

⁵⁷ UPI, "Russia's Lavrov: EU Energy Market Reforms Hindering Closer Ties," August 16, 2013. http://www.upi.com/Business_News/Energy-Resources/2013/08/16/Russias-Lavrov-EU-energy-market-reforms-hindering-closer-ties/UPI-87371376625840/

In Chapter 4 we briefly dealt with a few elements of the Third Energy Package: Directives 2009/72/EC and 2009/73/EC, the latter of which repealed the former. The Third Energy Package consists of these two directives plus three Regulations.^{58*} The impetus behind the Package lies in intensifying the creation of a competitive internal EU energy market; as discussed in Chapter 4, Directive 2009/73/EC established the legal parameters for unbundling European energy companies. This directive is coupled with a regulation (713/2009) that established the Agency for the Cooperation of Energy Regulators (ACER) to monitor and regulate the single gas and electricity market's development.⁵⁹ As the regulation states, improving the regulatory framework at the Community level is a key tool for completing the internal market as envisioned in the 2007 "An Energy Policy for Europe."⁶⁰ ACER monitors regional cooperation between transmission system operators and the European Network of Transmission System Operators for Gas (ENTSOG) to ensure the market functions smoothly.⁶¹ The second regulation aims to set fair rules for cross-border exchanges in the internal market for electricity through harmonization of principles on cross-border transmission charges and compensation.⁶² The third regulation provides a similar regulatory function for the natural

⁵⁸ European Union, *Acts adopted under the EC Treaty/Euratom Treaty whose Publication is Obligatory*, Official Journal of the European Union, L 211, Volume 52, (14 August 2009), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:FULL:EN:PDF> (Accessed on March 11, 2014).

* Regulation (EC) No. 714/2009, No. 715/2009, and No. 713/2009.

⁵⁹ European Parliament and Council, *Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators*, Official Journal of the European Union, L 211, (14 August 2009) <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:FULL:EN:PDF> (Accessed on March 11, 2014).

⁶⁰ European Parliament and Council, *Regulation (EC) No 713/2009*.

⁶¹ Ibid.

⁶² European Parliament and Council, *Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on Conditions for Access to the Network for Cross-border Exchanges in Electricity and Repealing Regulation (EC) No 1228/2003*, Official Journal of the European Union, (14 August, 2009), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:FULL:EN:PDF> (Accessed on March 11, 2014). Art. 1.

gas market by setting non-discriminatory rules for access conditions to the natural gas transmission system, LNG (liquid natural gas) facilities and storages, and for facilitating the emergence of a wholesale market with harmonized rules for cross-border gas trading.⁶⁴ This regulation also advocated for the establishment of ENTSOG to ensure optimal management of the gas transmission network.⁶⁵

The Third Energy Package entered into force on May 3, 2011. Within a year from then, member states were expected to implement one of three unbundling options: full ownership unbundling, creating an independent system operator, or creating an independent transmission operator.⁶⁶ The latter option is also known as “legal unbundling,” in which an energy company can retain ownership of their transmission networks, but transmission subsidiaries are legally independent joint stock companies with an autonomous management.

How does this affect energy relations with Russia? The problem is that these regulations apply to third-party companies operating within the EU market, which directly affects Russia by involving Gazprom subsidiaries and assets operating or based in EU territory.⁶⁷ The legislative base for this is in Directive 2009/73/EC. The directive

⁶⁴ European Parliament and Council, *Regulation (EC) No 715/2009 of the European Parliament and of the Council on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005*, Official Journal of the European Union, L 211, (14 August 2009), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:FULL:EN:PDF> (Accessed on March 11, 2014). Art 1.

⁶⁵ European Parliament and Council, *Regulation (EC) No 715/2009*.

⁶⁶ European Parliament and Council, *Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 Concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 2003/55/EC*, Official Journal of the European Union (14 August 2008), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:EN:PDF> (Accessed on March 11, 2014). Art. 5.

⁶⁷ Jarosław Cwiek-Karpowicz. “Russian Energy Policy Towards the European Union in the Context of the Economic Crisis,” *The Polish Quarterly of International Affairs*, no. 1, (2011): 31-48, <http://www.ceeol.com/asp/issuedetails.aspx?issueid=680c5710-8645-4561-a145-e63d5f0d3464&articleId=34133bf0-dd84-48a9-a7ce-ce11de0559e0> (Accessed on November 1, 2013). p. 36.

states that the separation of supply and production activities should apply to “both Community and *non-Community undertakings* [my italics].”⁶⁸ Furthermore:

To ensure, in addition, respect for the international obligations of the Community and solidarity and energy security within the Community, the Commission should have the right to give an opinion on certification in relation to a transmission system owner or a transmission system operator which is controlled by a *person or persons from a third country or third countries* [my italics].⁶⁹

This is the source of the dispute between the EU and Russia over “vertical integration” and its implications for Russian energy company assets in the EU. Vertical integration refers to a situation in which a sole company has control of the upstream (production) and downstream (supply) networks in the gas or electricity market. This is exactly what Gazprom has been doing by buying downstream networks through Gazprom subsidiaries operating in EU countries to establish a presence in end-consumer markets.⁷⁰ Gazprom directly controls the distribution of its natural gas production. However, as mentioned previously, the EU’s goal is to establish a competitive internal energy market.⁷¹ To reach this goal, production and supply networks need to be separated to encourage competition and discourage monopolies or oligopolies: hence the unbundling measures.⁷² Without unbundling, the EU believes “there is a risk of discrimination not only in the operation of the network but also in the incentives for vertically integrated undertakings to invest adequately in their networks.”⁷³ Russia, however, does not agree with this vision of an

⁶⁸ European Parliament and Council, *Directive 2009/73/EC*.

⁶⁹ *Ibid.*

⁷⁰ Gazprom Export, “Development of End-Consumer Sales [online],” 2014, <http://www.gazpromexport.ru/en/strategy/consumers/> (Accessed on March 11, 2014).

⁷¹ European Parliament and Council, *Directive 2009/73/EC*, Article 5.

⁷² European Parliament and Council, *Directive 2009/73/EC*, Article 6.

⁷³ *Ibid.*

energy market, as we saw in previous chapters. The Kremlin's economic policy aims to maintain the role of the state in energy monopolies and oligopolies (Gazprom in particular) and encourage the growth of their influence on the European energy market.⁷⁴ If Russia were to accept the unbundling principle, it would mean that Gazprom would have to forfeit control and ownership over select gas pipelines in EU territory,⁷⁵ meaning a loss of future revenue and breaking up pipeline networks that were an expensive initial investment for Russia.

Russia has made clear its displeasure over this issue. In February 2012, Putin stated that the Third Energy Package is designed to push integrated Russian energy companies out of the European market, and hinted that this scares off potential investment in new infrastructure projects.⁷⁶ In July 2013, Putin encouraged traditional European gas suppliers to resist pressure from adopting the Third Energy Package.⁷⁷ If we consider Russia's energy policy goals, it becomes clear why this is such an issue for Russia. Russia's strategic objective in the foreign energy policy area is the "maximum efficient use of the Russian energy potential *for full-scale integration into the world energy market, enhancement of positions thereon and gaining the highest possible profit for the national economy* [my italics]."⁷⁸ Is this because Russia wishes to dominate Europe through dependency?

⁷⁴ Vladimir Milov, "Russia-EU Energy Dialog," p. 132-142.

⁷⁵ Ćwiek-Karpowicz, "Russian Energy Policy," p. 36.

⁷⁶ Vladimir Putin, "Russia and the Changing World," *Russia Today* [online] (February 27, 2012). <http://rt.com/politics/official-word/putin-russia-changing-world-263/> (Accessed on March 11, 2014).

⁷⁷ Russia Beyond the Headlines, "Putin urges gas exporters to resist Third Energy Package," July 1, 2013. http://rbth.co.uk/news/2013/07/01/putin_urges_gas_exporters_to_resist_third_energy_package_27643.html (Accessed on March 11, 2014).

⁷⁸ Ministry of Energy of the Russian Federation, *Energy 2030*, p. 55.

Not quite. Again, it must be kept in mind that the profitability of Russian energy industry is critical to the Kremlin's goal of encouraging the socioeconomic development of the country. The Russian state provides subsidies to its energy companies to provide cheap energy for consumers and industry; the profits are made in the European market, where oil and natural gas are sold at market prices. The latest Russian energy policy posits that state involvement in the energy sector will gradually *decrease* and make way for more private enterprise.⁷⁹ However, history has shown that liberalization of the domestic Russian energy market remains a skeptical prospect, best exemplified by the Yukos affair.⁸⁰ More recently, the Strategic Sectors law and the fact that Gazprom and Rosneft, the latter of which is also controlled by the state through the government's majority shareholder position, remain dominant players in the domestic oil and gas markets,⁸¹ makes it questionable whether the Russian state is serious about dialing down its role in the energy industry. The rational course of action for Putin's administration would be to liberalize these companies; without state protection, they would be forced to compete and invest in greater production and efficiency. The current business model of Russia's energy industry risks damaging the growth of the general economy. It must be emphasized how much investment the Russian oil and gas sectors need until 2030 to remain viable. The oil sector requires US\$75 billion for transportation, US\$55 billion for refining, and an astounding US\$505 billion for exploration and production.⁸² In the gas

⁷⁹ Ibid, p. 27.

⁸⁰ Vladimir Milov, "The Role of Oil & Gas in the Russian Economy," *Interdisciplinary Studies on Central and Eastern Europe*, Vol. 8.: *Russian Challenges: Between Freedom and Energy*, eds. Galina Michaleva & Andrey Ryabov. Berne, IN: Peter Lang AF, 2011, 244 pages. pp. 35 - 38.

⁸¹ Milov, "The Role of Oil & Gas," p. 49.

⁸² Tatiana Mitrova, "Strategy of the Russian Energy Sector Development with its Implication for the Technologies." *Institut Energeticheskikh Issledovaniy*, Japan, (February 2011), http://www.rotobo.or.jp/events/20110217_22presentation.pdf (Accessed on March 5, 2014). p. 18.

sector, US\$108 billion is needed for processing, US\$292 billion for transportation, and US\$204 billion for production.⁸³ This need for massive investment presents a great risk for Russia's economy if demand or prices for oil and natural gas exports decrease, and could complicate the planned phasing-out of the Russian energy industry's share of GDP.⁸⁴

Could ideology be coming into play and obfuscating these risks? Since Putin came to power, the main thrust of his foreign economic policy has been one of supporting Russian businesses abroad, fighting back against discrimination towards Russian interests in world markets, and participating in international trade organizations. Russia's economic nationalism, as we saw in chapter 4, equates the interests of Russian business with the interests of the Russian nation (i.e. socioeconomic development and national unity).⁸⁵ Thus, attracting foreign investment through privatization and liberalization on a wide scale is out of the question, as it does not coincide with the normative values that underpin the rationale of the Putin administration. By refusing to liberalize its energy sector and attract the necessary investment and technology to increase output and reduce input costs, the Kremlin is endangering its dominant position in the European market and encouraging the EU to look elsewhere for its energy needs. Thus, this is more a case of Russia acting rationally according its ideological assumptions than anything else.

⁸³ Mitrova, "Strategy of the Russian Energy Sector," p. 20.

⁸⁴ A.A. Makarov, T.A. Mitrova, V.A. Kulagin, "Dolgosrochnyi prognoz razvitiia energetiki mira i Rossii," *Ekonomicheskii Zhurnal VSHE*, No. 2 (October 2012): 172 - 204, http://ecsocman.hse.ru/hse/data/2012/10/22/1246011005/16_02_03.pdf (Accessed on March 3, 2014). p. 202 - 203.

⁸⁵ Maya Eichler, "Explaining Postcommunist Transformations: Economic Nationalism in Ukraine and Russia" in *Economic Nationalism in a Globalizing World*, ed. Eric Helleiner and Andreas Pickel, 69 - 90 (Ithaca; London: Cornell University Press, 2005). p. 80.

However, one could also infer that Russia is simply protecting its industries that are not modernized enough to compete with more advanced economies in Europe. Although Russia's strategy of state-controlled of natural resources clashes with the EU's liberalization policies, the strategy is similar to those of EU member states during their own periods of industrialization and modernization. For example, Russia's use of dual-energy pricing (cheaper, subsidized prices for Russian consumers versus market-level prices elsewhere) falls in line with the broader trade policy debates of the Doha Round talks; developing countries argue that control over their resources is necessary for economic development, while developed countries argue that liberalized trade is the better method for economic growth.⁸⁶ Subsidized energy prices for Russian industry, for instance, allow Russian products to be more competitive by having reduced input costs for production. As we saw in Chapter 4 in Russia's energy policy, Russia's energy sector is crucial in modernizing the economy in general, especially since it occupies a disproportionate amount of federal revenue and export profits. Thus, while the EU and Russia may have differing ideological underpinnings that inform how their economies should work, it seems that, at least from Russia's perspective, it is more concerned with legal and structural economic issues in its energy relations with Europe.

⁸⁶ Daniel Behn and Vitaliy Pogoretsky, "Tensions between the Liberalist and Statist Approaches to Energy Trade Governance: The Case of Gas Dual Pricing" in *Dynamics of Energy Governance in Europe and Russia*. Eds. Caroline Kuzemko, Andrei Belyi, Andreas Goldthau and Michael F. Keating. 45 - 65 (UK: Palgrave Macmillan, 2012). p. 50 - 51.

Gazprom and the EU Antitrust Suit

In October 2013, the EU launched a legal action against Gazprom based on antitrust law.⁸⁷ The source of the antitrust suit goes back to 2004 and Lithuania's dispute with Gazprom, but it ties into the Third Energy Package, as the dispute centred on Lithuania's attempt to unbundle its gas network according to the Package.

Upon joining the EU in 2004, Lithuania was instructed to shut down its only nuclear power plant; this plant fed 77 percent of the country's electricity demand. In 2009 Lithuania effectively closed the power plant, but replaced it with Russian gas imports (through Gazprom) that now cover almost 90 percent of Lithuania's energy needs. Not only that, but Gazprom also controls the pipelines that cross through Lithuania and into the rest of Europe.⁸⁸ In 2004, Gazprom bought shares in Lithuania's largest energy supplier, Lietuvos Dujos, and now owns 37.1 percent of the company's shares, along with German E.ON (38.9 percent) and the Lithuanian state (17.7 percent).⁸⁹

Gazprom's entry into Lithuania took place on the backdrop of the EU's drive to liberalize the EU energy market and maintain competitiveness. On 16 May 2006, EU antitrust staff raided more than 20 sites of European energy giants E.ON, RWE, Gaz de France, Distrigas, and OMV AG in Germany, France, Italy, Austria, Belgium and

⁸⁷ EurActiv, "EU Preparing to Charge Gazprom in Antitrust Case," October 3, 2013. <http://www.euractiv.com/energy/eu-preparing-charge-gazprom-anti-news-530858> (Accessed on March 1, 2014).

⁸⁸ Valentina Pop, "Taking on Gazprom: Lithuania's Battle for Energy Interdependence." *EuObserver*, 10 June, 2013. <http://euobserver.com/lithuania/120406> (Accessed on March 5, 2014).

⁸⁹ EurActiv, "Gazprom Pressures Lithuania over Gas Unbundling," 26 August, 2010. <http://www.euractiv.com/energy/gazprom-pressures-lithuania-gas-news-497190> (Accessed on March 5, 2014); Agata Łoskot - Strachota & Katarzyna Pełzyńska - Nałęcz, "Gazprom's expansion in the EU: co-operation or domination?" *Ośrodek Studiów Wschodnich Im. Marka Karpia - Centre for Eastern Studies*, April 2008, http://www.osw.waw.pl/sites/default/files/gp_eu_en_.pdf (Accessed on March 6, 2014). p. 13.

Hungary.⁹⁰ In compliance with the EU's Third Energy Package, Lithuania has been trying to unbundle its gas transmission network. However, Gazprom is resisting this, and has taken the Lithuanian state to court over the issue. Lithuania filed a complaint in response, and the EU antitrust probe was launched as a result.⁹¹

On September 4, 2012, the European Commission formally opened antitrust proceedings to investigate whether Gazprom was hindering competition in Central and East European gas markets. The Commission suspected Gazprom of three specific activities: dividing gas markets by hindering the flow of gas across Member States; possibly preventing the diversification of the supply of gas; and imposing unfair prices on customers by linking the price of gas to oil prices.⁹² As mentioned previously, the spark of the dispute was Lithuania's attempts to follow the Third Energy Package, which directly affected a Gazprom (and E.ON Ruhrgas) assets in the country, although the European Commission claims that it also decided to take action due to its monitoring policy and information provided by market participants.⁹³

Gazprom's response is that it has always complied with EU law, and that the EU investigation will have to deal with the Russian state as the company performs "nationwide scale functions."⁹⁴ Thus we see from the response how the Russian state is

⁹⁰ Euractiv, "Commission Clamps Down on Energy Giants," 18 May 2006. <http://www.euractiv.com/energy/commission-clamps-energy-giants/article-155405> (Accessed on March 15, 2014); European Commission, *DG Competition Report on Energy Sector Inquiry*, European Commission - Competition DG, SEC(2006) 1724, 10 January 2007, http://ec.europa.eu/competition/sectors/energy/inquiry/full_report_part1.pdf (Accessed on March 6, 2014). p. 20.

⁹¹ UPI Business News, "EU, Gazprom to Seek Settlement in Antitrust Probe," 6 December 2013, http://www.upi.com/Business_News/Energy-Resources/2013/12/06/EU-Gazprom-to-see-settlement-in-antitrust-probe/UPI-56281386306120/ (Accessed on March 10, 2014).

⁹² European Commission Press Release, *Antitrust: Commission Opens Proceedings Against Gazprom*, 4 September 2012. http://europa.eu/rapid/press-release_IP-12-937_en.htm (Accessed on March 10, 2014).

⁹³ Konoplyanik, "European Commission vs. Gazprom," p. 4.

⁹⁴ Ibid, p. 4 - 5.

directly invested in whatever Gazprom decides to do in the European energy market, and will stand by the company if it calls for help.

Is the antitrust suit a result of the clash of the ideological values of Russia and the EU? As the accusations in the EU Commission's press release show, Gazprom (and by extension, the Russian state) is being taken to task for engaging in business behavior that contradicts the spirit of the European internal energy market. Obviously, the antitrust investigation does not contribute to cooperation between both parties, but that is precisely the point; the EU is adamant that Russia play by the rules of a free market, regardless of whether that is desirable or even feasible on Russia's end. Yet, this goes back to the previous issue of the EU placing its *acquis communautaire* as the legal reference point for itself and Russia. Indeed, the antitrust action seems to ignore the problem of a lack of common understanding between both parties, with no real constructive outcome stemming from it. In that sense, it seems that the antitrust suit is more politically motivated than anything else, and is not quite related to ideological influences.

On 11 February 2014, Gazprom announced that it would comply with the Third Energy Package in Lithuania and withdraw from Lithuania's gas transmission network operator, Amber Grid, by 31 October 2014. Amber Grid, created in 2013, is a subsidiary of Lietuvos Dujos, thus Gazprom's stake in Lietuvos extends to Amber Grid. Gazprom has stated that it will no longer question the implementation of the Third Energy Package,⁹⁵ but on 25 February Lithuania's prime minister announced that Gazprom's

⁹⁵ Enerdata: Global Energy Intelligence, "Lithuania Reaches Agreement with Gazprom on EU Third Energy Package," 11 February 2014. http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/lithuania-reaches-agreement-gazprom-eu-third-energy-package_25763.html (Accessed on March 26, 2014).

latest proposal regarding the management of Amber Grid contradicts the Third Energy Package.⁹⁶ Lithuania's president, Dalia Grybauskaitė, stated that Gazprom's proposals are unacceptable and are similar to a previous Gazprom memorandum from April 2013. This memorandum provided for the postponement of unbundling ownership of Lietuvos Dujos until 31 October 2015 if negotiations fail. Currently, Gazprom is expected to withdraw from the Amber Grid by November 2014, but negotiations continue.⁹⁷

Having examined the two cases of disagreement between the EU and Russia, the conclusion to be drawn seems to show a nuanced result. For one, the ideological underpinnings in the energy policy of each party do create friction in negotiations on treaties and legal agreements in the field of energy cooperation to some extent. The EU consistently insists on dealing with Russia through the framework of a liberalized energy market, while the Russian state refuses to dismantle the monopolistic structure of its domestic energy market and the portions of it that interact with the European energy market. However, ideology does not explain everything. As discussed above, economic and legal explanations also play an important role. The legal structure of EU - Russia energy relations is problematic, particularly in the aspects of the ECT and the primacy of EU rules in EU territory, and the current structure of the ECT and Third Energy Package seems to favour developed, energy consuming economies over developing producer countries that are dependent on undiversified economic structures.

⁹⁶ The Lithuania Tribune, "PM: Gazprom's Offer on Amber Grid runs counter to EU's Third Energy Package." February 25, 2014. <http://www.lithuaniatribune.com/64080/pm-gazproms-offer-on-amber-grid-runs-counter-to-eus-third-energy-package-201464080/> (Accessed on March 26, 2014).

⁹⁷ Enerdata, "Lithuania Reaches Agreement"; Artur Ciechanowicz, "Confusion over gas in Lithuania," *Ośrodek Studiów Wschodnich im. Marka Karpia*. April 17, 2013. <http://www.osw.waw.pl/en/publikacje/analyses/2013-04-17/confusion-over-gas-lithuania> (Accessed on March 26, 2014).

Chapter 6: Conclusion

This thesis set out to provide an answer to the following research question: Why have Russia and the European Union been unable to agree on energy security over the last two decades? The hypothesis is that Russia and the European Union have failed to agree on energy security due to conflicting political - economic ideology: the EU and Russia have incompatible ideologies concerning political economy. The EU follows an economic liberal ideology, while Russia adheres to an economic nationalist ideology. Before discussing the main findings of the paper and possible areas for future research, let us first discuss some alternative explanations in relation to the hypothesis of this thesis.

Alternative Explanations

As mentioned in Chapter 1 and 2, many scholars and writers on the subject of EU - Russia energy relations explain the relationship, explicitly or implicitly, through a realist IR lens. Now that the paper has discussed all the relevant disputes in EU - Russia energy relations and the ideology behind those disputes, realist explanations will be considered to see if they can provide a good refutation of this paper's approach. Realist scholars argue that, as far as EU - Russia relations are concerned, both parties are engaged in a struggle of power based in energy resources. Thus, evidence that would point to EU or Russian energy policy geared towards increasing the distribution of power in the respective party's favour would fit with the realist explanation. This will be contrasted

with evidence that points to structural factors based on legal norms and economic interests, such as differing legal norms or conflicting interests of producer and consumer countries.

The predominant argument in realist explanations is that Russia under Putin's regime has turned its oil and natural gas resources into political and economic weapons against Europe. Marshall Goldman argues that from 1999 onwards Russia has used oil exports to repay its foreign debts, and natural gas exports and pipelines to build itself into an energy superpower with restored political clout.¹ Since Russia controls all the gas pipelines in the Central and Eastern Europe (through its inheritance of the Soviet Union's gas networks), it could halt the flow of gas to Europe at its own discretion, while Europe would be relatively helpless to do anything. Additionally, gas pipelines are expensive to build, so it would be unfeasible for the EU to construct 'standby' pipelines in case Russia suddenly shuts off the supply.² Europe is essentially at the mercy of Russia.

Mert Bilgin argues that Russia benefits from the EU's free trade structure in its energy market. The Russian state, through political means, helps Russian energy companies grab dominant shares of the European energy market, while these companies in turn provide the Russian state with revenue and a geopolitical lever through which it can exert influence in Europe.³ For instance, Bilgin argues that the delay in drawing up a legal framework for EU - Russia energy relations was not due to any normative mismatch between free market liberalism and economic nationalism, but due to Russian

¹ Marshall I. Goldman, *Petrostate: Putin, Power and the New Russia* (New York: Oxford University Press, 2010). p. 136.

² Goldman, *Petrostate*, p. 138.

³ Mert Bilgin, "Energy Security and Russia's Strategy: The Symbiotic Relationship between the State and Firms," *Communist and Post-Communist Studies*, 44, (2011): 119 - 127. p. 119.

geopolitical concerns stemming from the resurgence of Russian state power.⁴ The Ukraine - Russia gas disputes demonstrated the nature of the Russian state's involvement in its energy industry, and Russia's 2009 Draft Convention was designed to block European involvement in Ukraine's gas transportation system. Ukraine and the EU signed an agreement on March 23, 2009, to renovate and expand the capacity of the Ukrainian gas trunk pipeline without Russian participation. Russia prefers to deal through bilateral relations with as little EU involvement as possible.⁵ However, Bilgin argues that Russia's political and economic concerns are not only drawn from state interests; rather, they are linked to the Russian natural gas sector, "which makes it defy any anchor of liberalization in due course."⁶ Thus, Bilgin posits that Gazprom's efforts at controlling Central Asian gas supply and European gas transit networks can be interpreted as both a firm trying to maximize its profits, and as the Russian state using monopoly control over the firm for protecting its geopolitical interests.⁷

Pavel K. Baev, Kevin C. Smith and Stephen Blank make similar arguments to those of Goldman and Bilgin, arguing that Putin has blended energy business and power politics, making profit maximization indistinguishable from establishing positions of power, and using energy as a policy weapon in its dealings with Europe to accept Russian political and economic influence.⁸ Pierre Noël argues that energy dependency is not the

⁴ Bilgin, "Energy Security and Russia's Strategy," p. 120.

⁵ Ibid, p. 120 - 121.

⁶ Ibid, p. 121.

⁷ Ibid, p. 125 - 126.

⁸ Pavel K. Baev, *Russian Energy Policy and Military Power: Putin's Quest for Greatness* (New York, NY: Routledge, 2008). p. 118; Stephen Blank, "Russian Energy and Russian Security," *The Whitehead Journal of Diplomacy and International Relations*, Vol. 12, No. 1 (Winter 2011): 173 -186 (Accessed on July 4, 2013); Kevin C. Smith, *Russian and European Energy Security: Divide and Dominate*, (Center for Strategic & International Studies: October 2008). http://csis.org/files/media/csis/pubs/081024_smith_russiaeuroenergy_web.pdf

real issue for the EU. Instead, concern should be placed on Russia's refusal to depoliticize its gas trade with the EU since it is part of Russia's energy strategy, that is, that Russia turns disagreements in energy relations into political conflicts with the EU.⁹

Some of the conclusions of the realist analyses are accurate. True, Russia, at least under Putin's administration, has employed its fossil fuel resources to rebuild itself into an economic and political power. However, these scholars deduce from this that Russia conducts its energy relations with the EU according to strictly geopolitical concerns, sometimes with openly hostile intent. Yet, as we have seen in this paper, Russia and the EU are mutually dependent. Additionally, Russian oil and gas production is steadily declining due to insufficient investment, while Europe is making efforts to reduce the proportion of fossil fuels in its energy mix. Neither is Russia stubbornly sticking to a fossil fuel based economy in the long term. If the latest Russian energy strategy is to be believed, the financial weight of the energy sector in the Russian economy will decrease substantially over the coming decades as industry is modernized. Additionally, as the EU moves away from a carbon based economy and the U.S. steps up LNG production, Russia and Gazprom's bargaining power in Europe is steadily falling. It seems questionable then that Russia is the preponderant *realpolitik* actor as some scholars conclude.

To be clear, no argument is being made that realist explanations are outright wrong. What is being emphasized is that realist explanations do not go far enough into explaining the causality behind the disagreements in EU - Russia energy relations. While

⁹ Pierre Noël, "Beyond Dependence: How to Deal With Russian Gas," *European Council on Foreign Relations, ECFR/09, November 2008*, http://ecfr.eu/content/entry/russia_gas_policy_brief (Accessed on July 6, 2013).

considerations of power do play a role in these relations, it is important to understand how each party's conception of "power" or interest is conceptualized. In the case of the EU for instance, energy security is understood to be actualized through the establishment of a competitive internal energy market along free market principles. For Russia, energy demand security is the prime concern, and is tied up with building the socioeconomic potential of the Russian populace and the Russian nation, as well as political and economic power.

What about ideology as the deciding factor in the way EU - Russia energy relations play out? As Denzau and North's Shared Mental Model framework posits, utility is realized through idiosyncratic ideas and beliefs of a subject's interests. Ideology is the shared framework of the mental model an individual possesses that provides interpretations of the environment and how it should be structured.¹⁰ As Daniel Treisman has shown, once Putin came to power, veterans of the Soviet security services (known as the *siloviki*) were placed in positions of power and placed in company boardrooms (Putin himself hails from the same professional background). These individuals have amassed considerable wealth through their participation in Russian business, and are convinced that it is in the interest of the Russian state and people for the commanding heights of the economy to be controlled by the government, whether that control is direct or indirect.¹¹ That is not to say that these individuals have taken complete control of the Russian state.

¹⁰ A.T. Denzau and D.C. North, "Shared Mental Models: Ideologies and Institutions." *Kyklos*, vol. 47, no. 1 (1994): 3 - 31 (Accessed January 16, 2014). p. 4.

¹¹ Daniel Treisman, "Putin's *Silovarchs*," *Foreign Policy Research Institute*, (Winter 2007): 141 - 153, http://ac.els-cdn.com.proxy1.library.mcgill.ca/S0030438706001141/1-s2.0-S0030438706001141-main.pdf?_tid=225c4bec-afa0-11e3-bd08-00000aacb35d&acdnat=1395258985_dd09229a35a12a309894d84c1b5be718 (Accessed March 20, 2014). p. 141 - 143.

Rather, the point is that the range of policy options in the energy sphere of policy are limited by the beliefs and ideas of the administration. Concerns of national strength, unity and directed economic development trump economic liberalism. For Russia to play by the rules of the European internal energy market simply does not intersect with the ideological imperatives of the Russian state; it is 'irrational' to do so from Russia's point of view.

In the context of the EU, energy policy since the 1960s has adopted a neoliberal approach, believing in the free market and no state control of the energy sector as the key to Europe's economic development and security of energy supply. Although the EU's policy does contain some interventionist measures, they are more geared towards ensuring the proper functioning of a competitive energy market and preventing the formation or consolidation of monopolies or oligopolies. Additionally, the EU approaches energy relations with Russia under the assumptions of a free market framework; the Energy Charter Treaty and the Third Energy Package embody the ideological values of the EU, as well as the legal basis of EU - Russia energy relations through the Partnership and Cooperation Agreement.

However, it seems that based on the empirical evidence observed in the analysis of the disputes in Chapter 5, ideology may not explain everything adequately. From a structural perspective, disagreements in EU - Russia energy relations could also be explained by their roles as consumer and producer countries. As discussed in Chapter 4, Russia's energy strategy is focused on using energy to modernize the Russian economy and be the foundation for the socioeconomic development of the population.

Additionally, as Putin's statements to the Federal Assembly have shown, Russia's energy infrastructure network and its development are crucial for providing employment for the population and encouraging the populace to rally around the state. Although the monopolistic structure of the Russian energy industry has led to production inefficiencies, cheap energy prices have made Russian industry more competitive through cheaper energy inputs, and has provided the state with the financial revenue to provide social services and subsidies to raise the standard of living of the population. A stable demand of energy exports is crucial for this strategy to survive. However, the EU is a consumer of energy and is gradually moving away from a fossil fuel based economy. Although gas will continue to be a major component of the European fuel mix in the near future, Europe aims to diversify its sources of natural gas and is not as dependent on fossil fuels for economic and financial growth as Russia. Additionally, the legal structure of EU - Russia energy relations also contributes to understanding the dynamic of the disputes, and is tied to the consumer/producer dichotomy. The Energy Charter Treaty and Third Energy Package are legally structured in such a way that Russia is at a disadvantage. The EU's insistence on including the REIO clause in the Transit Protocol means EU rules take precedence over international legal norms, a situation that puts Russia in a difficult position and lessens the security of its investments should a dispute with the EU arise. The EU refuses to give way on these normative legal issues.

Main Findings

Having discussed alternative explanations of disagreements EU - Russia energy relations, the paper now turns to the main findings of the research.

Based on the findings, the hypothesis of this thesis is partially validated. There is an ideological component to EU - Russia energy relations, but ideology is not enough in explaining the major disputes in the relationship. Although ideology does inform the policy foundations of each party's energy policies, the disputes surrounding the intersecting of these policies sometimes falls on ideological lines, sometimes on legal and structural lines. To better understand this, let us examine the findings in each chapter.

In Chapter 3, the research set out to determine whether ideology as a factor exists in the determination of the economic priorities of the European Union and the Russian Federation. This was done by analyzing the development of the European Single Market from the 1960s to the 1990s, and the economic reforms of 1970s Soviet Russia to post-Soviet Russia until 1999. By examining policy papers and debates on economic policy of the respective units of analysis, there is an observable ideological foundation in the current economic policies of the European Union and the Russian Federation. The European Community gradually abandoned Keynesian economic policy over the late 1970s and 1980s, replacing it with neoliberal economic policy. The establishment of the European Single Market was motivated by the belief that the free movement of labor, goods, services and capital with minimal state intervention in markets is the best method of encouraging economic growth. Energy, from the late 1950s, was considered a critical element in the success of a neoliberal Single European Market.

Soviet Russia briefly experimented with limited neoliberalism through small-scale privatization and liberalization during Gorbachev's rule; this was expanded into full-scale neoliberalism during the Yeltsin era. Yeltsin's administration argued for moving Russia into a Western-style free market economy to rebuild the Russian nation and encourage democracy. However, neoliberal reforms resulted in catastrophic economic collapse between 1992 and 1997 and an equal collapse in living standards for the population. The trauma of the neoliberal reforms paved the way for Vladimir Putin's entry into the Kremlin and his promotion of economic nationalism as the guiding economic ideology of the country. Under Putin's administration, energy became a key tool for rebuilding Russia's economy and, by extension, encouraging the socioeconomic development of Russia and strengthening national unity and identity around the state.

With the findings in Chapter 3, the research was able in Chapter 4 to properly determine whether the respective ideologies of Russia and the European Union affect their respective energy policies. This analysis was carried out by examining the development of energy policy in the EU and Russia in the 1990s and 2000s, and the conclusion is that their energy policies are indeed replete with ideological norms. Europe's energy policy has consistently placed itself as the key to establishing a successful single market and a competitive European economy. The EU's desired energy industry structure is one of multiple, privately owned companies in open competition with each other, along with minimal tariffs and state intervention to provide competitive prices to European consumers and guarantee security of supply. In Russia's case, energy policy is driven by the need to protect the national interests of the Russian state and

protect the socioeconomic development of the population. State control of the energy sector is considered critical to achieving the policy's strategic goals; the competitiveness of the energy industry in the domestic Russian market is not a priority. Rather, Putin's administration employs state control of the energy sector to direct it towards export production and competitiveness in foreign markets. The Russian state is the majority shareholder in Gazprom, Russia's giant gas monopoly, and Rosneft, the dominant oil concern in the Russian oil industry. In his annual addresses to the Federal Assembly, Putin has made it clear that the growth of the energy industry, and energy infrastructure in particular, is intimately tied with rebuilding the Russian nation and getting the population to feel invested in the Russian state.

In Chapter 5, we see how these divergent policies, informed by differing ideological motivations, clashed in negotiations on establishing energy cooperation agreements between the EU and Russia. The 1994 Partnership and Cooperation agreement, which is designed to promote closer economic cooperation between Russia and the EU, including energy cooperation, is an agreement envisioning cooperation based on a free-market framework. However, the agreement quickly came to naught, as Russia early on made it clear it would not adopt any norms it felt were not in its best interests, and the EU would not give way on employing EU legal rules as the basis for energy cooperation with Russia. As a result, the agreement has not resulted in any concrete outcome for either party. This is due to both ideological and legal factors, which is observable in the Energy Charter Treaty. Championed by the EU, the treaty sought to create an energy cooperation regime based on the liberalization of the European energy

sector and the values of the EU *acquis communautaire*. However, with the expansion of the EU and the inclusion of the REIO clause in the Transit Protocol, the EU applies the stricter rules of the Single Market in its energy market, while Russia is unable to have any exceptions of its own. Thus, should Russia agree to the treaty, it would have to abide by the EU's internal energy market rules that would have the same status as international laws or agreements. Coupled with the EU's insistence on adopting short-term contracts for oil and gas, Russia is in a difficult position as a producer; without stable demand, and with the EU's move away from fossil fuels, it is risky for Russia to invest massive sums into increasing production and infrastructure without endangering its economic modernization.

The EU Third Energy Package has witnessed similar problems to the Energy Charter Treaty. Although the Package is directed at the EU's internal energy market, it affects Russia's energy companies due to EU energy market rules applying to non-EC members. Russia's energy monopolies would have to unbundle their assets according to the Package's rules, effectively dismantling Gazprom's downstream networks it has painstakingly acquired over the past two decades. Russia perceives the Package as an attempt to squeeze its companies out of the European energy market. Although from a rational economic perspective, Russia's energy industry would benefit from the investment and technology transfers that liberalization and privatization would attract, the Kremlin still maintains a presence in the energy industry.

Possible Areas for Future Research

An area for future research would be to apply the concept of political economy ideology to other economic sectors. Because this thesis focuses on one particular sector (energy), it is difficult to determine if the insights generated from the analysis are generalizable across other economic sectors, at least as far as economic relations between Russia and the European Union are concerned. This is the main limitation of the research.

Additionally, the conceptual framework of this study can also be applied to other states, as units of analysis, to test its validity and accuracy, or even to determine whether states are willing or not to give way in their ideological preferences depending on the distribution of power in the relationship. As this study shows, Russia and the European Union are mutually dependent in energy; future research could examine the dynamics of economic ideology and energy relations in cases where dependency is asymmetrical. An example case would be a state that is very dependent on Russian energy imports (Greece, for instance), but eschews diversifying its energy mix despite the potential political and economic risks of doing so. Applying the conceptual framework to this type of case could potentially refute, or validate, a realist explanation of the behavior of the dependent state in this type energy relationship.

Significance of this Research

The main contribution of this research is the application of the constructivist Shared Mental Model Framework to analyzing energy relations between Russia and the European Union. As the literature review in Chapter 2 demonstrates, the academic

literature consists mainly of rationalist, realist approaches to analyzing and answering research questions on the political economy EU - Russia energy relations. Thus, this research has added to the literature by contributing findings based in a different theoretical perspective, one that is in certain respects a refinement of the rationalist approach since the former can be too simplistic to offer a plausible explanation for certain state behaviors. As the findings of this research shows, there is ample evidence that the behaviour of the European Union and Russia, in negotiations over energy cooperation, can be explained by more than utilitarian calculations of power. That is not to say that rationalist explanations are wrong. Rather, the rationality underpinning the selection of policy priorities can be based in assumptions that draw upon contexts not necessarily imbued with realpolitik concerns. Additionally, the ideological models that inform the selection of policy priorities can explain why one policy option is selected over the other, even when that selection does not result in an outcome that optimizes utility. To put it briefly, what is “rational” depends on the particular actor’s definition of what is rational/irrational. This is what this study has done: it has examined EU - Russia energy relations to explain why both parties have not been able to cooperate on a matter that would greatly benefit from cooperation, and has found that the source of discord goes beyond the standard discourse of balance-of-power politics and realpolitik.

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