

# Can the European Union's Market Liberalism Ensure Energy Security in a Time of 'Economic Nationalism'?

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#### **Abstract**

The EU's higher profile in energy policy matters is arguably due to the increased importance of market liberalisation as a policy objective over the last twenty years. Given the EU's own competences in the internal market and competition policy, the European Commission has accordingly been able to play a more active role in energy policy-making. Moreover it has been active in extending this approach to its energy relations with its neighbours as manifest in the Energy Charter Treaty, the European Energy Community Treaty and bilateral agreements with third countries. The European Commission has been keen to assert the centrality of market liberalisation to its future energy policy and energy diplomacy, notwithstanding the changes that have taken place in energy markets. Given that there appears to be an increased interest in 'national champions' amongst both energy exporting countries and at least some EU member states, how far can the EU sustain a strategy of market liberalisation? The article will place current policy dilemmas (and the EU's role) in the context of a shifting energy policy agenda – essentially from a supply security 'economic nationalism' to market liberalism and back again. It then considers how EU policy is adapting to these circumstances and assesses the effectiveness of this response.

THIS ARTICLE EXPLORES ONE OF THE CENTRAL DILEMMAS FACING THE EUROPEAN UNION (EU) as it develops a common energy policy: how far can a market-led approach to energy deliver security of supply at a time when concerns over sovereignty and policies of 'economic nationalism' appear to be in the ascendant? The dilemma is manifest externally and internally. Attempts to pursue an energy diplomacy based on opening up access to suppliers' markets and liberalising investment conditions have had mixed results as governments and firms in producing countries have sought to maintain or extend control over their energy assets. Inside the EU, some member states remain resistant to the idea of a full liberalisation of market conditions, apparently preferring to support their 'national champions'. There is a dynamic between the internal and external aspects of both positions. For proponents of full liberalisation, greater access to the markets of exporting countries is both a logical extension of the internal market and a pre-requisite for its full achievement. Defenders of the status quo argue that maintaining powerful integrated incumbents provides, amongst other things, the best basis for negotiations with third countries and for ensuring secure supply.

In each respect, supporters of, and sceptics towards, full liberalisation invoke 'energy security' to justify their stance. This reappearance of security as an energy policy priority has been a relatively recent phenomenon. As increasing global demand has pushed up prices

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and short term disruptions have raised questions about the reliability and motivations of suppliers, policy-makers in the EU and elsewhere are once again worrying about the availability of energy resources in the short, medium and longer terms. These concerns echo the debates of the 1970s when disruption to energy supplies was last a high profile policy issue. While by no means a carbon copy of circumstances in the 1970s, the current market and political conditions have rendered energy salient in a way not seen since that decade. It is in this context that the European Union launched a new attempt to develop an 'Energy Policy for Europe' in early 2007 (European Commission 2007a; European Council 2007a). This initiative has been equally concerned with 'climate change' as another major, possibly existential, challenge for energy policy, but it is 'energy security' that has given the policy debate a particular immediacy and profile.<sup>1</sup>

As part of that policy, the Commission has stressed and the Council has endorsed the central importance of market liberalisation as a means to the end of ensuring supply security.<sup>2</sup> Moreover it has sought to project the principle of open markets beyond its borders by negotiating agreements with neighbours and other countries involved in the production and transmission of energy for consumption in the Union. The emphasis is not surprising, given the prevailing orthodoxy of economic liberalism in energy policy in recent years. However, it is unclear how well the EU's advocacy of market liberalisation in its energy policy and energy diplomacy sits with the 'new' energy policy environment. The revival of energy security has been accompanied by a concern with sovereignty on energy matters in both producing and consuming countries.

There appears to be an increased interest in 'national champions' amongst both energy exporting and consuming countries, the latter including a number of EU member states. Such a shift in energy policy arguably challenges the EU's emphasis on liberalisation and with it the strategy adopted by the EU in its external energy relations. While recent developments suggest that the European Commission wants to adopt a tougher stance in negotiations with third countries, it remains to be seen whether this policy can be sustained given internal differences on the direction of policy to pursue and the degree to which the EU is united in its dealings with energy exporters.

The article begins by placing current developments in the context of changes in the overall pattern of energy policy development in recent decades, in particular the rise of liberalisation as a means and, according to some, an end of energy policy. It then turns to the evolution of EU energy policy, reviewing both the overall development of policy and the external dimension. The article highlights the growing importance of market liberalisation as a principle of both internal energy policy making and the conduct of energy diplomacy, noting how this principle is seen as a way of ensuring greater supply security. It then reviews how far this approach can be pursued given recent changes in the broader energy policy context – principally the revival of concern with energy security and of economic nationalism. It also considers the implications of these changes for the EU's internal and external energy policies.

Given that the issues under discussion are ongoing, any conclusion is tentative. Nonetheless, it appears that, while there is a clear logic between the internal and external aspects of EU energy policy, the pursuit of that logic is likely to remain compromised by the traditional obstacle to the development of collective energy policy responses, namely, national sovereignty. In both supplier countries and a number of member states, concerns about sovereignty appear likely to prevail over the full liberalisation of investment and market

<sup>1</sup> While there is no doubting the seriousness of the climate change issue and there are clearly trade-offs between addressing this issue, pursuing market liberalisation and ensuring energy security, this article will focus on the interaction between the latter two objectives.

<sup>&</sup>lt;sup>2</sup> Supply security has a variety of meanings in energy policy discussions. It can refer to short term availabilities affected by system stability and usually regarded as a function of infrastructure investment, operation and protection. Another short term manifestation relates to the risk of supply disruptions which is addressed by maintaining emergency stocks of fuels. A longer term dimension of supply security is that of dependency upon external supplies and suppliers of energy.

conditions. Moreover, the EU's ability to assert the latter objectives will depend on both the specific nature of its relationship with each partner and the coherence of its own position. In analysing this issue, the article focuses on the evolution of EU energy policy both in the last few years and over the longer run, highlighting the way in which questions of market liberalisation have come to influence both the overall orientation of EU energy policy and its attempts at energy diplomacy. The logic of market liberalisation – understood as attempts to encourage competition and market access on the one hand and to limit the scope for unfair discrimination or subsidies and the abuse of market power on the other – has been pursued in EU energy policy for at least twenty years. The way in which such logic applies varies from sector to sector, but the Commission's promotion of it has been comprehensive and has intensified over time.

It should also be noted that the issues discussed in this paper are more controversial within the context of some sectors than in others. This reflects market structures and the degree of EU dependence on different sources of energy. Of particular importance is natural gas, the characteristics of which highlight two of the most sensitive issues in energy policy; (1) a commodity which is largely produced outside the EU and where access to upstream activities is generally limited, and (2) an energy resource which has been traditionally transmitted, distributed and supplied on a monopolistic and integrated basis, a structure which the EU is seeking to liberalise. In its analysis of recent developments, the article focuses primarily on this sector.<sup>3</sup>

Finally, a word about terminology; as already stated above, this article focuses on the process of market liberalisation in the energy sector and the limits to that process. In this regard the article deals with a variety of activities – mainly on the part of governments – designed to maintain or extend sovereignty over particular assets (whether resources or firms). These actions have been commonly referred to as instances of 'economic nationalism', 'resource nationalism' or 'energy nationalism' and the terms have become a feature of recent media reporting and speeches by politicians and officials in recent years. As such they could be considered to be inappropriate for academic discourse. Yet the concept of economic nationalism has a long legacy in academic debate as well as in wider usage (Johnson 1967; Burnell 1986; Levi-Faur 1997). Academically the term has been deployed (positively and negatively) to refer to state activism in defence of the national interest.<sup>4</sup> For the purposes of this article we use these phrases to refer to such practices in order to capture the ways in which governments have reacted against liberalisation, or have attempted to contain its scope and not to cast judgement on whether such measures are economically sound.

## The Changing Debate on Energy Policy: Shifting Priorities Between Markets and Sovereignty

The context in which EU energy policy has developed is shaped by broader debates on energy policy itself. The priorities of energy policy, whether officially defined or informally pursued, have embraced a wide variety of concerns over the years. Considerations of inflation control, employment protection, balance of payments management, regional development, technological innovation and poverty alleviation have all informed national policies towards the energy sector at different times. However, the central objective of energy policy has traditionally been that of ensuring adequate supplies of energy resources. In the last two decades this objective has been accompanied by increased attention to improving the functioning of energy markets, mainly through liberalisation and privatisation,

<sup>&</sup>lt;sup>3</sup> While gas is clearly the main focus of policy and of this paper, the issue of upstream investment access also applies to the oil sector. The issue of network ownership is also relevant in the electricity sector.

<sup>&</sup>lt;sup>4</sup> In recent years some academics, critical of the conventional meaning of economic nationalism, have sought to reappropriate the term to refer to a much wider range of economic policies which could be interpreted as 'nationalist' – see the collection edited by Helleiner and Pickel (2005). Ironically they did so more or less at the same time as the term (in its older sense) re-emerged into public discourse.



and addressing the environmental consequences of energy production and consumption (McGowan 1990).

The relative importance of supply security, market liberalisation and environmental protection has shifted over time. For much of the post war period, particularly after the oil shocks of the 1970s, energy policy tended to prioritise supply security and was largely government-led, embracing long range planning and investment and public ownership and intervention. At the heart of this policy was a concern to maintain a high degree of national sovereignty over the energy sectors. In the 1980s and 1990s, as energy supplies appeared abundant and prices fell substantially, policy became less concerned with supply issues and gave greater emphasis to market forces and private initiative. This shift was as much a reflection of broader ideological changes (Lawson 1982) as it was a response to energy market conditions, but it had important consequences for the way in which energy investment and policy decisions were taken. As energy came to be regarded as 'just another commodity' and amenable to the logic of market forces, a more short-term perspective prevailed at the expense of long-term considerations of energy availability.

In the last few years, however, the context has changed again with the re-emergence of concerns about the security of energy supply. Rising energy prices, particularly since 2006, have reflected a rapidly changing supply-demand balance. Consumption has increased rapidly on the back of continued growth within the industrialized world and rapid growth in the emerging economies, particularly China and India. The likelihood of this higher demand being sustained over the longer term has focused attention upon the evolution of the supply side, particularly the availability of energy. For some the location of available resources is also an important issue given the apparent increasing concentration of reserves in a diminishing cluster of countries and regions. These concerns with supply security have given energy policy a more strategic, even geopolitical, twist.<sup>5</sup> Despite these changes, a number of policy makers and advisers remain committed to energy market liberalisation as the key not only to a competitive economy overall, but also to improving supply security.<sup>6</sup>

#### **EU Energy Policy: From Supply Security to Market Liberalisation**

The commitment to a market based energy policy appears to be particularly strong within the European Union. The European Commission and, for the most part, EU member states maintain the stance that open energy markets are a precondition for the pursuit of other energy policy objectives. Whether or not this is the case, it does appear that market liberalisation has been important in developing EU level policies for the energy sector.

Throughout the history of the EU there have been a number of attempts to develop a 'Common Energy Policy' (CEP). For example, the original European Coal and Steel Community (ECSC) and Euratom treaties were designed, amongst other things, to foster a cooperative approach to the handling of the traditional backbone of energy supply (coal) and the 'fuel of the future' (nuclear power). As it transpired, neither was particularly effective and attempts within the European Economic Community (EEC) to coordinate a CEP were largely inconclusive. While the 1970s energy crises led to a number of attempts to relaunch such a policy, the debates amongst member states tended to expose their differences rather than to foster closer cooperation and for many years, the CEP amounted to relatively little. That is not to say that there were no achievements in the area of energy policy; numerous Council meetings secured agreement on such issues as financial programmes to foster new energy technologies, restrictions on the use of oil and gas in power production, requirements on the storage of oil stocks for emergencies, dialogues with third countries on energy matters and a regular set of indicative 'objectives' for energy policy. However, it could

<sup>5</sup> The growing importance of the security dimension in energy policy is covered by Yergin (2006) and Monaghan (2006).

<sup>&</sup>lt;sup>6</sup> Roller *et al.* (2007) offer an economic analysis of these trade-offs. Helm (2007) highlights how the EU needs to take into account higher energy prices in reconciling other energy policy objectives.

not be argued that these measures superseded or constrained national energy policies to any great extent (SPRU-RIIA 1989).

The Community's failure to act collectively in this area was perhaps not surprising given the centrality of energy to national sovereignty in that period, and given the fact that both economic integration and the conduct of external relations were at a relatively early stage of development. From the 1980s onwards, however, the Commission became more effective at proposing common initiatives and the EU's member states became more willing to agree joint measures. These measures tended to be framed on the basis of other policy objectives, reflecting the way in which national energy debates had also been redefined in that period. The more general shift towards economic liberalism facilitated the involvement of the EU given the centrality of such principles in European integration, particularly in the wake of the Single Market initiative in the mid 1980s.7 Energy was not part of the original package proposed in the Cockfield Report on 'Completing the Internal Market', but the latter's success prompted the Commission to make a number of proposals for an 'Internal Energy Market' in 1988 (European Commission 1988). Achieving such a market has been a drawn out process; for example the liberalisation of the gas and electricity sectors has proved to be an affair which even today is not yet complete. Even so, applying the principles of the internal market and competition policy to the energy sector has had important effects, not the least of which was to reopen and to redefine the overall European energy policy debate.

A central part of that redefinition was to reconcile the principles of supply security and market liberalisation. Critics of the latter tended to argue that greater competition would undermine the long term investment horizons which had traditionally characterized energy policy decisions. In response, the Commission has argued that liberalisation was not only compatible with supply security but would reinforce it. In the 1988 proposals the Commission claimed that an internal energy market would reinforce rather than undermine supply security by allowing greater interconnection and increase the availability of emergency resources in the event of a crisis. Following up the issue in a 1990 working paper, the Commission stressed the compatibility of supply security and internal market: the removal of obstacles to energy trade would "allow more efficient exploitation of the Community's energy resources" and reduce "reliance on external resources of energy" (European Commission 1990: 4). While the paper recognised that commercial decisions might "need to be supplemented for strategic reasons to obtain an acceptable security of supply at the Community level" (European Commission 1990: 5), it also noted that national policy measures such as extensive aid or long term contracts risked undermining the creation of a single energy market. In order to avoid this possibility, the paper stressed the need to establish Community-wide criteria for reconciling supply security policies with competition and internal market rules (i.e. the development of a Community-level approach to energy policy) (European Commission 1990: 14).

For much of the 1990s, in any case, the relative significance of supply security diminished, without wholly disappearing from the agenda, and concerns over the environmental consequences of energy use increased. This reordering of priorities was perhaps not surprising because as the salience of climate change, as a policy issue, increased on the one hand, on the other, energy prices remained at very low levels compared with the 1970s. The latter conditions made it relatively easy to argue for market-led energy policy measures. Over the course of the 1990s, therefore, the Commission made a series of proposals for a CEP (particularly around the time of the Amsterdam Treaty) which outlined a variety of measures ranging from support for new energy technologies to closer cooperation with external energy suppliers, but also continued to emphasise the importance of market liberalisation (European Commission 1995a, 1995b, 1997).

<sup>&</sup>lt;sup>7</sup> In fact, energy market liberalisation had been discussed within the parameters of EU energy policy beforethe 1968 guidelines for energy gave considerable emphasis to integrating Community energy market (European Commission 1968). However these proposals were not followed up and were superseded by supply security considerations during the energy crises of the 1970s and early 1980s.



#### **EU Energy Policy: Reviving Security, Deepening Liberalisation?**

While individual initiatives on energy policy have been negotiated and agreed at the EU level over the last two decades, agreement on an overarching policy framework remained elusive. The ascent of the issue to the top of the EU's policy agenda in the last two years is due to many factors (with climate change the most significant) but the re-emergence of supply security concerns has also been an important catalyst. These concerns did not reappear over night and there was always a recognition in EU proposals that future sources of energy supplies remained a long term issue. Indeed the Commission produced a Green Paper on energy supply security in 2000 (European Commission 2000). However it does appear that the debate entered a new phase at the beginning of 2006. The trigger was the apparent disruption of gas supplies to the EU as a result of a dispute between Russia and Ukraine over gas prices at that time.<sup>9</sup> The responsibility for the disruption is contested though it does not appear to have been a direct show of strength by Russia as was reported in much of the media at the time.<sup>10</sup> However, the dispute, along with subsequent reductions in supply due to a fiercely cold winter in Russia and Eastern Europe, appeared to feed a sense of vulnerability about an increasing reliance on a small range of suppliers as the EU became more and more dependent on energy imports.

The strands of this new energy policy were proposed by the Commission at the start of 2006, revised at the start of 2007 and approved in principle by the heads of state of the EU27 in spring 2007 (European Commission 2006a, 2007a; European Council 2007a). The agreed policy included an EU wide commitment to a 20% reduction on 1990 levels of greenhouse gases regardless of international agreements. To meet this objective the member states agreed to a 2020 target of increasing the share of renewable energy to 20% of overall energy supply as well as an improvement in energy efficiency by 20%. As regards security of supply the proposals stressed the importance not only of achieving a better energy balance (something which arguably the combination of improved energy efficiency and increased renewables would facilitate) and improving network integration, but also of developing better relations with energy suppliers from outside the EU. While various mechanisms designed to achieve these objectives were envisioned, they were not independent of market liberalisation, which continued to remain central to the overall policy objectives. The Commission's proposals make clear that not only would market integration deliver competitiveness but it would also help to (1) meet sustainability objectives by enabling the "effective application of economic instruments" and promoting competition from cleaner sources of energy and (2) increase security of supply by giving incentives to invest in new capacity, promoting diversity and enhancing interdependence among member states. By contrast, it claims, existing practices which distorted the internal market would work against achieving energy security and a sustainable low-carbon future (European Commission 2007a: 6-7).

As noted, the Commission's proposals were largely accepted by EU Heads of State at their 2007 Spring Summit. There were, however, various aspects of the programme which proved contentious. Amongst the most divisive of issues were the proposals for extending the internal market in the electricity and gas sectors. Attempts to increase competition in these sectors had been at the heart of the Commission's attempts to liberalise the energy sector since the late 1980s. However, securing member state agreement had been extremely time-consuming and, in the Commission's view, of limited success. A Commission investigation of

<sup>8</sup> However, it is worth noting that an explicit chapter on Energy Policy was included in both the Constitutional and Reform Treaties.

<sup>&</sup>lt;sup>9</sup> Energy issues were already attracting greater attention - as reflected in the British government's initiative at the informal Hampton Court summit on 27 October 2005 under the UK Presidency of the European Council and French government proposals earlier that year - but the events of early 2006 appear to have concentrated minds.

<sup>&</sup>lt;sup>10</sup> Stern (2006) argues that far from being a sudden show of strength by the Russian authorities, the dispute with Ukraine over gas supply, transit and prices had been ongoing for a number of years. However he recognises that while Gazprom's actions may have been largely driven by economic considerations the perception of the crisis was very different.

the lack of competition in these markets highlighted the market power of incumbent vertically integrated utilities in a number of member states (European Commission 2006d).

While the Commission's 2007 proposals envisaged a number of measures to increase competition and effective regulation, the most contentious was the requirement that vertically integrated gas and electricity utilities should be 'unbundled' into separately owned companies responsible for the functions of production and transmission (European Commission 2007b, 2007c). The Commission argues that the present 'unbundling' of these functions, whereby existing firms separate the different functions into subsidiaries with different management and accounting systems, has not been sufficient to allow new firms to enter the market or to prevent incumbent firms from exploiting their integrated structures. By requiring full ownership unbundling, or by establishing a highly regulated system of functional separation, the Commission hopes that competition would increase throughout Europe's energy markets. Needless to say, most of the companies which would be affected by the Commission's proposal opposed such divestment. These companies were also supported by their governments, with France and Germany leading a substantial minority of member states in rejecting the Commission's plans. Amongst the arguments raised against the proposal was its impact on supply security; breaking up national energy champions would weaken their bargaining power vis-à-vis external suppliers. It is clear that for some parts of the EU energy economy, the relationship between greater competition and greater security was not wholly accepted.

#### The EU's Energy Diplomacy: Market Rules?

As the dispute over unbundling indicates, there is a clear relationship between the EU's internal policy development (such as market liberalisation) and its external energy relations. Indeed, while the EU's past and present attempts at energy policy have been internally focused, there remains an important strand of EU energy policy which is externally orientated. Given the high degree of dependence on external sources of supply, it is not surprising that energy diplomacy should be an element of the strategy.<sup>11</sup> Moreover, as in other parts of the EU's energy policy, it is possible to detect the growing influence of market liberalisation. However, the scope for such a market driven approach is not as great as might be thought. Given the EU's competence in external trade relations and its bargaining power as a major economic bloc in the world economy, it could be expected that the EU would have developed an effective energy diplomacy. In practice, the development of such a policy has been limited due to the particular nature of energy markets. The application of international trade rules to energy has been much debated but scarcely pursued (not least because many of the major energy exporting countries were not members of the GATT/WTO). Suppliers and consumers have mostly preferred to conduct energy commerce outside of such frameworks (WTO 1998; Selivanova 2007).

In any case, the EU's attempts to develop a common front, vis-à-vis external energy suppliers, has been mixed. One of the reasons why earlier attempts to develop a common energy policy were unsuccessful was the diversity of national interests regarding relations with supplier countries and the determination of member states to defend those interests. The failure of the then nine member states to present a united front during the 1970s energy crises (or indeed of the "eight" to support the Netherlands when it faced a boycott of oil supplies by Arab exporters in 1973) only underlined the persistence of 'national' over 'Community' concerns (Lucas 1977; Lieber 1980). Subsequent attempts to develop an energy diplomacy were less ambitious and took the form of a series of dialogues with major energy suppliers, notably oil exporting nations in the Middle East and the Gulf. Such dialogues were designed to encourage economic development and diversification in exchange for a stabilisation of supplies. In the 1980s and 1990s the Commission presided over a wide range

<sup>&</sup>lt;sup>11</sup> Imports accounted for slightly more than 50% of energy needs in 2005 and this is expected to rise to 70% by 2030 on current trends.

of international programmes designed to foster cooperation on energy matters, mostly in the realms of training and research on technical issues of energy technologies and policy analysis (European Commission 1995c). Such cooperative initiatives have remained an important part of the EU's external energy relations, but increasingly the overall thrust of energy diplomacy has been couched in terms of market access with the aim of opening up trade and investment opportunities in energy exporting countries. Therefore, just as market liberalisation emerged as a core element of the intra-EU energy policy agenda in the 1990s, so too did it become a more important component of EU relations with external energy supplier states (European Commission 1997: 2). Moreover the EU's growing effectiveness in trade policy strengthened its willingness to adopt a more active energy diplomacy.

With renewed concerns over supply security, the diplomatic dimension of energy policy has become more important. This is reflected in the fact that energy has become an important part of external relations (van der Linde 2007). As an indication of its significance, in 2006 Commission President Barroso called for all summits with third countries to prioritise energy matters (Barroso 2006). The overall thrust of policy was expressed in a joint document prepared by the European Council and Commission in June 2006. Stressing that "(w)ellfunctioning world markets are the best way of ensuring safe and affordable energy supplies" the document proposed that the EU should extend its energy market "to include its neighbours within a common regulatory area with shared trade, transit and environmental rules" while more widely "the EU should advocate reciprocity in market opening and respect for market rules: non discrimination, competition, transparency and enforcement" (European Council 2006a: 2). At the multilateral level the report called for the integration of "the EU's energy objectives...into its multilateral trade policy", a proposal subsequently reinforced by the Trade Commissioner (Hagry 2006). A similar emphasis on markets was apparent in the Commission's follow-up work. The 2007 Energy Policy proposals make very clear the importance that the EU "speaks with one voice" on international energy matters and argues that it use its established role in trade to secure commitments from energy suppliers for the liberalisation of trading, investment and access conditions (European Commission 2007a: 17-18).

The most important target of the EU's external energy policy are its neighbours or near neighbours, many of whom are suppliers of energy to the EU or host the infrastructure which delivers key resources to the Union. A key component of this policy is the EU's determination to provide clear legal frameworks premised on market access, in effect bringing the logic of the internal market and international trade rules to the energy sector across much of Eurasia and the Mediterranean. The EU's approach is a mix of regional and bilateral agreements, the former setting out a mixture of general principles and obligations, the latter consolidating these objectives and commitments according to the specific characteristics of the partner and the EU's relationship with them.

One of the first expressions of the EU's 'liberal' energy diplomacy was the European Energy Charter, later the Energy Charter Treaty (European Commission 1991, 1993; Energy Charter Treaty Secretariat 2002). Originally mooted by Dutch Prime Minister, Ruud Luubers, as a post cold war equivalent of the ECSC which would bring together the countries of Eastern and Western Europe through closer energy relations, the European Energy Charter was signed in 1991. It set out a framework for cooperation which was to span the whole of Europe on the basis of principles of open markets, non discrimination and access for foreign investment *inter alia*. It also stressed the need for an international agreement to provide a common set of rules and dispute settlement procedures which would be based on GATT/WTO principles and rules. Negotiations on the Energy Charter Treaty began in 1992 and the Treaty was signed in 1994, entering into force in 1998 and subsequently followed up by negotiations on various protocols, including one on transit (i.e. access to networks in countries between the seller and buyer of energy). However, while signed and ratified by most of the governments of Europe, the Treaty remains to be ratified by some of the most important energy players in the region, notably the Russian government (Haghighi 2007).

The Energy Community Treaty which entered into force in 2006 (European Commission 2006b) effectively applies the EU energy *acquis*, particularly the internal market provisions, to the Western Balkans and it may be extended to other near neighbours such as Moldova, Turkey and Ukraine. While the Treaty provides the non-EU parties with access to EU energy markets, the core intention of the agreement is to establish a single framework for energy markets in both the EU and those countries that are, or may become, candidates for EU membership. Parties to the Treaty are in the process of agreeing national 'road maps' which are intended to bring their energy policies into line with this goal.

The Commission has indicated that it is keen to extend the provisions of the Energy Community Treaty to reforming countries in other strategic regions, notably around the Black and Caspian Seas. In the interim, however, it has established separate frameworks for engaging these regions in an energy policy dialogue. The 'Baku Initiative' of 2004 involves countries from these regions, as well as from Central Asia, in a joint effort to foster regional energy markets and develop new infrastructure with the longer term aims of bringing about the convergence of energy policies and the creation of a larger energy market (European Commission 2006c).

With regard to its neighbours to the south of the Mediterranean, the EU has been seeking to develop a similar framework for its energy relations. Since the 1995 Euro-Mediterranean Conference, member states and the countries of the Middle East and North Africa (MENA) have been trying to agree a framework for enhancing energy cooperation. As part of the 'Barcelona Process', the Commission has used these discussions to foster reform in the energy producing and transit countries of MENA as a means to provide 'security of investment' (European Commission 1996).<sup>12</sup> Initial proposals to extend the Energy Charter Treaty framework to the region have given way to a range of other projects, the most recent of which was a 2007 agreement on a five year 'Priority Action Plan' to bring about the convergence of market conditions and energy policies as a prelude to creating a Common Euro-Mediterranean Energy Market (European Council 2007b).

Such regional frameworks, along with more general programmes such as the European Neighbourhood Policy, are potentially important in framing the terms of the EU's energy relations with its near neighbours, particularly where the agreements entail binding commitments and dispute settlement procedures. However, the EU has also put considerable effort into securing bilateral agreements with individual energy supplier or transit countries. Indeed it has sought to substantiate the broad principles of regional agreements with more detailed agreements on a bilateral basis. So far such bilateral agreements have been negotiated with Azerbaijan, Morocco, Ukraine and Jordan. It has also been courting suppliers such as Kazakhstan and Turkmenistan (European Commission 2007d).

However, the major prize for EU energy diplomacy would be an agreement with Russia to place energy relations on a surer footing. Russia supplies 20% of the EU's oil needs and 40% of its gas needs. For a number of years the EU sought to persuade the Russian government to ratify the Energy Charter Treaty and its Transit Protocol. The Russians, arguably correctly, saw this proposal as a potential threat to the market position of the country's incumbent energy companies, notably Gazprom, and have so far been unwilling to sign up (Haghighi 2007). Instead, the main framework for EU-Russian energy relations has been an 'Energy Dialogue' (European Commission 2004). Established in 2000, this has been the venue for some quite difficult discussions on energy matters over the last few years and hopes of a

<sup>&</sup>lt;sup>12</sup> When the Euro-Mediterranean Partnership was launched there were also hopes that the Energy Charter framework would be extended to relations with energy suppliers in the Mediterranean.



more wide ranging agreement to open up energy markets have yet to bear fruit (Johnson 2005; Gomart 2007).

#### The Return of Security and Sovereignty in Energy Policy

The Russian response to the EU's calls for more liberalisation is perhaps the strongest example of the limits to the EU's strategy. Given the way that market liberalisation has come to influence EU energy policy overall, its increased prominence in energy diplomacy is understandable. The Commission and many energy consuming states claim that such an approach is the best guarantee of supply security because it removes obstacles to market access and investment. However, it is not at all clear that such a view prevails elsewhere, particularly amongst the major energy exporting countries. For many of these countries, and arguably some energy consuming countries as well, the return of energy security as a core concern has also revived interest in national sovereignty over energy resources.<sup>13</sup>

The last few years have seen a backlash against the terms on which foreign investors secured energy assets in the developing world and former socialist states. Governments in those countries have sought to revisit what they consider to be unfair agreements, often renationalising the assets or asserting greater control over their development. In addition, energy firms from those countries have, in some cases, been keen to develop their presence in 'downstream' energy markets, even selling direct to final consumers, as a way of securing more of the economic benefits from their assets. These moves by governments to assert greater sovereignty over what are often the key sources of export and fiscal revenue have been characterised as the principal example of a revived 'economic/resource nationalism'. Arguably this revival has been a contributory factor to the rising energy prices and supply security concerns. It is, however, debateable whether higher energy prices and tighter energy markets have prompted governments to seek greater control and economic rents, or whether governments' interventions have themselves contributed to higher prices and supply side constraints.

While signs of such 'energy nationalism' are apparent in Sub-Saharan Africa, Latin America and parts of Central Asia, the most important developments for the EU have been those taking place in Russia and Algeria. Taken together they account for around 60% of the EU's gas imports (Russia 42% and Algeria 18%). In both cases, the national governments maintain close relations with the principal national energy companies through partial or complete state ownership and those relationships have been deployed in recent years to strengthen control over national energy resources at the expense of foreign involvement in 'upstream' activities such as exploration and production.

Partially state-owned Gazprom has been able to rely on the support of the Russian authorities in securing a stronger position within the Russian oil and gas markets, in some cases revisiting the terms on which foreign participation in new energy projects had previously been agreed. Over the last few years a number of Russian projects in which companies such as BP and Shell had secured highly advantageous terms began to encounter serious regulatory problems. In the case of Shell, only after it reduced its major shareholding in the Sakhalin II gas project were the regulatory difficulties resolved (Ostrovsky 2006).

Over the same period, Algerian relations with foreign investors in its energy sector have also been revised (though with less of the highly public tensions which have accompanied the Russian cases). In 2006 the Algerian government reversed a planned liberalisation of its investment regime for oil and gas, reinstating the principle of majority Algerian ownership in new projects (Hoyos 2006). In 2007 the state owned oil and gas company Sonatrach rescinded an agreement with the Spanish companies Gas Natural and Repsol for the

<sup>&</sup>lt;sup>13</sup> The changes are particularly apparent in the oil sector (see Hoyos 2007).

development of a major oil and gas project on the grounds of delays and cost overruns (England 2008a, 2008b).

At the same time as consolidating their control over domestic gas production, both companies have also been able to take advantage of their market power vis-à-vis consuming countries to gain a greater downstream presence in many parts of the EU. In recent years energy companies such as Sonatrach and Gazprom have been able to establish or acquire supply companies in a number of EU member states, enabling them to sell directly to consumers. In the case of Gazprom, for example, the company has been able to acquire distribution and transmission companies and has established supplier subsidiaries in a number of member states (Locatelli 2008). Sonatrach has also acquired stakes in many European energy companies and established its own marketing companies to sell direct to final customers, often in the face of opposition from existing suppliers in those markets (see Crawford and England 2008). Furthermore, in a further sign that it wants to see the state owned company diversify downstream, the Algerian government has indicated that granting future exploration rights for foreign investors would be dependent on obtaining overseas energy assets (England 2008a, 2008b).

#### The EU's Response: Reciprocity and its Limits

Such activism has crystallised concerns in some member states and the European Commission that the balance of power between suppliers and consumers has become seriously skewed to the EU's disadvantage. There is the potential for third country energy suppliers to penetrate EU downstream markets at the same time as EU firms were facing more upstream restrictions. To compound the fears of a shift in the balance of power, there has been a growth in concern about the possibility of supplier companies (notably Sonatrach and Gazprom) developing closer links, possibly leading to the creation of a gas supplier cartel equivalent to OPEC.<sup>14</sup>

Overlapping with these worries was a wider concern about state owned enterprises in investing in 'strategic' industries within the EU. While some of these concerns were directed to the increasing prominence of so-called Sovereign Wealth Funds – government owned investment vehicles which often draw upon the fiscal gains from high commodity prices (Whyte and Barysch 2007) – they were also directed at the presence of state owned energy firms as investors in EU energy utilities. There was a worry in some member states that such investors might use their ownership position in pursuit of wider political objectives rather than immediate economic returns.<sup>15</sup>

The response of the European Commission to these developments has been to back up its call for market opening agreements with a more active use of its competition and internal market powers. In the first instance it has used the competition provisions of the Treaty to tackle the more restrictive elements of agreements between energy producers in third countries and their utility customers within the EU. In the second it is aiming to use its internal market reforms to impose limits on the way energy suppliers from third countries can operate inside the EU, making full access conditional on a reciprocal opening up of home markets.

Signs of a more aggressive approach towards energy exporters have been apparent in the approach adopted by the Commission's competition authorities in recent years. For many

<sup>&</sup>lt;sup>14</sup> Fears of such a cartel have been widely debated since 2006 and were highlighted by organisations such as NATO (Buckley et al 2006). Others are more skeptical about the possibilities of such an arrangement given the nature of the international gas trade (see Finon 2007; Darbouche 2007).

<sup>&</sup>lt;sup>15</sup> According to President Barroso, while generally the EU welcomed foreign investment, in the energy sector "we should be open but we should not be naive. We want to have a mechanism which if needed can be activated to protect the internal market from foreign designs whose motives are not purely commercial." (Hagry 2007).

years gas exporters and their partners within the EU have agreed to a number of restrictions on the marketing of contracted gas, in particular limits on the scope for gas buyers to resell outside of their supply zone. The Commission considered such restrictions to be against European competition rules and launched investigations in 2000. Between 2003 and 2007, all of the major exporters and their EU based customers have agreed to remove any restrictions on the sale of such gas and profit sharing (Wäktare 2007). So far, however, it has not applied its competition powers more widely against what some would consider the anticompetitive behaviour of some suppliers (Milligan 2007).

Instead, the Commission has sought to use its reform of EU gas and electricity markets to tackle the structure of exporting companies' operations and potentially to obtain some reciprocity in terms of investment and possibly market access conditions. As noted, the main objective of the EU's legislation was to ensure a fully competitive internal market for electricity and gas. The reforms involve amendments to existing rules on market liberalisation to increase the degree of separation between companies involved in importing or producing gas and electricity on the one hand and transmitting, distributing and supplying it on the other. However, such changes would not only apply to the utilities based inside the EU; companies from third countries which produced or supplied energy to EU markets would also not be able to own transmission systems within the Union. In addition, the Commission's proposals require that third country operators would not be able to own such assets unless there was an agreement between that country and the EU which covered a wider range of energy market issues. In effect the Commission's proposal implies greater reciprocity of market access in exchange for involvement by energy suppliers in downstream markets within the EU (ab lago 2007a).

These requirements, commonly referred to as the 'Gazprom clause', have proven to be very controversial and have been criticised by both third country suppliers and their governments. However, it is not clear whether the proposed measures will be translated into legislation. As noted, the directives in which these provisions are included have been heavily criticised by a number of EU energy companies and their governments. Needless to say, those energy utilities which are not fully unbundled have been the most hostile to the Commission's proposals in this area. They and their governments have been seeking to water down the unbundling provisions since the principle was mooted by the Commission (ab lago 2007b). While their opposition is premised on the impact on their own operations, any changes they were able to secure might also impact upon what is expected of third country operators. The question of a reciprocity clause would probably be addressed separately.

Indeed, while the vertically integrated incumbents tend to defend their market power as necessary to negotiate on equal terms with exporters such as Gazprom, their relationships with such suppliers are generally good, with many of them having recently renewed long term supply contracts with the exporters and some (such as E.ON) have still closer linkages through minority shareholdings. The Chair of one utility has been reported as claiming the threat to EU energy supplies does not come from companies such as Gazprom but from the European Commission on the grounds that its various energy proposals are discouraging future investment (Milne 2007).

In a sense therefore the Commission's attempts to liberalise both internally and externally, face a significant challenge from within its borders as well as from outside. Indeed, throughout the liberalisation process it has encountered an alliance of companies and governments which has constrained and shaped the pace of reform. The parameters of that alliance have changed with market developments but it remains a problem as governments have sought to promote and protect the interests of their national energy champions.

Aside from the unbundling issue the main manifestation of the tension between the Commission and some states has been over the issue of corporate restructuring. While the

 $^{16}$  See for example the critical response of Vladimir Putin at the time of the EU Russia Summit (Bruls 2007) and from the CEO of Gazprom (ab lago 2008).

Commission has generally sought to encourage the development of Europe-wide utilities which would compete for consumers across many member states, it has been faced with a number of member states seeking to shape such reorganisation to the advantage of their national firms. In some respects, such as where mergers between national firms have escaped the scrutiny of the EU Merger Regulation, the Commission has been unable to act. In other cases, however, it has sought with mixed results to prevent national authorities from blocking takeover attempts either through a 'golden share'<sup>17</sup> or the manipulation of corporate governance and other rules. In such cases, the member states justify their actions as necessary to defend their strategic interests in maintaining energy supply. While the Commission has sought to act against these restrictions where they conflict with Internal Market principles, the process is drawn out and uncertain. In the meantime, such manifestations of 'energy nationalism' inside as well as outside the EU might be regarded as compromising the Commission's attempts to liberalise energy markets at home and abroad.

#### Conclusion

This article has attempted to show how liberalisation has become an important principle of not only the EU's internal energy policy but also its energy diplomacy. In both respects, moreover, the pursuit of market opening has been seen as important for ensuring the security of energy supplies. The policy has had some successes, particularly with countries which aspire to join the EU (and where arguably the EU has a stronger bargaining position). Yet it is not clear how far this strategy can be pursued with those energy suppliers who are unlikely to be candidates for membership. In these cases, the EU's limited bargaining power is further constrained by the revival of sovereignty and security concerns inside and outside the EU. With 'economic nationalism' apparent in the policies of not only many energy exporters but also some member states, a strategy of relying on liberalisation may not be as effective as it is claimed. In effect, there appears to be a mismatch between, on the one hand, an ostensible commitment to internal and external liberal strategies led by EU authorities and, on the other, conduct inside and outside the Union where governments support and protect incumbent firms. There are signs that aspects of this policy are changing, most notably in terms of the willingness of the Commission to push a policy of 'reciprocity' in the treatment of market access and investment in the energy sector. However, even this strategy depends upon member states agreeing to internal reforms which are opposed by a significant minority.

Clearly the processes of internal and external liberalisation are intertwined. As the Joint Council-Commission proposals stressed "(e)xternal energy relations cannot be separated artificially from the wider question of what sort of energy policy the EU and its Member States want...A more fully developed internal policy is a pre-condition for delivering the EU's external energy interests, and for better judging what leverage the EU is able to bring to bear in its external relations for furthering these interests" (European Council 2006a: 1). One could add that a limited internal policy is likely to be matched at the external level.

In other areas of policy (such as telecoms or airlines) the EU has been arguably quite effective in using internal liberalisation as a driver for external liberalisation. Moreover the area of trade policy has been the area of external relations where the EU has been most effective. However, it is clear that energy is different from other external trade policies as regards the nature and flows of the traded goods and the regimes governing them. In these circumstances it appears difficult for the EU to conduct a common energy diplomacy when many member states not only maintain policies at odds with the overall orientation of market liberalisation but also seem to prefer to work with their *national champions* to arrange future energy supplies with external suppliers. For the time being it appears that sovereignty remains the prevailing principle for a number of member states. As long as this is

<sup>&</sup>lt;sup>17</sup> A golden share provides a state with a 'non-financial' stake in a company (usually considered important to national interest) which provides it with a veto over a possible merger of that company.

the case the EU's energy policy, in its internal and external forms, will exist more in principle than in practice.

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