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## A Liberal Actor in a Realist World? States, Markets and European Union Energy Policy

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Central European University  
Under review by *New Political Economy*

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Presented at GR:EEN Case Study Integrity Forum on European Public Policy and Governance, Central European University, Budapest, 18-19 October 2012

Under review by *New Political Economy*

Since 1992 the European Union has put liberalisation at the core of its energy policy agenda. At the time, this aspiration was very much in line with the emerging post-cold War multipolar international order, and particularly the new international political economy driven by the neo-liberal (Washington) consensus. The central challenge for the EU is that the world has changed, while the EU has not. More precisely, several important global trends that were at odds with this new international political economy were evident as early as the end of the 1990s: the rise of China, Russia's increased assertiveness, persistent energy price volatility and supply risk. Although the EU has supplemented its own focus on liberal energy markets with emphasis on public service and security of supply, the liberal paradigm remains

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This research acknowledges the support of the FP7 large-scale integrated research project **GR:REEN - Global Re-ordering: Evolution through European Networks** European Commission Project Number: 266809

prevalent in Brussels. In the present paper we analyse the EU's (primarily the European Commission's) reaction to these international challenges, and explore the limits of its liberal model in a world dominated by geopolitics. Whilst our study confirms that the EU remains *predominantly* a liberal actor even as the world turns more realist, we find that this is i) not by design, but by choice; ii) that there are important exceptions, and iii) that these exceptions reflect the tension between the Brussels-based regulatory approach and the domestic political economy of energy in key member states.

**Keywords:** International Political Economy of Energy, EU Energy Policy; Geopolitics; Energy Markets; Regulatory State.

The authors gratefully acknowledge the support of the EU FP7 large-scale integrated research project GR:EEN – Global Re-ordering: Evolution through European Networks, European Union Project Number: 266809

It is often said that we live in the age of the regulatory state. Indeed, the European Union is regularly held up as the prime example of a regulatory state because its policy tools draw more heavily on law and regulation than of redistribution of resources and direct intervention in industry (Majone 1994; Majone 1996). The liberal blueprint that was built into the Treaty of Rome in the 1950s as a lowest common denominator among states featuring different approaches to economic policy (Gerber 1998; Milward 1984) turned out to be very close to the new West European policy consensus by the end of the 1980s (McGowan and Wallace 1996). The EU regulatory model was, in a sense, an idea whose time had come. Domestic policy change toward the economic right in France, Britain and Germany (Taylor 1989), coupled with the collapse of communism and Fukuyama's "end of history" (Fukuyama 1989) presented the European Community with a window of opportunity: to build a liberal Single European Market (SEM) at home and project its liberal market model on to the international scene. However, by the end of the 1990s, this window had begun to close. The Washington consensus became increasingly contested; fuelled by rising oil prices Putin's Russia became increasingly assertive; and the significance of China as an alternative politico-economic models became ever clearer. The question at the centre of this paper is whether the EU has changed with the world; or whether it has remained a liberal actor – committed to the 'regulatory state' agenda both at home and abroad – in an increasingly realist world.

Energy – sometimes called the lifeblood of any modern society– is a powerful example of the dynamics set out above. The oil and gas sector provides not only a rich case study, but also a critical case study. The heterogeneity of member state policies and preferences notwithstanding; if the EU cannot respond to changes in the international political economy of energy – a sector where the global and local level are extraordinarily closely linked and a sector at the heart of economic policy and regulation – it can hardly be expected to address other strategic sector successfully. Markets for molecules are not the same as markets for shoes. Energy has a public good dimension that fundamentally distinguished this sector not only from pure private goods, but even from other heavily regulated network sectors such as telecommunications and rail transport (Helm 2002). In addition to its private good characteristics, energy markets include a security dimension defined as reliable supply at affordable prices (Yergin 1991).

Developments in the international political economy of energy since the end of the Cold War have presented serious challenges for the European Union in terms of energy policy. More assertive producer-states, rising resource nationalism and the rise of new consumers undermine the market-based liberal model of international energy trade. Markets are increasingly erratic and unpredictable. The increasing role of opaquely governed national oil

companies, state-flanked energy deals and government funding of energy projects has contributed to uncertainty regarding supply and demand, increase price volatility, and consequently high adjustments costs for the industry, consumers and society. The EU, and more specifically the European Commission (both as regulator and executive), faces a challenge in two crucial respects, which we explore in the present article: a) how to establish and maintain an international energy market, and b) how to make these markets work adequately in practice. To be sure, the EU also faces a third, related, challenge in terms of how to mitigate the effects of energy production and consumption – the climate change challenge. We restrict the present discussion to the governance of energy markets, because combating climate change is part of a much broader agenda (related to de-carbonising global energy systems) and a very different type of challenge for the EU.<sup>1</sup> A second caveat is that we focus on the Commission's strategy, and not on member states policies and preferences, except inasmuch as the Commission allows exemptions from single market rules (e.g. with respect to pipeline projects).

The paper – like Caesar's Gaul – is divided into three parts. The first section applies the literature on the EU regulatory state to the energy sector and elaborates our hypotheses about the external face of the regulatory states. The second section tests the hypotheses by investigating and assessing the EU's response to geopolitical changes in terms of market-making and of making markets work. Key challenges involve dealing with market imperfections such as asymmetric information, externalities, imperfect competition and undersupply of public goods. The third section turns to the explanatory mechanisms at work here: *why* is the EU predominantly a liberal actor in international energy markets, and when it is not, why is it not? The concluding section returns to the question whether the EU's soft power approach to global energy eventually has a hard edge.

## **1. The EU Regulatory State and the New International Political Economy of Energy**

The point of this paper is not to contest whether the EU is a regulatory state, but to investigate the *external manifestations of the EU regulatory state*. Characterisations of the EU as a regulatory state rest on positive arguments related to the nature of its policy tools and resources (Jordana and Levi-Faur 2005; Lodge 2008; Majone 1994; Majone 1996); on normative arguments linked to the EU's reliance on technocratic output legitimacy (Rosamond 2000); as well as the historical context in which the original treaties were drawn up in the 1950 (McGowan and Wallace 1996). In either case, what is

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<sup>1</sup> We regard the EU's climate change challenge primarily as a global collective action problem, which merits 'great power' concerted action by the EU, USA and China (Goldthau and Sitter, forthcoming), rather a problem of market regulation and choice between different regulatory tools.

essentially an assessment of the EU as a market-building project has implications for the EU's wider role in the international political economy: to the extent that the EU is a regulatory state at home, does it act as a regulatory state abroad too?

As it happens, the Single Market (or '1992' project) came to fruition at an extraordinarily favourable moment: the west had emerged victorious in the cold war and liberal economic ideas triumphed to the extent that TINA – the ubiquitous acronym for *There Is No Alternative* – dominated both domestic and international public policy debates; consumer countries were in the driver seat in international energy markets after the oil price collapse of 1986 and OPEC's organisational decline; and an optimistic view about international organisations' abilities to tackle cross-border environmental problems through policies that 'flanked' the core free trade model, such as EC environmental policy as well as the Montreal Treaty, prevailed. By the turn of the millennium, these conditions had already begun to change. A benign international context reinforced the EU's regulatory state in the 1990s; but in today's less benign setting the EU's regulatory state approach to energy policy has come under considerable stress. Indeed, both scholars and policy analysts have called for a stronger, more muscular, and more realist external policy on the part of the EU (Correlje and van der Linde 2006; Smith 2010; Youngs 2009). However, the lesson from the political economy literature associated with Douglass North and new institutionalism is that institutions matter: existing institutions and norms constrain choice, shape preferences and make radical change difficult (North 1990). Hence our hypothesis that the EU's external energy policy remains consistent with its internal regulatory state profile – both in terms of what it does and how it does it.

To be sure, the EU regulatory state never quite lived up to the ideal-type set out in the literature in the mid-1990. Even Majone (Majone 1996; Majone 2005) argued that the regulatory state was the central characteristic of the EU, but not the only important characteristic, and that this depended very much on the political and economic climate in its member states. (McGowan and Wallace 1996) emphasised that the EU's shift toward a regulatory state approach to public policy involved more than legislating for liberalisation: EU regulation mainly regulated the national regulators, and there were considerable gaps between EU policy and the policies actually implemented by national authorities. The common themes in the literature on the regulatory state in the EU and its member states (Levi-Faur 2004; Lodge 2008; Moran 2002) include a shift in focus toward regulation (remedying market failure) at the expense of other core tasks of the state such as redistribution of resources and macroeconomic stabilisation; a shift from reliance primarily on majoritarian institutions to independent agencies; and a shift from policy tools such as direct state ownership and subsidies to rule-making and arm's-length

governance. However, the regulatory state in the EU varies both across sectors and between states (Andersen and Sitter 2009; Hayward and Wurzel 2012). It has evolved and changed in response to policy failures (Lodge 2002), and met political opposition in the more interventionist member states (Menz 2005). Indeed, as Lodge concluded in a cross-country analysis of Europeanisation of the regulatory state: “the impact of ‘Europeanisation’ remains heavily influenced by domestic politics and policy-making” (Lodge 2002), 63).

Indeed, when it is applied to a single sector, like energy, the regulatory state model turn out to be somewhat fuzzy: there is a well-documented gap between the ideal-type and policy as actually applied in the EU and across its member states(Andersen and Sitter 2009). Although the European Commission’s liberal paradigm triumphed in the 1990s, with the support of a few states led by the UK (Kuzemko 2013), the twenty-year story of EU energy liberalisation has been far from a smooth path to fully-blown liberalisation. The original SEM initiative excluded electricity and gas along with other utilities, and for a good reason. When the Commission proposed that the single market take a ‘public turn’ and be extended to the state-dominated utilities sectors, “many of the established actors in European gas industries [...] regarded the introduction of liberalization as the equivalent of the end of civilization” (Stern 1998), 91 ). The directives liberalising electricity (1996) and gas (1998) markets in Europe featured limited and gradual market opening, and were seen as a first step in a longer process. They included temporary derogations and member state discretion in implementation, but also promised further revisions and (for electricity) featured a reciprocity clause that permitted states to block access to their market for firms from less liberalised markets (Pelkmans 2001), 444). The gas directive allowed derogations over take-or-pay contracts upon decisions by states or their regulatory authorities, and for emergent markets or markets with only one external supplier. A second round of liberalisation followed in 2003, with a gas directive that required that that all states adopt a regulated access tariff and establish independent regulators and mandated that non-discriminatory third party access be developed through legal unbundling of transport from trading services. Two years later a Commission review concluded that “the provisions of the previous [2003] Directives have not been adequate to achieve the objective of competition, even for larger users” (Communities 2004), 3). A third round of directives followed in 2009 with a focus on ownership unbundling, new regimes for independent systems operators or independent transmission operators, strengthening national regulators, and establishing a new EU regulatory agency. By the time the Agency for the Cooperation of Energy Operators was up and running in 2011 the EUs internal market in energy was liberalised to the extent that it made sense to speak of a

regulatory state model, albeit one that involved a degree of heterogeneity because of member state diversity.

The central hypothesis in what follows is drawn directly from the regulatory state model. Even if EU energy policy does not live up to the full liberal ideal-type, several core expectations about the EU's external behaviour can be derived from new institutionalist analysis of the EU as a regulatory state. The EU has an in-built bias in broadly favour free trade (despite episodes of protectionism); and the Commission's internal energy market policy is driven liberal norms. Therefore, to the extent that the EU is a regulatory state at home it is reasonable to expect it to rely primarily on the tools of the regulatory state abroad too. Hence the main hypothesis: *the EU remains a liberal actor in the international world of energy, even as this world changes beyond the benign environment of the 1990s*. To be sure, this is not to equate the regulatory state with neo-liberalism, since the regulatory state may often amount to a 'rescue of the welfare state' (Levi-Faur 2011); it is simply to assert that the external manifestation of the EU's regulatory state overlaps with liberal (as opposed to mercantilist or realist) approaches to international political economy.

The first and most important element of change in the global political economy since the 1990s is driven by geopolitics. The collapse of communism brought about a shift in the global distribution of political and economic power, from a bipolar world to world Krauthammer called the 'unipolar moment' (Krauthammer 1990). However, the new geopolitical scene proved as ephemeral as it was difficult to describe. As Gaddis put it: "we never had a good name for it, and now it is over" (Gaddis 2001), 3). From the EU's perspective the beginning of the 1990s was the opposite of an international relations 'perfect storm': a brief period in which national, regional and international development combined to make for a perfectly calm situation that allowed the EU single market to be consolidated and extended to network utilities such as gas, telecommunications and electricity. Reagan and Gorbachev provided the geopolitical context in which the EU regulatory state could project itself beyond the then twelve member states, through the European Economic Area, enlargements and regimes for trade with the 'near abroad'. This was essentially a market-making project, and effort to extend the EU single market to the energy sector and beyond the EU's boundaries. The 'liberal moment' had passed by the turn of the millennium: the 'west' could no longer set the rules of the game.

The central question related to this geopolitical change concerns how the EU has responded to this shift in rule-setting power: how does the EU seek to make markets for Energy? The global system is now best described as multipolar. Most of the rising powers reject one or more core elements of the

'Washington Consensus'. The rules of the game are up for grabs, and the liberal trade model long pursued by the EU is seriously under threat. The internal dimension of the EU Single Market model is manifestly based on the principles of rule-based, non-discriminatory regimes for exchange of goods and services. However, when it comes to its external dimension the picture is less clear (Youngs 2009).

Three hypotheses follow from the assumption that the EU's regulatory state bias shapes its external energy policy. First, to secure a level playing field, the EU is expected to defend the status quo and seek to extend existing trade regime to energy as well as to minimize opt-outs and special arrangements. Second, where energy markets warrant special arrangements, such as rules on transit and investment, to ensure consistency and fair competition the EU is expected to seek to establish general regulatory rules rather than ad-hoc bilateral arrangements. Third, as a liberal regulatory state the EU would also be expected to maintain a level playing field for energy firms regardless of their national origin – in this case the obvious question concerns how to understand and deal with Gazprom. If Gazprom is seen primarily as a profit-oriented firm (like other dominant suppliers such as Statoil) a liberal approach would not prescribe firm-specific rules. However, if the company is seen as a tool of the Russian government, a more discriminatory policy might be merited.

The second important change in the global political economy is related to a handful of fundamental shifts in international oil and gas markets that induce market failures. By the 1990s the world had already witnessed three broad eras (Maugeri 2006; Parra 2004; Yergin 1991). Until the Tripoli and Tehran agreements of 1971 that nationalised reserves held by international (western) oil companies, the Seven Sisters effectively constituted a consumer cartel that dominated the non-communist market. The following decade saw the OPEC producer cartel dominate markets (and use oil as a political weapon in Middle East conflicts). However, by the early 1980s the combination of non-OPEC production (the USSR and the North Sea), increased energy efficiency in the OECD countries (driven by high oil prices) and the effects of the Iran-Iraq war on both OPEC's cohesion and the two belligerents' oil output brought about a liberal age and a buyers' market in oil. The 1986 'counter-shock' and the collapse of communism reinforced this trend into the early 1990s. Here the question is how the EU responded to new market developments in the late 1990 – a fourth era – particularly with the rapid rise in oil prices after the record low of \$9/bd in 1998. Prices crossed \$20 in 1999, \$30 the following year, ascended steadily past the \$100-mark in early 2008, and hit a high of \$147 in June the same year (BP 2011). In continental Europe gas prices also rose, because most long-term contracts are pegged to oil prices. Furthermore, international oil markets changed structurally with the emergence of 'new consumers', signalled by China becoming a net importer of oil in 1995. New

patterns of international energy trade and exploration were driven by a combination of mercantilist government policy and the emergence of 'consumer NOCs' (notably PetroChina) (Downs 2005). Consequently, markets have become less transparent and predictable over the last decade, which in turn reinforces price volatility. So whilst geopolitical changes posed challenges related to market-making, the changes in international oil and gas trade raised challenges related to the actual operation and management of international markets – how to address market failures?

To the extent that the EU's regulatory-state bias shapes its external policy, the principal question is what kind of policy tools the EU uses to address problems that it perceives as market failures. The most salient problems concern energy security – defined as "adequate, reliable supplies of energy at reasonable prices"(Yergin 1988), 117. The Commission has long seen free, fair and efficient markets as the principal answer to this. From this perspective, several types of market failure in energy can cause problems, and each can be addressed through a range of policy tools (see also (Goldthau 2011). First, problems of transparency can be addressed by mechanisms that enhance openly accessible information (the liberal response) or policy responses that seek to shift asymmetry in one's own favour. Second, energy markets are famously exposed to externalities from political/economic events such as domestic instability in producer countries. Here the question is whether the EU's response is cast primarily in terms of liberal measures such as oil stocks that can be released on the general market, or in terms of preventive measures such as arranging privileged access to energy resources. Third, international energy markets feature imperfect competition in the shape of producer cartels and monopolies. A liberal response primarily involves effort to build markets, in this case a matter of extending the EU's own liberal rules abroad; a mercantilist response would aim at building a monoposony or a consumer cartel. Fourth and finally, market imperfections may arise from public goods characteristics, particularly related to energy transport and transit, e.g. gas pipelines. Again the main choice is between a liberal approach that emphasises a common regulatory framework for pipelines, whereas a more 'realist'<sup>2</sup> response might centre on 'pipeline diplomacy' and bi-lateral deals on transit and transport. The next section explores the EU's action in terms of market making and mitigating externalities in more detail; but it leaves discussion of outliers to the fourth section.

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<sup>2</sup>The focus in this article is on the common assumptions and features of regulatory state models, liberal trade models and the liberal paradigm in international relations theory. Like Tolstoy's happy families they are all (more or less) alike; and just as unhappy families in *Anna Karenina* are all unhappy in their own very different ways, so there are many ways states can use non-liberal policy tools. Examples range from mercantilism and consumer cartels to empire-building and resource wars, but mapping these is not the subject of the present article.

## 2. The External Dimension of the EU Regulatory State: Making Markets for Energy and Making them Work

International markets are not spontaneous; they are designed by governments and order by institutions. In the early 1990s the prospect for international markets governed by liberal institutions looked bright, even in the oil and gas sector. Two decades later producer states are more assertive and resource nationalism has become household term in energy policy debates. The window of opportunity to extend the World Trade Organisation (WTO) regime to oil and gas closed when Russia and China re-emerged as important players on the global scene in the late 1990s. These two WTO-applicants were not interested in extending the WTO regime to energy. China has adopted its own approach to energy, characterised by mercantilism, national champions and off-market deals (Downs 2005). Under Putin's leadership Russia has sought to retain state control over strategic sectors such as energy (Gaddy and Ickes 2009). The timeline of our investigation covers both the extension of the SEM to energy in the 1990s and the effort to extend this beyond the EU's own boundaries, and the more politicised period that followed in the 2000s. Because our investigation centres on the preferences and actions of the European Commission, the empirical data analysed in what follows comprises Commission proposals and EU legislation (directives, regulations) as well as direct action through agreements with third parties, external projects, and the use of competition policy and law to extent that it affects external actors. The data set includes more than 800 energy related acts by EU institutions between 1990 and 2012, of which 85 were reported in *Agence Europe* and of which about half have a clear external dimension.

The first set of three issues is related to the first question we asked above: how to make markets? The three issues are: trade regimes, regulating investment and transit, and non-EU firms' access to the SEM. The empirical investigation explores i) EU efforts to extend international and regional trading regimes as far as possible, both in terms of adding new members and in terms of extending the scope to energy; ii) developing regimes for, or extending trade regimes to cover, rules for investment and transit; and iii) single market rules that affect non-EU firms operating in Europe. The policy tools for the first two are international agreements and treaties; for the third the policy instruments are SEM regulation and competition policy. Table 1 sets out key examples of such policy tools, and how they are used in practice.

The second set of four issues is related to the second question we asked above: how to make markets work? They are: asymmetric information, externalities from non-energy events, imperfect competition, and undersupply of public goods. The empirical investigation explores iv) measures to foster transparency at home and abroad; v) different ways that the EU seeks to

manage the consequences of political and economic shocks that threaten energy security; vi) action designed to restore competition where it is distorted or to deal with the effects of lopsided market dominance by external players; and vii) the EU's involvement in providing infrastructure e.g. in the shape of pipelines, inter-connectors and energy networks. Table 2 sets out key examples of such policy tools, and how they are used in practice.

Both tables 1 and 2 set out the policy issues, the Commission's aims and preferences, and the principal means at the EU's disposal that fit its regulatory state profile. However, the policy tools as actually applied are not restricted to the liberal toolbox. The findings reported in the fourth column of each table reflect the somewhat broader repertoire of policy instruments that we have documented. In the fifth column we have scored each of the actions listed on a three-point scale; where 1 represent a non-liberal response, 2 a neutral response, and 3 a liberal response. A 'liberal response' is defined as one that is in line with the principles of the regulatory state model and constitutes an extension of the EU's internal regulatory state model to its external energy environment. 'Non-liberal' responses include a wider range of policy tools, such as measures designed to protect EU markets or firms, to project EU consumer power vis-à-vis third parties, and the use of political and economic power to open up or access new markets. Although the line is sometimes blurred, for example in the case of infrastructure projects, the measures that we assess as 'non-liberal' are closer to the policy tools associated with a realist response.

### **Table 1 here**

The first and most important element in the EU's external economic policy is its effort to extend international and regional trading regimes as far as possible. Its overall preferences for free trade are hard-wired into the organisation through its treaties and fundamental principles as well as member state economic policy preferences (Moravcsik 1998). Although there are exceptions to this rule, such as the Common Agricultural Policy, energy is not such an exception. The principal means by which the EU pursues this is multilateral and bilateral agreements. Prime examples include the effort to include energy in the WTO framework and close energy-related loopholes such as dual-pricing for gas. In respect the EU has failed somewhat: when the predominantly liberal WTO regime was extended to Russia (2012) and Saudi Arabia (2005) energy was not included. A more successful example is the European Economic Area, which extended the SEM to the EFTA states, notably oil and gas-rich Norway. Norway consequently has to dismantle the Gas Negotiation Committee (GFU), its monopoly organisation for coordination export of gas between 1986 and 2002 (Austvik 2001). In addition the EU funds a number of non-supply related programs that address renewable

energy and energy efficiency in third countries. The overall finding is that the EU pushes a liberal agenda that represents an external extension of its own regulatory state characteristics, but that its ability to do this is varied.

The second element in the EU's external policy is specific to energy markets: both gas and petroleum trade require substantial upstream investment in production capacity and midstream spending on transport infrastructure, which in turn requires a long time-horizon. More to the point, it also requires stable and predictable legal frameworks and trans-national dispute resolution mechanisms, both for foreign direct investment and transit. This is precisely what the Energy Charter Treaty of 1991 was designed to establish (Dore and Bauw 1995; Waelde 1995). Although Russia signed the ECT, it declined to ratify the treaty (as, indeed, did Norway) and stopped the provisional application of the ECT in 2009. The reason as stated by the Russian government was that the treaty is biased toward the EU's interests and western liberal principles, and was negotiated at a time of Russian weakness (for a discussion of the ECT see (Selivanova 2012)). Although Norway has not ratified the ECT, as far as trade with the EU is concerned most of these issues are covered by the EEA agreement and the Norwegian regulatory regime. The 2006 Energy Community Treaty, which includes most West Balkans states (Albania, Bosnia, Croatia, Macedonia, Montenegro, Serbia and Kosovo) the Ukraine and Moldova, commits the signatories to implementing the EU gas liberalisation legislative packages. On occasion, such as in the case of the three Baltic member states (which electricity grid is part of the old Soviet infrastructure), the Commission negotiates with third parties on its member states behalf on operationalising energy markets. The EU also has a number of softer policy instruments at its disposal, including the establishment of expert groups to discuss technical issues and a wide range of partnership agreements (Association Agreements, Partnership and Cooperation Agreements, SYNERGY agreements). The EU's policy toolbox also includes a number of less liberal options for addressing issues related to transit, such as investment in pipelines project and exempting such projects from SEM rules. We return to this below (table 2), because it concerns the actual provision of physical infrastructure.

The third element in the EU's external policy concerns how and to what extent SEM rules affect third-country firms' access to the EU market. The basic principle is that all firms active in the SEM have to comply with EU competition rules and energy market regulation (e.g. registering and providing data), and the best example of this is the end of Norway's GFU discussed above. More controversially, this implies that non-EU firms that operate in the EU market are bound by its rules, as the Microsoft cases illustrated (e.g. Case T-201/04). We return to the application of competition law to the energy sector below. Two point merit a comment. First, the SEM rules are best described as 'fuzzy

liberalisation' because they leave the Member State considerable room for manoeuvre, including their negotiation of external long-term contracts (Andersen and Sitter 2009). Second, the Third Energy Package of 2009, which extended gas market liberalisation rule to cover 'unbundling' between transmission and other operations, was tailored specifically to address the failure of the ECT and concerns about Gazprom's dominant position in EU markets in the context of a more assertive Russia and the gas supply crisis of 2006. The directive not only requires non-EU firms to comply with unbundling rules as far as their EU operations are concerned – what Cottier, Matteotti-Berkutova and Nartova call a kind of 'conditionality for firms' – but also stipulates that member state authorities that certify transmission operators should ensure that non-EU firms' ownership does not put security of supply at risk, a requirement that does not apply in the case of EU firms (Cottier, Matteotti-Berkutova, and Nartova 2010).

### **Table 2 here**

The first challenge that the EU faces in terms of making markets actually work in practice, is related to the notorious lack of transparency in international energy markets. The oil market may be the only truly integrated commodities market on the planet (and certainly the biggest one), but it is an incomplete market. Around half the crude oil that is traded internationally is not subject to an open market price mechanism; it is traded bilaterally by way of a range of different medium and long term contract. Even the part that is subject to spot and futures trading on the open market lacks some of the important characteristics of fully functioning markets. Some important producers, such as Saudi Arabia reveal neither capacity nor reserves; key oil consumers, such as China, conceal their level of demand; most National Oil Companies (NOCs) are not subject to the same reporting requirement as International Oil Companies (IOCs) or firms listed on stock markets; and even when it exists market data suffers from a lack of accuracy and common standards of measurement (Holscher, Bachan, and Stimpson 2008; IEA 2009). Gas markets are, if anything, even further from the text-book model of an open market. Most trade in natural gas remains regional, because of its nature as a commodity that is primarily transported by pipeline. For historical reasons the gas trade outside North America is dominated by long-term take-or-pay contracts (the buyer pays even if they do not take the gas) and is therefore bilateral, with prices that not shaped by demand and supply but rather usually by an oil-price peg that is adjusted with a time lag. In short, both oil and gas markets are incomplete at the international level. They feature a number of market failures that are directly linked to the very structure of these markets, and these failures are getting worse rather as a consequence of the geopolitical changes discussed in the previous section. Participants in global oil markets are left with educated guesses about market fundamentals.

Insufficient data, lack of accurate projections on supply and demand and a general lack of transparency decreases planning security. Investment, even if profitable, may not take place, leading to market failure on the supply side. This uncertainty spills over into gas markets through the price-peg. To be sure the International Energy Agency is tasked with providing such data for oil markets, but only for the OECD countries. The Commission support and reinforce the IEA's effort at three levels: direct support for IEA and the Joint Oil Data Initiative through Eurostat; collection of data on agreements between EU firms and their third-country suppliers; and market statistics pertaining to the SEM. These measures are all scored as fully liberal, in terms both of policy tools and their application.

The second challenge concerns spillover from non-energy economic and political events. Both oil and gas markets are subject to a series of externalities that render markets volatile and supply insecure. A wide range of economic and political events have tremendous effect on the demand and supply of energy. Examples of demand slumps include the Asian economic crisis in the mid-1990 that reduced global demand for oil and the post-communist collapse of Russian industry that led to a 'gas bubble' in Europe at the same time. Fossil fuel production influences the political economy of producer countries: from Russia to Iran, public spending and political stability in producer countries has become intimately linked to the oil price. Conversely, domestic and political turmoil or crisis, whether directly linked to energy trade or not, generate negative externalities for oil and gas markets. Domestic instability unrelated to oil, such as Nigeria's ethnic conflict, obviously affects both investment and production. Political and industrial disputes in the oil sector, such as the PdVSA 2002-03 strike against nationalisation in Venezuela, can cripple production and cause an international oil shock. Trade disputes between a gas producer and a transit country, whether driven by politics, economics or a mixture of both (Gazprom reportedly lost some \$1.5bn in two weeks in the 2009 dispute with Ukraine), can have severe repercussions for a third party consumer. The direct effect was on five South-East European countries in 2009 was interrupted gas supplies; the indirect effect was that security of supply shot to the top of the EU gas policy agenda. Finally, the Middle East offers a raft of examples of international wars (the Yom Kippur war, 1973) or domestic regime change (Iran 1979) causing global oil shocks. The EU's efforts have centred on buffering oil price shocks by maintaining and managing strategic petroleum stocks and supporting the IEA's efforts and capacities in this regard (notably coordination of release of stocks in emergencies). With regards to gas, the EU requires member states to hold stocks and put in place measures for dealing with disruptions, and it has promoted measures to make supply networks more robust (e.g. Trans-European Energy Networks, interconnectors and reverse pipeline capacity). All these measures are clearly directed at managing externalities and coping

with their effects, rather than preventing them from occurring, and is thus fully in line with the regulatory state logic.

Even when oil and gas markets are spared supply or price shocks or negative externalities, they can hardly be described as perfectly competitive. This is the third challenge for the EU. Historically market-domination has oscillated between consumer and producer cartels; in the 2000s, after a decade of low oil prices and a post-communist 'gas bubble', the pendulum began to swing back toward oil and gas producers. Drivers include the rise of new oil consumers, the overall projected increase in global demand (IEA 2011), reduced production in war zones (Iraq) and countries subject to sanctions (Iran), as well as the rising and comparatively high cost of non-OPEC production. The combined effect is strong demand in the face of flat supply, and the EU therefore faces more powerful external suppliers. With regards to gas supply, the Commission attempts to deal with this through competition policy instruments, e.g. the above-cited break-up of the GFU and decisions that oblige firms that supply the EU market to remove 'destination clauses' that restrict a buyer's freedom to re-sell gas anywhere in the SEM. In oil markets, imperfect competition is a problem at the global (not the regional) level. The Commission's efforts are therefore channelled through the broader western petroleum consumer club IEA, including the measures discussed above, such as strategic petroleum stocks aimed at smoothening sharp price fluctuations and measures to enhance transparency. However, there are two notable exceptions from this general finding that the Commission addresses imperfect competition by trying to make markets function more efficiently rather than by circumventing them. One, the Commission has proposed what effectively amounts to a gas buyers' consortium in the shape of the Caspian Development Corporation. The aim is to pool EU consumer power vis-à-vis Central Asian producer states, in order to secure large volumes of gas for Europe and diversify sources of supply beyond Russia through long-term 'ship-or-pay' agreements for transit pipelines(IHS CERA 2010). Two, although the Commission's acting as a 'referee' and vetting deals negotiated between it member states and third parties can be regarded as 'liberal', its assuming a direct role and helping Poland renegotiate its long-term gas contracts with Russia in 2010 borders on consumer collusion (monopsony) and takes the Commission considerably beyond its regulatory state role.

Finally, oil and gas markets have important public goods characteristics that result in undersupply of certain goods – particularly transport infrastructure. When private actors produce goods that have public goods characteristics they are unlikely to produce them in an optimal quantity. For example, strategic oil stocks benefit the country or company that bears the cost of holding them, but they also benefit the rest of the consumers if and when released in response to an external shock (as discussed above). Smaller

states have an incentive to free-ride, unless a substantial number of them coordinate collective action. The IEA was established to address this problem, by managing its member states strategic petroleum reserves. Likewise, the builder and operator of a pipeline take both the costs and benefits, but pipeline multiplicity is a public good inasmuch as it reduces the EU market's reliance on a single external dominant supplier. Given Russia's share of the EU market, pipelines that improve access to non-Russian supplies are a public good. Given the Ukraine's dominant position in the transit market for Russian gas, direct pipelines to Russia that circumvent this country also have public goods characteristics. To be sure, some transport problems can be overcome if a single actor has sufficiently strong incentives to supply the public good, for example the Straits of Hormuz (through which 2/3 of all Middle East oil exports pass) have been kept open first by the British Empire and later the USA. The structural characteristics of gas markets make it difficult for a single actor to play a similar role. The EU faces a dilemma: it can try to extend its regulatory state competition-driven model beyond its own borders by what we label 'liberal measures', or it can try to fund infrastructure projects to overcome the public goods aspect of the pipeline problem but may require compromising on competition policy. Examples include the exemption of the *Nord Stream* pipeline between Germany and Russia under the Baltic sea from some SEM rules, as well as similar exemptions for the *Nabucco* pipeline designed to establish a 'Southern Corridor' to Central Asian gas that circumvents both Russia and the Ukraine. More standard liberal measures include the *INOGATE* technical assistance programme to promote construction of inter-connector infrastructure that represents alternatives to existing Russian infrastructure.

Overall, our main finding is that the Commission – and EU as a whole – has indeed adopted a liberal paradigm, but with plenty of room for ambivalent implementation. The EU has sought to extend international trade regimes to the energy sector, and to cover investment and transit. The Commission's response to Gazprom's efforts to establish a presence on the SEM has involved the use of classical competition policy tools, such as the September 2012 anti-trust investigation based on "concerns that Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States" (Commission 2012). The EU makes a substantial contribution to reducing international information asymmetries (even when it Member States protects their incumbents, transparency is required), and to the management of the consequences of external shocks. Even when it comes to dealing with imperfect competition and undersupply of cross-border pipelines the Commission's main tools are that of the regulatory state toolbox, several important exceptions notwithstanding. The next section turns to the exceptions.

### 3. Liberal by Choice? The Significance of the Exceptions to the Rule

The findings reported in the previous section point toward two broad conclusions: first, the EU is – mostly – a liberal actor, even as the world of energy turns more realist; and second, it is so by choice rather than by design or default. When it comes to the first set of issues analysed – how to make markets for energy – the European Commission’s strategy, and indeed the strategy of the EU as a whole, is overwhelmingly liberal. If strategy is defined as a matter of what ones aims should be and how they ought to be pursued (raking a leaf out of the both military and business literature – see (Carl von Clausewitz 1832; Porter 1980), the evidence is clear: the overall aim is the establishment of rule-based energy trade characterised by fair competition, and the means centre on a combination of new and existing international and regional institutions and the EU’s own single market rules. To be sure, the SEM is best characterised as ‘fuzzy liberalisation’, but this has little to do with the nature of external energy markets and simply reflects practical accommodation of Member State heterogeneity in the context of the triumph of a liberal paradigm for the internal EU market in energy. When it comes to making markets work the picture is somewhat more diverse: liberal tools are dominant when it comes to redressing asymmetric and incomplete information and managing the consequences of external shocks to price or supply; but when it comes to coping with Gazprom’s dominant supply role and problems of pipeline politics the Commission has proven ready to employ a more diverse toolbox. The reason is partly similar to the explanation of the SEM’s fuzziness: a pragmatic solution to a complex reality. But it also reflects a dilemma that the EU faces in the increasingly realist international context: if it is not possible to extend the regulatory state, it might be necessary to compromise on some of its principles abroad in order to maintain the regulatory-market model at home.

If the rule is that the EU remains a liberal actor in a realist world, the exceptions to the rule are significant. They demonstrate that the EU and its member states have other options, and by extension that the EU is a liberal actors by choice. Its strategy is liberal, not only because the Treaties and the SEM entail a built-in liberal bias or blueprint, but also because the Commission has decidedly adopted a broadly liberal strategy. However, both the Commission and the member states have non-liberal instruments at their disposal, and they are prepared to use them when this is deemed appropriate or necessary. The most obvious example is the so-called ‘Gazprom clause’ in the Third Energy Package, which entitles regulators to take security of supply risks into account when certifying third-country firms acquisition, ownership and operation of transmission networks. Furthermore, the Commission has been quick to approve exemptions from SEM rules for pipeline projects, both those championed by some member states but opposed by others (*Nord*

*Stream* – favoured by Germany but strongly opposed by Poland and the Baltic states) and less controversial projects (such as the less financially robust, and now much shortened, *Nabucco* pipeline project and the broader quest for a ‘Southern Corridor’). These decisions can be seen both as efforts to help supply public goods (pipelines), and as efforts to support infrastructure project designed to weaken dominant players on the external market such as Gazprom/Russia on the supply side and Ukraine as a transit country. The latter can be seen as a tactics that compensates for a failure to extend SEM rules on trade, transit and investment to the former Soviet states. The same can be said of the Commission’s active role in negotiating member states’ bilateral gas deals with Gazprom/Russia. Likewise, the Caspian Development Corporation constitutes a non-liberal response to a lopsided regional gas market, inasmuch as it seeks to circumvent Russia and exercise consumer power. Having said this, the Commission has chosen to stick to its liberal guns on other issues, such as prioritising the battle against destination clauses in gas contracts, investigating Gazprom’s pricing practices in Europe, and vetting member states’ (or their firms’) engagement in bilateral deals with main suppliers.

The Commission’s strategy when it comes to building and operating markets for oil and gas suggest that it is caught between a rock and a hard place: soft power cannot work and hard power does not work. The central point about soft power – “the ability to get what you want through attraction rather than coercion or payments” (Nye 2004), x) – is that it relies on the attractiveness of the country’s politics or policies. The EU’s problem when it comes to energy policy is that Russia – its government and its firms – does not find the EU regulatory state model particularly attractive. The government’s rejection of the ECT and Gazprom’s market strategy towards its EU customers leaves no doubt as to this. Hard power, on the other hand, is problematic in terms of the EU’s capacity. Our survey of EU policies on external oil and gas markets indicates that the EU does have the capacity or use hard power, and that the Commission can be persuaded to do so under certain circumstances, but that the real problem lies in the member states’ heterogeneity of preferences. Hard power does not work, not because it cannot, but because nuclear France, oil-rich UK, coal-fired Germany and former Soviet-bloc Poland have very different preferences when it comes to external energy policy (and even when it came to establishing the internal energy market, and maintaining its operation). The member states that are more reliant on Gazprom and have a half-century or longer history behind the iron curtain are far more concerned over Russian policy than is Germany, let alone countries with very different internal energy policies and market exposure such as the liberal UK and Mediterranean France. The EU is therefore left with a third, more pragmatic approach: a liberal strategy by choice, which allows for important exceptions. This can be described as soft power (liberalism/regulatory policy tools) with a hard edge

(more interventionist policy tools, used on occasion to make imperfect markets work more to the EU's satisfaction).

#### **4. Conclusion: *Mostly* Liberal – Soft Power with a Hard Edge**

The conclusion that the EU is a liberal actor in a realist world merits an adjective: *mostly*. Not unlike Ford Prefect in Douglas Adams' *The Hitchhiker's Guide to the Galaxy* trilogy, who after years of painstaking research modifies the entry on the earth from 'harmless' to 'mostly harmless', we conclude that this adjective is of some significance. The EU's overall strategy remains liberal, even as the international political economy of energy is undergoing fundamental change. But its liberalism allows for significant exemptions. This is soft power with a hard edge. The hard edge consists of two main elements: the use of coercion as a tool of the regulatory state, and the use of financial resources as a more classically interventionist or *dirigiste* policy tool. The most significant examples of liberal hard power is the Commission's use of competition policy tools to break up or weaken external monopolists that sell gas to the single market, by breaking up the GFU, banning destination clauses and investigating Gazprom's abuse of its dominant market position with respect to several of the new member states. The important cases of more interventionist hard power include the Commission's financial, regulatory and diplomatic aid for pipeline projects, and its accommodation (and often encouragement) of some member states' or firms' participation in such projects. The term 'soft power with a hard edge' is used here to suggest that this strategy is not quite as contradictory as it might seem at first glance: the Commission's use of non-liberal tools can be seen as a Plan B, an effort to work around or address problems when its primary strategy fails. The fundamental challenge for the Commission is that the EU is increasingly caught between its liberal market model and a world less and less inclined to stick to it. The EU's response has been to stick to its liberal guns – by choice and with conviction – even if this no longer fully resonates in the new environment. However, the Commission has added a significant 'hard edge' to its 'soft power' policy toolbox.

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