THE IMPACT OF THE EUROPEAN UNION-RUSSIA RELATIONS ON CREATING A COMMON EU ENERGY POLICY

A Master's Thesis

by

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Ankara
September 2008

To my parents and my sister

THE IMPACT OF THE EUROPEAN UNION-RUSSIA RELATIONS ON CREATING A COMMON EU ENERGY POLICY

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of
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ABSTRACT

THE IMPACT OF THE EUROPEAN UNION-RUSSIA RELATIONS ON CREATING A COMMON EU ENERGY POLICY

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This thesis aims to understand the bilateral relations of five key member states of the European Union, namely Germany, the United Kingdom, France, Italy and Austria, with Russia in supplying their energy need and to discover how these relations affect the EU policy making process in creating a common energy policy in the light of two theories of European integration: intergovernmentalism and liberal intergovernmentalism. The thesis reaches three main conclusions on how the national preferences of five key member states are formed, to what extent these preferences affect intergovernmental bargaining or interstate negotiations on creating a common EU energy policy, and whether the result of this bargaining process is in favour or against the goal of EU to achieve a common energy policy. First, the national preferences of these states are driven by issue-specific economic interests. Second, national preferences of these states have a considerable impact on their decisions on creating a common EU energy policy. Finally, diverse and plural interests of these states on the liberalisation of EU electricity and gas sectors and their relations with Russia to differing degrees had an impact on EU policy making process in achieving a common EU energy policy.

Keywords: Energy Dialogue, European Union, Russia, intergovernmentalism, liberal intergovernmentalism

ÖZET

AVRUPA BİRLİĞİ-RUSYA İLİŞKİLERİNİN AVRUPA BİRLİĞİ ORTAK ENERJİ POLİTİKASI OLUŞTURULMASINA ETKİSİ

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Bu çalışma, Avrupa Birliği'nin beş önemli üye ülkesi olan Almanya, Birleşik Krallık, Fransa, İtalya ve Avusturya'nın enerji ihtiyaçlarını karşılamakta Rusya'yla olan iki yönlü ilişkilerini anlamayı ve bu ilişkilerin, Avrupa Birliği'nde ortak bir enerji politikası oluşturma sürecini nasıl etkilediğini keşfetmeyi, iki bütünleşme teorisinin ışığı altında hedefler: hükümetlerarası ve liberal hükümetlerarası kuram. Bu çalışma üç ana sonuca ulaşmaktadır. Beş üye ülkenin ulusal çıkarlarının nasıl şekillendiği, Avrupa Birliği ortak enerji politikası oluşturulurken bu ulusal çıkarların hükümetlerarası pazarlıkları veya devletlerarası görüşmeleri ne oranda etkilediği, son olarak bu pazarlıkların sonucunun Avrupa Birliği ortak enerji politikası amacını destekleyip desteklemediği tartışılmıştır. Öncelikle, beş üye ülkenin ulusal çıkarlarının 'konu-özellikli' ekonomik çıkarlar doğrultusunda şekillendiği sonucuna varır. Daha sonra, bu ülkelerin ulusal çıkarlarının Avrupa Birliği ortak enerji politikası oluşturulması üzerinde önemli bir etkisi olduğuna ulaşır. Son olarak, bu ülkelerin Avrupa Birliği elektrik ve gaz sektörlerinin özelleştirilmesi üzerine farklı ve çeşitli tercihlerinin, Rusya ile farklı seviyedeki ilişkilerinin Avrupa Birliği ortak enerji politikası oluşturulmasını etkilediği sonucuna varır.

Anahtar kelimeler: Enerji Diyalogu, Avrupa Birliği, Rusya, hükümetlerarası kuram, liberal hükümetlerarası kuram

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CHAPTER 1

INTRODUCTION

The European Union (EU) with its twenty-seven member states tries to find a unique voice in terms of creating common policies in the union such as a common energy policy. However, it is hard to achieve a common sense among the EU members. All are sovereign states and many of them are not willing to give up their sovereign rights on certain issues in the process of converging national policies into the EU common policies. The common energy policy is one of the most crucial aspects of the process of deepening that the EU members have been reluctant to reach a consensus on so far.

However, there have been challenges in the process of creating a common energy market starting with the initiatives and policy recommendations outlined since the issuance of the Green Paper for the first time in 2000. In this thesis, the focus is on five members of the EU, namely Germany, the United Kingdom, France, Italy, and Austria, whose proven natural energy resources are not enough to meet the energy demand of those countries. Thus, they are dependent on imports from other countries to different degrees. Increasingly, there is a greater dependence on imports of natural energy resources, particularly natural gas, from the Russian Federation. Within this framework, this thesis seeks to answer two major questions: (i) how do these countries pursue their

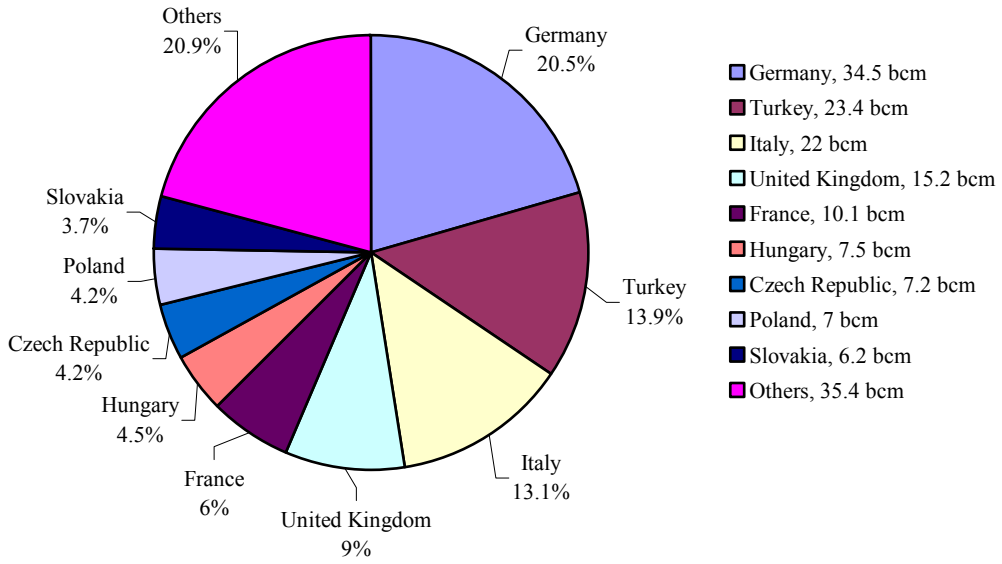
bilateral relations with the Russian Federation in terms of supplying their energy need and (ii) do these countries' bilateral relations with Russia in energy affect the EU of forming a common energy policy?

Table 1: The EU Member States' Dependency Rates on Russian Natural Gas Imports (2005 Statistics)

Country	Gross Inland Energy Consumption (ktoe)	Share of Gas in Gross Inland Energy Consumption (%)	Total Imports of Gas (bcm)	Share of Russian Gas in Total Gas Imports (%)	Share of Russian Gas Imports in Gross Inland Energy Consumption (%)
BE-Belgium	54 952	26	18.92	5.1	5.1
BG-Bulgaria	19 884	14	2.85	100	87.7
CZ-Czech Republic	44 795	17	9.48	76.1	75.1
DK-Denmark	19 538	23	-	-	-
DE-Germany	345 451	23	90.70	41.7	37.9
EE-Estonia	5 563	14	0.97	100	100
IE-Ireland	15 121	23	3.05	-	-
EL-Greece	31 240	8	2.40	83.6	82.8
ES-Spain	143 486	21	11.59	-	-
FR-France	275 438	15	36.20	19.5	19.8
IT-Italy	186 766	38	70.99	31.8	27.0
CY-Cyprus	2 461	-	-	-	-
LV-Latvia	4 718	29	1.75	100	>100
LT-Lithuania	8 592	29	2.93	100	>100
LU-Luxembourg	4 698	25	1.40	-	-
HU-Hungary	27 920	43	10.82	73.4	59.5
MT-Malta	953	-	-	-	-
NL-Netherlands	80 963	44	17.58	-	-
AT-Austria	33 980	24	8.68	70.0	68.8
PL-Poland	93 935	13	10.21	65.9	46.1
PT-Portugal	26 677	14	2.62	-	-
RO-Romania	39 146	36	6.25	100	30.1
SI-Slovenia	7 305	13	1.10	59.8	59.6
SK-Slovakia	19 407	31	6.40	100	>100
FI-Finland	34 515	10	4.20	100	100
SE-Sweden	51 555	2	1.03	-	-
UK-United Kingdom	232 259	37	14.65	-	-

Source: BP, 2006: 30. European Commission and Eurostat, 2007a: 32, 2007b and 2007c: 56

Figure 1: Volume and Structure of Gazprom's Gas Sales Far Abroad in 2007, bcm and %



Source: Gazprom Website, last accessed on 28 August 2008.

Being dependent particularly on Russian exports of gas, the members of the EU became vulnerable to any changes that would affect the supply of natural resources, since three countries, namely Russia, Norway and Algeria, are the major gas exporters to the EU. Thus, the EU needs to diversify its countries of origin to meet its increasing gas demand (See Table 1 and Figure 1). One recent experience that highlighted the vulnerability of the EU was the energy crisis between the Russian Federation and Ukraine in January 2006. The energy crisis was a result of a price hike maintained by the Russian Federation against Ukraine. Because Ukraine was reluctant to accept this price hike, the Russian company Gazprom turned off the pipelines. This crisis not only

strained the relations between the Russian Federation and Ukraine, but also led the Russian Federation into a confrontation with the members of the EU. Turning off the pipelines indirectly affected the Russian exports of natural energy resources going into the EU. Therefore, after the energy crisis, the EU revised its energy policy and concentrated its efforts to secure new energy resources for the members of the EU.

Germany, the United Kingdom, France, Italy, and Austria are chosen to seek a plausible explanation for the research questions. These countries are selected because they are key member states of the EU and they have different levels of energy dependency as well as bilateral relations with Russia. To understand the bilateral relations of these countries with the Russian Federation in supplying their energy need and how the ongoing relationship with Russia affects the EU policy making process in achieving a common energy policy, an attempt to apply both intergovernmentalist and liberal intergovernmentalist theories is made to seek a plausible explanation.

First of all, in the following section two theories of European integration will be examined briefly: intergovernmentalism and liberal intergovernmentalism. Following this section in Chapter 1, Chapter 2 will cover the significant role of energy in Russian foreign policy. It will also seek to explore the energy policy of the EU by examining the Green Papers of 2000 and 2006 of the European Commission. Then, it will study the EU-Russia dialogue on energy by looking at the mechanisms for continuing the dialogue, the developments influencing the dialogue such as the Ukraine-Russia energy crisis, price hike in Turkmen gas, and the Sochi and Samara Summits between the EU and Russia. The section about the major natural gas supplies will be discussed under two headings: existing and proposed pipelines. Yamal-Europe I will be covered as the existing natural gas pipeline between the EU and Russia. Then, the projects of Nord

Stream, South Stream and Yamal-Europe II will be examined under the heading of proposed pipelines.

Chapter 3 will then examine the energy outlooks of the selected countries, namely Germany, the United Kingdom, France, Italy and Austria. Then, with reference to the energy policy of the EU outlined in Chapter 2, it will try to answer the question of whether these countries have convergent or divergent interests with the EU as an organization. Finally, the relations between these selected countries and Russia will be examined to find a more plausible explanation for these countries' stance on the common energy policy of the EU.

Finally, Chapter 4 will seek to review how the theories discussed in Chapter 1, intergovernmentalism and liberal intergovernmentalism, explain the selected countries' bilateral relations with the Russian Federation in supplying their energy need and how these relations with Russia in energy affect the EU policy making process in achieving a common energy policy.

1.1. Theories of European Integration

1.1.1. Intergovernmentalism

Intergovernmentalism is a political science approach to integration (Mattli, 1999: 19). This approach prioritises states in studying integration; it is a "state-centred work on

the European Communities (EC)" (Rosamond, 2000: 75). One of the advocates of intergovernmentalism, Stanley Hoffmann, describes states as the basic units of the international system. Since states are the basic and major players, national interests of these states have crucial roles in world politics as well. Hoffmann defines interests as such: "state interests ... are constructs in which ideas and ideals, precedents and past experiences, and domestic forces and rulers all play a role" (Hoffmann, 1995: 5). Rosamond also adds that states' interests are "diverse rather than convergent" (Rosamond, 2000: 76). Hoffmann argues, "Any international system would be likely to produce diversity rather than synthesis among the units. The present system was 'profoundly conservative' of diversity" (Rosamond, 2000: 76). According to Rosamond (2000: 76), this diversity would be the natural end of plurality of domestic imperatives and the uniqueness of every state's position in the international system.

The diverse and plural interests of states lead Hoffmann to the analysis of "high" and "low" politics. According to the study of Hoffmann on high and low politics, states would be reluctant to integrate in issues –high politics– that might jeopardize their national interests while, on the other hand, low politics is an area where states feel secure to integrate. Hoffmann differentiates high and low politics "to explain why integration was possible in certain technocratic and uncontroversial areas and why it was likely to generate conflict in matters where the autonomy of governments or components of national identity were at stake" (Rosamond, 2000: 77).

Carole Webb (Rosamond, 2000: 79) criticises Hoffmann's analysis of high and low politics and indicates:

> The development of the Common Foreign and Security (CFSP) and the commitment to enact Economic and Monetary Union (EMU) within a specified period can be seen as instances where member states *willingly* surrendered control over issues of central importance to national sovereignty.

Therefore, the members of the Union are unwilling to integrate in issues of high politics and reluctant to integrate in some important issues, for instance a common energy policy. The reason is that every state has distinct interests and continues to strengthen their energy security according to the traditional perspective of national security. The Union tries to create a common energy policy among its members, but aforementioned members of the Union, namely Germany, the United Kingdom, France, Italy, and Austria have different levels of relationship with Russia in securing particularly their gas supplies.

1.1.2. Liberal Intergovernmentalism

Liberal intergovernmentalism is the other theory of European integration used to examine the attitudes of the aforementioned five member states of the EU towards establishing a common energy policy within the Union and forming close ties with Russia on energy.

Andrew Moravcsik (Pollack, 2000: 18), the pioneer of liberal intergovernmentalism, proposes:

> A three-step model, which combines: (1) a liberal theory of national preference formation with; (2) an intergovernmental model of EU-level bargaining; and (3) a model of institutional choice emphasizing the role of international institutions in providing 'credible commitments' for member governments.

Frank Schimmelfennig (Wiener and Diez, 2004: 76) also studies Moravcsik's liberal intergovernmentalism according to "three levels of abstraction." At the highest level of abstraction, Schimmelfennig observes the fundamentals of liberal intergovernmentalism in rationalist institutionalism of International Relations theory, which "seeks to explain the establishment and design of international institutions as a collective outcome of interdependent ('strategic') rational state choices and intergovernmental negotiations in an anarchical context" (Wiener and Diez, 2004: 76-77). At a medium level of abstraction, Schimmelfennig outlines above model of Moravcsik with three theories: "a liberal theory of national preference formation, a bargaining theory of international negotiations, and a functional theory of institutional choice." At the lowest level of abstraction, Schimmelfennig gives an overview of main propositions of Moravcsik's liberal intergovernmentalism in European integration.

Table 2: Overview of Liberal Intergovernmentalism

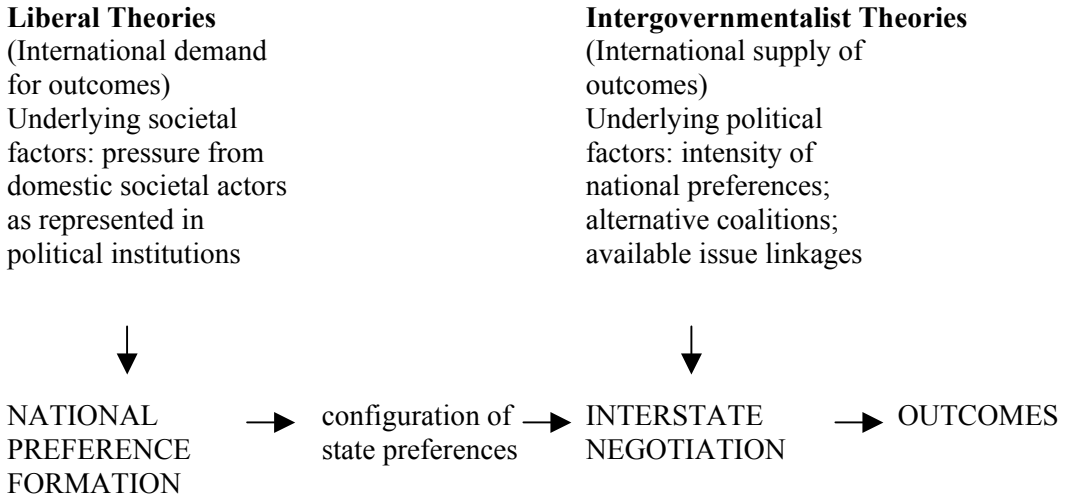
Level of Abstraction	Preferences	Cooperation	Institutions
High	IR rationalist institutionalism: state actors in international anarchy, rational choice of international institutions		
Medium	Liberal theory of state preferences	Bargaining theory	Functional theory of institutional choice
Low	Domestic economic interests	Intergovernmental asymmetrical interdependence	Credible commitments

Source: Wiener and Diez, 2004: 76

The first step of Andrew Moravcsik's liberal intergovernmentalism, liberal theory of state preferences, touches upon domestically determined and diverse national interests of EU member states. According to this theory, national interests of member states are defined by state-society relations, in other terms, domestic societal actors determine these interests (Moravcsik, 1993: 481). So, through domestic political bargaining between national governments and domestic societal actors, national preferences are formed.

At the lowest level of abstraction, with regard to European integration, aforementioned national preferences are driven by "issue-specific economic interests" (Wiener and Diez, 2004: 78-79). Moravcsik (1998b: 3) argues that these preferences reflect "primarily the commercial interests of powerful economic producers" and "secondarily the macro-economic preferences of ruling governmental coalitions".

Table 3: The Liberal Intergovernmentalist Framework of Analysis



Source: Moravcsik, 1993: 482

The second stage, bargaining theory of international negotiations as Schimmelfennig terms, follows the liberal stage of national preference formation. Once the national interests of member states are defined, states try to realize these interests through intergovernmental bargaining without the interference of a higher institution like the European Commission (Pollack, 2000: 18). Moravcsik (1993: 481) makes an interesting analogy between these two stages and demand-supply functions:

> A domestic preference formation process identifies the potential benefits of policy co-ordination perceived by national governments (demand), while a process of interstate strategic interaction defines the possible political responses of the EC political system to pressures from those governments (supply). The interaction of demand and supply, of preference and strategic opportunities, shapes the foreign policy behaviour of states.

Schimmelfennig (Wiener and Diez, 2004: 77), at this stage of Moravcsik's three-step model of liberal intergovernmentalism, refers to rationalist institutionalism, which differentiates "first- and second-order problems of international collective choice in problematic situations of international interdependence." When states individually choose to opt out from cooperation, this will in the end not make them better off. Schimmelfennig (Wiener and Diez, 2004: 77) describes these problems as such:

> The first-order problem consists in overcoming such collectively suboptimal outcomes and achieving coordination or cooperation for mutual benefit. The second-order problems arise once the suboptimal outcomes are overcome. First, how are the mutual gains of cooperation distributed among the states? Second, how are states prevented from defecting from an agreement in order to exploit the cooperation of others?

So, Moravcsik's intergovernmental model of EU-level bargaining or bargaining theory argues the aforementioned outcomes are determined by "the relative bargaining power of the actors," which is influenced by to what extent these actors access 'information' and by the 'benefits of cooperation' compared to "outside options" (Wiener and Diez, 2004: 77). Schimmelfennig (Wiener and Diez, 2004: 77) argues, the more information the actors have, more bargaining power they acquire in interstate negotiations, which in turn result in a favourable outcome for these actors. In addition, if the actors have outside options, then they will have more power to influence the outcome of bargaining process.

Moravcsik's intergovernmental model of EU-level bargaining focuses on the second-order problem of how the mutual gains of cooperation are distributed among the

states or in other words, "*distribution* of gains from substantive cooperation" (Wiener and Diez, 2004: 79). In this context, he distinguishes the relatively more bargaining power of member states compared to supranational institutions, here the EU, since these institutions lack necessary 'information' to bargain successfully (Wiener and Diez, 2004: 79).

Third and final stage of Moravcsik's three-step model of liberal intergovernmentalism, functional theory of institutional choice, argues states, in order to avoid first- and second-order problems discussed by Schimmelfennig, agree to establish international institutions (Wiener and Diez, 2004: 78). Regarding the first-order problems of achieving coordination or cooperation for mutual benefit, Schimmelfennig (Wiener and Diez, 2004: 78) argues,

> international institutions may help states reach a collectively superior outcome, above all by reducing the transaction costs of further international negotiations on specific issues and by providing the necessary information to reduce the states' uncertainty about each other's preferences and behaviour.

The second-order problems, of how the mutual gains of cooperation are distributed among the states, and how states are prevented from defecting from an agreement in order to exploit the cooperation of others, may be overcome by introduction of certain rules and sanctions in order to ensure states "commit themselves credibly to their mutual promises" (Pollack, 2000: 18; Wiener and Diez, 2004: 78).

Recalling the lowest level of abstraction, EU member states rely on the Union in order to overcome the second-order problem of how states are prevented from defecting

from an agreement in order to exploit the cooperation of others. Moravcsik also argues that member states are more prone to transfer sovereignty to EU if the gains from cooperation and the risks of non-compliance are high (Moravcsik, 1998b: 9, 486-487).

So, following chapters seek to address the main focus of this thesis of how Germany, the United Kingdom, France, Italy, and Austria pursue their bilateral relations with the Russian Federation in terms of supplying their energy need, and whether these countries' bilateral relations with Russia in energy affect the EU of forming a common energy policy in the context of intergovernmentalist premises and Moravcsik's three-step model of liberal intergovernmentalism.

CHAPTER 2

THE ROLE OF ENERGY IN EU-RUSSIA RELATIONS

This chapter seeks to explore the crucial role of energy in Russian foreign policy and the challenges in creating a common energy policy among the EU member states. Then, it addresses the dialogue between the EU and Russia on energy, and how certain developments affected this dialogue in addition to a brief description of the current, under-construction and planned pipelines from Russia to the EU countries.

2.1. The Importance of Energy in Russian Foreign Policy

The end of the Cold War brought the collapse of the bipolar international system, where the United States and Russia were the super powers, and left the international environment dominated by economic interests (TÜRKSAM Website, last accessed on 24 August 2008):

> With the end of the Cold War, the era of bipolar ideological struggle has been superseded by an international relations environment basically dominated by competition of economic interests, where relations are

> determined by economic factors and the one in which economic considerations attain priority on the agenda of foreign policies of states.

Relations based on ideological and security rivalry during the Cold War were replaced by economic relations after the war, especially under the former President of Russia, Vladimir Putin. Therefore, Russia, possessing the most crucial energy resources in its territory, started to put emphasis on energy in its foreign policy agenda (Jaffe and Manning, 2001; Balzer, 2005; Olcott, 2004).

There are both internal and external reasons why Russian foreign policy shifted from its military security orientation to energy based foreign policy. As an internal reason, the collapse of the Union of Soviet Socialist Republics (USSR) in 1991, Russia was facing difficulties in transforming its centrally-planned economy into a liberal economy. During this process, the energy sector was the major contributor to Russian economy since it provides 45% of the export revenues of Russia and constitutes 39% of its government budget (TÜRKSAM Website, last accessed on 24 August 2008).

In fact, an article written by the former President of Russia, Vladimir Putin himself in 1999 suggests that natural resources were perceived as crucial in the recovery of Russian economy (Balzer, 2005: 219). Putin emphasised his argument as follows:

> The existing socio-economic conditions and also the strategy for Russia's exit from the deep crisis and restoration of its former power on a qualitatively new basis demonstrate that the condition of the natural resource complex remains the most important factor in the state's development in the near term (Balzer, 2005: 219).

Aware of the importance of energy sector, influential companies in this sector, such as Gazprom, Lukoil and Transneft, try to have a voice in the government decision-making process, especially in Russian foreign policy, because they have certain energy projects abroad. In addition, since state is the major partner of these companies and managerial staff of these companies has strong ties with government bureaucracy, these companies have leverage in government decision-making process.

Thus, Putin, when he came to power, declared that he would challenge the oligarchs within the state; he could control the oligarchs of energy sector who might create a problem for him in internal political system. In this way, these oligarchs would not have a strong voice in the internal political system, but they would be given opportunities to be effective in foreign policy (TÜRKSAM Website, last accessed on 24 August 2008). Therefore, Putin took the necessary steps to control the oligarchs in the energy sector.

The arrest of Yukos CEO Mikhail Khodorkovsky, one of the oil oligarchs in Russia, on 25 October 2003, is a crucial event to understand Putin's desire to control the oligarchs of energy sector. So, Putin consolidated domestic power so as to boost state revenues from energy exports as well as to increase Russia's role in international politics. Olcott (2004: 13) indicates, "from Putin's point of view, there seem to have been two separate issues: 1) Khodorkovsky's political ambitions, and 2) the evolving international posture of Yukos." Yukos executives arranged the sale of 25-40% of the company's assets to two western firms, namely ChevronTexaco and ExxonMobil. This arrangement would have lessened state control over the energy sector.

Therefore, Putin's emphasis on 'state control' over the energy sector in the country has had a crucial role in the shift to an energy-based foreign policy. Putin

indicated that state should be responsible for the development and use of its natural resources (Balzer, 2005: 218). Putin elaborated on his idea of the necessity of state control:

> Unfortunately, when market reforms began the state lost control of the resource sector. However, now the market euphoria of the first years of economic reform is gradually giving way to a more measured approach, allowing the possibility and recognizing the need for regulatory activity by the state in economic processes in general and in natural resource use in particular…. A contemporary strategy for rational use of resources cannot be based exclusively on the possibilities of the market. This applies even more to conditions of economic development in a transition, and, thus, to the Russian economy (Balzer, 2005: 218).

Putin, then describes the steps to be taken in order to develop and use its natural resources (Olcott, 2004: 21):

- completing the changeover to a rational combination of administrative and economic (i.e. market driven) means in the state regulation of natural resources,
- creating an efficient system of state organs of management in the area of natural resources, that includes the clear delineation of their functions and base of coordination,
- developing a legal basis for stimulating innovation and investment in the area of natural resource use,

- optimising the volumes and increasing the diversification of sources of investment in the production, consumption and protection of natural resources,
- developing state regulation of export-import operations in the sphere of natural resources,
- ensuring the delineation of rights and functions of both the federal organs and of the subjects of the Russian Federation in the area of natural resources,
- implementing state support for scientific research (in these areas),
- creating the conditions for the balanced use of natural resources as the basic factor in the country's stable development,
- accounting for regional features in the use of natural resources to improve the functioning of the Russian economy as a whole.

The external reasons why Russian foreign policy shifted from military security to its energy basis are first of all, after the collapse of the East Bloc, the bipolar system and ideological rivalry ended. Now, the new world order has been based on economic interests and these interests are subjects of struggle between states today. So, taking into consideration economic rivalry, both national security and foreign policy doctrines of Russia gave importance to 'geoeconomy' instead of 'geostrategy'. Secondly, the West is against re-expansion of Russian military influence in the former Soviet territories. Lastly, energy could be used by Russia as a tool to influence the former Soviet territories again (TÜRKSAM Website, last accessed on 24 August 2008).

2.2. The Energy Policy of the European Union

The European Union, having scarce natural resources in its territory, consumes more energy than it produces. Only 0.6% of world oil and 2% of world natural gas reserves are located in the EU (EIA, 2006). Therefore, the EU relies upon energy imports. According to the BP Statistical Review of 2006, the EU imported 41% of natural gas from Russia, 25% from Norway and 15% from Algeria in 2005.

Taking into consideration this scarcity of domestic natural resources, production-consumption imbalance and EU dependency on energy imports, a common energy policy among the EU member states has turned out to be an important step to overcome the aforementioned problems.

A common energy policy is one of the most crucial aspects of the process of deepening of the EU that the member states have so far been reluctant to reach a consensus on. However, on 29 November 2000, the first step was taken by the European Commission in adopting a Green Paper: Towards a European Strategy for the Security of Energy Supply. Also, on 8 March 2006, another Green Paper: A European Strategy for Sustainable, Competitive and Secure Energy was adopted by the Commission. The following two sections give an outlook of the changing emphasis of the two Green Papers.

2.2.1. Green Paper of 2000: Towards a European Strategy for the Security of Energy Supply

The first Green Paper, adopted in 2000, underlined the importance of growing consumption of energy by the member states and the consequent increase in the volume of imports. The paper indicates, "If no measures are taken, in the next 20 to 30 years 70% of the Union's energy requirements, as opposed to the current 50%, will be covered by import products" (The Green Paper, 2000: 2).

The dependency on energy imports, especially on natural gas imports from Russia, Norway and Algeria, has led the European Commission to underline the importance of this issue in its Green Paper (2000: 41):

> In the long run, the supply of gas in Europe risks creating a new situation of dependence, all the more so given the less intensive consumption of carbon. Greater consumption of gas could be followed by an upward trend in prices and undermine the European Union's security of supply.

So, the Green Paper of 2000 has outlined a strategy to manage demand by reducing energy consumption and encouraging energy savings, to diversify EU energy sources by using nuclear energy, coal, biofuels and renewables, to create a competitive internal energy market by liberalising EU electricity and gas markets, and to control supply side by diversifying the origin of energy supplies.

2.2.2. Green Paper of 2006: A European Strategy for Sustainable, Competitive and Secure Energy

The second Green Paper of 2006 focuses on three major objectives of a European energy policy: how to create an internal energy market, and, once this is created, how competitiveness can be ensured; sustainability; and security of supply.

Sustainability refers to "(i) developing competitive renewable sources of energy and other low carbon energy sources and carriers, particularly alternative transport fuels, (ii) curbing energy demand within Europe, and (iii) leading global efforts to halt climate change and improve local air quality" (The Green Paper, 2006: 17).

Security of supply indicates "tackling the EU's rising dependence on imported energy through (i) an integrated approach – reducing demand, diversifying the EU's energy mix with greater use of competitive indigenous and renewable energy, and diversifying sources and routes of supply of imported energy, (ii) creating the framework which will stimulate adequate investments to meet growing energy demand, (iii) better equipping the EU to cope with emergencies, (iv) improving the conditions for European companies seeking access to global resources, and (v) making sure that all citizens and business have access to energy" (The Green Paper, 2006: 18).

Competitiveness addresses "(i) ensuring that energy market opening brings benefits to consumers and to the economy as a whole, while stimulating investment in clean energy production and energy efficiency, (ii) mitigating the impact of higher international energy prices on the EU economy and its citizens and (iii) keeping Europe at the cutting edge of energy technologies" (The Green Paper, 2006: 17-18). Regarding

these aims, the Commission (2007: 7), in its Communication to the European Council and the European Parliament, proposed two options for unbundling EU gas and electricity markets to liberalise these markets which in turn would create a competitive internal energy market:

> A full Independent System Operator (where the vertically integrated company remains owner of the network assets and receives a regulated return on them, but is not responsible for their operation, maintenance or development) or *ownership unbundling* (where network companies are wholly separate from the supply and generation companies) (emphasise added).

Following the three major objectives, sustainability, security of supply and competitiveness of The Green Paper of 2006, the Directorate General for Competition of the European Commission issued a report on energy sector of EU titled as "DG Competition Report on Energy Sector Inquiry" on 10 January 2007.

The Energy Sector Inquiry has focused on certain key areas where immediate action is necessary in order to ensure secure energy supplies at competitive prices by opening up Europe's gas and electricity markets to competition and by creating a single European energy market (Commission of the European Communities, 2007a: 2-3):

> (1) market concentration/market power, (2) vertical foreclosure (most prominently inadequate unbundling of network and supply), (3) lack of market integration (including lack of regulatory oversight for cross border issues), (4) lack of transparency, (5) price formation, (6) downstream markets, (7) balancing markets, and (8) liquefied natural gas (LNG).

The inquiry then calls for initiatives to be taken to address the shortcomings of aforementioned areas. "Achieving effective unbundling of network and supply activities, removing the regulatory gaps (in particular for cross border issues), addressing market concentration and barriers to entry, and increasing transparency in market operations" are the four main areas of concern (Commission of the European Communities, 2007a: 3).

According to the findings of the inquiry, both EU gas and electricity markets are highly concentrated and there is limited level of new entries in these markets. The vertically integrated incumbent companies still dominate both markets where they "control up-stream gas imports and/or domestic gas production," "trade only a small proportion of their gas on gas exchanges ('hubs')," "exercise market power by raising prices," or conclude long-term contracts with suppliers (Commission of the European Communities, 2007a: 5).

Inadequate unbundling of network and supply adds up to high level of market concentration constituting obstacles to new entries in EU gas and electricity markets and threatening security of supply (Commission of the European Communities, 2007a: 6). Vertical foreclosure leads to limited access of new entrants to gas networks, to storage and to LNG terminals and to "operational and investment decisions to be taken on the basis of the supply interests of the integrated company rather than in the interest of network/infrastructure operations" (Commission of the European Communities, 2007a: 6). Another form of vertical integration occurs when the same company benefits from both generation/imports and supply interests which in turn "reduces the incentives for incumbents to trade on wholesale markets and leads to sub-optimal levels of liquidity in these markets" (Commission of the European Communities, 2007a: 6).

Obviously, there have been differing opinions over the Commission's proposal of unbundling. The proposal was welcomed by Belgium, Denmark, Finland, the Netherlands, Spain, Sweden, Romania and the United Kingdom whereas France, Germany, Austria, Bulgaria, Greece, Cyprus, Latvia, Luxembourg, and Slovakia opposed the proposal. The opposition was led by France and Germany whose gas and electricity markets are highly concentrated, and dominated by vertically integrated incumbent companies such as GdF and EdF in France, E.ON and RWE in Germany.

On the other hand, new entrants and customers supported the proposal of unbundling since it would help cease the control of incumbent companies over up-stream gas imports and/or domestic gas production and decrease their market power by separating the transmission and distribution functions of these companies from the functions of generation/production and/or supply. New entrants and customers have become more concerned when incumbent companies took decisions in favour of their own supply businesses and concluded long-term contracts with their retail subsidiaries (European Commission, 2007: 210-211).

As France and Germany, backed by seven other member states, opposed both options for unbundling, 'ownership unbundling'[1] and 'Independent System Operator (ISO),'[2] they introduced a 'third way' option "whereby companies retain full network ownership and control, while operations are managed by an Independent Transmission Operator (ITO) that would ensure fair network access and push for investments to upgrade and expand grids" (Euractiv Website, last accessed on 11 July 2008).

[1] Ownership unbundling is the process of separating the transmission and distribution functions of a utility from the functions of generation/production and/or supply.
[2] ISO allows the EU member states to maintain ownership of their transmission functions, but leaves the management of these functions to an independent body.

The European Parliament voted in favour of this third way for EU gas sector liberalisation rejecting the ISO option and proposed creating an "independent trustee" (Euractiv Website, last accessed on 11 July 2008).[3] This supervisory body would oversee the internal decisions of the vertically integrated gas companies. On the other hand, deal on EU electricity sector liberalisation has not yet been reached. In June, the Parliament voted against both the ISO and ITO options and backed UK Socialist MEP Eluned Morgan's draft report favouring ownership unbundling as the only option for EU electricity sector liberalisation (Euractiv Website, last accessed on 30 June 2008).[4]

So, diverse and plural interests of EU member states on liberalising EU gas and electricity markets have an effect on creating a competitive internal energy market and a common EU energy policy. The national preferences of member states mainly driven by the commercial interests of powerful economic producers, like EdF or GdF in France and E.ON or RWE in Germany, affected the outcome on the liberalisation of EU gas and electricity sectors.

How these national preferences are formed will be dealt in detail in Chapter 3 by examining five key EU member states namely Germany, the United Kingdom, France, Italy, and Austria. The dependency of these countries on energy, their energy companies' dominance in internal energy markets, and relations of these companies with the Russian energy company Gazprom will be covered as the major factors leading to national preference formation.

The outcome, driven by these preferences and reached through intergovernmental bargaining between EU member states, is the rejection of both

[3] 579 members of the European Parliament (MEPs) voted in favour with 80 against and 52 abstentions.
[4] 449 MEPs were in favour and 204 were against.

options for unbundling for the liberalisation of EU gas sector while leaving the liberalisation of electricity markets in ambiguity. This outcome demonstrates how EU member states' concern about the distribution of gains from substantive cooperation on the Commission's proposal of unbundling affect their decisions and stance. So, as Moravcsik (1998b: 3) also argues,

> The outcomes reflected the relative power of states – more precisely patterns of asymmetrical interdependence. Those who gained the most economically from integration compromised the most on the margin to realize it, whereas those who gained the least or for whom the costs of adaptation were highest imposed conditions.

Obviously, EU member states such as Belgium, Denmark, Finland, the Netherlands, Spain, Sweden, Romania and the United Kingdom, who would gain the most liberalising their both electricity and gas sectors gave their approval for the Commission's proposal on unbundling. On the other hand, France, Germany, Austria, Bulgaria, Greece, Cyprus, Latvia, Luxembourg, and Slovakia stayed as opponents.

Since the energy markets of both Germany and France are highly concentrated and dominated by a limited number of energy companies, these EU members would gain the least liberalising their both electricity and gas sectors. Therefore, they came up with a solution of 'third way' instead of accepting the Commission's proposal on unbundling. They 'imposed' their own conditions.

2.3. The European Union-Russia Dialogue on Energy

When the USSR collapsed in 1991, the EU, then known as the European Community (EC), wanted to initiate energy dialogues with Russia and the former Soviet Republics. Therefore, the European Energy Charter was signed in 1991 as the first step of an energy dialogue between the East and West. Following the charter, in December 1994 the Energy Charter Treaty was signed and came into force in April 1998. The objectives of this treaty included protection of foreign investment, carrying out the energy trade in accordance with the regulations of the World Trade Organization (WTO), resolution of disputes between participating countries, liberalization of energy markets, increase in the efficiency of energy resources, and free transfer of these resources.

However, although Russia agreed to sign the Energy Charter Treaty in 1994, it has not yet ratified it. This creates anxieties in the EU. Furthermore, a series of events and ongoing dialogue between the EU and Russia lowered the trust of the EU towards Russia and raised concerns over Russia as a reliable partner in energy sector.

In 1994, the Partnership and Cooperation Agreement (PCA) between Russia and the EU was signed in order to "set up institutional structures for the establishment of cooperation on all subjects of common interest" (Commission of the European Communities, 2004: 2). However, this agreement was not sufficient to find solutions for the problems related to the energy issue between the EU and Russia. The economic interdependence between the EU and Russia strengthened in the light of "the development of the internal energy market in Europe, Russia's bid to join the WTO (World Trade Organization), enlargement of the EU by ten Member States, of which

eight from Central and Eastern Europe" (Commission of the European Communities, 2004: 2). So, the inability of the PCA to resolve the energy issues between the EU and Russia and the growing economic interdependence between the EU and Russia created a need for further cooperation between the EU and Russia, particularly to establish an institutionalised relation in terms of agreements and norms to regulate the increasing relations in the energy sector. Thus, the EU and the Russian Federation initiated an "energy dialogue" in October 2000 when the EU-Russia Summit convened in Paris.

In this summit, the issues discussed were the security of energy supply to the EU, security of infrastructure, protection of foreign investment, implementation of objectives of the Kyoto Protocol, and ratification of the Energy Charter Treaty by Russia. The former Presidents of Russia, France and the European Commission, Vladimir Putin, Jacques Chirac and Romano Prodi, respectively, were present in launching the energy dialogue.

The energy dialogue between the EU and Russia aimed to improve the investment climate in the energy sector, activate the energy trade, and touch upon the issues of energy transportation and the environmental impacts of the energy sector. Two interlocutors were nominated by Putin and Prodi in order to enhance the energy dialogue between the EU and Russia.[5] These interlocutors prepare joint progress reports in order to inform the EU and Russia about the state of development on issues discussed in the EU-Russia Summits. So, these joint progress reports are in a sense guides for the resolution of the problems between the EU and Russia on certain issues and for future work.

[5] These two persons were Victor Khristenko, the Russian Minister of Industry and Energy, and François Lamoureux, the Director-General of the Directorate-General for Energy and Transport, representing the EU.

Within the framework of the sixth progress report in 2005, the progress achieved so far and the work to be done in the future on areas of increased security for suppliers and consumers, enhancing the investment climate, the energy dialogue and sustainable development, transportation of oil and oil products, the EU-Russia Joint Energy Technology Centre, and enhancing co-operation in the field of nuclear energy, were discussed (Sixth Progress Report, 2005: 4). The report indicates that the energy dialogue between the EU and Russia ensured the security of energy supplies and the mutually beneficial cooperation in the energy sector. However, it should be noted that this progress report was prepared before the energy crisis between Ukraine and Russia in January 2006.

The report also mentions the importance of long-term gas contracts between the EU and Russia, which eliminated the clause indicating that the EU should set a limit of 30 percent on its energy imports from an external supplier. Similarly, the sixth progress report of 2005 states that the EU should eliminate the restrictions on hydrocarbon imports into the EU in order to ensure increased security for energy suppliers and consumers.

Furthermore, the report indicates that the EU should address any barriers that prevent Russian firms from investing in the EU energy sector in order to enhance the investment climate within the EU. According to the report, both the EU and Russia recognized "the key energy sectors for investment include enhancing the production at existing sites, upgrading the oil refineries, building new and upgrading old power plants and developing and upgrading the energy transportation infrastructure" (Sixth Progress Report, 2005: 4).

Since the Kyoto Protocol entered into force in February 2005, climate-friendly investments should be observed. So, both sides agreed to cooperate for energy efficient investments. These investments include "projects on 'Energy Efficiency at a Regional Level (Archangelsk, Astrakhan and Kaliningrad)' and on 'Renewable Energy Policy and Rehabilitation of Small Scale Hydro Power Plants," (Sixth Progress Report, 2005: 5).

The transportation of oil and oil products is another subject of concern within the framework of the sixth progress report. Both sides recognised the significance of the safety and reliability of oil transport in the sense that the transportation of oil and oil products may have negative impacts on the environment. For instance, if these products are transported by sea routes and if there is leakage of oil, then, marine pollution will be inevitable.

As the sixth progress report indicates, both the EU and Russia agree to enhance safety, market opening, fair competition, environmental protection, and the security and reliability of the energy transportation networks. The two sides claimed to welcome the developments in both natural gas transport infrastructure and oil transport through pipelines by emphasising the Yamal-Europe gas pipeline, the North European gas pipeline project, the Druzhba and Adria oil pipelines, and the Burgas-Alexandroupolis oil pipeline project (Sixth Progress Report, 2005: 6).

The last subject dealt within the framework of the sixth progress report is the cooperation in the field of nuclear energy. Under this heading the EU and Russia desire to secure stable, predictable and transparent conditions for the trade in nuclear materials.

Within this framework, the main objectives of the EU-Russia energy dialogue are listed as follows: "to strengthen competition in the internal energy market, to defend sustainable development and guarantee external supply security"(Commission of the

European Communities, 2004: 6). The following paragraphs assess the extent to which these objectives are accomplished.

i. Internal energy market

In the internal energy market, the EU aims to introduce necessary directives to create clear, predictable and transparent rules for companies to enhance competition. The companies that have the ability to compete in the internal energy market, such as BP, Shell, TOTAL or ENI, then might be able to invest in Russia. The existence of such rules also encourages the Russian firms to invest in the EU.

The major expected positive impacts of the single market of the EU are that no import taxes are put on goods brought in from other member states for personal use; as a result of increased competition, wider consumer choice and lower prices are provided; and trade barriers are dismantled.

However, a single energy market has not yet been achieved. For example, some of the internal market rules should be examined in order to eliminate the territorial restriction clauses, which are contrary to free movement and competition. Then, these rules will ensure the security of energy supplies by improving the investment plans and infrastructure projects related to the energy sector in the EU.

ii. Sustainable development and external supply security

The energy dialogue between the EU and Russia is crucial for the sustainable development as well. The insistence of the European Commission on the ratification of the Kyoto Protocol by Russia was fruitful. On 22 October 2004, Russia ratified the Kyoto Protocol. By the Kyoto Protocol, Russia will use its energy resources more efficiently and effectively. Russia will perform reforms regarding "the structure and management of natural monopolies, pricing structures and the taxation of natural resources" (Commission of the European Communities, 2004: 7). These reforms will enhance the economic sectors of Russia as well as the energy sector. Therefore, there will be more energy exports to the EU from Russia, which in turn will increase the energy transportation between the EU and Russia.

The growing interdependence between the EU and Russia in the energy sector shaped the EU-Russia energy dialogue as a policy tool to ensure stable and predictable energy supply. In order to achieve stable and predictable supply, predictable trade rules have to be established, networks improved, investments encouraged by promoting a more stable and transparent legal framework, and key reforms undertaken in the Russian energy sector. The trade in energy products, such as hydrocarbons or nuclear materials, should be secured by the establishment of transparent, stable and predictable energy trade rules between the EU and Russia. For instance, "Russia made WTO commitments related to the price of gas to industrial users and export duties on energy products" (Commission of the European Communities, 2004: 9-10).

Another way to accomplish stable and predictable supply is to develop the Trans-European energy networks. Energy transport, especially the transport of hydrocarbons

coming from Russia, is carried out by land transport or maritime transport systems. Because the maritime transport system sometimes gives rise to negative consequences, such as maritime accidents leading to oil spill or density of traffic along the coasts, land transport gained importance. So, the Trans-European energy networks programme was launched in order to execute a number of electricity, gas and oil infrastructure projects. Also, energy transport by railroads might take the place of maritime transport reducing the risk of environmental pollution.

iii. Exchange of technology

The EU-Russia energy dialogue is crucial for the exchange of technology, which in turn increases energy efficiency of the Russia's energy sector. So, for this purpose, to increase energy efficiency, joint pilot projects were implemented in Archangelsk, Astrakhan and Kaliningrad.

> For Kaliningrad, estimations of energy savings as a result of an energy efficiency programme are in the order of 35-40%. This potential is significant considering that 90% of the enclave's primary energy comes from Russia (gas pipeline) and 95% of its electricity comes from the Russian network IPS/UPOS (Integrated Power System/United Power System) (Commission of the European Communities, 2004: 8).

These projects are important in the sense that the Baltic States became members of the EU and these members will increase the demand of energy and electricity supplies.

iv. Lessening pollution in energy transport

The energy dialogue between the EU and Russia also aims for a less-polluting energy transport system. It aims to enhance the security and increase the effectiveness of Russian export networks. In this context, marine pollution is quite important for countries bordering the Baltic Sea and the North Sea. Maritime accidents, some resulting in the leaking of oil, and the density of maritime traffic along the coasts, led to the cooperation of the EU and Russia on the issue of a less-polluting energy transport system. The standards of the International Maritime Organisation (IMO) are necessary to achieve this goal. In addition to maritime transport, land transport, such as rail transport or oil pipelines, is under concern in order to reduce the environmental pollution.

v. Common electricity market

The EU-Russia energy dialogue brought the Russian and the EU energy markets together. Even if the two markets are separate, they share the same principles of "energy

efficiency, reform of internal industrial structures, reform in the electricity sector and unbundling" (Commission of the European Communities, 2004: 11). An interconnected electricity network and a common electricity market are required in light of European electricity needs. "According to IEA (International Energy Agency) and Eurelectric forecasts, between now and 2030, the EU could need to invest in new electricity capacities of almost 600GW in order to cover consumer needs." (Commission of the European Communities, 2004: 11) A common electricity market requires a sufficient electricity framework in Russia, the adoption of "environmental and safety standards for electricity production, such as clean coal combustion rules and the guarantee of nuclear safety", and "the putting in place of necessary infrastructure for the joint use and synchronisation of the electricity systems of Russia and of Member States" (Commission of the European Communities, 2004: 12).

vi. Joint use of satellite navigation systems

The EU and Russia have decided on the joint use of their satellite navigation systems, the GALILEO and the GLONASS (Global Navigation Satellite System), respectively. The EU aims to use its GALILEO system for civilian and commercial applications. Also, Russia plans to open up its GLONASS system for civilian purposes. These satellite navigation systems are crucial for the energy sectors of both the EU and Russia in the sense that they might be used for exploration, construction, transport and site monitoring. The joint use of the GLONASS and the GALILEO will "reinforce the

safety of energy transport infrastructures and energy production" (Commission of the European Communities, 2004: 12).

Both the EU and Russia recognise the importance of working together towards a strategic EU-Russia energy partnership, given the importance of ensuring adequate energy supplies and appropriate energy prices for economic development across the whole of the European continent, as well as the long-term nature of investments in energy production and transport.

2.3.1. The Mechanisms for the Continuing Energy Dialogue

Before the major events that triggered increasing concerns over energy security of the EU and its dependency on Russia, particularly in gas, mechanisms have put in place for the continuing energy dialogue between the EU and Russia. The energy dialogue between the EU and Russia is carried out by (i) interlocutors of both the EU and Russia, (ii) organisation of round tables and (iii) support structures, such as the EU-Russia Permanent Partnership Council, the Cooperation Committee and subcommittees dealing with energy issues.

2.3.1.1. The role of interlocutors

In order to carry out the energy dialogue between the EU and Russia, regular meetings between the interlocutors take place. The two sides regularly meet in order to discuss and share opinions about various subjects related to the energy issue, such as natural gas and uranium trade or electricity exchanges (Commission of the European Communities, 2004: 4).

2.3.1.2. Organisation of round tables

In addition to interlocutors' meetings, round tables are organised on various topics of natural gas, electricity and so on.

For a successful dialogue to be achieved between the EU and Russia, the full participation of industrial representatives is needed in the sense that these representatives examine common areas of interest and define priority sectors for cooperation such as strategies, technology transfer, investments, environmental questions related to the energy issue, and energy efficiency (Commission of the European Communities, 2004: 3). The work of these representatives can be grouped under four themes, related to investments, infrastructures, energy efficiency and trade flows.

Besides these thematic working groups, the EU-Russia Industrialists' Round Table is necessary for the active participation of industrial representatives in the energy dialogue between the EU and Russia. The EU-Russia Industrialists' Round Table of

December 2003 created the “pilot group on energy” which enabled the participation of the companies of both the EU and Russia in the energy dialogue.

2.3.1.3. Support structures

There are two basic support structures of the energy dialogue between the EU and Russia. One of these structures is the EU-Russia Joint Energy Technology Centre. This Centre was established in Moscow on 5 November 2002. The Centre aims to advance energy technologies in the sectors of natural gas, electricity, oil, coal, new and renewable energy sources and energy savings; and to promote investments in the energy sector.

The other support structure is the market observatory. This observatory system is crucial in the sense that it can monitor whether there are any potential threats against the internal and external supplies to the EU or not. It accelerates the construction of infrastructures related to the energy sector. It provides data for the member states of the EU to implement or carry out their energy policies of new investments in the energy sector.

2.3.2. Developments Influencing the EU-Russia Energy Dialogue

The aim of the energy dialogue between the European Union and Russia is to enhance the energy security of the European continent by improving the relations of Russia and the EU on issues of mutual concern in the energy sector and to ensure the policies of opening and integrating energy markets are pursued. Regarding the strong mutual dependency and common interest in the energy sector, this is clearly a significant area of EU-Russia relations. Russia is already the largest single energy partner of the EU and is bound to become even more integrated into Europe's energy market.

In this respect, Russia already plays a role in the EU internal energy market by supplying EU's energy demand and by taking part in the energy markets of EU member states (See Table 4). So, EU expects Russia to fulfil the requirements of "reciprocity in market principles, mechanisms and opportunities, as well as equivalent environmental standards" (European Commission Website, last accessed on 29 August 2008).

Accordingly, Russia and the EU are natural partners in the energy sector and EU continues to be the dominant market for Russian energy exports (See Table 1 in Chapter 1). For example,

> Some 63% (130 billion cubic meters (Bcm)) of Russia's total natural gas exports of 205 Bcm were delivered to European countries in the year 2000, with contractual requirements to increase deliveries to around 200 Bcm by the year 2008. Approximately 56% (73 Bcm) of the natural gas exported to Europe in 2000 was delivered to the EU (European Commission Website, last accessed on 29 August 2008).

Table 4: Main Foreign Entities with Gazprom Group Participation (As of 31 December 2007)

Country of Registration	Entity	Interest, %	Other Shareholders / Participants
Europe			
Austria	Gazprom Neft Trading GmbH	100	-
	ZGG-Zarubezhgazneftekhim Trading GmbH	100	-
	ZMB Gasspeicher Holding GmbH	67,67	Centrex
	Gas und Warenhandelsgesellschaft m.b.H. (GWH m.b.H.)	50	Centrex Gas & Energy Europe AG
	Centrex Beteiligungs GmbH	38	Centrex Gas & Energy Europe AG
United Kingdom	Gazprom Marketing and Trading Ltd.	100	-
	Gazprom Marketing and Trading Retail Ltd.	100	-
	Wingas Storage UK Ltd.	33,33	Wingas GmbH, Centrex
	Interconnector (UK) Ltd.	10	ConocoPhilips, Distrigas, ENI, E.ON Ruhrgas
Germany	Gazprom Germania GmbH	100	-
	ZMB GmbH	100	-
	ZMB Mobil GmbH	100	-
	Wintershall Erdgas Handelshaus GmbH & Co KG (WIEH)	50	Wintershall Holding AG
	Wintershall Gas GmbH (Wingas GmbH)	49,98	Wintershall Holding AG
	Wintershall AG	49	Wintershall Holding AG
	Etzel Kavernenbetriebs-Verwaltungsgesellschaft mbH	33	BP, DONG
	Etzel Kavernenbetriebsgesellschaft mbH & Co. KG	33	BP, DONG
	VNG AG	5,26	EWE AG, Wintershall Holding AG
Greece	Prometheus Gas S.A.	50	Copelouzos Bros. Corp.
Italy	Gazprom Marketing and Trading Italy, S.r.l.	100	-
	Promgas SpA	50	ENI
Netherlands	Gazprom Netherlands B.V.	100	-
	Gazprom Libya B.V.	100	-
	Blue Stream Pipeline Company B.V.	50	ENI
Finland	Gazum Oy	25	Fortum Corporation, E.ON Ruhrgas, Republic of Finland
France	Gazprom Marketing and Trading France SAS	100	-
Switzerland	ZMB (Schweiz) AG	100	-
	Baltic LNG AG	80	OAO Sovkomflot
	Nord Stream AG	51	E.ON Ruhrgas, Wintershall Holding AG
	Gas Project Development Center Asia AG	50	Centrex Gas & Energy Europe AG
	Wintershall Erdgas Handelshaus Zug AG (WIEE)	50	Wintershall Holding AG
	RosUkrEnergo AG	50	Centragas Holding AG
Bulgaria	Topenergy	100	-

	Overgas Inc. AD DEXIA-Bulgaria OOD	50 26	Overgas Holding AG WIEE AG
Hungary	Panrusgaz Rt.	40	E.ON Foldgas Trading Rt.
Poland	STG EuRoPol GAZ S.A.	48	PGNiG S.A., Gas Trading S.A.
	Gas Trading S.A.	16	PGNiG S.A., Bartimpex S.A., WIEH, Wenglokoks
Romania	WIEE Romania SRL	50	WIEE AG
	Wirom Gas S.A.	26	WIEE AG, Distrigaz Sud S.A.
Serbia	Yugorosgas	50	Serbiagas, Central ME Energy and Gas
Turkey	Turusgaz	45	Botas International Ltd., Gama Industrial Plants Manufacturing and Erection Corp.
	Bosforus Gas Corporation AS	40	Tur Enerji
Czech Republic	Vemex s.r.o.	33	Centrex Gas & Energy Europe AG
CIS and Baltic States			
Armenia	ZAO ArmRosgasprom	53,4	Armenian Ministry of Energy, Itera
Belarus	OAO Beltrangas	12,5	Belarus State Committee for Property
Kazakhstan	TOO KazRosGas	50	NC KazMunayGas
Moldova	AO MoldovaGas	50	Moldova Republic, Transnistria
Uzbekistan	OOO Ustyurt-Zarubezhneftegas	100	-
	UC Zarubezhneftegas-GPD Central Asia	50	Gas Project Development Center Asia AG
Ukraine	Gastransit	37	NJSC Naftogaz of Ukraine, AO Turusgaz
Latvia	Latvijas Gaze AS	34	Itera-Latvia, E.ON Ruhrgas
Lithuania	ZAO Kaunasskaya power plant	99	
	Lietuvos Dujos AB	37	E.ON Ruhrgas, Lithuanian Republic
	ZAO Stella Vitae	30	Individuals
Estonia	Eesti Gaas AS	37	E.ON Ruhrgas, Fortum Corporation, Itera-Latvia
Other Countries / Sites of Registration			
Bermuda	Sakhalin Energy Investment Company Ltd.	50 + one share	Shell Sakhalin Holdings B.V. (Shell), Mitsui Sakhalin Holdings B.V. (Mitsui), Diamond Gas Sakhalin (Mitsubishi)
Venezuela	Urdanetgazprom-1, S.A. Urdanetgazprom-2, S.A.	99 99	
Vietnam	JOC Vietgazprom	50	NK Petrovietnam
USA	Gazprom Marketing and Trading USA, Inc.	100	-

Source: Gazprom Website, last accessed on 28 August 2008.

As the EU and Russia are interdependent in energy sector –the EU is relied upon the imports of energy products coming from Russia and Russia still needs the EU since it is the major market for Russian energy exports–, developments inciting price hikes or speculative fluctuations in energy markets alarmed the EU. Thus, following developments in the EU-Russia energy dialogue, namely, the recent energy crisis between Ukraine and Russia following the Orange Revolution in Ukraine, Turkmenistan increase in the price of natural gas which it sells to Russia, the Sochi Summit of 25 May 2006 and the Samara Summit of 17-18 May 2007, increased the concerns of the EU Commission as well as the member states on energy security.

One reason that fuels the anxiety of the EU member states stems from dependency on Russian gas imports. For instance, Estonia, Latvia, Lithuania, Slovakia and Finland use only Russian gas in their gross inland energy consumption. Also, the share of the Russian gas imports in their total gas imports is 100% (See Table 1 in Chapter 1). Also, the use of Russian natural gas in gross inland energy consumption of Bulgaria (87.7%), the Czech Republic (75.1%), Greece (82.8%), Hungary (59.5%), Austria (68.8%), and Slovenia (59.6%) is all above 50%. (See Table 1 in Chapter 1). In addition, the shares of Russian gas imports in total gas imports of three founding states of EU, namely Germany, France and Italy, are 41.7%, 19.5% and 31.8% respectively (See Table 1 in Chapter 1). The shares of Russian natural gas used in gross inland energy consumption of Germany, France and Italy are 37.9%, 19.8% and 27% respectively (See Table 1 in Chapter 1).

2.3.2.1. Ukraine-Russia Energy Crisis

The energy crisis of January 2006 broke out between Russia and Ukraine because of the unilateral decision of Russia to increase the price of natural gas it exports to Ukraine. So, Russia decided to "turn off the pipelines" which export natural gas from Russia to Ukraine. This event also clarifies how the issue of energy becomes a powerful tool of Russian foreign policy. The energy crisis between Russia and Ukraine not only strained the relations between those two countries, but also those between Russia and the EU. The policy of "turning off the pipelines" against Ukraine meant cold and dark days for the EU, which is dependent on the Russian natural gas exports. After the energy crisis, the EU has taken more seriously the task of establishing a common energy policy, as the EU energy policy process has been described in the previous section.

2.3.2.2. The Critical Role of Turkmen Gas Supply

In June 2006, Turkmenistan declared that it would increase the price of natural gas, which it sells to Russia. This raised the question of whether there would be new energy crisis between Russia and Ukraine because the rising anxiety was due to an increase in the price of Turkmen gas, which in turn might lead to another price hike for Ukraine, given that Turkmen natural gas exported through Gazprom's pipeline network goes to Ukraine. Thus, another potential energy crisis between Russia and Ukraine

alarmed the EU and the EU directed itself to diversify its energy resources and routes to decrease its dependency on Russia.

2.3.2.3. The Sochi Summit

An important milestone of the EU-Russia energy dialogue is the Sochi Summit convened in 25 May 2006 in Sochi. The main subject of the summit was to achieve the ratification of the Energy Charter Treaty by Russia, so that the EU will put an end to Gazprom's monopoly on Central Asian natural gas exports. However, Russia again refused to ratify the treaty. On the contrary, the awaited decision from the summit for Russia was that there would be no interference in Gazprom's activities to take part in European energy markets.

2.3.2.4. The Samara Summit

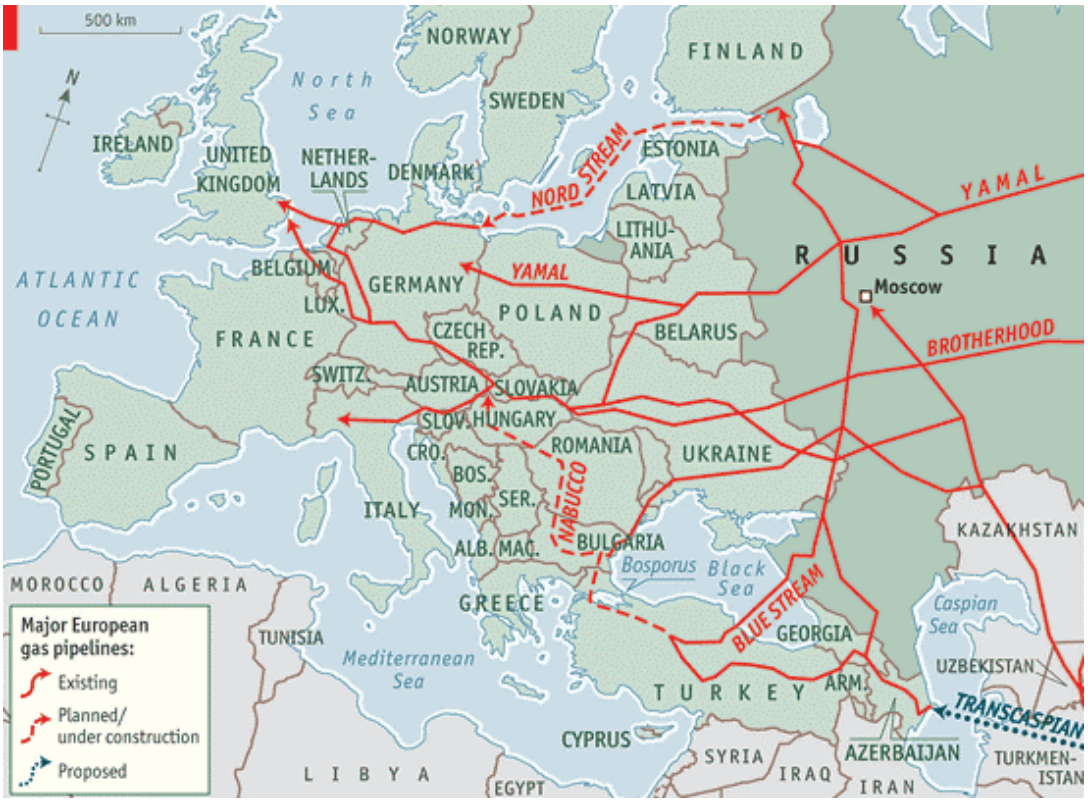
The EU-Russia summit was convened in Volzhsky Utyos, Samara region of Russia on 17-18 May 2007, with the participation of the President of the European Commission José Manuel Barroso, President of the European Council, Chancellor of Germany Angela Merkel, and the former President of Russia Vladimir Putin. The other participants were the Commissioner for External Relations and European

Neighbourhood Policy Benita Ferrero-Waldner, Vice-Chancellor and Foreign Minister of Germany Frank-Walter Steinmeier, and the Russian Government Ministers including current Minister of Foreign Affairs Sergei Lavrov. The importance of this summit relates to the topics covered, preparations for a new EU-Russia agreement to replace the current Partnership and Cooperation Agreement of 1994, state of progress in Russia's WTO accession, energy cooperation and better exchange of information on possible problems in connection with the supplies of gas and oil, implementation of the Kyoto Protocol and the preparations for post-2012 climate change negotiations, and enhanced cooperation in the science and education fields.

To sum up, even if the energy dialogue between the EU-Russia seems as if it is a monologue in which Russia has more energy leverage, the EU is now trying to transform this into a real dialogue by increasing its leverage as well by implementing certain energy projects like the Nabucco Natural Gas Pipeline Project and the Turkey-Greece-Italy Natural Gas Pipeline Project. While the EU is dependent on energy supplies from Russia, Russia also needs the high technology and capital from the EU. So, in order to fulfil the concept of 'dialogue', both the EU and Russia need to undertake their obligations and sometimes compromise from national policies.

2.4. Major Natural Gas Pipelines between Europe and Russia

Figure 2: Map of Major Natural Gas Pipelines between Europe and Russia



2.4.1. Existing Pipelines

2.4.1.1. Yamal-Europe I

The Yamal-Europe pipeline is 4196 kilometres in length of whose 2932 kilometres pass through Russia, approximately 575 kilometres through Belarus and 680 kilometres through Poland. The JAGAL pipeline connecting the gas system in Germany to the Yamal-Europe pipeline is around 1695 kilometres (EuRoPol GAZ Website, last accessed on 12 June 2008).

The Yamal-Europe pipeline carries natural gas supplied from the gas fields in the Nadym Pur Taz District of the Tyumen Region on the Yamal peninsula, Russia to Germany across Belarus and Poland (EuRoPol GAZ Website, last accessed on 12 June 2008).

In 1993, Russia, Belarus and Poland signed the Intergovernmental Agreements to initiate the Yamal-Europe natural gas pipeline project. In 1994, the construction of the German section of the pipeline started by the efforts of WINGAS, a joint venture of Russian company Gazprom and German company Wintershall. In 1997, the first flow of natural gas to Germany via the Belarus-Polish corridor was realised. The Belarussian and Polish sections of the Yamal-Europe pipeline were commissioned in 1999. Eventually, in 2005, when all the compressor stations were built, the flow of natural gas

from the Yamal-Europe pipeline reached its designed capacity of 33 bcm per year (EuRoPol GAZ Website, last accessed on 12 June 2008).

The Russian company Gazprom owns and operates both the Russian and Belarussian sections of the pipeline. The Polish company EuRoPol GAZ S.A. is the owner and operator of the Polish section of the pipeline.[6]

2.4.2. Proposed Pipelines

2.4.2.1. Nord Stream

Nord Stream is planned to carry 55 bcm of natural gas when its construction is finalised in 2011. The construction of Nord Stream will be realised in two phases in which the first pipeline built in the first phase will be followed by a second pipeline each having a transport capacity of 27.5 bcm per year. The latter pipelines is planned to be commissioned in 2012 for the flow of natural gas (Nord Stream Gas Pipeline Project Website, last accessed on 12 June 2008).

[6] EuRoPol GAZ S.A. is a joint venture of the Polish company PGNiG, the Russian company Gazprom and Polish Gas Trading S.A. having shares of 48%, 48% and 4% respectively.

Nord Stream will have 1220 kilometres long offshore section as well as on-shore connections in both Russia and Germany, 917 kilometres and 850 kilometres respectively. The on-shore section in Russia aims to connect the pipeline to the Russian gas transmission system. In Germany, two on-shore connections will be built by WINGAS, a joint venture of Wintershall Holding and Gazprom, and E.ON Ruhrgas from Greifswald to the south and west of Germany (Nord Stream Gas Pipeline Project Website, last accessed on 12 June 2008).

Figure 3: Map of Nord Stream Pipeline

Source: Gazprom Website, last accessed on 12 June 2008.

The Nord Stream natural gas pipeline project plans to carry Russian natural gas from its Yuzhno-Russkoye oil and gas reserves, Yamal Peninsula, Ob-Taz bay and Shtokmanovskoye fields via the Baltic Sea from Portovaya Bay near Vyborg, Russia to

the Baltic coast of Germany, Mecklenburg-Western Pomerania near Greifswald. Together with Germany, Denmark, the Netherlands, Belgium, the United Kingdom, and France are the other target markets for the Russian natural gas suppliers through Nord Stream (Gazprom Website, last accessed on 12 June 2008).

First step was taken by Russian company Gazprom and German companies, BASF AG and E.ON AG to construct the Nord Stream natural gas pipeline by concluding an in-principle Agreement on 8 September 2005 in Berlin. According to this agreement, a joint venture Nord Stream AG was to be established, Gazprom, Wintershall Holding (BASF AG subsidiary), E.ON Ruhrgas (Ruhrgas AG before 1 July 2004; starting from February 2003 is part of E.ON) having 51%, 24.5%, and 24.5% shares respectively (Gazprom Website, last accessed on 12 June 2008).

Following this step, Gazprom and Dutch company N.V. Nederlandse Gasunie signed an Umbrella Agreement on 6 November 2007 which made the Dutch company the fourth partner of Nord Stream AG with 9% share. So, recent distribution of shares in Nord Stream AG is 51% (Gazprom), 20% (Wintershall Holding), 20% (E.ON Ruhrgas), and 9% (N.V. Nederlandse Gasunie) (Gazprom Website, last accessed on 12 June 2008).

2.4.2.2. South Stream

Figure 4: Map of South Stream Pipeline

Source: Gazprom Website, last accessed on 12 June 2008.

South Stream is another project foreseen by Gazprom to export natural gas to Europe without relying on third parties. The project aims to carry Russian natural gas under the Black Sea from the Beregovaya compressor station in the Russian coast to Bulgarian coast (Gazprom Website, last accessed on 12 June 2008).

The offshore section of the South Stream project, which is to be commissioned in 2013, will approximately be 900 kilometres in length and have a full capacity of 30 bcm per year. Currently, two different routes, north-westwards to Hungary reaching Austria (1300 kilometres) and south-westwards to Greece extending to Otranto in Italy (1000 kilometres), are under consideration of how Russian natural gas will be distributed to Europe from the Bulgarian onshore section of South Stream (Crooks, 24 June 2007).

Bilateral dialogue commenced between Gazprom and ENI on 23 June 2007 by signing of a Memorandum of Understanding to implement the South Stream project led to the foundation of the South Stream AG Special Purpose Entity on 18 January 2008 both companies having equal shares (Gazprom Website, last accessed on 12 June 2008).

2.4.2.3. Yamal-Europe II

The Yamal-Europe II pipeline project, expected to be realised by 2010, aims to double the capacity of the Yamal-Europe I pipeline, carrying Russian natural gas to Germany across Belarus and Poland, to 66 bcm per year (EIA, 2008: 12).

The Russian company Gazprom and Poland cannot reach an agreement on the route of the proposed pipeline since Gazprom's choice is the pipeline passing through south-eastern Poland to Slovakia and then to Central Europe. On the contrary, Poland prefers the route travelling via its territory to Germany (EIA, 2008: 12).

CHAPTER 3

CASES: CREATING A COMMON EU ENERGY POLICY

This chapter will cover the energy outlooks of Germany, the United Kingdom, France, Italy and Austria since they are the major countries leading the deepening and enlargement issues of the EU integration process. Thus, their position regarding common energy policy can shed a light on the challenges to create internal energy market and a common energy policy given their different levels of energy dependency. Then, it attempts to assess whether these countries' bilateral relations with Russia in energy affect the EU policy making process in achieving a common energy policy. Lastly, it will address the question of how these countries pursue their bilateral relations with the Russian Federation in supplying their energy need.

3.1. Germany

3.1.1. The Energy Outlook of Germany

Germany is one of the member states whose energy import dependency exceeds the EU-average of 50.1% with 62%. Germany is the top oil and natural gas importer within the Union. Germany imports 112 Mt (2005) of oil and 94 Mm^3 (2006) of natural gas (IEA Website, last accessed on 12 June 2008). Imported oil comes from both Russia and Norway; in addition, together with the Netherlands these two countries meet the natural gas need of Germany. There are five wholesale gas companies dominating the German gas industry, namely, E.ON-Ruhrgas, RWE, VNG, Wingas and BEB (European Commission, Germany Internal Market Fact Sheet, 2007: 1).

3.1.2. Germany: Converging or Diverging Interests with the EU?

The largest wholesale company of the German gas industry E.ON-Ruhrgas has a 60% share in the wholesale market as well as 30% in the regional distribution companies. Since there are long-term contracts finalised between the suppliers and distributors, there is no room left for new entrants in the market (European Commission, Germany Internal Market Fact Sheet, 2007: 1). This non-competitiveness in one of the

founding states of the EU contradicts with "competitiveness", one of the three major goals of European energy policy outlined in The Green Paper of 2006 of the Commission.

Both the 'ownership unbundling' and 'Independent System Operator (ISO)' options proposed by the Commission in order to secure competition in energy markets of member states was not welcomed by Germany (Euractiv Website, last accessed on 6 May 2008). Together with France, Austria, Bulgaria, Greece, Cyprus, Luxembourg, Latvia and Slovakia, Germany strongly opposed the Commission's proposal of ownership unbundling because this meant breaking up of the shares of large energy companies in energy sector such as E.ON and RWE of Germany (Laitner and Parker, 2006).

Along with competitiveness, security of supply is also perceived necessary to create an energy policy among the EU member states as introduced in The Green Paper of 2006. The goal of securing supply is to tackle the dependency of EU on imports of natural resources. In the following section, whether Germany is on the path of achieving this goal or not will be discussed in detail.

3.1.3. Germany-Russia Relations in Energy

The Nord Stream Project, previously named in 2005 the North European Natural Gas Pipeline Project, which is undertaken by the Russian natural gas company, Gazprom, the German companies BASF AG and E.ON AG, and the Dutch company

N.V. Nederlandse Gasunie is an important project that will increase dependency of Germany on Russia as well as strengthening Russia's dominance in the EU energy market (Nord Stream Website, last accessed on 12 June 2008). The designed capacity of the pipeline, which is to be completed by 2011, is 55 bcm per year. With this project, the Russian natural gas will be transferred to Germany under the Baltic Sea. Gazprom has a share of 51% in this project whereas the other two German companies had to split the rest 40% evenly among themselves since N.V. Nederlandse Gasunie has a stake of 9% (Nord Stream Website, last accessed on 12 June 2008).

The Nord Stream Project provided two significant advantages for Russia. Firstly, the project will secure the EU energy market since the members of the EU, namely Germany, Denmark, the Netherlands, Belgium, the United Kingdom, and France will become more dependent on the energy resources of Russia with the initiation of this project. Secondly, the project will not rely on third parties, by other terms it will bypass Poland and the Baltic States which in turn will reduce the political risks and costs of transmitting gas and strengthen the role of Russia as a reliable energy supplier (Gazprom Website, last accessed on 12 June 2008).

So, since Germany has high level of energy import dependency, 62%, and it depends on Russian gas imports, constituting 41.7% of its total gas imports (See Table 1 in Chapter 1), Germany's dominant energy company in gas industry, E.ON Ruhrgas[7], does not hesitate to form bilateral relations with the Russian company Gazprom to secure Germany's gas imports from Russia by agreeing on the Nord Stream Pipeline project. All these factors have an effect on Germany's national preference formation

[7] RWE, VNG, Wingas and BEB are the other wholesale gas companies dominating the German gas industry.

which in turn determines its stance on creating a common EU energy policy. These factors led Germany to oppose the Commission's proposal of unbundling vertically integrated incumbent energy companies in order to liberalise EU energy markets and to create a competitive internal energy market under the provisions of The Green Paper of 2006. Since this proposal directly targets E.ON and RWE in Germany, Germany is one of the leading opponents together with France, Austria, Bulgaria, Greece, Cyprus, Latvia, Luxembourg, and Slovakia.

3.2. The United Kingdom

3.2.1. The Energy Outlook of The United Kingdom

The United Kingdom is not as dependent on energy imports as Germany. Taking into consideration the EU-27 average energy import dependency of 50.1%, the UK is far under this percentage with 5.2% in 2004 and increasing to 14% in 2005 (European Commission, United Kingdom Energy Mix Fact Sheet, 2007: 2). The reasons behind this rise in the percentage of energy import dependency are the decrease in North Sea energy production in the face of an increase in domestic demand. Therefore, for the first time in 2004 since 1991, the UK became a net importer of energy resources (IEA, last accessed on 12 June 2008). These imports of natural gas and oil mostly come from Norway. Still,

the UK is the top producer of oil and natural gas in the EU (European Commission, United Kingdom Energy Mix Fact Sheet, 2007: 2).

3.2.2. The United Kingdom: Converging or Diverging Interests with the EU?

The United Kingdom has the most competitive energy market with respect to the energy markets of countries examined in this thesis, namely Germany, France, Italy and Austria. Both wholesale and retail markets of the UK are competitive in the sense that gas and electricity transmission companies are fully ownership unbundled whereas there are still vertically integrated companies retaining some distribution systems (Ipek and Williams, 2008: 18). The six major electricity companies control the British downstream gas market together with the French company GdF and multinational companies like BP, TOTAL and Shell (European Commission, United Kingdom Internal Market Fact Sheet, 2007).

Taking into consideration the competitive British energy market, the UK strongly supports unbundling vertically integrated companies in both gas and electricity markets in the EU member states. Under this provision, the UK, together with seven other EU member states, namely Spain, the Netherlands, Belgium, Sweden, Finland and Romania, supported Denmark's energy minister calling upon Andris Piebalgs, the energy commissioner, and Neelie Kroes, European Commissioner for Competition that they back unbundling vertically integrated companies such as E.ON (Germany), EdF

(France), and ENI (Italy) to create a competitive European energy market (Crooks and Laitner, 2007).

The next section about the relations between the UK and Russia in energy will try to assess whether the UK fulfils its responsibilities as an EU member state to create a common external energy policy in terms of securing supply, and how if it fulfils them.

3.2.3. The United Kingdom-Russia Relations in Energy

The United Kingdom is one of the EU members Russia has an energy related bilateral dialogue with. The developments related to energy issues between the UK and Russia are Gazprom's bid to join the downstream gas transport and retail markets of the UK and the sale of British assets in TNK-BP, British-Russian joint venture, to Gazprom, state-controlled gas company of Russia.

Russia announced its aim to take part in the national energy market of the UK by seizing the British natural gas distribution company, Centrica (Warner, 2006). However, Alexander Medvedev, Deputy Chairman of Gazprom's Management Committee, then negated this aim since no talks were carried on with Centrica reserving the option of joining the downstream gas transport and retail markets of the UK (Martinson, 2007). However, Russia took part in the energy market of the UK by purchasing the two commercial and industrial companies of the UK. The acquisitions of Pennine Gas in June 2006 and Natural Gas Shipping Services in 2007, together having less than 1% share in the gas retail market of the UK, by Gazprom clearly demonstrates to what

extent Russia can be serious about joining the UK energy market (Adetunji, 2006 and Crooks, 29 June 2007).

The sale of British assets in TNK-BP, British-Russian joint venture, to Gazprom, state-controlled gas company of Russia is another significant event in order to understand how the relations between the UK and Russia has developed over time.

Under the leadership of BP's former chief executive Lord Browne, BP made an investment of $8 billion (£4 billion) in the Russian oil and gas industry (O'Connell, 2007). TNK-BP together with Potanin's Interros, having 62.8% and 37.2% shares respectively, were the shareholders of Russia Petroleum which holds the license to develop the Kovytka gas field in the Irkutsk region in Russia (Olcott, 2004: 26; O'Connell, 2007). The Kovytka gas field, having an estimated volume of 2000 bcm gas and 83 mt of gas condensate, is expected to be in full production in 2015 (O'Connell, 2007).

Russia's strategy of 'state control' to run the energy sector in the country shaped the course of the sale of British assets in TNK-BP to the Russian company Gazprom in June 2007 (Balzer, 2005: 218; Olcott, 2004: 26). An interview between Craig Murphy and Sergei Kuprianov, press spokesman for the former chairman and the current President of Russia of Gazprom, Dimitri Medvedev, clearly illustrates how Russia approaches foreign investment in Russia. Upon a question of Murphy (2007) whether foreign investors are no longer welcome in Russia Kuprianov stated, "Russia no longer needs any foreign investment. Back in the Nineties we lacked capital and expertise. Now we have plenty of both".

Russia's claim that the British-Russian joint venture TNK-BP has produced only less than 2.5 bcm of gas per year instead of targeted annual amount of 9 bcm of gas (O'Connell, 2007), has led BP and TNK-BP to sell its assets in Russia Petroleum to Gazprom in 2007 (Kramer, 2007).

The sale of British assets in TNK-BP to Russian Gazprom is not the first incident Russia has taken hold of foreign companies' stakes. Royal Dutch Shell also sold its assets in the Sakhalin II oil and gas project to Gazprom. The energy experts interpreted the sale of assets of Shell as a forced bargain, raising concerns about foreign investment in Russia (Kramer, 2007).

Thus, the significance of the case of TNK-BP is that it clearly demonstrates how Russia approaches foreign energy companies, which want to do business in Russian territory.

So, factors such as the United Kingdom's low level of energy import dependency, 14%, compared to EU-27 average of 50.1%, its highly competitive energy market, and its being not solely dependent of Russian gas imports, shapes its national preferences accordingly and determines its position pursuant to the requirements to achieve a competitive internal energy market and a common EU energy policy. That is why the United Kingdom strongly supports the Commission's proposal of unbundling vertically integrated companies together with Spain, the Netherlands, Belgium, Sweden, Finland, Romania, and Denmark.

3.3. France

3.3.1. The Energy Outlook of France

The significant aspect of France's energy supply is that it is the largest producer of nuclear energy, which supplies 40% of its energy need from and uses for electricity generation, in the EU. Nevertheless, France also imports oil and natural gas. Its energy import dependency ratio is 52% closer to the EU average of 50.1%. It imports 84 Mt of oil from Norway, Saudi Arabia, Russia, Kazakhstan, Iran, Algeria and Libya, and 45 Mm^3 of natural gas from Norway, Russia, Algeria, Nigeria and Egypt. As indicated in the Internal Market Fact Sheet of France of the European Commission (2007: 1), "the gas industry in France is dominated by Gaz de France (GdF) which directly or indirectly operates at all market levels – imports/wholesale, transmission and distribution, and supply".

3.3.2. France: Converging or Diverging Interests with the EU?

The electricity and gas energy markets of France are highly concentrated with a small number of companies controlling these markets. The transmission system operators (TSO) in both markets are unbundled, but still vertically integrated companies

own these operators, and distribution companies were unbundled in July 2007 (European Commission, France Internal Market Fact Sheet, 2007: 1).

Within the electricity market, EdF, which owns the TSO and DSO (Distribution System Operator) supplying 95% of customer needs, is the dominant company with 87% of electricity generation capacity along with Electrabel-Suez and SNET, having 4% and 2% of production capacity respectively (European Commission, France Internal Market Fact Sheet, 2007: 1).

The gas market, on the other hand, is dominated by GdF. GdF and TOTAL, holding 95% of gas imports, are the two major companies which supply gas to the French gas market (European Commission, France Internal Market Fact Sheet, 2007: 1). Two TSOs in France are controlled by GdF and TOTAL, having 88% and 12% shares respectively whereas GdF dominates the distribution level of the gas market with a share of 96% (European Commission, France Internal Market Fact Sheet, 2007: 1).

Taking into account the above figures in French energy market, it will be naïve to believe that France is a strong supporter of a competitive internal energy market which is a major goal of the EU outlined in The Green Paper of 2006. France is one of the nine countries, Germany, Austria, Bulgaria, Greece, Cyprus, Luxembourg, Latvia and Slovakia, which opposes the proposal of the Commission to unbundle the vertically integrated companies in EU member states or to give the management of these companies' transmission functions to an Independent System Operator to ensure the liberalisation of EU gas and electricity markets (Euractiv Website, last accessed on 6 May 2008).

Therefore, France and Germany proposed an alternative option, "third way," which will ensure E.ON's and EdF's ownership of their assets. However, according to

Euractiv news (Euractiv Website, last accessed on 6 May 2008), an independent body, the Independent Transmission Operator (ITO) would manage these assets by

> … adopting its annual investment plan and raising money on the capital market, in particular through borrowing and capital increase. Every year, the TSO would be required to submit a ten-year investment plan to the energy regulator at national level, based on existing supply and demand forecasts.

A supervisory body, an international trustee, will be responsible for taking the decisions, which may affect the value of the assets of the vertically integrated company (Euractiv Website, last accessed on 6 May 2008). Only one member of this body, who will have "a veto right with respect to decisions that in his view may significantly reduce the asset value of the transmission system operator," will be appointed by the EU member states and the rest will be selected among candidates having no relations with the vertically integrated company for at least five years prior to his appointment for the position (Euractiv Website, last accessed on 6 May 2008).

The following section will examine how the relations between France and Russia in energy augment the reluctance of France in achieving a common energy policy.

3.3.3. France-Russia Relations in Energy

France made a deal with Russia on 13 July 2007 in which the Russian gas company Gazprom and the French oil and gas company TOTAL agreed to cooperate in developing the Shtokman gas field in the Barents Sea (Noel, 2007). The Nord Stream is the project, which will undertake this task. It will carry Russian natural gas from Shtokman fields to France as well as Germany, Denmark, the Netherlands, Belgium and the United Kingdom.

Given the expropriation of a large gas field, Kovytka, operated by the British-Russian joint venture TNK-BP and of Sakhalin II oil and gas project undertaken by Royal Dutch Shell, the deal between a multinational company TOTAL and a state-controlled gas company Gazprom is a significant achievement in terms of foreign investment in Russia (Noel, 2007). That is because Vladimir Putin, the former President of Russia, preferred state regulation on natural resource use and asserted that this sector is "beyond the capacity of market mechanisms" (Balzer, 2005: 218, Olcott, 2004: 21).

A significant point in the Shtokman deal between TOTAL and Gazprom is that it demonstrates the vulnerability of the Russian government and Gazprom in the sense that Russia needs a foreign partner, in this case TOTAL, to develop the Shtokman fields in its territory since it cannot achieve this task on its own (Noel, 2007).

So, France, being dependent on energy imports by 52%, relying on Russian gas imports, which constitute 19.5% of its total gas imports (See Table 1 in Chapter 1), and having highly concentrated electricity and gas sectors, does not seem to be a strong supporter of a competitive internal energy market and a common EU energy policy. As

EdF and GdF, which are the two dominant companies in France's electricity and gas markets, are targets of the Commission's proposal of unbundling vertically integrated companies, these two are the major players in France's decision on opposing unbundling. That is why France together with Germany proposed an alternative option, 'third way,' which would ensure full ownership of these two vertically integrated companies on their assets. Thus, national preferences of France, driven by the "commercial interests of powerful economic producers," like EdF and GdF, directly affected France's divergent stance on achieving a competitive internal energy market and a common EU energy policy (Moravcsik, 1998b: 3).

3.4. Italy

3.4.1. The Energy Outlook of Italy

Italy is one of the EU member states that has a very high dependency of 84% on oil and natural gas imports with respect to the EU average of 50.1%. 95 Mt of oil and 77 Mm^3 of natural gas are imported in Italy (IEA Website, last accessed on 12 June 2008). Imported oil is from Libya, Russia and Saudi Arabia. It is dependent on Russia, Algeria and Norway for natural gas imports. The Italian company ENI dominates the gas industry in Italy having shares of 84%, 62% and 44% in domestic production of energy,

imports of natural resources and retail activity respectively (European Commission, Italy Internal Market Fact, 2007: 1).

3.4.2. Italy: Converging or Diverging Interests with the EU?

The Italian energy market is highly concentrated, however, in electricity market the level of concentration decreased when Enel, a major company in electricity market previously owned by state, was split between the Italian Economy and Finance Ministry (21.1%), Cassa Depositi e Prestiti (10.1%), institutional investors (34.3%) and retail investors (34.5%) (Enel Website, last accessed on 12 June 2008).

The electricity market of Italy is dominated by Enel (39%) followed by Edison (12.1%), Edipower (9%), Endesa Italia (7.4%), ENI (6%) and other small enterprises having less than 2.5% shares (European Commission, Italy Internal Market Fact Sheet, 2007: 1). The retail market of Italy is divided between the free market and the regulated market whose 85.5% of its supplies are met by Enel Distribuzione (European Commission, Italy Internal Market Fact Sheet, 2007: 1).

ENI is the dominant actor in the Italian gas industry. 84% of domestic production, 62% of imports and 44% of retail activities are controlled by ENI (European Commission, Italy Internal Market Fact Sheet, 2007: 1). The owner and operator of transport pipelines in Italy is SnamReteGas and of most storage facilities is Snogit, in which ENI has 50% and 100% shares respectively (European Commission, Italy Internal Market Fact Sheet, 2007: 1). The Italian retail gas market is under control of three major

companies, ENI has a share of 44%, ENEL has 15% of shares and Edison has 8% whereas there are about 430 operators in the distribution network, in which Italgas, owned completely by ENI, being the largest company with a share of 32% (European Commission, Italy Internal Market Fact Sheet, 2007: 1).

The major Italian companies such as ENI, SnamReteGas and Enel have not been in favour of fragmented energy market in Italy, entrance of new entrants in the market or improvement of infrastructure for energy trading since all these may challenge the interests of these companies (Ipek and Williams, 2008: 10).

Regarding the high level of dependency of 84% on oil and gas imports, the reluctance of major Italian companies for a competitive energy market in Italy and the bilateral relations between Italy and Russia in energy, which will be discussed in the following section, will pave the way for a better understanding of Italy's reluctance to act in accordance with the efforts of the European Commission to achieve a common internal energy market and a common external energy policy in the EU.

3.4.3. Italy-Russia Relations in Energy

The Blue Stream natural gas pipeline having an annual designed capacity of 16 bcm and total length of 1213 kilometres (EIA, 2008: 13) is one of the projects along with the South Stream project that strengthens the relations between Italy and Russia in energy. Blue Stream, aiming to supply Russian natural gas directly to Turkey through the Black Sea without relying on third parties for transmission, is owned by an equal

partnership between the Russian company Gazprom and the Italian company ENI, namely Blue Stream Pipeline B.V. Company (BSPC) (ENI Website, last accessed on 12 June 2008).

The BSPC was founded in November 1999 following the Memorandum of Understanding signed between Gazprom and ENI in February 1999 to implement the Blue Stream project (Gazprom Website, last accessed on 12 June 2008). The BSPC now only owns the offshore section of Blue Stream whereas the Russian company Gazprom owns and operates the onshore section of the pipeline (Gazprom Website, last accessed on 12 June 2008). Saipem, given the right to undertake the project by the BSPC in November 1999, implemented the construction of the Blue Stream project in February 2000 and in November 2005; Blue Stream was officially inaugurated in Turkey (Gazprom Website, last accessed on 12 June 2008).

The relations between Italy and Russia in energy increased progressively when the Russian company Gazprom and the Italian company ENI signed on 23 June 2007 a Memorandum of Understanding to implement the South Stream project. Following this initiative, South Stream AG Special Purpose Entity where both companies having equal shares was founded on 18 January 2008 (Gazprom Website, last accessed on 12 June 2008).

The South Stream project, with an annual designed capacity of 30 bcm to be commissioned in 2013, aims to carry Russian natural gas under the Black Sea to Bulgaria from where it would follow either northwest or southwest route or both (Gazprom Website, last accessed on 12 June 2008). The total length of the South Stream project is foreseen as 3200 kilometres, if both routes are considered, 900 kilometres of

offshore section passing from the Beregovaya compressor station in the Russian coast to Bulgarian coast, 1300 kilometres passing through Hungary to Austria, and 1000 kilometres extending to Greece to reach Italy in the end (Crooks, 24 June 2007).

Alexander Medvedev, Deputy Chairman of Gazprom's Management Committee, described "the memorandum as part of Gazprom's strategy aimed at 'diversifying Russian gas supply routes toward European countries and at significantly contributing to Europe's energy security'" (Crooks, 24 June 2007). So, the South Stream project will strengthen Gazprom's strategy of building pipelines to secure the EU energy markets for Russian gas supplies without relying on third parties since the project will bypass Turkey, which in turn will reduce the transmission costs and political risks.

So, Italy's high level of energy import dependency, 84%, its dependency on Russian gas imports, constituting 31.8% of its total gas imports (See Table 1 in Chapter 1), and its highly concentrated gas markets dominated by ENI having strong ties with the Russian company Gazprom, are the major determinants of Italy's national preferences on creating a competitive internal energy market and achieving a common EU energy policy. Since the vertically integrated Italian gas company ENI has opposed the full liberalisation of gas markets, this had lessened Italy's support for a competitive internal energy market. In addition, since Italy is dependent on energy imports, the dominant company in Italian gas sector, ENI, pursues bilateral talks with the Russian company Gazprom in order to secure Russian gas imports by agreeing on the South Stream Pipeline project. This in turn leads to Italy's tenuous support for a common EU energy policy.

3.5. Austria

3.5.1. The Energy Outlook of Austria

Austria having an energy import dependency of 70.8% is far from the EU average of 50.1% (European Commission, Austria Energy Mix Fact Sheet, 2007: 1). Saudi Arabia, Libya, Kazakhstan and Russia are the major countries importing oil to Austria. For natural gas, Austria is dependent on Russian gas imports. Apart from oil and natural gas, renewable sources have a significant level of 21% in the energy supply of Austria when compared to the EU average of 6% (European Commission, Austria Energy Mix Fact Sheet, 2007: 1). Austria, being a major transit country for gas transmissions, only consumes one fourth of gas carried via Austria. Another significant feature of gas industry in Austria is that it is divided into three "control areas", two of which are connected to the gas network of Germany (European Commission, Austria Internal Market Fact Sheet, 2007: 1). As indicated in the Internal Market Fact Sheet of Austria of the European Commission (2007: 1),

> Gas wholesaling takes place at two levels: foreign and domestic producers supply the Austrian first-level wholesalers who then pass on these deliveries to distributors and traders in the second-level wholesale market. The large distributors also supply the bulk of both small and large end-users. *Currently, no gas supplier is independent from local players* (emphasise added).

3.5.2. Austria: Converging or Diverging Interests with the EU?

The electricity market of Austria is controlled mostly by publicly owned companies of federal and provincial governments or municipal councils (European Commission, Austria Internal Market Fact Sheet, 2007: 1). Both distribution and retail network is highly concentrated in Austria where the largest companies of electricity industry integrated their facilities of retail marketing and trading (European Commission, Austria Internal Market Fact Sheet, 2007: 1).

Therefore, Austria supported France and Germany's rejection of the European Commission's proposals of unbundling or Independent System Operator with Bulgaria, Greece, Cyprus, Luxembourg, Latvia and Slovakia. Following Italy, Austria, has the highest dependency ratio of 70.8% on oil and gas imports, especially from Russia. So, Austria has to have strong relations with Russia to secure its imports. The next section will examine these relations in detail to better understand the Austria's relatively little support for a competitive and liberal internal energy market and a common external energy policy of the EU.

3.5.3. Austria-Russia Relations in Energy

Unlike Germany, the United Kingdom, France and Italy, Austria preferred to follow a different strategy with Russia. Instead of making investments in building

pipelines with Russia, Austria is trying to become the "biggest continental hub for natural gas" through which much of the fuel will be supplied by Russia. (Dempsey, 2007). Wolfgang Ruttensforter, CEO and Chief Executive of OMV, expressed his desire for the participation of Russia in this "continental hub", "We want the Russians in it. We already have forty market participants. We are trading more than 1 bcm a month. All the big guys in the world are trading there. *We want Russians to be interested in developing this biggest hub in Continental Europe*" (emphasise added) (Dempsey, 2007).

On the other hand, Austria is leading the Nabucco Pipeline project, passing via Turkey, Bulgaria, Romania, Hungary and ending in Baumgarten, Austria, which will carry natural gas from Central Asia and the Middle East to Europe. This project is expected to come into operation in 2011 and to carry 30 bcm natural gas per year. The participating companies in the Nabucco Project are BOTAŞ (Turkey), OMV (Austria), Transgaz (Romania), MOL (Hungary), and Bulgargaz (Bulgaria) (Nabucco Gas Pipeline Project Website, last accessed on 12 June 2008). The significance of the Nabucco Project is that it will diversify the energy resources by expanding country of origin among energy exporting countries.

So, Austria's high level of energy import dependency, 70.8%, its dependency on natural gas imports from Russia, which constitute 70% of its total gas imports (See Table 1 in Chapter 1), and its highly concentrated energy markets leaves Austria reluctant to support a competitive internal energy market and a common EU energy policy. Having highly concentrated energy markets has led Austria to oppose the Commission's proposal of unbundling vertically integrated energy companies in order to liberalise the EU electricity and gas markets. Also, relying mostly on Russian natural gas

imports in its gross inland energy consumption, 68.8% (See Table 1 in Chapter 1), Austria has defined its strategy to become a 'continental hub' in which it calls for Russian participation. Thus, it seems less likely that Austria is willing to diversify its energy suppliers which demonstrates its tenuous support for a common EU energy policy.

Creating a continental hub for natural gas for Europe and building a pipeline that will secure the diversification of energy resources are certainly in favour of European interests. On the contrary, it could lead to a conflict between Austria, which is dependent on Russian gas supplies, and Russia since the Nabucco Pipeline will serve the interests of Europe in reducing the dependency on Russian gas (Dempsey, 2007). Therefore, Russia expresses its discomfort by strengthening its relations by building Nord Stream Pipeline with Germany, developing its Shtokman gas fields with France and having a project with Italy on building South Stream Pipeline.

CHAPTER 4

CONCLUSION

This thesis aimed to explore the impact of the European Union-Russia relations on creating a common EU energy policy in light of two theories of European integration: intergovernmentalism and liberal intergovernmentalism. Following this motive, five key member states of the European Union, namely Germany, the United Kingdom, France, Italy, and Austria are selected to understand the bilateral relations of these countries with Russia in supplying their energy need and how the ongoing relationship with Russia affects EU policy making process in creating a common energy policy.

Thus, this thesis has examined first, the significant role of energy in Russian foreign policy, second, the energy policy of the EU by studying the Green Papers of 2000 and 2006 of the European Commission, third, the EU-Russia dialogue on energy by looking at the mechanisms for continuing the dialogue, the developments influencing the dialogue such as the Ukraine-Russia energy crisis, price hike in Turkmen gas, and the Sochi and Samara Summits between the EU and Russia, and last, the existing and proposed natural gas pipelines between the EU and Russia.

Following these topics, the energy outlooks of five key member states of the EU and whether these countries have convergent or divergent interests with the EU in

creating a common energy policy, placing emphasis on the bilateral relations between these selected countries and Russia, have been examined.

Regarding the topics covered, this thesis reached three main conclusions on how the national preferences of five key member states are formed, to what extent these preferences affect intergovernmental bargaining or interstate negotiations on creating a competitive internal energy market and a common EU energy policy, and whether the result of this bargaining process is in favour or against the goal of EU to achieve a common energy policy.

First, the national preferences of five key member states are driven by "issue-specific economic interests" (Wiener and Diez, 2004: 78-79). The level of dependency on energy imports and of concentration in their internal energy markets, and relations of their energy companies with the Russian company Gazprom are the major factors determining these member states' national interests.

Germany (62%), France (52%), Italy (84%) and Austria (70.8%) have high levels of dependency on energy imports and they rely on Russian gas imports to differing degrees, 41.7%, 19.5%, 31.8%, and 70% respectively. In addition, they have highly concentrated energy markets, which a limited number of vertically integrated companies dominate, like E.ON and RWE in Germany, EdF and GdF in France, or ENI in Italy. So, bilateral relations of these companies with Gazprom by concluding long-term contracts on gas imports or by agreeing on certain projects of natural gas pipelines make these member states more dependent on Russian gas. One outstanding conclusion to be drawn is that among the five key member states, the United Kingdom is the only country that has a low level of energy import dependency, 14%, and a highly

competitive energy market. So, all these factors have a significant role in determining the national preferences of five key member states.

Second, national preferences of Germany, the United Kingdom, France, Italy, and Austria have a considerable impact on their decisions on creating a competitive internal energy market and a common EU energy policy. Through intergovernmental bargaining or interstate negotiations, these member states try to reach the most appropriate outcome that would serve their interests best.

Since Germany, France, Italy and Austria have highly concentrated energy markets, and their national preferences are driven by the "commercial interests of powerful economic producers" in these markets, they have all opposed the Commission's proposal of unbundling vertically integrated energy companies in order to liberalise of EU gas and electricity markets which would in the end pose a threat to their energy companies' interests (Moravcsik, 1998b: 3). These countries are backed by six other EU member states as well, namely Bulgaria, Greece, Cyprus, Luxembourg, Latvia, and Slovakia. Obviously, the United Kingdom has strongly supported the proposal since it has highly competitive energy markets together with Spain, the Netherlands, Belgium, Sweden, Finland, and Romania.

Finally, diverse and plural interests of five key member states on the liberalisation of EU electricity and gas sectors and their relations with Russia to differing degrees had an impact on EU policy making process in achieving a common EU energy policy. Since each member state has distinct interests and continues to strengthen their energy security given their economic interests and preference formation at national level, it would be challenging for EU to reach a consensus on an issue of "high" politics,

a common energy policy, which might threaten the national interests of member states (Rosamond, 2000: 77).

Germany's bilateral negotiations with the Russian company Gazprom to secure Germany's gas imports from Russia by agreeing on the Nord Stream Pipeline project, the French company TOTAL's deal with Gazprom to develop the Shtokman gas fields in the Barents Sea, the Italian company ENI's bilateral talks with Gazprom in order to secure Russian gas imports by agreeing on the South Stream Pipeline project, and Austria's desire to become a 'continental hub' in which it calls for Russian participation make these EU member more dependent on Russia and determine their position towards creating a common energy policy. On the other hand, the United Kingdom is a strong supporter of EU's aim to achieve a common energy policy.

To the extent that EU depends on Russian energy imports, Russia is also dependent on EU in order to keep up with its energy policy and to protect its crucial role in exporting natural gas. Russia needs financial and technological support from the EU to explore the natural energy reserves and to export these resources. At the same time, Russia wants its relations with the EU to rest on mutual interests. As EU wants the elimination of Russia's dominance on natural gas exports, protection of foreign investments in Russia under the scope of the Energy Charter Treaty and the liberalisation of the Russian energy markets, Russia in turn wants to take part in the energy markets of the member countries of the EU.

It is interesting that Russia has bilateral negotiations with the members of the EU instead of negotiating with the EU as a whole about the issue of energy. Russia having bilateral talks especially with the key members of the EU, such as, Germany, the United Kingdom, France, Italy and Austria raises a crucial question in minds: does the EU 'as a

whole' want to have an energy dialogue with Russia or not? Instead of approaching Russia as a union in the area of energy, for now, the EU seems to be comfortable about the bilateral negotiations between its members and Russia. So, it is hard to achieve a common sense among the EU members. All are sovereign states and many of them are not willing to give up their rights on certain issues, in this case a common energy policy, in the process of converging national policies into the EU common policies.

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