

EU COMPETITION POLICY AND MARKET LIBERALIZATION; USING THE GAZPROM
ANTITRUST CASE TO EXAMINE THE EU INFLUENCE ON RUSSIAN ENERGY POLICY

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A thesis submitted to the faculty of the University of North Carolina at Chapel Hill in partial fulfillment
of the requirements for the degree of Master of Arts in the Department of Political Science, Concentration
European Governance.

Chapel Hill
2018

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ABSTRACT

David Callahan Hager: EU Competition Policy and Market Liberalization; Using the Gazprom Antitrust Case to Examine the EU Influence on Russian Energy Policy
(Under the direction of Holger Moroff)

To examine the EU influence on Russian energy policy, this thesis isolates EU competition policy in natural gas markets and considers the European Commission's antitrust proceedings against Russian-state owned Gazprom. By applying the neofunctionalist principle of spillover to natural gas markets, I examine the degree to which the EU has influenced Russian energy policy. I find there exists no visible change in domestic energy policy of Russia due to the implementation of competition rules in the EU internal energy market. By examining the Gazprom antitrust case, I find that the EU's competition policy has weakened the ability of the Kremlin to use Gazprom as a tool of foreign policy. With these findings, we are able to better understand the means by which the Russian federation is able to coerce energy importing Member States using natural gas as political leverage.

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LIST OF ABBREVIATIONS

BCM	Billion Cubic Meters
DG COMP	European Commission Competition Directorate
ENTSO-E/G	European Network of Transmission System Operators for Electricity
EU	European Union
LNG	Liquified Natural Gas
PCA	Partnership and Cooperation Agreement
TFEU	Treaty on the Functioning of the European Union
TOP	Take-or-pay

CHAPTER 1: INTRODUCTION

The European Union (EU) has made significant changes to its internal energy policy in recent years. The EU has introduced several new policies, strategies, and directives in order to decarbonize the economies of the soon-to-be EU-27 and provide a greater degree of collective energy security to its Member States. However, given the EU's strong energy ties with Russia, European energy policy is largely connected to the supply of energy from Russia. The influence that the Russian Federation exerts politically and economically on the European Union is a highly debated topic and remains a primary concern for European policymakers. This concern is most evident in European and Eurasian energy markets. While the EU-Russia relationship is often examined from the perspective of Russian influence on the European project, this paper considers the inverse relationship. More specifically, this paper focuses on the sub-sector of natural gas to examine the influence that EU energy policy has on the domestic energy policy of Russia.

Energy security remains a key objective of contemporary energy policy of the European Union. As past regional conflicts, global market shocks, and environmental concerns influence the supply and demand of various energy resources in Europe, the EU has prioritized energy security and market stability through its legislation in numerous ways. From the European perspective, one of the fundamental threats to energy security is the EU's dependence on the Russian supply of energy resources. Given that natural gas accounts for the majority of fossil fuels traded between the EU and Russia, this particular energy source forms the basis of political and economic relations between the two, over that of other hydrocarbons such as crude oil or liquified natural gas (LNG). However, it's evident that the European Union and the Russian Federation are co-dependent when considering energy flows; the former needing a vast amount of energy to meet the market demand of its Member States, and the latter needing energy export revenues to support its economy and maintain a strong energy production sector.

While the mutual benefits of energy sales between the EU and Russia are clear, their respective energy policies have differed substantially. A key strategy of the EU has been to facilitate competition within its internal markets to increase the degree of collective energy security for its Member States. This strategy has been set in motion by market liberalization policies implemented at the EU level. At its core, this restructuring of the gas markets is designed to eliminate the possibility of a monopoly, offer market-based prices for customers, and limit the political and economic influence of external supplier countries in domestic European markets.

External influence on internal European markets is arguably most visible in the case of Russia. In the case of natural gas transmission from Russia to the EU, this external pressure on European competition is identifiable with Gazprom, Russia's state-owned energy company. This paper seeks to answer the following question: is EU energy policy influencing Russian energy policy? As a theoretical component to this research question, a neofunctionalist principle will be applied to this research question. I anticipate that the primary theoretical component of neofunctionalism, the concept of spillover, will demonstrate that the supranational energy policy of the EU is directly impacting the way the Russian government responds to changing energy market dynamics, thus shaping its domestic energy policy. I will attempt to demonstrate this concept by examining competition, or antitrust, policy in European natural gas markets. Isolating the case of Gazprom, this paper will discuss how EU competition policy has directly affected the natural gas policy in Russia.

The presence of this occurrence, to any degree, would prove to be significant as the EU holds no authority nor domain over Russian energy policy. Gazprom serves as an excellent example as it is the largest energy company in Russia, is state owned with 51 percent ownership by the Kremlin, and is the company that accounts for the majority of natural gas imported into the European Union. For the purposes of this thesis, majority Russian State ownership of Gazprom is an element that permits the extrapolation of the Gazprom business model to federal policy in Russia. The Russian government has frequently used Gazprom as a political tool in international affairs, and this paper will later discuss the implications that changes in the operations and business model of Gazprom has on national policy in Russia.

As Locatelli (2015) discusses in her article, Gazprom's business model directly contradicts the market liberalization transition that EU policy is facilitating. This characteristic illustrates the stark differences that exist between the Russian federal state and the European supranational polity. The political relevance of this topic stems from the interdependence of the EU and Russia, the supply and demand balance of fossil fuels, and has broader potential implications in the fields of European integration, international political economy, and international relations. It's critical to assert that this paper does not intend nor attempt to determine the efficacy of the EU's antitrust strategy as a response to heightened energy security concerns. But, rather, this thesis seeks to understand the political force the European Union is able to exert on domestic energy policies within its regional neighborhood. Subsequent sections of this paper will discuss in greater detail EU integration theory, EU-Russia relations, energy policy, market liberalization in Europe, and the role and power of Gazprom. Throughout this paper, the policies, markets, and institutions referred to as "European" are representative of the European Union rather than a broader definition that encompasses geographical or cultural boundaries. At the time of writing the EU comprises 28 Member States.

CHAPTER 2: THEORIES OF INTEGRATION

As the European project has developed and expanded, scholars and politicians have attempted to understand and conceptualize the integration that EU Member States have willingly accepted over the past several decades. The EU exhibits various traits of a federal state, an intergovernmental organization, and a confederation, among other political structures. This unique blend of political characteristics in Europe prevents scholars from applying framework typically used to understand the development and structure of nation states. Theories of European integration offer insight to the contexts, motives, and actors that drive nation states to strategically pool their sovereignty and delegate national competencies to a supranational polity and its institutions, such as the European Union. Furthermore, theories of integration in turn provide a better understanding of the European Union, its actions, and the effects its institutions have on its regional neighborhood and the international community. As certain policy areas have been collectively pooled, assigned, and entrusted to the European Union by Member States, these European competencies thus make the EU a leading actor in the global arena. The EU holds exclusive competence in matters pertaining to the customs union, monetary policy in the Eurozone, competition regulation in the internal market, and commercial policy, among others. In addition, social policy, transportation, energy, consumer protection, and the environment are examples of policy areas where the EU holds “shared competence” with Member States (European Commission, 2018).

Understanding the external pressures both placed on and projected from the EU is directly relevant to the case at hand: the EU’s influence on Russian energy policy. Integration theory can offer insight as to why a country outside of the EU may elect to harmonize its domestic policy with that of a supranational body in its regional neighborhood. For the purpose of this thesis, one theory of European integration will be discussed and used to explain the international shifts in policy that are expected to exist in the chosen policy domain. Among the multiple theories of integration, neofunctionalism offers the greatest

potential for a theoretical understanding of EU-Russia energy relations due to its distinguishing characteristic: spillover. The following section will provide a concise overview of both the theory and concept, and how it is expected to explain the relationship in question.

Neofunctionalism

Neofunctionalism remains a prominent theory of European integration, alongside the likes of Federalism, Liberal Intergovernmentalism, and Social Constructivism. Initially conceived by the work of Haas and Lindberg, Neofunctionalism has historically been used as a primary way to explain the development of the European Union and the integration of its Member States. Haas defined integration as follows:

“The progress whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states. The end result of a process of political integration is a new political community, superimposed over the pre-existing ones” (Niemann and Schmitter, 2009).

Neofunctionalism was accepted to be the leading theory of integration until the mid-1960s. However, its assumptions and framework have fallen subject to criticism in recent decades (Niemann and Schmitter, 2009). Neofunctionalism is concerned primarily with the delegation or pooling of sovereignty of EU Member States or candidate countries, and thus, the theory has not generally found application in the case of Russia. However, this paper seeks to examine the theory’s concept of spillover in greater detail, with the aim of determining the EU competition policies on Russian domestic energy policies. The central claim of this paper is that the EU is having a direct influence on the energy policy of Russia, which can be best explained using the idea of spillover. This paper holds wider applications to integration studies, as the research focuses on a particular sub-sector of energy policy and potentially offers a greater understanding of sectoral-based integration of non-EU Member States.

Neofunctionalist theory places an importance on the way decisions are made between actors of integration. Actors’ decisions are understood to be made on an incremental basis, rather than stimulated by a formal, overarching political goal. Furthermore, this theory highlights that the decision-making of states results from previous decisions or changes in regional policy (Bergmann and Niemann, 2015).

Neofunctionalists prioritize the idea of the independent power and leverage of supranational institutions as drivers of integration. Distant from a functionalist approach, neofunctionalists place an importance on regional political interaction (Niemann and Schmitter, 2009). Three assumptions characterize the logic of the theory and are widely accepted by neofunctionalists: integration is a process that evolves over time; regional integration occurs as a result of multiple actors; and decisions are made by rational, self-interested actors capable of changing their individual preferences (Bergmann and Niemann, 2015). The second assumption remains distinctly relevant, as the theory asserts that integrative change can occur as result of state, supranational, and private entities, among others.

Spillover

The term “spillover” continues to be the principle that separates neofunctionalism from other integration theories. At its core, spillover describes the notion that some sectors of the economy are so strongly interconnected that inevitable integration occurs in other sectors regardless of national borders (Niemann and Schmitter, 2009). This concept includes a natural spreading, or enlargement, effect that explains why nation states alter or delegate their policies to neighboring countries, with a regional understanding applied to the case of contemporary Europe. The principle of spillover can be categorized by three classifications: functional, political, and cultivated spillover (Bergmann and Niemann, 2015). Functional spillover is the concept’s most pertinent form to the question at hand by asserting the economic, functional argument as the reason for integration.

“Integration would occur to the extent that (a) transnational activity and economic interdependence proceeded, revealing the potential both to reap joint gains and to deal with the negative externalities created by transnational activity; (b) European elites (private actors, firms, and public officials) were led to seek regional—rather than national—solutions to shared problems; and (c) supranational organs of governance supplied rules (law, procedures for the ongoing production of rules and dispute resolution) that satisfied these needs” (Sandholtz and Sweet, 2012).

Haas and Lindberg considered the role of political elites to be critical in the integration process. According to the theorists, elites are capable of recognizing that regional issues cannot be effectively resolved by domestic political framework, and therefore succumb to various economic pressures by turning to a new center and adapting a new strategy of policy-making (Niemann and Schmitter, 2009). Functional spillo-

ver's focus on supranational law works to support the principle idea of this thesis, as EU competition law applies to multinational companies operating within the borders of its Member States.

I consider the claim that subsequent sectoral integration promoted by political elites will occur naturally following the initial integration of an economic sector to be unlikely in the case of the EU and Russia. As will be examined with the case of Gazprom, I argue that Russian elites have found it to their benefit to alter their energy policies to that of the EU but have not necessarily found substantial value in re-evaluating their focus toward EU institutions. This idea will be explored in greater detail in the following sections of this paper.

CHAPTER 3: EU-RUSSIA RELATIONS

Relations between the Russian Federation and the European Union illustrate both a geopolitical struggle and balance on numerous political and economic issues. Both the formation of a common market in Eurasia, the Ukrainian crisis, and ongoing economic sanctions continue to be the contemporary events that set the tone of EU-Russia relations. The EU and Russia are key partners on numerous issues of mutual benefit and have maintained strong historical ties by working together on relevant regional and international issues (EEAS, 2017). From a legal perspective, the EU-Russia relationship is largely characterized by the Partnership and Cooperation Agreement (PCA). The PCA was introduced in 1997 and has been re-approved by both parties on a yearly basis after it was initially slated to expire in 2007 (EEAS, 2017). The PCA designated framework for the Russian Federation and European Union to consult with each other on relevant issues and has been expanded through the addition of tangential sectoral agreements. While some of the consultations between the two PCA parties have halted following Russia's annexation of Crimea, the EU and Russia have generally maintained open communication on issues relating to trade, education, technology, science, energy and environment, transportation, and the prevention of illegal activities (EEAS, 2017).

Today, the European Union is the largest trading partner to the Russian Federation (EEAS, 2017). However, despite cooperation on many aspects of trade, as the contemporary structure of the EU developed, Russia led the creation and implementation of the Commonwealth of Independent States (CIS). The creation of the CIS can be viewed as an attempt by Russia to counter the formation of a unified European market by establishing a similar market structure among post-Soviet states in the EU's eastern neighborhood. Rather than pursuing additional agreements, cooperation, or any degree of prospective integration with its western community, Russia led the creation of a rival economic community in 1991. This underscores the understanding that Russia has deliberately remained distant from the EU in the historical case of integration and focused its political cooperation in post-soviet Eurasia. The CIS is also illustrative of

the political differences that are present between the EU and Russia, and thus how contrasting political structures and political agendas have resulted in EU-Russia cooperation in a certain few policy areas.

Apart from the creation of a regional economic union, Russia's standing relationship with the EU has been shaped by the ongoing crisis in Ukraine. Armed conflict in Ukraine has continued since it first started 2014, following civil unrest that took hold in 2013 after Viktor Yanukovich ceased Ukrainian cooperation talks with the EU (Godzimirski, 2014). The EU responded with its first set of economic sanctions in March of 2014, with additional diplomatic measures introduced in July and September of the same year (EEAS, 2018). As a result, western sanctions imposed on Russia have restricted and limited access to capital across all sectors (Franza, 2016). Ukraine's geopolitical position as a transit country for Russian gas prompted strong concern among Europeans and altered energy relations across the continent. By considering Ukraine's membership in the EU Energy Community and Ukraine's substantial domestic market for Russian gas, the complexities that hinder regional cooperation are evident (Godzimirski, 2014).

CHAPTER 4: EU-RUSSIA NATURAL GAS RELATIONS

As of 2000, the term “energy dialogue” has been used to describe EU-Russia energy relations (Godzimirski, 2014). This dialogue is largely shaped by the flow of energy from east to west, with the majority of energy flows consisting of natural gas. The energy policies and strategies of the two political entities are known to be starkly different. While the European Union imports significant amounts of natural gas, dependency on the resource varies drastically among Member States. Legislation, directives, and targets at the supranational level influences the way Member States manage their natural resources and respective energy mixes, thus impacting the demand for natural gas within the EU.

Natural gas consumption in the European Union has declined in recent years. This decline in consumption can be attributed to existing decarbonization policies in place at the EU level. Despite the carbon merits of natural gas in the goal of decarbonizing Europe, the EU has instead focused on renewable energy development and energy efficiency programs (Pisca, 2016). Furthermore, competition with coal, the global financial crisis, and economic downturn have fostered the decline of natural gas consumption within the collective EU-28. Presently, no regional consensus has been reached on forecasted EU natural gas demand over the next decade. While the collective demand has decreased as of late, projections for future demand vary widely between organizations and research bodies. Many experts in the sector expect for EU natural gas demand to increase in the coming years as economic activity expands in the Union, while others anticipate declines as Member States limit their energy consumption through energy efficiency measures and increase the prevalence of renewable energy sources domestically. Overall, present demand outlooks for natural gas in Europe largely remain characterized by uncertainty (Pisca, 2016).

As with other sectors of its economy, the EU has adopted a liberal-institutional approach to manage its energy needs, governed through supranational institutions and 28 Member States that are involved in the decision-making process (Godzimirski, 2014). Due to the number of institutions and Member States contributing to the drafting, revision, and implementation of policy, the EU is known for its lengthy

legislative process. Most EU Member States also lack access to the necessary natural resources needed within their internal borders, which has increased the importance of energy supplies on the EU political agenda and contributed to the overall complexity of the issues. Furthermore, the EU is known for its strong environmental and climate policies, which largely influences the direction of policy within the EU-28, as exhibited by the Energy Union (Godzimirski, 2014).

In comparison, Russia is a highly centralized federal state that has a strong leader capable of making swift changes in policy. The Russian State has regularly challenged western ideals and markets, of which the EU embodies (Godzimirski, 2014). The degree of centralization in Russia permits quick implementation or alteration of both domestic and foreign policy. Additionally, Russia has prioritized maximizing profits from its energy exports, and maintaining its international position as a leading energy producer (Godzimirski, 2014). For years the Russian government has attempted to consolidate its market share in European gas markets and has influenced Gazprom to purchase additional downstream assets in Europe to strengthen the country's market position (Boussena and Locatelli, 2011).

Russia has maintained its position as the leading supplier of energy to the European Union since the collapse of the Soviet Union in 1991. In 2016, Russia maintained approximately 30 percent and 40 percent of the market share in the EU for consumption and imports, respectively (Franza, 2016). Between 2008 and 2015, gas exports from Russia to the EU declined 23 billion cubic meters (Bcm). Although the year-to-year change has not declined consecutively, the trend illustrates the decrease in demand discussed in the previous section of this paper. However, the EU continues to be Russia's most profitable market, and Russia has intentions of expanding its energy exports to Europe via the Nord Stream network (Boussena and Locatelli, 2011). Energy represents a strong political tool in Russia and is a primary source of income for the state. In 2014, an estimated 50 percent of state revenues were received from the production, sale, and export of energy commodities, which is vital in the Russian government's ability to balance its national budget (Godzimirski, 2014).

CHAPTER 5: ENERGY POLICY

In order to analyze the influence that the European Union is able, or unable, to project on the energy policy of Russia, an understanding of energy policy is necessary. Regulating and managing a sector of such geopolitical importance is no easy challenge for any nation state or political entity. Energy policy is often highly interdependent with other policy areas, and comprehensively covers the development, distribution, and consumption of energy resources. Energy policy includes legislation, programs, and relations on energy efficiency, renewable energy, climate, energy security, electricity, and most relevant to this thesis, hydrocarbons. The natural gas sector is critical, as the resource serves as a primary electricity generation type, while other fossil fuels are used primarily for heating, the manufacturing of plastics, or the transportation sector.

EU Energy Policy

As part of the EU's reaction to the Ukrainian Crisis, in February of 2015 the European Commission released the Energy Union Package (Rutten, 2016). This set of documents formally detailed the EU's energy and climate strategy and exists as the backbone of the European Union's energy policy today. Following the implementation of the Energy Union strategy, several guidelines and publications were introduced and elaborated on additional goals and considerations for Member States. Further proposals are intended to be unveiled in the future, as the rotation of the European Council Presidency is likely to shift the priorities and goals of the future Energy Union (Rutten, 2016). In its contemporary form, five key dimensions have formed the strategy of the Energy Union: security and trust; full integration of the internal energy market; energy efficiency; climate action and decarbonization; research and competitiveness (EEAS, 2017).

A major point of the Energy Union Package is its focus on Russian supplies of natural gas. Of the six guiding principles included in the package, the common theme is the Commission's clear motivation to diversify EU energy resources and lessen the community's dependence on Russian supplies. Much of

the energy security rhetoric originating from the European Commission is specific to natural gas, as opposed to the other components of security in the policy domain (Rutten, 2016). Among the multiple objectives of the Energy Union, the Member States together strongly support the prioritization of the internal market as well as the implementation of market instruments that facilitate the Union to function in its current design (Rutten, 2016). The consensus among Member States is that of support for a single internal market in the EU. Furthermore, Member States generally agree that the implementation of market instruments at the EU-level are highly relevant to the case later examined in this thesis: antitrust policy.

Of further relevance to the research question posed in this thesis, is the European Commission's correspondence on the regulatory framework of the Energy Union. The Commission has issued its opinion on the need for improvements on the existing regulatory structure. The European Networks Transmission System Operations for Electricity and Gas (ENTSO-E/G) is the current regulatory body responsible for natural gas transmission networks in Europe. As stated by the Commission in the Energy Union Package,

“EU-wide regulation of the single market should be strengthened, through a significant reinforcement of the powers and independence of the ACER to carry out regulatory functions at the European level in order to enable it to effectively oversee the development of the internal energy market and the related market rules as well as to deal with all cross-border issues necessary to create a seamless internal market” (European Commission, 2015).

Russian Energy Policy

With the energy sector being the backbone of the Russian economy, the development and structure of energy policy is both complex and of great political importance. In the Russian Federation, the Prime Minister is responsible for the formation and implementation of energy and environmental policy and is supported by a team of Deputy Prime Ministers in the policy-making process. The Prime Minister's role is significant, as the office maintains the authority to nominate government officials to the boards or audit committees of state-owned companies (OECD/IEA, 2014). Although the energy sector falls under the Prime Minister's domain, the President holds the supreme decision-making authority and the President's administration oversees contracts of state-owned energy companies.

From an institutional consideration, the Ministry of Energy of the Russian Federation is the primary division of the Russian government responsible for all areas of energy policy. Energy policy is further influenced and executed by several other government agencies, such as the Ministry of Finance and the Ministry of Natural Resources and Environment, which are responsible for the taxing of hydrocarbon exports and upstream regulation, respectively (OECD/IEA, 2014). In addition, the Presidential Commission for Strategic Development of the Fuel and Energy Sector and Safe Environment is formed of representatives from various energy companies, relevant government ministers, and regulatory authorities (OECD/IEA, 2014). Numerous other regulatory bodies and committees are involved in various aspects of policy formation, and represent the interests of energy security, sustainability programs, and regional programs and governments, among others (OECD/IEA, 2014).

Russian energy policy objectives are identified in the Energy Strategy to 2030 that was approved by the government in November of 2009. Russia's long-term energy policy priorities are identified as follows: energy security, energy efficiency of the economy, budget efficiency of the energy sector, and environmental safety of the energy sector (Ministry of Energy, 2010). Current legislation is designed to expand the global role of Russia as an energy exporting country and to secure affordable, competitive energy while increasing the sustainability of its national energy mix (OECD/IEA, 2014).

Specific to the natural gas sector, the following policy developments have occurred in recent years. The Russian government has determined that numerous resources across Russia are of "federal strategic importance" (OECD/IEA, 2014). The Ministry of Energy also has pushed for increased oil and gas exports from resources in Russia's eastern regions and released a tax reform plan to reduce tax burdens associated with "hard-to-recover" resource extraction. Additionally, Russia has worked with foreign companies to further develop its resources in arctic regions. Legal framework relating to the increased liberalization of liquefied natural gas exports has also been unveiled, despite Russia not holding a specific competitive advantage in LNG markets (OECD/IEA, 2014). While the policy developments included in this section do not constitute an exhaustive list of the changes that have occurred in the sector, they illustrate the fluid and active nature of energy policy in Russia. While other policy developments like energy

efficiency or renewable energy are substantial components of energy policy, the natural gas sector is highly dependent upon external relations with, demand in, and consumption of other states. Furthermore, a stated priority for Russian energy policy is the role of the country as a global exporter of energy, and its goal of maintaining or increasing its international market share is a political priority unique to Russia.

Gazprom

Arguably one of the most important energy companies operating in Europe is Russian-state owned Gazprom. According to the company, Gazprom gas reserves amount to 17 percent and 72 percent of the global and Russian reserves, respectively. Additionally, Gazprom accounts for 11 percent of global and 66 percent of Russian natural gas output. In 2009 alone, Gazprom natural gas exports declined approximately 21 percent as a result of the global financial crisis (Boussena and Locatelli, 2011). However, in the following years natural gas exports to EU Member States have increased steadily. According to the Financial Times, in 2018 Gazprom was the sole provider of approximately 40 percent of the natural gas imported into the European block. While Gazprom holds the largest share of the natural gas market of any single company operating in the EU, Gazprom's market share varies drastically among Member States. Despite declines in EU demand, Gazprom has played a large role in maintaining Russia's market share, largely resulting from previously negotiated take-or-pay (TOP) contracts (Franza, 2016).

CHAPTER 6: EU ANTITRUST POLICY AND MARKET LIBERALIZATION

Increased competition within energy markets has been a goal of European energy policy for two decades. The transformation of the European natural gas market has been influenced by a series of gas directives at the EU level, with legislation that prioritized market liberalization first introduced by the EU in the 1990s (European Commission, 2012). Article 9 of Regulation 1/2003 regulates the introduction of the competition policy in the EU (Stern and Yafimaya, 2017). Policy changes introduced in the sector were specifically designed to establish rules that permit and promote competition, and to restrict any uncompetitive behaviors by energy companies. The transition towards a more liberal, single energy market aims to prohibit present and future monopolies from developing in the sector and to increase choices among consumers through equal market access for companies and sector diversification. These policies are applied universally to all energy companies, prospective or active, in the internal European market, regardless of the ‘incumbent’ status that companies like Gazprom have, de facto, obtained (Opolska, 2017). Antitrust policy has been implemented to facilitate, and to a great extent force, the unbundling of natural monopolies that have operated in the sector for decades. Additionally, the EU also introduced its “third country clause,” stating that if a third-party country is to maintain operations within the European gas market, it cannot exhibit any signs of threat to EU energy security (Boussena and Locatelli, 2011).

With a political focus on creating competition rather than maintaining transmission networks owned and operated by a sole provider, the industry value chain has been inherently disrupted (Opolska, 2017). This shift to a focus on market-based prices, equal access to the natural gas grid for third parties, and short-term contracts, among others signaled a change in priorities for the EU. The shifts in regulations have had strong implications for Russian gas providers, and thus has produced stress on EU-Russia relations. As a result of directives in 1998 and 2003, institutional and market changes began to increasingly liberalize gas markets across EU Member States (Boussena and Locatelli, 2011). The Commission has

stated that the intended nature of competition policy in the natural gas and electricity sectors was to open internal markets to increased competition, gradually. Initially, companies and consumers exhibited concern for the slow development of markets, high prices, and limited market choices (European Commission, 2012). The following table contains the policy tools that the EU adapted to liberalize natural gas markets as described in Opolska's article.

Table 1. EU Policy Tools for Market Liberalization

Policy Tool
Unbundling
Third-party access (TPA) to the gas network
Market opening
Independent regulatory authority (IRA)
Balancing rules
Virtual trading point (VTP)
Gas exchange
Gas release program
Privatization

As identified in Table 1, policy on the unbundling of energy assets is a primary tool that has been used by the EU to increase competition in its internal market. Bundling refers to the acquisition of downstream assets, such as transmission infrastructure or distribution companies, by producer companies in order to control the majority, if not all, of a particular supply chain. Bundling is a technique that Russian energy companies have applied in European markets since the 1980s (Boussena and Locatelli, 2011). The Russian bundling of production, transmission, distribution, and electricity generation assets was permitted to develop in the EU prior to the formation of the Energy Union as supranational policy was underdeveloped. Policy lacked specificity and focus concerning issues of antitrust and little-to-no viable alternative options to importing Russian hydrocarbons were present to meet the energy demands of Member States. Russian companies have preferred to bundle assets, which essentially complete end-to-end sales without

middle-men in downstream markets and allow them to capitalize on profit margins and increased revenue. This policy focus on unbundling is designed to prevent further deployment of the business strategy and to effectively break-up control of energy assets across Europe. By separating downstream assets, competition will be permitted in wholesale markets where it previously did not exist.

Another point of contention with the market liberalization policies in the European energy space is the use of TOP contracts. TOP contracts were the de facto foundation for energy policy in the EU for decades. Widespread TOP contracts were the norm in the sector prior to the implementation of the energy directives and the formation of a single Energy Union. TOP contracts are understood to facilitate risk-sharing between supplying and consuming parties in a transaction, rather than leaving sales and prices to market forces and mechanisms. Russian companies, and in particular Gazprom, see TOP contracts as a means to ensure continued gas sales to EU Member States (Boussena and Locatelli, 2011).

Gazprom Antitrust Case

As the largest supplier of Russian natural gas to the European Union, Gazprom has experienced complexities with liberalization policies that have been implemented in EU gas markets. In 2012, an Eastern European Member State lobbied for EU action against Gazprom for violating antitrust laws on the basis of its dominant supplier position and price discrimination (Franza, 2016). In September of 2012, the Commission's Competition Directorate (DC COMP) launched official proceedings against Gazprom. (Stern and Yafimaya, 2017). Under Article 102 of the Treaty on the Functioning of the European Union (TFEU), EU proceedings argued Gazprom had abused its position in markets by setting unfair prices for customers, preventing the free movement of gas supplies, and hindering the diversification of gas supplies in the EU market (Stern and Yafimaya, 2017). These violations are clearly exhibited by Gazprom's widespread bundling of downstream energy assets and use of TOP contracts. Although the structure of TOP contracts shares risks between consumer and producers, Gazprom, and by extension the Kremlin, benefited greatly from increased profits associated with the type of contract and were able to organize existing contracts by using its natural gas supplies as political leverage.

Specific cases of violations in Bulgaria, Estonia, Latvia, Lithuania, and Poland on the basis of both territorial restrictions and unfair pricing were brought forward in the EU's proceedings that developed in 2015. Further instances of violation were provided in other Member States' markets. This motion by DG COMP was met with strong reactions and disapproval by the Russian government. Unfair pricing claims by the EU were justified by Gazprom's indexing of gas prices to baskets of oil products. Territorial restrictions claims were identified as Gazprom had included destination clauses and export bans in previous agreements with some of the aforementioned Member States (Stern and Yafimaya, 2017).

The EU made clear its view that Gazprom's operations and existing agreements in the EU were hindering market liquidity and serving as barriers to entry for other energy companies wishing to operate in the market (Boussena and Locatelli, 2011). The use of TOP contracts can be seen as the primary business tool of Gazprom, and the use of such contracts appear to directly contradict the EU's antitrust policy. A key characteristic of TOP contracts between Russian exporters and European importers were the duration of the agreements, which has been addressed as a problem by the EU. TOP contracts are also seen to violate EU competition policy due to price indexation formulas associated with existing agreements, as well as the inflexible quantities of gas that import countries must take from providers (Boussena and Locatelli, 2011). Furthermore, Gazprom's widespread use of TOP contracts have served as way for the Russian government to force political discussions with import countries, and further politicize EU-Russia relations on the basis of gas transactions. As a result of EU antitrust action, Gazprom has gradually renegotiated the terms of its natural gas commitments in an attempt to avoid arbitration in EU markets (Franza, 2016).

"Today, one of the possible sources of friction between the EU and Gazprom (and probably other suppliers as well) is the possible re-examination of these long-term contracts or amendments to some of their clauses that are deemed incompatible with the flexibility needed for the operation of a single natural gas market" (Boussena and Locatelli, 2011).

Despite no admission of guilt or acknowledgement of wrongdoing, Gazprom has publicly announced its plans to ameliorate the conflicts associated with its sale and operations in the EU. With respect to territorial restriction claims, Gazprom has stated its willingness to not apply policies that place

restrictions on resale or territorial bases and to omit any such policies from any existing or future gas supply contracts (Stern and Yafimaya, 2017). Gazprom has also offered to consider changes to existing gas supply contracts that may hinder interconnection agreements with nearby Member States. This response can be seen in the cases of Bulgaria and Greece (Stern and Yafimaya, 2017). Lastly, Gazprom has allowed buyers in Slovakia, Hungary, and Poland with existing long-term contracts the right to request a change in delivery points. DG COMP, on behalf of the EU, views this option to change delivery points as a key way to open up markets and provide additional business opportunities (Stern and Yafimaya, 2017). In regards to pricing issues raised by DG COMP, Gazprom committed to incorporating Western hub prices, among other competitive benchmarks, into its energy agreements with Bulgaria, Estonia, Latvia, Lithuania, and Poland. The company has also announced its intentions to revise prices more frequently and in an expedited manner (Stern and Yafimaya, 2017).

CHAPTER 7: ANALYSIS

Antitrust concerns in European natural gas markets are most evident in the formal proceedings brought against Gazprom by the EU. The EU's attempt at market restructuring to facilitate competition has implications both across the Union and across its external borders. But does the introduction of competition policy by the EU as part of its energy policy influence the energy policy of Russia? Does the case of Gazprom illustrate this influence by a resulting change in domestic policy in Russia? This section will address these questions and connections in further detail.

The Gazprom antitrust case is still active and has yet to be closed with a final penalty, or lack thereof, for the company's clear violations of EU competition law. Gazprom has made preliminary changes to its existing agreements to address antitrust proceedings against its operations in the EU. These preliminary changes are important, as the EU is able to force compliance with its laws to external entities operating within its markets and is currently able to do so before the closing of its antitrust cases. Changes in agreements and operations by Gazprom are notable as they have inherently altered the way the company conducts its import and export negotiations with buyers. However, some eastern European Member States have voiced that Gazprom's changes to existing gas contracts represent only a minimal change in the company's behavior and aren't sufficient action to rectify its alleged antitrust violations. Given the vast market share that Gazprom maintains in Europe, the fact that the Kremlin uses Gazprom as political leverage in negotiations, and the Russian state's majority shareholdings in Gazprom, it's plausible to ask what changes like these might mean for Russian energy policy.

Presently, no direct signs of functional spillover that produce a change in Russian policy objectives or legislation are evident. The Energy Strategy to 2030 continues to be the policy piece that characterizes Russian energy policy, with no comprehensive strategy adopted since the 2030 strategy's implementation in 2009. As previously discussed, recent policy developments have occurred in Russia, but ap-

pear to be issue or region specific. Revisiting the notion of supranational governance as a condition of functional spillover, while EU law does apply universally to companies operating in the EU, the idea fails to explain the lack of change in Russian policy. Furthermore, any changes in Russian policy that have occurred since the implementation of an EU competition policy have not altered the way that the Kremlin approaches its hydrocarbon sales to the European Union. Changes in Gazprom's operation model have not led to wider implications on Russian policy. Some TOP contracts with eastern European Member States have been dissolved or reevaluated but maintaining and increasing market share in natural gas markets continue to be in the economic interest of Gazprom, and by extension, the Russian government.

The Russian government's focus on economic interests is evident with the construction of Nord Stream and Nord Stream 2 pipelines in the Baltic Sea, even though the EU's demand outlook for natural gas remains mixed. However, the domestic production of natural gas in Member States is declining, and the two Nord Stream projects are a way for Gazprom to preserve its economic interests and expand its operations in Europe. Although the Nord Stream AG is a consortium of five energy companies and Nord Stream 2 AG a consortium of six, Gazprom is the largest shareholder for both projects, with 51 percent and 50 percent ownership, respectively. This majority ownership underscores the economic power of Gazprom and the incentives present for the company to further its business in Europe.

But what can be said of the changes in contracts that have occurred from Gazprom thus far, ahead of the case decision from the EU? Further, does the neofunctionalist concept of spillover have any implications for the future of EU-Russia relations? Although spillover yielded no explanatory power in this particular case, the study has additional implications for the principle. As discussed in Chapter 2 of this thesis, spillover places an importance on multiple actors as drivers of regional integration. Economic incentives and actors in the private sector, with changing needs and preferences, are incorporated in the definition of functional spillover and contribute to its occurrence. This understanding of functional spillover stands as both interesting and relevant, as officials of energy companies are included in various parts of the energy policy framework in Russia. As discussed in greater detail in Chapter 5, political and business interests are strongly intertwined in the Russian institutions responsible for energy governance. One fur-

ther example of this close-knit relationship is visible as the Russian Prime Minister maintains the power to nominate heads of Russian state-owned companies. Considering economic motives, the EU continues to be Gazprom's most profitable export market, over that of the domestic Russian market or markets in CIS countries (Boussena and Locatelli, 2011). With strong economic incentives for EU-Russia cooperation, preliminary compliance with EU law from Gazprom, and Gazprom officials holding an integral role in the policy-making process, future spillover in Russia is a distinct possibility.

Given the vast natural resources of Russia and the large volumes of hydrocarbons it exports to countries around the world, it's easy to comprehend how Russia uses its state-owned energy companies as a political tool in the international community. Vladimir Putin has previously stated that Gazprom represents a "powerful political and economic lever of influence over the rest of the world." Russia's usage of Gazprom as a political pawn can be seen in two distinct cases involving Ukraine. First, the actions of former Ukrainian President Yanukovich to reject an association agreement with the EU was met with lower gas prices to Ukraine from Gazprom. This decision, which led to civil unrest in Ukraine, illustrates the willingness of Gazprom to use its natural gas supplies as political leverage, with an offer of economic incentives to politicians that align policies to the goals of the Kremlin. Second, in the months following the ousting of Victor Yanukovich by the Ukrainian people, a western-aligned government was elected in Ukraine. Gazprom shortly thereafter announced an increase in price by 81 percent for natural gas supplied to Ukraine. It's clear that for Russia, natural gas isn't just a commodity to be transported beyond its borders. It's a foreign policy tool.

As highlighted previously, the competition policy of the EU is designed to give Member States options on where they receive their gas imports. Prior to the establishment of the Energy Union, Member States relied heavily on Russian imports to meet their individual energy demands. This resource-based position gave immense negotiating power to Russian energy companies, and the Russian government was able to use the country's energy companies in export negotiations and international export agreements to establish advantageous political positions against neighboring nation states via energy agreements. EU proceedings on Gazprom hold no direct implications on the Russian government. However, this case

serves as an excellent example of how the EU has minimized the Kremlin's ability to use state-owned companies as a political chess piece. Gazprom's willingness to align its existing agreements to European buyers with the policies of the Energy Union weakens its ability to impose the will of the Kremlin on import countries by offering them access to increased market options. This was a stated goal of EU competition policy. These changes indicate the importance of Russian exports to Europe as a means to maintain Russia's position as a leading energy exporter.

Although I argue that the implementation and likely enforcement of competition rules in natural gas markets has weakened the Kremlin's ability to leverage Gazprom as an instrument of foreign policy, other notable forces have contributed to the weakening effect. Two strategic actions on behalf of the United States have contributed to the weakening of Gazprom as a political tool: expansion of the American LNG market and the U.S. Government's clear disapproval of the Nord Stream 2 project in the Baltic Sea. The shale revolution in the United States has allowed the U.S. to become a leader in natural gas production and LNG transmission. While natural gas and LNG markets differ, LNG serves as a potential economic substitute for many EU Member States that are heavily reliant on natural gas. Additionally, the U.S. has taken a strong position in opposition to the Nord Stream 2 project, claiming that while bypassing the Ukrainian transit route, the pipeline does not effectively contribute to the diversification and energy security strategy of the EU. American efforts to illustrate the vulnerability associated transporting the majority of the EU's natural gas through one pipeline network has resulted in other countries taking public stances against the project and highlighting its ability to be used against the EU as political leverage by the Russian government.

CHAPTER 8: CONCLUSION

The research discussed in this thesis did not result in any identifiable changes in Russian national energy policy following the implementation of EU liberalization policies in its internal energy market and the opening of the Gazprom antitrust case. Applying the concept of functional spillover to the case of Gazprom did not illustrate any degree of policy harmonization between the Russian Federation and the European Union. The case for spillover can be made for a potential harmonization of EU and Russian energy policies in the future due to the economic nature of the relationship and the private actors involved in agenda setting and policy-making process in Russia. Although the current relationship remains stressed, the economic benefits associated with the flow of natural gas from east to west could result in a shift in Russian policy towards that of the EU.

No clear correlation was evident between the introduction of competition policy in the European energy sector and recent policy changes in the Russian energy sector. While there is no current proof of a direct influence from the EU, this case did offer insight into Russia's use of Gazprom as a political tool. Furthermore, Gazprom's legal battle with the EU has led to numerous changes in the way the company operates in the EU's internal energy market. By altering provisions in existing energy agreements, Gazprom permitted greater market access to several EU Member States, thus weakening its strategic position in negotiations. This economic and political weakening, due to EU competition policy and antitrust proceedings, can also be attributed to the rapidly expanding U.S. LNG market and the U.S. Government's opposition to the Nord Stream 2 project. Gazprom's weaker position can be extended to the Russian government, which has a majority stake in the company and has exhibited a willingness to use the company as a means to further Russian interests. It's clear that Gazprom holds both company and country specific interests in the EU and is willing to preliminary comply with EU law if challenged. Future changes in Gazprom's operating strategy in Europe may further illustrate the extent to which the Kremlin is able to

use the company as a tool of foreign policy. As it currently stands, Russian domestic energy policy appears to be uninfluenced by the actions of the European Union.

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