

RE-POLITICISING REGULATION: POLITICS: REGULATORY VARIATION AND FUZZY LIBERALISATION IN THE SINGLE EUROPEAN ENERGY MARKET

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The idea that we are living in the age of the regulatory state has dominated the study of public policy in the European Union and its member states in general, and the study of the utilities sectors in particular.¹ The European Commission's continuous drive to expand the Single Market has therefore been a free-market and rule-oriented project, driven by regulatory politics rather than policies that involve direct public expenditure. The dynamics of European integration are rooted in three central concepts: free trade, multilateral rules, and supranational cooperation. During the 1990s EU competition policy took a 'public turn' and set its sights on the public sector.² EU legislation broke up national monopolies in telecommunications, electricity and gas, and set the scene for further extension of the single market into hitherto protected sectors. Both the integration theory literature (intergovernmentalist and institutionalist alike) and literature on the emergence of the EU as a 'regulatory state' assumed that this was primarily a matter of policy *making*: once agreement had been reached to liberalise the utilities markets a relatively homogeneous process would follow. The regulatory state model fit the original common market blueprint better the old industrial policy approaches. On the other hand, sector-specific studies continue to reveal a less than fully homogeneous internal market. The EU has undergone momentous changes in the last two decades, which have rendered the notion of a homogeneous single market somewhat unrealistic.

Recent research shows that the de-politicised, homogeneous Single Market that long informed much of the political and academic debate is at best an exaggeration, and more probably misleading. Mutual adaptation between the EU and the member states and between the EU and the outside world is generating several different patterns of European integration. Whereas the Single European Act envisaged free-market, multi-lateral EU regimes, characterised by regulatory policy, the last two decades have demonstrated the resilience of politics. This paper suggests that this 'rediscovery of politics', which is amply demonstrated by the case of liberalisation of European gas

¹ G. Majone, "The Rise of the Regulatory State in Europe", *West European Politics*, 17:3 (1994), 77-101; F. McGowan & H. Wallace, "Towards a European Regulatory State", *Journal of European Public Policy*, 3:4 (1996), 560-576.

² D. Gerber, *Law and Competition in the Twentieth Century: Protecting Prometheus*, (Oxford, Clarendon Press, 1998).

markets, is not an exception to a dominant pattern of homogeneous integration. Differentiated integration and regulatory variation is becoming the norm, even when there is broad agreement on liberal market principles.

Over the last decade, the EU has become more heterogeneous as well as more integrated. It has widened to 27 member states; the authority of its institutions has been strengthened; and its scope has expanded. It has become a colourful and heterogeneous family of states. This expansion in width, breadth and depth poses challenges for further integration of the Single Market. Common policies increasingly go hand in hand with differentiation and re-politicisation of Single Market regulation at the national level; the Lisbon process has formalised the EU's practice of 'soft law' and policy coordination into the Open Method of Coordination (OMC); and in some cases countries have opted out of policies or have yet to qualify for full participation. The literature on *European integration* generally focuses on the establishment of common institutions and policies at the EU level; it has paid less attention to variation in the national impact of such processes. On the other hand, the literature on *Europeanization* that has developed over the last two decades constitutes an effort to explore and explain precisely this kind of variation. This variation is usually explained in terms of national institutions, the EU rules for decision making in any give sector, or the dynamics of each sector. In any specific case, constructing an explanation along such lines may be both fruitful and convincing. This paper links variation at the national level to a broader concept of European integration: European integration comes in four types, which we distinguish from one another because they have very different effect on policy at the member state level.

At the same time the EU's external environment is changing. This holds particularly for particularly its relationship with the other big European power and central actor in the energy sector: Russia. The EU now faces an increasingly self-confident Russia, which is challenging the EU's core principles of multilateralism and open markets. Russia is increasingly oriented towards bi-lateral arrangements and direct deals, bypassing the political and economic structures of EU. The interplay between internal developments and the EU's capacity to act in a unified way on the international scene shapes the development of the Single Market. Russian strategies affect the core interest of the European Union and its member states, and under Vladimir Putin's presidency Russia has turned increasingly away from multilateral, rule-based engagement with the EU and adopted a more bi-lateral and politicised approach to EU energy markets. We therefore suggest that both the internal and external factors amplify the tendency towards '*differentiated integration*' – *i.e. the multiple forms of (or varieties in) European integration*, including both exemptions from EU initiatives and variations in the national impact of EU policies. In the following we set out a theoretical framework for the study of the internal and external dimension of EU integration, before proceeding to explore the internal dimension of the effort to establish a single market for gas in more detail.

The Internal Dimension - Europeanisation and Differentiated Integration

The EU is changing radically along three dimensions: deepening, widening and broadening. Integration is 'deeper', the authority of the EU institutions has been strengthened and the decision making processes have become more supranational.

These changes raise two broad questions about the development of European integration, particularly with respect to the Single Market, and therefore warrant new thinking about the types and patterns of European integration.

Two new questions about integration

The first question concerns exemptions (opt-outs) from EU initiatives: should all states participate in all policy sectors in the same way? Not all member states are equally eager, let alone able, to participate in all aspects of integration. For example, the 2004 enlargement left all the new member states short of full participation in Economic and Monetary Union and the Schengen arrangement. Sweden, Denmark and the UK have chosen not to take part in EMU, and the latter two also have special arrangements regarding Schengen. For much of the 1990s, the UK enjoyed an 'opt-out' from the Social Chapter. The 'opt-outs' of the 1990s were seen primarily as temporary and exceptional. As such, they have been seen as typical examples of 'differentiated integration.'³ By 2007, however, these kinds of arrangements have become more common, and in some cases they seem semi-permanent.

The second question concerns the impact of EU policies at the national level: what are the effects of the discretionary power and competence the member states enjoy when transposing EU rules into national legislation? Expansion into new policy areas and to states with widely different institutional traditions and capacities has come at the price of heterogeneity. The considerable variation in national adaptation reflects the different context and trajectories of integration, as captured in the literature on Europeanization.⁴ Because 'differentiated integration' is meant to capture the multiple forms of (or varieties in) European integration, we argue that the term should be broadened to encompass the aspects of differentiation associated with variation in Europeanisation. The term 'differentiated integration' is thus used to capture the empirical variation in the impact of EU decisions at the national level.

Much of the debate about European integration – both political and academic – has been based on the unrealistic assumption that once an agreement is reached at the EU level, it is implemented in a fairly homogeneous way across the EU. *However, developments in European integration over the last decade suggest that, in fact, such homogeneous integration may be the exception rather than the rule.* Two research agendas have begun to treat integration as an independent variable, and explore the impact of integration at the national level. The literature on 'Europeanization' explores the plenitude of variation in EU policy, often based on case- or sector-

³ A. C. Stubb, (1996), "A Categorization of Differentiated Integration", *Journal of Common Market Studies*, 34:2, 283-295; A. Kölliker, (2001) "Bringing Together or Driving Apart the Union? Toward a Theory of Differentiated Integration", *West European Politics*, 24:4, 125-151.

⁴ S. Bulmer, (2005) "Theory on Europeanization", in *Europeanization: A Handbook for a New Research Agenda*, (London, Palgrave Macmillan).

specific explanations.⁵ The *institutionalist turn* in EU studies offers a set of explanatory mechanisms to account for such variations.⁶

We argue that there are two principal sources of variation in the links between policy-making at one level and implementation at another. First, the hierarchical relationship between the EU and the national level ranges from tight to loose. EU-level decision-making involves political compromises that often lead to general or ambiguous policy formulations. Second, member state institutions vary, as does their capacity for policy implementation. The member states' institutions are rarely all equally compatible with any given EU directive. Pressure for de-coupling from EU requirements may therefore be the product of institutions that shape local identities, norms and even preferences.⁷

	Coupling between EU level and national level:	
	Normative: Tight Organisational: Tight	Normative: Tight Organisational: Loose
Weak pressure for decoupling at national level	1. <i>homogeneous integration</i>	2. <i>aligned integration</i>
Strong pressure for decoupling at national level	3. <i>deviant integration</i>	4. <i>autonomous integration</i>

Major Types of Integration

In reality these two dimensions are of course linked: strong resistance to strict EU-rules by a number of member states usually leads to watered-down directives at the EU-level. The four patterns (or types) of integration are therefore not equally likely.

- *Homogeneous integration* is the ideal-type, and is based on the assumption that EU-level rules are clearly defined with precise organisational requirements, that these are implemented more or less uniformly by states, and subject to effective supervision and evaluation. Competition policy comes close to this ideal type, though Eyre & Lodge provide a detailed account of the Europeanization of competition law as reform processes, and describe the tension between

⁵ J. P. Olsen (2002) "The Many Faces of Europeanization", *Journal of Common Market Studies* 40:5, 921-952; see also K. Goetz & Hix, S. (eds 2000) *Europeanized Politics? European integration and Political Systems*, (London, Frank Cass); A. Dimitrova, & B. Steunenberg (2000) "The search for convergence in national policies in the European Union", *European Union Politics* 1:2, 201-226.

⁶ S. Bulmer (1993) "The Governance of the European Union: A New Institutionalist Approach", *JPP*, 13:4, 351-380; M. Aspinwall & G. Schneider (eds 2001) *The Rules of Integration: The Institutionalist Approach to European Studies*, (Manchester, Manchester University Press).

⁷ S. S. Andersen (2004) "The Mosaic of Europeanization: An Organizational Perspective on National Re-Contextualization", Oslo, ARENA Working Paper 11/2004; also in J. From & N. Sitter (eds 2006), *Europe's Nascent State: Public Policy in the European Union*, (Oslo: Gyldendal Akademiske).

convergence and divergence as countries are increasingly playing a ‘European melody’, but with distinct ‘national tunes’.⁸

- In a number of policy sectors, EU rules are more loosely defined, but several states share the same general interests as those expressed in an EU directive, and therefore proceed according to the spirit of the law even if this is not strictly speaking required. *Aligned integration* relies on mutually reinforcing overlap of state and EU-level interest, and is fairly common. OMC success is based on this.
- Perhaps the most common pattern is one in which a number of governments object to strict EU rules, and directives are therefore vague on a number of points. *Autonomous integration* takes place in situations where the central demands for particular organisational and behavioural patterns are weak, and local pressure to maintain existing practices is strong. OMC sometimes results in this.⁹
- The last type, *deviant integration*, is less common. Whereas the other three types of integration are consistent with legal requirements, what we call deviant integration is in principle an illegal circumvention of EU law. This situation features strict EU legal requirements and expectations about loyal national implementation, but at the same time strong local resistance. In theory this may be because a government has lost a vote in the Council of Ministers, in practice it is more likely to reflect unsuccessful attempts to influence a decision (for example on the part of new and inexperienced EU countries, or EEA-countries).

Our starting point was that in the EU public policy is normally made and implemented at different levels and by different actors or organisations. The ‘implementation gaps’ that result from this are also well documented in national public policy studies. The central point here is not that public policy is seldom implemented exactly as planned, but rather that the heterogeneity of the EU system makes for considerable variation. Even where common directives are faithfully transposed into national law, the impact of integration is not necessarily uniform. *In short: differentiated integration has brought about more room for manoeuvre for the member state governments, and a degree of re-politicisation of the Single Market.* EU expansion (the combination of deepening and widening) has led to less binding EU policies and more room for manoeuvre for national governments in the EU and the EEA. This, in turn, allows more scope for interests and organisations at the national level to affect policy outcomes inasmuch as there is room for discretion in transposition and implementation. The central question, which we explore further below in the context of gas liberalisation, is how the EU handles policy variation, and how much variation the EU can accommodate.

The External Dimension of the Single Market – Re-politicisation?

The EU’s effort to establish and extend the Single Market fits into a broader pattern of international market- and institution-building in the late 1980s and 1990s. At the

⁸ S. Eyre & M. Lodge (2000) “National Tunes and a European Melody? Competition Law Reform in the UK and Germany”, *Journal of European Public Policy*, 7:1, 63-79.

⁹ D. Chalmers & M. Lodge, “The Open Method of Co-ordination and the European Welfare State”, *CARR Discussion Paper*, 11/2003.

national level, many states embarked on programmes of liberalisation and/or privatisation. At the EU level, this provided the backdrop for the Single Market. At the international level, and particularly after the collapse of communism in the Soviet bloc, general market-based rules were the order of the day as optimistic prophesies about the 'end of history' and 'triumph of globalisation' abound. This was the height of what Correljé & van der Linde call the '*Markets and Institutions*' approach to international economic and political cooperation: an integrated, multilateral world with effective institutions and markets.

Recent developments in international economic relations point to an alternative to the free-trade, multi-lateral approach of the 'markets and institutions' variety: Correljé & van der Linde label the alternative pattern or narrative '*Regions and Empires*'. This involves "a world broken up in rival political and economic blocs, competing for resources and markets via political, economic and military power."¹⁰ In terms of international relations theory this comes close to the neo-realist paradigm (as opposed to the neo-liberal 'market and institutions' approach). It is no coincidence that Correljé and van der Linde's analysis of the EU focuses on the energy sector: the most important single sector for two of the EU's neighbours – Russia and Norway. This illustrates how the present Single Market integration is affected by broader international trends and the actions of key neighbour countries.

The EU's international role has hitherto been cast very much in line with neo-liberal theories of international relations – and the 'markets and institutions' narrative – based on assumptions that the possibility of mutual gains from trade warrants market-based institutional arrangements. Although the EU has not shied away from confrontations with the USA over specific issues in the WTO, the general approach both within the EU and vis-à-vis the rest of the world has been to proceed from the assumption that international trade is a positive-sum game. With a few exceptions, such as negotiations over fisheries policy, the EU's relationship with the EFTA states (the European Economic Area agreement) is based on the same principles.¹¹

The EU's present relationship with Russia is developing more as neo-realist theories would predict: increasing politicisation and, at least on the part of the Russian government, a quest for bi-lateral arrangements rather than universal market rules. Particularly in the energy sector, the Russian government follows a strategy that corresponds to the 'realpolitik' 'regions and empires' narrative, rather than the 'markets and institutions' approach associated with the Energy Charter Treaty. Trade is part of the broader geo-political security game, and relative gains are more significant than absolute gains. Moscow's more assertive posture places different demands on the EU as an external actor, different from the immediate post-cold war world. This changing international context means that the EU confronts a situation to its north characterised by increasing linkage between foreign policy and foreign trade. This is more reminiscent of the period in which the EEC began to develop its foreign

¹⁰ A. Correljé & C. van der Linde (2006) "European Supply Security and Geopolitics: A European Perspective", *Energy Policy*, 34:5, 532-543, p.532.

¹¹ S. S. Andersen, (2000) "Norway: Insider AND Outsider", *ARENA Working Paper 4/2000*; M. Emerson, M. Vahl & S. Woolcock (2002) *Navigating by the Stars: Norway, the European Economic Area and the European Union*, (CEPS); K. A. Eliassen & N. Sitter (2003) "Ever Closer Co-operation? The Limits of the 'Norwegian Method' of European Integration", *Scandinavian Political Studies*, 26:2, 125-144; S. S. Andersen (2006) 'Kampen om energimarkedene i EU' *MAGMA* 9:5-6, 40-48.

policy dimension in the 1970s, which reflected both the explicit ‘linkage’ of trade and security in the Helsinki Final Act and the de facto linkage of trade and foreign policy questions brought about first by oil embargoes and later by the Falklands war. *In short: the EU’s role as an external political actor is brought back to centre stage.* We therefore suggest that Russia’s more assertive strategies has politicised EU external relations in a way which reinforces differentiated integration.

In the energy sector, the geopolitical context in which the EU operates has changed considerably since 1989. The fall of communism coincided with the EU’s drive to extend the single market into the utilities sector, including the gas market. Throughout the 1990s – the period during which gas liberalisation was negotiated – the international scene was better described by the ‘markets and institutions’ narrative than the realpolitik of ‘empires and regions’. EU liberalisation leaned heavily on the US experience, although the final compromise departed quite far from the more liberal US mode. The formerly communist states looked toward the EU, and prepared to accept the new EU regimes as and when they joined. The Energy Charter Treaty sought to establish a common liberal free-trade for energy beyond the borders of the EU. However, both the EU liberalisation process and the international context looked very different by the end of the 1990s, let alone from a 2007 perspective. Although a liberal model became the basis for the common EU energy market, it was a watered down version. Moreover, by the time liberal principles had triumphed in the EU, Russia was moving toward a more political strategy for energy.

Building the Single European Gas Market – Fuzzy Liberalisation

Energy policy is in many ways a problematic case for the EU, but also characteristic of the general EU-development. For most of the post-war era, member state energy policies were strongly embedded in national policy paradigms with a statist orientation. Attempts to introduce a common liberal EU energy policy went through periods of stagnation and conflict – before the break-through during the late 1990s. The Commission’s drive for a single market in energy can be traced back to its 1988 green paper on the internal energy market (IEM), which concluded that the main obstacles to this goal lay in structures and practices associated with member state energy markets that protected the industry from competition.¹² It estimated the cost of ‘non-Europe’ in the energy sector at 0.5% of GDP. While the 1985 white paper on this single market had excluded gas and electricity along with other utilities, these two sectors were placed firmly on the single market agenda by 1988.¹³ Moreover, from the Commission’s point of view, the solution to this problem was to be found in a single model of regulation that guaranteed third parties access to the member state gas and electricity distribution networks. Though the initial focus fell on enabling transit between utilities across networks,¹⁴ its long term aim was to extend the single market to cover the energy sector; to extend the liberal paradigm that characterised the single market to the electricity and gas sectors. Two decades later the liberal policy paradigm has become dominant, but it is incomplete inasmuch as it has serious omissions and modifications. Although the shift from direct intervention to regulation

¹² Commission of the European Communities, *The Internal Energy Market*, 1998, COM (88) 238.

¹³ Commission of the European Communities, *Completing the Single Market*, 1985, COM (85) 310.

¹⁴ S. Padgett, “The Single European Energy Market: The Politics of Realization”, *Journal of Common Market Studies*, 30:1 (1992), 53-75, p. 58.

has extended to the energy sector, variations in national regulatory regimes have been accommodated to the extent that it is perhaps better to speak of 'fuzzy liberalisation' than of an unequivocal triumph of the liberal principles and a common regulatory state.

Initiatives towards a common EU energy policy are, with the exception of the UK, for the most part external to the national policy context. They reflect international trends as well as the growing weight of the EU as a supranational institution embracing a liberal market model as reflected in the single market. This liberal model can be seen as a new *paradigm: a set of beliefs and ideas that are shared by key policy makers and are reflected in informal and formal rules and regulations*. The transformation of EU energy policy over the last fifteen years has seen the institutionalisation of policy-paradigms at the EU and at the national level. This transformation is not only a matter of sector change, but also part of a wider EU integration process. It is a break-through for a liberal perspective. New initiatives were strongly contested by large majority of national interests and the energy industry. The development of EU common policy is not only a matter of transferring authority from national to a supra-national level. It also involves a redefinition of issues in an abstract and universalistic language that can accommodate the many different interests and ambitions.

In 1992 the Commission introduced a formal *Proposal for a Council directive concerning common rules for the internal market in natural gas*. This became the focus for the prolonged conflict that eventually led to the passing of the modified *Gas directive* in 1998, a further directive in 2003 and proposals in January 2007 for separating or unbundling upstream and downstream activities. Although the Commission's liberal principles have won through, this has been at the cost of clarity and precision.

The Single European Market and the Energy Sector in the 1980s

For a long time the energy sector in the Western world was influenced by strong state regulation and hierarchy. Sometime during the 1980s this dominant international model became contested. This led to far-reaching changes in the USA, but also in other countries, most notable the UK. Energy had been heavily regulated for decades in both the USA and the UK, and liberalisation of the energy sectors followed a political break-through for 'free-market ideology'.¹⁵ The Commission's preparatory work on a gas market proposal must be viewed in the context of both the single market the growing support for international institutional models emphasising market organisation of the energy sectors. The model for a liberalised single European gas market was inspired by an emerging international paradigm that served as a normative model. This model was most clearly expressed in the US system with its emphasis on an active competition authority. In other words, the Commission initiative did not reflect local performance problems, but the normative appeal of a general model emphasising market functionality and a strong competition authority.

The change towards a new international economic policy paradigm for energy reflected the general political climate, but also changes in the international supply

¹⁵ F. Tugwell (1988), *The energy crisis and the American political economy: Politics and markets in the management of natural resources*, Stanford: Stanford University Press.

situation that had been 'normalised' after more than a decade of turbulence. The change in the dominant political-economic perspective on energy was partly formalised by the Energy Charter Treaty during the early 1990s.¹⁶ This Treaty brought together the former Soviet Union and its satellites and the OECD countries. In the EU the liberalisation of the energy sector was first carried out in the UK during the mid 1980s. These reforms, most importantly privatisations, were primarily motivated and legitimated by a revival of liberal ideology in economic policy ('Thatcherism').¹⁷ At the EU-level pressures for change were picked up and reinforced by the Commission and the British government, as part of the Single Market programme.

There were, however, some special characteristics of the energy sectors in EU countries that complicated the process, and these were related to historical experiences and perceptions of market failures as well as to political and industrial policy objectives. Important energy resources were concentrated in a few countries outside the EU (Russia, Norway and Algeria) and this had led to concern for supply and price stability. Moreover, There was a strong tendency in European countries to view the energy sector as more than just an economic sector. State interests were heavily biased by the fact that energy sectors were dominated by monopolistic companies (often state owned). Although linked by supply pipeline, the European gas market consisted of separate national markets.¹⁸ The natural gas sector was relatively new and it had expanded during the 1980s, almost as a 'counter culture' to the Single market programme. It was characterised by high degree of state regulation and an oligopolistic sector organisation. In its report *The internal market on energy* (1988: 57) the Commission stated that "*Natural or regional monopolies or virtual monopolies dominate the natural gas transmission and distribution industry in Europe ... The biggest barriers to free movement of natural gas in Europe are government controls on natural gas imports and exports and undertakings holding a monopoly or dominant position enabling them to block the movements of natural gas*".¹⁹ Estrada et al. provided an authoritative overview over the West-European gas market by the late 1980s: the "existing structure.. is well founded in a complex network of economic and political interests", and "it does take a lot of imagination to foresee the present structure being undermined [i.e. liberalised]."²⁰

The introduction of a new EU policy paradigm, as a directive proposal on the liberalisation of EU natural gas markets, challenged key elements in the existing system. The transmission companies, linking major sellers and buyers had an especially strong position. They would use their monopoly to serve as an intermediary, buying from a few producers and selling to national monopolies, with high profits. As a consequence there was no gas-to-gas competition. Natural gas was priced according to competing energy, most often oil. The benefit of the system was

¹⁶ J. Dore & R. De Bauw (1995) *The European Energy Charter. Origins, Aims and Prospects*, London: The Royal Institute of International Affairs.

¹⁷ S. S. Andersen, *The Struggle Over North Sea Oil and Gas*. (Oslo: Scandinavian University Press, 1993).

¹⁸ J. M. Arentsen, "Politics and regulation of gas in Europe", in Finon, D. and Midttun, A. (eds.) *Reshaping European Gas and Electricity Industry: Regulation, Markets and Business Strategies* (Elsevier 2004).

¹⁹ Commission of the European Communities, *The Internal Energy Market*, 1998, COM (88) 238, p.57

²⁰ J. Estrada, H.O. Bergesen, A. More & A.K. Sydnese (eds): *Natural Gas In Europe* (London: Pinter Publisher, 1988), p. 254 and 257.

that long-term contracts made it possible to secure the financing of gas field and transportation development, and thereby security of supplies. However, the Commission's general argument that increased EU-wide competition would improve global competitiveness was assumed to hold also for energy. The Commission's first, cautious, steps centred on transparency of cost, energy investment and transit between utilities. The Commission's proposals were adopted and entered into force by 1992, though not without resistance from German and Dutch gas suppliers.²¹

The 1992 Proposals for a Directive on Energy Liberalisation

While the Commission embarked on the first steps toward liberalisation, the debate over how to pursue the single market in energy was taking shape within the Commission. Competition Commissioner Leon Brittan led the argument for a rapid process under article 90 [now article 86], which permits the Commission to unilaterally issue directives breaking up monopolies, and Energy Commissioner Antonio Cardoso e Cunha arguing for a more cautious approach.²² In the event Cardoso's view prevailed with a 1991 proposal for a directive liberalising gas and electricity markets based on article 100a [now article 94], which requires Council approval by QMV. Even this approach encountered strong resistance, due to the 'common carrier' principle and regulated third party (TPA) access to networks.²³ Opposition centred on security of supply, fear that small consumers might bear the costs of competition, and arguments that liberalisation would require a large degree of regulation.²⁴ Differences between electricity and gas were now emerging, partly centred on the gas sector's long-term contracts.

The major issue concerned market opening: how much of the gas market should be opened for competition, and who should have the right to send gas through transmission lines? The latter had so far been the exclusive right of the pipeline owners. The proposal introduced the concept of regulated third party access with a EU-level regulatory authority. This became the major source of controversy in the years to come. The second major issue concerned the impact of liberalisation on long-term contracts (take-or pay) that traditionally had been a key instrument to secure investments and long term supplies. The third issue was whether it was possible to impose special obligations (equal price, supply security, environmental protection etc.) on suppliers all over Europe. The fourth issue concerned the need to establish separate markets around various functions in the gas market (labelled 'unbundling'), which had before been 'bundled' by monopolies.

The Commission proposal reflected a strategy for deregulation *and* liberalisation. However, with the exception of the UK, no EU member countries had any clear recognition of the crucial role to be played by EU regulatory authorities in the implementation and policing of competition and liberalisation.²⁵ The introduction of

²¹ S. S. Andersen, "Towards a Common EU Energy Policy", in S. S. Andersen & K. A. Eliassen (eds.) *Making Policy in Europe*, second edition, (London, Sage, 2000).

²² G. Ross, *Jacques Delors and European Integration*, (Oxford, Policy Press, 1995), p.180.

²³ Andersen, "Towards a Common EC Energy Policy", p.146.

²⁴ T. Weyman-Jones, "Energy Policy in the European Community", in S. Stavridis, E. Mossialos, R. Moran & H. Machin (eds.), *New Challenges to the European Union: Policies and Policy-Making*, (Aldershot, Dartmouth, 1997), p. 563

²⁵ J. P. Stern, *Competition and Liberalization in the European Gas Market. A Diversity Model* (London: The Royal Institute of International Affairs, 1998): p. xxii.

the directive proposal led to strong confrontation and polarisation, where a clear majority (11 of 12 member states) rejected the Commission initiative, and so did the industry. The Commission's attempt to involve the industry through committees, to achieve dialogue and find common ground, broke down. Because most countries were only, or primarily, consumers and heavily dependent on import, the Commission started by focusing on up-stream liberalisation (production and transmission). The expectation was that consumer prices would be lower in a (more) deregulated market. However, a major concern for most consumer countries was related to security of supplies, traditionally dealt with through diversification of supply countries and long term contracts. British gas production was primarily for domestic consumption, and the UK was the first to privatise its state gas monopoly. The UK pushed for radical EU reform, but knew that it would take time. In the meantime the national market could be protected and developed. The Netherlands, the other major EU producer and exporter, had a production and sales monopoly based on a partnership between the government and private international companies. It had played a key role in developing the European gas industry as major exporter and there was initially no interest in reforms.

The first years after the introduction of the Commission proposal was characterised by strong opposition, periodic stalemate and uncertainty about the feasibility of the project. As Stern put it: "many of the established actors in European gas industries ...regarded the introduction of liberalization as the equivalent of the end of civilization".²⁶ The opposition in the natural gas sector was to a certain extent legitimised by the general scepticism towards further EU-integration, symbolised by reactions to the Maastricht treaty. Despite strong and intense opposition discussion on the natural gas directive was kept alive, mainly due to the Commission. The legitimacy of Commission actions rested on formal mandates and earlier state-commitments. Such earlier state-commitments were weighed against the costs of accepting new sector arrangements. However, the proposed new policy paradigm also reflected the new appropriate form for organising any economic activity. In the face of this member states found it hard to come up with legitimate reasons for preserving the existing sector arrangements. Although opposition to parts of the proposal was still strong, it gradually became clear that natural gas issues had to be addressed in terms of new concepts and perspectives. The Commission submitted a revised proposal in 1993, this time in the form of two separate proposals for gas and electricity.

The Council quickly decided to focus on the electricity proposal, leaving the gas debate to follow. The debate centred on the monopoly utilities' opposition to third party access to networks and managerial 'Chinese walls' separating vertically integrated utilities' network and trading arms. In the event, both elements were watered down during negotiations as a "direct result of deep opposition by utilities", with more focus on negotiated rather than regulated TPA and replacement of 'managerial unbundling' to 'accountancy unbundling'.²⁷ Throughout 1994 the question of network access remained the main stumbling block, with the UK and Competition Commissioner van Miert as the main backers of regulated third party access. Meanwhile the German Presidency pressed for negotiated TPA as a

²⁶ J. P. Stern, *Competition and Liberalization in the European Gas Market*, p.91.

²⁷ Weyman-Jones, "Energy Policy in the European Community", p. 565

compromise in the second half of 1994, as the Presidency was about to pass to two more reluctant liberalisers, France and Spain. Both favoured permitting a 'single buyer model' (as an alternative to TPA) that would permit maintaining utility monopolies' sole right of purchasing electricity in the state. However, the Commission proposal for gas was rejected. Over the next years the EU Commission worked on an alternative, watered down, version of the original directive. Key concepts and formulations were modified, but the general perspective and normative orientation remained the same.

Towards the 1998 Directive

From the mid 1990s the nature discussions over the gas market reform changed in several ways. A key element in the Commission's formulation of the new paradigm had been to develop implications of market theory emphasising market functionality, with political concerns related to security of supply and public service obligations. This had made it possible to rethink a number of issues. Several key changes were adopted. First, some of the most provocative elements of the proposals were either taken out or reformulated in such a way that its content was open for negotiations. Second, rather than presenting the whole reform package, reforms were presented in steps. The expectation was that a gradual transformation would pave the way for further reforms as the new system started to take shape. This was particularly important in the European gas market. Gradually, the liberal perspectives gained a foothold. A major gas directive was passed in 1998, and transposed into national law in most countries. Additional directives were passed in the following years. However, the speed and vigour with which national governments and the EU court has pursued these new legislations vary considerably.²⁸

The agreement on electricity liberalisation in 1996 helped set the stage for gas liberalisation inasmuch as the electricity sector was an obstacle that had to be cleared before the member states would consider gas liberalisation. As President of the Council, France proposed the 'single buyer' model in early 1995.²⁹ The key question was whether this system could be considered compatible with the Treaty. Competition Commissioner Karel Van Miert argued that it could not, a view shared by several analysts and a preliminary Commission report.³⁰ Nevertheless, in March the Commission accepted the theoretical compatibility of a modified 'single buyer' system and negotiated third party access. It proceeded to propose its own liberalised version of this compromise, hailed by Energy Commissioner Christos Papoutsis as a pragmatic solution but drawing a cooler response from van Miert (who latter added pressure for progress by threatening to invoke article 90 unless progress were made by the end of the year).³¹ The negotiations were set against the backdrop of outright opposition from several utilities, led by Électricité de France and the Netherlands'

²⁸ Commission of the European Communities, *Annual Report on the Implementation of the Gas and Electricity Internal Market*, 2005, COM (2004) 863.

²⁹ "Energy liberalisation continues at a snail's pace", *Petroleum Economist*, 27 March 1995.

³⁰ K. Van Miert, speech at the Royal Institute for Foreign Affairs, London, 28 November 1994. RAPID summary, ref: IP/94/1104; L. Hancher is cited in "European Business - Sparks fly for free market in energy", *Daily Telegraph* 27 February 1995; "Single buyer power option would handicap access", Reuters 10 February 1995.

³¹ "Van Miert warns on electricity liberalisation", *Reuters*, 7 April 1995.

Gasunie, and a 30,000-strong French demonstration against liberalisation.³² With the network access question resolved in principle, the main problems were the pace of liberalisation and the qualitative and quantitative thresholds, i.e., target percentages for market opening and definition of 'eligible customers' who would have access to competitively sold electricity.³³ The compromise was hammered out at the May 1995 Energy Council. Only at this point were the ministers *reportedly* prepared to abandon consensus and invoke QMV (this was in the middle of the 'beef-crisis', when John Major's government employed an 'empty-chair-light' strategy of abstaining on all policy votes in the Council).³⁴ The final compromise on electricity came one year later, in the form of the Council's 'common position' of June 20th, 1996. This represented a victory for the advocates of limited liberalisation inasmuch as it allowed for continued existence of the single buyer model and imposition of 'public service obligations', and featured comparatively high thresholds. However, the principle of reciprocity and revision clause redressed the balance somewhat, as industry, the Commission and the liberalising states envisaged further liberalisation.³⁵ The final outcome was therefore based more on the Commission as a 'regulator of the regulators' than on a direct regulatory regime, let alone a single model of EU regulation.

As expected, gas negotiations took off following the electricity compromise, promoted by more enthusiastic liberalisers in the form of the Irish and Dutch Presidencies in 1996-97. In this case the single buyer option was rejected in favour of a system permitting only regulated or negotiated third party access to networks, partly because the extent of competition in gas production made the potential impact of TPA on competition somewhat less dramatic.³⁶ French and Belgian pressure for import monopolies that would effectively provide for a single buyer were questioned by the Council's legal service, and rejected.³⁷ However, negotiations were dogged by the same problems as in the latter stages in the electricity talks, centred on qualitative and quantitative levels of market opening and definitions of eligible customers. In the spring of 1997, pressing hard for a compromise in time for the May Energy Council, the Dutch Presidency abandoned its proposed figures on rapid and thorough liberalisation, setting the scene for further watering down of the process of market opening. However, at this time, market pressure in the gas sector led both industry analysis and the more free-market governments to take a 'the glass is half full' view, expecting liberalisation to progress far beyond the directive's stipulations. European markets faced gas supplies outpacing even the rapidly growing demand for gas, and therefore downward pressure on prices.³⁸ The glut in the post-Soviet market as

³² "Sparks fly over deregulation - France's power monopoly is resisting an EU plan for liberalisation", *Financial Times*, 31 May 1995; "EdF rejette le nouveau document de la Commission", *Agence Europe*, 28 March 1995; Gasunie opposed EU liberalisation in principle as per *Het Financieele Dagblad*, 16 February 1995.

³³ "Council defines conclusions on electricity market liberalisation", *Agence Europe* 3 June 1995.

³⁴ "European Business - Beef ban veto bites", *Daily Telegraph* 29 May 1996.

³⁵ Power Europe: A foot in the door", *Financial Times Energy*, 28 June 1996; "EU electricity deal seen benefiting big business" *Reuters* 24 June 1996.

³⁶ "Dutch EU presidency seen boosting Euro gas access", *Reuters*, 23 January 1997.

³⁷ "EC Energy Monthly: The Hague GAS meeting: some real progress at last?", *Financial Times Energy*, 21 February 1997.

³⁸ J. P. Stern, *European Gas Markets: Challenges and Opportunities in the 1990s*, (London, The Royal Institute of International Affairs, 1990); J. P. Stern, *The Russian Natural Gas 'Bubble': Consequences for European Gas Markets* (London, The Royal Institute of International Affairs, 1995).

demand collapse with the fall of communism was compounded by a considerable expansion of pipeline capacity during the 1990s, including new routes to Russia, Norway and North Africa. Interconnection of the competitive UK market and the continent was likewise expected to add further downward pressure on prices and increasing industrial consumers' demand for liberalisation.

The arguments and the nature of confrontations over the EU gas market reform changed gradually during the mid-1990s. This happened partly in political negotiations, partly through long drawn expert-driven arguments. This was also driven by court decisions and new strategic initiatives from parts of the industry. Arguments were more about appropriateness than specific consequences, and traditional industrial policy arguments were losing ground. The implementation of the electricity directive served as a model, both in terms of providing legitimacy and in clarifying the strategic implications of a new perspective. Increasingly the question was not if a new gas market directive was to be passed, but when and with what provisions. Stern's 1992 analysis of gas liberalisation anticipated these developments: he suggested that the *content* of major provisions, like third party access, would be shaped by the major industrial players.³⁹ The alternative would be more clear-cut EU regulations to be imposed by a powerful EU-level regulatory authority. His analysis provides a good account of how a contested new paradigm is specified in political processes that runs parallel to processes in the court and market system.

The central question for gas liberalisation was third-party access to networks. The original Commission proposal had been inspired by a so-called common carrier concept in the USA. The problem became how to secure so-called voluntary or negotiated third party access to pipelines that controlled the flow of natural gas; as well as the percentages of the traded volume should be covered by such arrangements. Another key controversy concerned the problems of securing long term investment, and thereby supplies, in a system that undermined traditional long-term contracts. A new concept of security gradually developed, which emphasised the mutual interdependence between exporters and importers and the reduced operational risk in an integrated European system. The controversy over the nature and level of public obligations to be met by companies was resolved, partly through the use of the court system. The controversy over unbundling of commercial functions led to a general accept for the principle, in line with competition law.

The UK position reflected London's desire for explicit rules for third party access (preferably regulated TPA, where companies' access to pipelines was regulated through a tariff) and a high degree of market opening as soon as possible. Although most other countries still had reservations about even the modified liberalisation directive, some had begun to change their positions. The Netherlands was the first member states to turn, but it was soon followed by Spain. In both countries governments decided to move towards opening up market more quickly than dictated by the directive. France, however, remained reluctant and aimed to limit the role of competition to preserve the public service obligation. In Germany the dominant position of Ruhrgas prevented rapid political changes. However, the announcement by the German gas company Wintershall that it would build new pipelines in 1989 (to

³⁹ J. P. Stern, *European Gas Markets: Challenges and Opportunities in the 1990s*, (London, The Royal Institute of International Affairs, 1990); *Third Party Access in European Gas Industries: Regulation-driven or Market-led?* (London, The Royal Institute of International Affairs, 1992).

further the consumer interests of the parent company BASF) and in 1990 (in partnership with the Russian Gazprom) introduced a degree of competition. Norway, one of three major exporters to the EU, waged a lobby campaign against the new natural gas directive. In Norway natural gas was produced by several companies and production had to be regulated through one central negotiating authority (GFU): the challenge was to find a way to preserve a legitimate form of such regulation (Norway failed, and the GFU was broken up under European Economic Area rules in 2001).

The 1998 Directive: Fuzzy Liberalisation

Agreement on Gas liberalisation came in December 1997, when a common position was adopted unanimously, albeit in the shadow of the threat of a QMV that had been invoked by the Luxembourg Presidency. The compromise promised limited and gradual market opening with some scope for temporary derogations and Member State discretion in implementation. Its key points included states defining the 'eligible costumers' (but all gas-fired power generators and consumers of more than 25 mcm/y must qualify, reduced to 5 mcm/y by 2008); initial opening of 20% of Member State markets, rising to 28% 2003 and 33% in 2008; market access based on negotiated or regulated TPA; and accounts were to be unbundled, as in the electricity directive. Within this framework it allowed temporary derogations over take-or-pay contracts, upon decisions by states or their regulatory authorities subject to established guidelines and possible amendment by the Commission, as well as temporary derogations for emergent markets or markets with only one external supplier.

The 1998 directive was thus a compromise: it represented a triumph for the liberal paradigm inasmuch as it opened markets, but it was also riddled with unresolved issues.⁴⁰ On the one hand, it opened up for an alternative to the pre-existing monopolised system. On the other hand, the direct and immediate requirements of the directive were limited. Systems for regulating third party to pipelines were to be developed on the national level. In addition, companies could apply for exception from the third party access article if serious economic and financial problems should arise as a consequence. The so-called public service obligations, allowed for national protection of vulnerable customers, protection of final customers' rights, social and economic cohesion, environmental protection and security of supply.⁴¹ The directive contained very few super-national regulations, and the member countries had preserved considerable freedom to regulate national markets in the future. Two of the most important battles, determination of tariff methodologies and regulatory provisions for enforcing competition and third party access at the EU-level, had been defeated in 1994, before the first attempts to find agreement in the Council. As Stern concluded:

The value of the directive, therefore, lies not so much in its specific provisions, which are likely to be rapidly overtaken by events, but rather in the fact that it established both the principle of access to (pipeline) networks, and

⁴⁰ L. Hanscher, 'Harmonization of EU gas markets: The EU gas directive', in M.J.Arentsen & R. W. Künneke (eds.) *National Reforms in Natural Gas* (Elsevier 2003).

⁴¹ Specified in the Commission's amendment of the initial directive. Com (2001/125) Commission communication: Completing the internal energy market

the assurance that opponents of competition and liberalisation cannot indefinitely procrastinate in the opening up of their gas markets.⁴²

Increasingly national regulatory efforts and new market strategies became important in providing the content and pace of market liberalisation. Member states were committed to bring into force the laws, regulations and administrative provisions necessary to comply with the gas directive no later than in 2000. However, by mid 2002 some countries like France and Germany had only partially transposed the directive into national law. Portugal and Greece had, because of the emerging status of their gas industry a ten-year derogation from most of the directive's obligations. Other countries, like Italy and Spain had gone further than required. The UK was going further than everyone else. The basic rules of the game had changed, but the overall picture was mixed, reflecting different national considerations. Further clarification of what was meant by different concepts and provisions in the directive was left to the implementation process. The emphasis on subsidiarity, as a political necessity, opened up for different national approaches with respect to how various provisions should be secured at the national level. This meant that the further elaboration of the new policy paradigm shifted from the EU-level to member state level.

The implementation process faced the challenge of balancing three important aspects: i) to clarify the implications of the directive in relation to various national setting, ii) to permit a degree of flexibility with respect to the speed of reform and specific organisational solutions, and iii) at the same time making sure that solutions were consistent with the directive and general EU competition law. When the EU gas market reform reached the implementation stage the dynamics of EU gas market liberalisation was moved from the EU-level to the national level. National solutions have varied considerably. Only three states chose negotiated TPA, although all expect Portugal had established some kind of TPA regime by 2002. Moreover, the heterogeneity of the EU gas market increased considerably with enlargement in 2004, as did the differences among the member states as to how to address the security of supply issues raised by Russia's role as the supplier for 25 percent of the EU's gas consumption (through monopoly exporter Gazprom).

Even with the liberalised rules, the member states differ widely in the extent to which they permit or encourage large energy companies to use market rules to consolidate and strengthen dominant market positions regional and national markets. Important countries like Germany, France, Italy and Spain support their national champions. The EU directives in the gas market aimed at unbundling between the different vertical functions of the industry. While this is happening to some degree, there is a trend towards horizontal integration across different types of energy industries, like gas and electricity. This has happened first in Germany, later in other countries like Belgium and France. Nevertheless, the gas directive did change the basic logic and unleashed dynamic forces of liberalisation. A new gas directive was adopted in 2003, to address the shortcomings of the liberalisation process in the gas market. This directive made it compulsory to adopt a 'regulated' access tariff, and to establish an independent regulator for the gas industry. In addition a non-discriminatory third party access

⁴²J. P. Stern, *Competition and Liberalization in the European Gas Market. A Diversity Model* (London: The Royal Institute of International Affairs, 1998):p. xviii.

should be developed through legal unbundling of gas transport from trading services. At the time, only one of the fifteen member states was judged to have completed market opening in the gas sector: the UK. In January 2007, the Commission proposed a new series of measures that would separate (unbundle) production from distribution. These measures were directed primarily against large EU operators, but were widely seen to reflect concerns about Gazprom's increasing presence in the EU downstream market.⁴³

Although the EU and Russia launched their joint Energy Dialogue in 2000, designed as a forum for resolving questions related to market access, progress has been slow and the member states rather than the EU still play the dominant role vis-à-vis Russia. In the last few years Gazprom has signed long-term supply deals and/or bought into distribution companies in a number of EU states (including Italy, the UK, Denmark, Germany, Austria, Spain, Bulgaria, Hungary and France), and many of these deals involve trading long-term supply for access to distribution networks. With Gazprom's deal with EON and BASF over the North European Gas Pipeline adding pipeline capacity, and the Shtockman field expanding its production capacity, the overall picture is one in which Gazprom is emerging as a major player on the EU market. Seen in the context of the Russian government's decision to increase its share of Gazprom to 51 percent in 2005, its parliament's confirmation of Gazprom's export monopoly in 2006, the cut-off of supply to the Ukraine and Belarus in 2006, and Putin's hints that Russia might look to Asian markets if access to the EU is impeded, the company can be seen as somewhat more than a commercial actor, as part of Russia's overall geopolitical strategy in Europe. The Commission's effort to address this (and the question of vertically and horizontally integrated national champions in EU member states) notwithstanding, developments since 2000 indicate that EU energy policy has become more, rather than less, politicised.

Both foreign policy and energy supplies are primarily matters of national, rather than EU-level, competence. To the extent that the EU takes a common approach, it is consensual and based on accommodation of all national interests as determined by the member state governments. In terms of the patterns of integration set out above, this is generally a case of *autonomous integration* – limited and flexible common action that leaves much up to the member states. The pertinent question is therefore how the member states organise and develop their policies in any given issue. Differentiated integration in the EU, and in the gas sector in particular, may make it particularly difficult for the EU to develop common external policies towards Russia. The central concepts and principles behind European integration render the EU somewhat of an 'idealist actor in a realist world' – it focuses on projecting multilateral institution-building strategies onto an increasingly politicised international scene. The problem is exacerbated to the extent that the member states' autonomous and bilateral relationships with Russia take precedence over common policy.

Conclusion – Differential Integration and Fuzzy Liberalisation

Like many of the policy sectors that are covered by Single Market rules, the energy sector includes elements of what we have called homogeneous integration – the

⁴³ *Financial Times*, Special Report: Gazprom in Europe, 12/12/2006.

pattern of integration assumed in much of the literature on European integration. In principle, competition policy and internal market could be the basis for regulation in almost all sectors. However, as the gas case shows, in reality sector-specific regulation is often introduced because the sector involves special challenges and dynamics and/or because strong organised interests in some member states demand special consideration. Therefore, the impact of European integration may vary almost as much within as between sectors. If homogeneous integration had characterised the effort to establish a single market in energy, gas and electricity markets could have been liberalised by the mid-1990s. Article 90 [now 86] equipped the Commission with the power unilaterally to break up national monopolies. Some states, particularly the UK, supported the Commission's drives for liberalisation, but a majority of states were sceptical if not strongly opposed during much of the 1990s. The result was a protracted process that allowed some states to progress quickly towards liberalisation while others were required to make at least minimal effort. In effect, the Commission's drive for liberalisation yielded homogeneous integration only with respect to limited policy initiatives such as price transparency for electricity and gas contracts. The main elements of market opening were achieved by way of piecemeal negotiation, and correspond more closely to the alternative patterns of integration. The move to competitive markets in the energy sector, as in many other sectors, is better characterised as aligned or autonomous integration.

In the gas case, the outcome of the effort to establish a single market has varied not only with time and across specific issues, but also between states. The UK is almost an ideal case of what we call aligned integration: where mutually reinforcing overlap of state and EU-level interest means that a state pursues EU initiatives further than the pertinent directives require. In such situations there are local incentives to enact the spirit of EU level decision and rules, but alignment can have several different sources. Some countries welcome EU initiatives because they have played an active role in bringing them about. This was, for instance the case for liberalisation of energy as far as Britain was concerned. EU directives could legitimise national practices that were already in place. The gas sector also provides an example of a broader tendency for state and other actors to accept and enact EU regulations for their own motives, particularly when this is linked to market liberalisation. Over the last two decades, the strong political motivation for specific regulatory regimes has faded in many states, while privatisation and market models have gained more widespread support. EU-driven market reform presented not only a challenge, but also an opportunity and a solution.

Yet for several states (particularly France and the Mediterranean states, but to some extent also Germany) gas liberalisation was mainly a matter of autonomous integration: the central demands for particular organisational and behavioural patterns are weak, and local pressure to maintain existing practices remains strong. EU level decisions often omit sensitive issues and formulate standards that allow considerable flexibility in national transposition and implementation, as it did in the gas case. The controversial question of third party access to transmission networks for electricity and gas was resolved by a combination of ambiguity, omissions and opt-outs. The member states were allowed to choose between regulated and negotiated third party access, and to develop or maintain their national regulatory models. Germany has opted not to establish a regulatory authority for gas. A third 'single buyer' model was specifically tailored to allow France to maintain elements of her national electricity

monopoly, although in the event this option (practically an opt-out) was never used. The EU directives thus were designed to accommodate national demand for autonomy and regulatory diversity. Deviant integration has been a less common pattern in the energy case, except insofar as the Commission's progress reports regularly show that a number of states are quite far behind schedule in terms of opening gas markets. The 'fuzziness' of the rules have meant that even court cases against national import/export monopolies only met with partial success. Only more recently has the Commission moved to establish more precise rules, and once again the proposals are proving controversial.

In short, although the EU's continuing effort to liberalise gas markets has been successful in terms of bringing about an overall shift towards a more liberal paradigm, where the idea of free markets in gas seem to have won thought, this has so far brought about more mixed results in terms of actual market opening and competition. The liberalisation process has become increasingly politicised, partly because of some member states' efforts to protect industry and limit liberalisation, and partly due to the changing geopolitical context and the more openly political role played by Gazprom and the Russian government. The liberalisation of European gas markets can be described as a triumph of liberal market *ideals* and the *principles* of the EU regulatory state, but with considerable regulatory variety in practice. Given the continued role of politics in market-building, even in the regulatory state, and the room for differentiated integration, this should come as no surprise.