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# **International Law and EU-Russian Gas Relations**

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## **International Law and EU-Russian Gas Relations**

### **Summary**

This paper studies the impacts of international law on the political maneuvering rooms for Russia and the EU in the natural gas sector. The outset is that Russian energy policy with its long tradition of strong state control conflicts with the EU, representing a far more liberal economic ideology, both in terms of for whom policy should work and how it should be performed. At the same time, natural resource trade and investments have fewer international legal regulations than other international economic exchange. In this void, both sides pressure legal cases to make or prevent, respectively, Russia moving towards a Western-styled industrial organization and export policy. The paper asks to which extent Russia, as result of international law, eventually will change its energy policy to become more similar to the Western world. First, the article revisits the continued competing positions in economics and trade of Russia and the West. Second, the Russian accession to the WTO and the legal elements that directly affect the energy sector are presented. Third, the special treatment of natural resources in international law are outlined. Fourth, current legal EU-Russian natural gas disputes are discussed. The paper concludes that Russia's steps towards greater economic integration with the outside world, and following increased importance of international law in its policy making, leads to greater similarities with the West in political forms and processes. However, path-dependencies dominating society and politics, and the particularities of the energy industry, indicate that domestic Russian energy policy and external gas export policy may not necessarily lead to the same degree of similarity in actual political content, and, hence, real political convergence with the West.

**Keywords:** Russia, European Union (EU), International Law, WTO, Gazprom.

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## Introduction

Russian energy policy has a long tradition of strong state control. In spite of the fall of the Soviet Union and the planned economy in 1991, a centralized Russian gas industry has largely continued. The intended objectives for the concentrated market structure are to benefit the Russian nation and the state itself. In contrast, European Union (EU) countries represent a liberal economic ideology. The EU promotes neutral competition to the benefit of the whole EU Community, instead of focusing on any single country. The government's role in industrial affairs is ideally considered to be limited to being a regulator of economic activities undertaken by private actors. The objectives are EU-wide and the measures regulatory. The Russian and EU models confront each other both in terms of for whose interest policy should work and how it should be exercised. This creates two main challenges for common agreements. First, Russia as a manufacturer and exporter of oil and gas on the one side, and the EU as a consumer and importer of energy on the other, do not always share the same economic and political interests of the outcomes; second, Russia has a tradition and desire of stronger and more direct government control of the energy sector than what is proposed in the EU Single Market (SM).

In this paper we study the impacts of international law on the political maneuvering rooms for Russia and the EU in the natural gas sector. The backdrop is that natural resource trade and investments have fewer legal regulations than most other internationally traded commodities. The World Trade Organization (WTO) Treaty of 1994 and the Geneva Convention of 1958 assigns the right for national governments to conserve and control their natural resources. However, no laws regulate explicitly their international exchange. In this void, both the EU and Russia pressure legal cases against each other to make or prevent, respectively, Russia from moving towards a Western styled industrial organization and export policy. To which extent may international legal regulations force relationships in this part of the energy sector into commercial market transactions as opposed to existing political actions, negotiations and the use of economic and political power? To which extent will economic, organizational and political differences in Russia and the EU remain, and path dependencies sustained, or is it mainly a question of time before the same policy is fit for and desired by both? What is the political maneuvering room for both the EU and Russia to formally follow binding international rules while simultaneously support its own defined interests?

The paper, first, revisits the continued competing positions in economics and international trade of Russia and the West since World War II (WWII). Second, the Russian accession to the WTO and the legal elements that directly affect its energy sector are presented. Third, the special treatments of natural resources in international law are outlined. Fourth, current legal EU-Russian natural gas disputes are discussed; EU's competition case against Gazprom; and, Russia's objections to EU's Third Energy Package. Finally, the impact on political maneuvering room for Russia and the EU resulting from international legal bindings in the energy sector are discussed. The article argues that international law leads to greater similarity in all participating countries' formal political forms and processes, but not

necessarily to the same degree of similarity in actual political content. The question remains to which extent the West *de facto*, and in line with increasingly more *de jure* international regulations and the particularities of the energy industry, can expect that relations with Russia can be shaped as a mirror of how the West regulates its own economy and society.

## **1 The Governance of East-West Economic Relations.**

In the Western Hemisphere, the WTO, the EU and other Preferential Trading Areas (PTAs) have accommodated for rule-based trade in a gradually more open international economy after WWII. The WTO (and its predecessor the General Agreement on Trade and Tariffs, GATT) on the global scene is built after the Bretton Woods agreement from 1944, where the Western winners of WWII designed a new international economic order between themselves. This has had profound implications for global economic developments, regional integration and distribution of wealth, international affairs and national policy making. Especially within the EU, the economic integration taken place has led to strong political integration with accompanying legal, institutional and ideological change across nation states. Law, common institutions and harmonized policies have become increasingly more important and changed the political maneuvering rooms for participating nations, and made countries more similar in a number of economic, social and political affairs. National independence to formulate policy based on domestic preferences has been balanced against and changed in favor of the benefits of trading in larger markets in order to achieve higher economic standards of living. On the other side, Russia, and even more the Soviet Union, has historically had a non-liberal approach to economic organization and trade. Through Russia's accession to the WTO Treaty in 2012, as the last of the Group of the 20 major (G20) economies to join after China gained membership in 2001, the country accepted many rules and regulations for both its domestic economy and foreign trade. Still, the situation and path-dependencies from Communist times, and before, contribute in restraining its political convergence with the Rest of the World (RoW).

The different economic regimes are accompanied with hard powers. The international trade system shaped by the West is framed by political and military integration based on the belief that economic interdependence promotes peace and security in an economic plus-sum game where all parties involved benefit. The system got a security umbrella and hardware from NATO and Western nuclear deterrence assuming that the world over time might be anarchic where the stronger dominates or eliminates the weaker. Hence, it was created as a liberal economic system within a realist external political framework. The other winner of WWII was the Soviet Union. The country had created a plan-and-command-economy after the Bolshevik revolution in 1918, which after WWII included a number of domesticized republics and European satellite states. The Warsaw pact and its nuclear capabilities were their security umbrellas, while the COMECON, or CMEA (Council for Mutual Economic Aid), represented the bulk of their international economic regime, administering trade between the hand-on-economies. Hence, it was a realist and managed economic system within a realist external political framework. The Cold War

was the name of the East-West relationship at the time. It was spread around the globe and consisted of both military, social, political and economic controversies. Trade between the two was limited, often considered a zero-sum game and conflictive (grain, energy, technology).

Eventually, the Cold War was won by the West. Western liberal values and institutions for trade, finance, and the economy spread around the globe, and became the single dominating international economic and trade system. In Europe, all the Central and Eastern European States (CEEC), together with the former Soviet republics in the Baltics, became EU and NATO members. In Russia, after a period of economic and political volatility in the 1990s, a strong state apparatus was recreated under President Putin, helped by a long period with high oil prices making it able to pursue a more assertive policy towards its neighbors. The most remarkable is the policy towards Ukraine including disputes over energy, territory, political and economic systems, as well as external relations. Other global economic powers also emerged, leading to a gradual weakening of the Western supremacy over the market-based liberal economic foundation and ideology. Most importantly, China is now one of the world's largest economies with a Communist Party as its leadership. Both China and Russia consider energy as a geopolitical asset. The two countries see economics and trade as one out of many instruments in the struggle for geopolitical power together with military power (Kissinger 2014). Hence, today, a large part of the world economy is outside the sphere of direct control of the U.S. and NATO, and there is no longer a full match between economic and military relationships.

In EU-Russian relationships, the desire to integrate and a recognition of mutual dependence exist on both sides. Kratochvil and Tichy (2013) argues that "the EU and Russian integration discourses share a positive perception of the energy cooperation and the interdependence of the two partners." Even though the liberal economic idea is largely unchallenged in terms of the benefits of specialization and trade on both sides, the question remains as to what extent the West can expect relations with Russia in its realist-geopolitical narrative to be shaped as an image of how the West in its liberal market-based accounts regulate its own economies. At the same time, in natural resource trade, policy conflicts both in terms of policy objectives as well as in terms of policy methods and economic organization. Edward Stoddard (2013:457) explains this as "the contrasting positions that each adopts and their connections to broader historical intellectual trends in international thoughts". Realists often assume states to be unitary rational actors and that they are the only entities acting in relation to other states. National policies towards other countries and the international system are founded as what Kenneth Waltz (1959) phrased as a "Second Image" of domestic affairs. Both the EU and Russia today wants their outside worlds to be Second Images of their domestic affairs. While in Russia it is a strong state that is the ultimate policy actor, the EU is mainly a regulatory system for a number of private and national actors. Interdependence theorists like Keohane and Nye (1977) maintained that international relations have expanded beyond the international sphere, and far into domestic affairs. Although policies towards another country's government are in the final instance set by national governments, persons, companies, institutions and interest groups within a country also exert an influence. The international economy

often affects national policy making by acting upon domestic actors, which in turn affect the domestic political system through associations, state structure and ideology. The “Second Image Reversed” arguments phrased by Peter Gourevitch (1978) emphasize the impact of the international system on domestic affairs. The reversal of the Second Image stresses impacts on domestic policy and the distribution of economic activity, wealth and market power resulting from participation in the international economy, as well as the distribution of (military) power between states.

Thus, changes in both external and domestic affairs may change a country’s policy. In East-West relationships mostly hard political, military and economic powers on each side have been considered important. The relationships are however formed in a complex sum of a number of both hard and soft forces as competing policy instruments, interest-based decisions and path-dependent thinking and constraints. Soft power is in the West often considered to be a strength of the West, although both sides use soft power based on real or promoted images of attractiveness in the forms of reliability, strength, legitimacy, economic interdependence, cultural values (Feklyunina 2012:450-452, Nye 2004:256). In the interdependent world in which both sides now participate, international law is also become increasingly more important. Soft law refers most often to statements, principles, codes of conduct and practice as part of framework treaties, action plans and other non-treaty obligations which do not have any legally bindings (Fajardo 2014). In the EU it is often used to describe codes of conduct, guidelines, and communications as non-binding agreements. Soft law holds potential for, over time, morphing into "hard law" and indicates how a later written agreement may be interpreted and implemented. Legal affairs play an increasingly more important role as economic interdependence deepens, which in East-West economic relations is different from the situation during the Cold War. A “hard” international treaty has a direct *de facto* harmonizing impact on the formal political practices of the signatories. At the same time, there will for each signatory be various degrees of room for interpretation, implementation and compensatory policies when its *de facto* effects on a country’s policy shall be assessed. Same formal rules must not mean same *de facto* policy and full political convergence across countries (Austvik 2015).

## **2 Russian Energy Policy and the WTO Treaty**

After 1991, through a variety of international and regional approaches (such as through the IMF and the World Bank), the West has tried to make most countries in the world behave as Western sovereign nations by exerting the means of law and soft power. Russian energy affairs have had special treatment both before and after the country’s accession to the WTO. The country signed, but did not ratify, the Energy Charter Treaty (ECT) launched in the 1990s, because it thought it went too far into domestic policies and how Russia could manage its petroleum resources (Belyi 2009). The later EU-Russian Energy Dialogue since 2000 dealt with issues such as security of supply, energy efficiency, infrastructure (e.g., pipelines), investments, and trade (Aalto 2007). Even later, when the principles of the EU Single Market were drawn into the relationship, stronger regulations and sectorial specific directives became

new topics of controversy. In these, the EU has moved from its “building block” negotiations<sup>1</sup> with Russia to pursue anti-competitive claims against the Russian natural gas champion Gazprom, and attempted to force the company to adapt to EU regulations both in relation to its activities in member states as well as in terms of its export monopoly for natural gas.

As Russia was not member of the international economic system at the time of the Soviet break-up, the ECT was established in the early 1990s to implement WTO-similar rules for energy trade between Europe, Russia, and the former Soviet republics. The main elements were:<sup>2</sup>

- (i) establishing WTO principles for energy trade similar to those for trade in goods;
- (ii) promoting foreign investments in the energy sector;
- (iii) establishing free transit of gas transportation in pipelines, and;
- (iv) establishing a dispute resolution system on state-state, as well as on investor-state, levels.

As a Treaty specific to dealing with energy, the ECT had more rules crucial to this subject than the WTO. Most importantly, the WTO does not have specific rules concerning freedom of transit through pipelines, and an investor-state dispute resolution system (Lembo 2015). Russia participated in the negotiation process and signed the ECT in 1994, but never ratified it. In 2009, Russia issued a decree declaring a rejection of the treaty (Roche and Petit 2015). The main reason was the case the company Yukos filed against the country in 2007 at the Permanent Court of Arbitration (PCA)<sup>3</sup> (Roche & Petit 2009).<sup>4</sup> It appeared unacceptable to Russia that ECT rules regarding foreign investments would reduce the sovereignty to control its own natural resources and natural resource industry (Nappert 2010).<sup>5</sup> The PCA decided that although the Russian government notified its intention not to ratify the ECT, the Article 45(1) of the Treaty stipulates that “Each signatory agrees to apply this Treaty provisionally pending its entry into force (...).” The Court understood the ECT to apply provisionally to Russia from 1994 to 2009 and also over the following 20 years after 2009 of investments during the provisional application (Nieuwveld, Conway & Partners 2010).

The Energy Dialogue started in 2000 dealing with security-of-supply, energy efficiency, infrastructure (e.g., pipeline transportation), investments, and trade. The dialogue’s main goal was to provide a framework to mutually improve investment opportunities in the energy sector, promote

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<sup>1</sup> Bhagwati & Panagariya (1999) have used the term “building block” in international trade discussions to describe how trade agreements can lead to a construction of rules that can be used in multilateral negotiations.

<sup>2</sup> Source: ECT Secretariat 2015

<sup>3</sup> The PCA was established in The Hague in 1989 to facilitate arbitration and other forms of dispute resolution between states. It is composed by 117 member states. These days the PCA provides services for the resolution of disputes involving various combinations of states, state entities, intergovernmental organizations, and private parties (“Permanent Court of Arbitration” 2015).

<sup>4</sup> Yukos was privatized in 1995, and by 2002, it was Russia’s largest oil and gas company. The claimants alleged that Russia took a series of measures leading to Yukos’s bankruptcy. By 2007, Yukos’s assets were nationalized and acquired by the Russian state-owned companies Gazprom and Rosneft (Brauch 2014).

<sup>5</sup> The ECT has been signed by 54 countries and the EU. However, Australia, Belarus, Norway, and Russia have not ratified it.

energy efficiency and energy savings on the way to a low-carbon economy, and exchange information on legislative initiatives (Aalto 2009). Within the Dialogue was established a Gas Advisory Council of the Energy Dialogue to deal specifically with natural gas. This council puts together representatives from leading EU and Russian gas companies and academic research organizations, and has as its main topics the understanding of the market and its infrastructural developments. Several reports have been published by the council and, in 2009 an Early Warning Mechanism to ensure rapid communication in the event of a crisis to prevent interruption of supply in gas, oil or electricity was established. The dialogue, however, does not have a dispute settlement mechanism, as in the ECT, in place.

The WTO Treaty provides a global forum for trade liberalization, which it polices and decides through its Dispute Settlement Body (DSB) when rules have been breached and when retaliatory trade sanctions can be imposed.<sup>6</sup> The removal of trade barriers should stimulate greater and more diversified trade between Russia and the rest of the world, and make the allocation of resources within the country more efficient. As Heiko Pleines (2009:82) outlines: "Foreign as well as domestic companies in the Russian oil and gas industry are facing high insecurity concerning their property rights and the legal regulations of their business activities." Ivan Tchakarov, chief economist at Russian brokerage Renaissance Capital, told BBC news (16.12.2011) that "by becoming a WTO member, Russia will have to import certain rules and regulations that will address the very issues that foreign investors usually complain about, like corruption, the protection of minority shareholders, the independence of the judiciary.".. "We are achieving a completely new level of integration into the global economic system."

According to Article XII.1 of the WTO Agreement the process of becoming a WTO member is unique to each applicant country. The process takes about five years, on average. The longest was that of Russia, which after having applied to join GATT in 1993 was approved in 2011 and became a WTO member on 22 August 2012. For new members to be admitted all existing members must agree to the terms of their accession by the means of prior negotiations.<sup>7</sup> As part of this, the Russian accession to the WTO reflected extensive negotiations between the country and the EU. The protocol contains obligations for Russia beyond what was agreed upon between incumbent members of the WTO and reflects matters such as transit, export tariffs, and state-owned enterprises in the natural gas sector. There is a specific

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<sup>6</sup> The DSB is a central pillar of the current multilateral trading system and makes the trading system predictable. The system is based on clearly defined rules, with timetables for completing a case. First, rulings are made by a panel and endorsed (or rejected) by the WTO's full membership. Appeals based on points of law are possible. If the DSB decides that a member-country is not acting in accordance with the WTO rules, the country needs to change its policy in a way that is in accordance with the DSB report. If complying with the recommendation immediately proves impractical, the member will be given a "reasonable period of time" to do so. If it fails to act within this period, it has to enter into negotiations with the complaining country (or countries) in order to determine mutually acceptable compensation. If, after twenty days, no satisfactory compensation is agreed upon, the complaining side may ask the Dispute Settlement Body for permission to retaliate (i.e., to "suspend concessions or other obligations"). This is intended to be temporary, to encourage the other country to comply (WTO 2015).

<sup>7</sup> WTO (1994a) states: "Any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement and the Multilateral Trade Agreements may accede to this Agreement, on terms to be agreed upon by it and the WTO. Such accession shall apply to this Agreement and the Multilateral Trade Agreements annexed thereto."



compromise to apply Article V of the GATT, which deals with transit of goods, to energy transit. Although it does not give pipeline transportation as an example of energy transit, it would be difficult to argue that this transportation mode is not included in the Russian Accession Protocol.<sup>8</sup> This was crucial to the EU, as Article V gives import guarantees concerning the transit of goods, but it does not make clear if it deals with fixed infrastructure or not. As Russia accepted a “new language” to Article V, the text in the Russian accession document became close to what the EU was trying to achieve during the ECT negotiations, concerning transit through fixed infrastructures.

The GATT was based in several negotiation rounds with the main goal to reduce import tariffs with non-discriminatory principles as the Most Favored Nation (MFN) clause being applied (Article I). The last was the Uruguay round finished in 1994, which culminated with the creation of the WTO. The imposition of export tariffs as an extensive practice in Russia represented for the WTO a different logic than import tariffs. Export tariffs are neither prohibited by the WTO nor do they have a maximum level negotiated. Export tariffs represent an important source of income for exporting states, as well as having the effect of increasing the cost of goods exported, resulting in lower export volumes. An export tariff puts a comparative disadvantage for the exports of a country for most goods and services. In the Russian accession protocol export tariffs were consolidated on approximately 700 tariff lines including mineral fuels (WTO 2011: para. 1161). This means that mineral fuels will not be subject to higher export tariffs than what was consolidated during the Russian accession.

Article XVII of the GATT establishes rules regarding state-owned and state-controlled companies. The article emphasizes that purchases and selling of products from these companies should respect free market rules, regarding, for instance, price, and quality, available quantities, purchasing opportunities, and transporting costs. In the natural gas sector, Gazprom is often accused of making bilateral agreements in gas contracting, setting prices and political side-payments based on what market positions and Russia’s relations to purchasing countries allow for in each case. In the Russian accession protocol there was a debate concerning prices implemented by Gazprom:

“Some Members of the Working Party noted that the implication that the regulated price for gas was determined in accordance with supply and demand or that Gazprom determined the levels of internal calculated prices did not appear to be borne out by the facts. ... Members observed that this situation gave rise to questions as regards its compatibility with WTO requirements ... In response, the representative of the Russian Federation stated that the export price for gas was not regulated

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<sup>8</sup> WTO 2011, para 1161 took note that “The representative of the Russian Federation confirmed that the Russian Federation would apply all its laws, regulations and other measures governing transit of goods (including energy), such as those governing charges for transportation of goods in transit by road, rail and air, as well as other charges and customs fees imposed in connection with transit,”... and that.. “from the date of accession, all laws and regulations regarding the application and the level of those charges and customs fees imposed in connection with transit would be published. Further, upon receipt of a written request of a concerned Member, the Russian Federation would provide to that Member information on the revenue collected from a specific fee or charge and on the costs of providing the associated services.”

by the Government; the prices for deliveries of gas for exports were those negotiated between supplier and buyer. Contrary to the price of exported gas, the price of gas sold to domestic industrial consumers was regulated, except for gas purchased at its source; gas for new industrial customers; any increased quantity of gas supplied by Gazprom to its existing customers, and for gas from producers other than Gazprom which was unregulated.” (WTO 2011: 23–24)

Diverging views on such price discrimination between exporting and importing countries has been the subject of numerous debates within the WTO. Saudi Arabia, for example, was pressured to take on an explicit commitment to eliminate its dual-pricing program for the natural gas sector (CL: insert ref.). The discussions of Russia’s protocol of accession followed the same reasoning. Nevertheless, Russia adopted some exceptions to the criteria already established in Saudi Arabia’s protocol. Russia defended its dual pricing, arguing that it could not be considered a specific subsidy, since lower prices for natural gas in the domestic market would be granted unconditionally across the country, and would be available to all individuals and entities in a non-discriminatory way. It should therefore not qualify as falling under the category of illegal subsidization (Cavalcanti, Lembo, and Thorstensen 2013:x). In an open WTO economy, “national treatment” requirements of non-discrimination between foreign and national investors and companies is essential. For importers, low and managed domestic prices in exporting countries are perceived as a distortion in the international market and a subsidy to the exporting countries’ industries. Hence, dual pricing has been banned in current WTO negotiations (Lembo 2015:x).

### **3 Natural Resources and International Law**

Investments in natural resources often represent long-term contracts and need advanced production technology through Foreign Direct Investments (FDI). When produced, natural resources are more than almost any other products internationally traded. The ECT would have regulated this trade but the WTO rules are not drafted specifically to regulate natural resources. The reason is that they have a number of distinctive features that makes them different from other traded goods and investments. These include their uneven geographical distribution, exhaustibility (hence the large rents associated to their scarcity), environmental externalities deriving from their extraction and consumption, economic dominance in some economies, and high price volatility. WTO (2010) finds that export policy, rather than import restrictions, dominates natural resources trade policy. Resource-rich countries in the Organization of Petroleum Exporting Countries (OPEC), Russia in the case of natural gas, and others, may restrict exports by political decision making, from market power, resource management, and fiscal purposes (such as export taxes). Exporting countries employ policies to stimulate diversification of exports away from dominant resource sectors, and stabilize international resource prices in response to supply or demand shocks. In importing countries such as in the EU, consumer taxes on fossil fuels such as gasoline are high (equal to import tariffs if there is no domestic production) whereas import tariffs, quantitative restrictions, and other import restrictions are low. Domestic policies in importing countries

often have trade effects that are very similar to border measures, even if they were not introduced for that purpose. In terms of border measures, tariff escalation in importing countries make protection rise with the stage of processing. Michele Ruta (2010:x) notes that “import tariffs are on average 23% lower in natural resource sectors relative to other merchandise trade, while export taxes cover 11% of natural resources trade (compared to 5% of other merchandise trade) and export restrictions on natural resource products represent 35% of all notified export restrictions.”

Both importing and exporting countries must manage environmental externalities associated with the production or consumption of resources. The WTO Treaty has some relevance to natural resource management, such as in the exceptions in Article XX of the GATT that allows protectionist measures to assure the conservation of exhaustible resources. The Geneva Convention of 1958 (ref.) assigns an active role to the state from the outset by dictating that national governments have the exclusive rights to exploit resources found on their respective countries’ onshore and offshore territories. In legal terms, Russia’s position of a strong state control over the exploitation of its resources is justified by the “Principle of Permanent Sovereignty over Natural Resources Conservation of Resources” (Cavalcanti, Lembo, and Thorstensen 2013:97). The principle establishes that nations retain ownership of their natural resources and permanent sovereignty over their regulation and exploitation. In several United Nations Resolutions it was recommended that the exporting countries may maximize their exploitation through control of the supply chain and sales. In these terms, the principle of permanent sovereignty would reflect a state’s inherent, comprehensive right to control the production and use of its natural resources. In resource rich states, governments have often been at the core of economic developments rather than just a regulator and coordinator of economic activities as opposed to the varieties of capitalism (Hall & Soskice 2001) that exists under the liberal international economic regime “owned” by the West (Austvik 2012).<sup>9</sup> As exclusive resource owner the state can rent or lease the rights to explore and extract the resources to a private company as a landlord, or it can become an industrial entrepreneur itself (Klapp 1982, 1987). When combining the roles as landlord and industrial entrepreneur, the state can engage in the business in a manner similar to a private entrepreneur or a company, but the state can also use political and legal interventions and regulative measures to reach their goals (Eisinger 1988, Austvik 2010:106-109). As a political entrepreneur the state can define social (as opposed to private) goals for economic activities and use measures to reach those goals that private entrepreneurs do not have at their disposal. The goals for society may converge with the goals of private profit-maximizing firms, but in many aspects social goals also conflict with private ones. For Russia, as well as for other oil and gas producing countries, there are numerous discussions whether it aims at economic or political goals in its energy policy.

Due to resource exhaustibility, price volatility, imperfect competition, geopolitics and the political economy of contracting with governments, FDIs in natural resources are often more complex than other

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<sup>9</sup> Including countries such as the U.K. and Canada until the 1990s, Norway, France, and others.

FDIs. FDIs are rather taking comprehensive protection through Bilateral Investment Treaties (BITs), and foreign courts and arbitration arrangements are the ones in evidence, such as the PCA. Because a bilateral arrangement reflects bargaining power in favor of the stronger, it lowers the gains a resource rich country can achieve by signing a BIT. Accordingly, the credibility of the arbitration system will be important to decide whether the parties can trust that the enforcement will be real and to their benefit. Ruta and Venables (2012:27-28) argues that long-run resource investments should rather be dealt with within the WTO system in the same way as the Agreement on Government Procurement (AGP). The Extractive Industries Transparency Initiative (EITI) that the OECD now requires for membership could be used to counter corruption in contracts forcing illicit payments into the open, making it a criminal offense to bribe government officials anywhere in the world to win a contract. Both the EU and the Frank-Dodd Act in the U.S. are proposing similar measures against corruption. Ruta and Venables argues that the corruption initiative of the EITI “could be subsumed and made more effective by bringing corruption in resource extraction contracts under the clear remit of the WTO and requirement of WTO membership.” The WTO system would then offer dispute procedures through the DSB, giving governments a way of committing member countries to non-discriminatory fiscal and contractual terms, analogous to the MFN.

Alongside the increased economic influence of state-centered countries such as Russia and China in the world economy, the oil and gas industry has also become more state-centered. National Oil Companies (NOCs) now control some 75% of petroleum production in the world, which represents a dramatic change in the West since the time when Big Oil and the Seven Sisters dominated in the early Cold War period (the 1950s and 1960s). Besides the NOCs in the Arab states, Gazprom and Rosneft are two giant companies under the control of the Russian state. The Chinese state also owns or controls huge companies searching for oil and gas all over the world.<sup>10</sup> With increased energy demand from the new economies and lower demand from the OECD area, the balance in the international oil and gas market is now, to a large extent, between state-centered new economic areas and state-centered oil-producing economies. In the European gas market, Russia is a substantial resource owner, petroleum-producing state, and dominant seller, while the purchasers in the EU are mixtures of large state and private companies in competition. A strong role for the state with respect to industrial leadership and direct involvement in the energy sector is often considered contrary to the prevailing neoclassical liberal economic school on which EU and other Western economies are built.

## **4 Current Legal EU-Russian Natural Gas Disputes**

Both the EU and Russia have been testing each other by legal means in their natural gas relationships over the past few years. We shall discuss two cases. First, the competition case against Gazprom that

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<sup>10</sup> Major Chinese state-owned oil companies are China National Offshore Oil Corporation (CNOOC), China National Petroleum Corporation (CNPC), China National Refinery Corp, and Sinopec.

the EU put forward; second, the WTO Dispute Settlement case against the Third Energy Package (TEP)<sup>11</sup> that Russia put forward. Both cases are dealing with the extent to which the EU may regulate Russian energy policy to become more similar to that common in the West. In the first case, in 2012, the European Commission announced the initiation of an antitrust investigation against Gazprom with respect to:

- (i) resale obligations and territorial restrictions which limits the freedom of movement of gas between EU member states;
- (ii) unfair pricing policy, where Gazprom is accused of imposing unfair prices on contractors in those markets is has a dominant position, and;
- (iii) suppression of alternative competition to prevent purchasing EU countries and wholesalers, either politically or contractually, from buying gas from others and spreading risk.

The allegations were investigated for several years and, eventually, in April 2015, the Commission sent a Statement of Objection (SO)<sup>12</sup> to Gazprom alleging that some of its business practices were not in accordance with EU antitrust rules. In particular, it was the case with the TEP (EU 2015a) reflecting the hindering of cross-border gas sales, charging unfair prices, and making gas supplies conditional on obtaining unrelated commitments from wholesalers concerning gas transport infrastructure. Regarding the resale obligations, the Commission objected that Gazprom has agreed with wholesalers to ban the re-exporting of gas to destinations in eight CEEC countries.<sup>13</sup> Regarding the allegation of unfair pricing, the Commission had assessed prices in different countries and compared them to a number of benchmarks (such as Gazprom's costs, and gas prices in other markets). The findings indicated that prices have largely favored Gazprom over its customers in five Central and Eastern European Countries.<sup>14</sup> Regarding the claim that unrelated conditions were included in gas contracts, the Commission argued that Gazprom might be using its market dominance to obtain political commitments regarding two pipelines, one in Bulgaria and the other in Poland. In Bulgaria, Gazprom

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<sup>11</sup> The Third Energy Package, or TEP (EU 2009) consisted of two directives and three regulations, besides a focus on the realization of the two first energy packages. The First Energy Package from 1998 allowed the opening of the electricity and gas markets, the gradual introduction of competition, and imposed broad unbundling requirements to integrated companies. The Second Energy Package from 2003 focused on the concepts of unbundling and third-party access, defined the need for independent regulatory authorities, and set deadlines for the liberalization of electricity and gas retail markets in 2004 and 2007. The core elements of the TEP were ownership unbundling to separate companies' generation and sale operations from their transmission networks, the establishment of a national regulatory authority (NRA) for each Member State, and the establishment of an Agency for the Cooperation of Energy Regulators (ACER) to provide a forum for NRAs to work together. The TEP has yet to deliver fully. EU 2015b gives an overview of EU energy-market legislation.

<sup>12</sup> A SO is a "Written communication which the Commission has to address to persons or undertakings before adopting a decision that negatively affects their rights. This obligation of the Commission flows from the addressee's rights of defense which require that they be given the opportunity to make their point of view known on any objection the Commission may wish to make in a decision. The SO must contain all objections on which the Commission intends to rely upon in its final decision. The SO is an important procedural step foreseen in all competition procedures in which the Commission has the right to adopt negative decisions" See Article 19(1) of Regulation No 17, Article 18(3) of the Merger Regulation. Source: [www.concurrences.com](http://www.concurrences.com).

<sup>13</sup> These include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia.

<sup>14</sup> Bulgaria, Estonia, Latvia, Lithuania, and Poland.

required the participation of the Bulgarian incumbent wholesaler Bulgargaz in the South Stream pipeline project. In the case of Poland, Gazprom made gas supplies conditional upon maintaining control over key transit pipelines. In September 2015, as response, Gazprom proposed formal talks about the SO, as a parallel track on its obligation for a formal response to the antitrust charges made by the EU Commission.<sup>15</sup> By doing this, Gazprom showed that it is willing to negotiate with the Commission.

In the second case, Russia objected that the EU wanted to implement legislation that demanded the following (WTO 2014):

- (i) Unbundling of Gazprom operations in the EU, so that, as a producing company, it cannot be the same as a transportation/transmission company.
- (ii) A mandatory certification of foreign transmission system owners or operators within the EU territory.
- (iii) Non-discrimination. All network users should face the same regulated tariffs, and be able to provide both firm and interruptible third-party services within the EU.
- (iv) Discrimination of imported gas in terms of additional requirements (such as resale) affecting its internal sale, offering for sale, purchase, transportation, distribution or use within the territory of the EU.<sup>16</sup>

According to Russia, a major problem with the TEP is that, on every above-mentioned point, the EU offers exemptions to certain EU companies (e.g., pipeline companies), and the TEP discrimination between these and Russian companies is not in accordance with the MFN clause.<sup>17</sup> In May 2015, as consultations with the EU about the objections failed, Russia requested the establishment of a DSB panel to assess EU demands for changes in Gazprom activities within the EU.<sup>18</sup> The EU is as a PTA accepted as an exception to the MFN clause on non-discrimination by article XXIV of the GATT. Russia claimed that as a PTA within the WTO, the EU cannot regulate parties outside the common market (third parties) even if they operate within the EU. However, there has never been a clear DSB decision regarding the extent to which a PTA can regulate third parties. The WTO does not establish competition rules as the

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<sup>15</sup> The talks have the intention to come with a negotiated solution with the EU, avoiding potential fines. EU officials have said the Commission is open to the proposed negotiations, the competition commissioner, Margrethe Vestager, has signaled that she is reluctant to settle milestone cases. Furthermore, CEEC countries like Poland and the Baltic States see the Gazprom showdown as an important test of whether the EU will take a major antitrust decision in their favor. At the same time, it is important to notice that Gazprom's proposed talks is a signal of a willingness on their side to work within the EU energy regulations (Farchy 2015a-b).

<sup>16</sup> It is significant that this section of the TEP is often called the anti-Gazprom clause; see a related discussion in Cottier, Matteotti-Berkutova, and Nartova (2010).

<sup>17</sup> More specifically, Russia understands that the EU "Energy Third Package" is not in accordance to the following WTO rules: (i) Articles II, VI, XVI and XVII of the GATS and EU specific commitments under the GATS; (ii) Articles I, III, X and XI of the GATT 1994; (iii) Article 3 of the SCM Agreement; (iv) Article 2 of the TRIMs Agreement; and (v) Article XVI: 4 of the WTO Agreement.

<sup>18</sup> Brazil, China, India, Japan, Ukraine, and the United States are the third parties in this case. A panel is established by a DSB meeting when countries do not reach an understanding during the consultation period. A panel addresses the relevant provision cited by the parties in the dispute and comes up with a panel report, what, in the judicial system, would be equivalent to a sentence (WTO 1994).

EU does, so when assessing this case, the WTO will probably do it from a free-trade perspective. From this perspective, the EU may try to justify the unbundling of the market and all other measures adopted by the package as non-discriminatory and necessary to secure an energy supply. Regarding this last aspect, the EU will probably argue that its rules follow the General Agreement on Trade in Services (GATS) Article XIV<sup>bis</sup>, which is an exception to GATS general rules that allow countries to impose legal measures in order to protect security concerns.

The DSB panel shall assess the Russian objections according to free-trade rules in the WTO Treaty and not the domestic measures made by the EU. The WTO first and foremost regulates policy for foreign trade (tariffs, quotas), while the EU is more far-reaching in terms of establishing competition rules, directives and regulations for domestic economic activities, many with a de facto impact on foreign trade. In lack of precedence in DSB cases whether or not a PTA can regulate third parties, it is unclear whether security-of-supply arguments to defend EU demands on Gazprom apply. The Russian request for a DSB panel can be seen as a reaction to EU's initiation of an antitrust investigation against Gazprom about resale, unfair pricing, and politicization of contracts just a month before (April 2015). Both cases raise questions about jurisdiction and lack thereof, and also about disagreements about economic organization and economic and political interests. As the rules that DSB will be using to decide are from a different nature than the one the Commission will, in the end of the day, it is hard to predict what will happen if the EU lose the WTO case.

In addition to these two formal disputes between states, there is also private arbitrations between EU companies and Gazprom. Outside the international public law, also known as rules of treaties, there have been disputes arguing the disrespect of Gazprom to contract law, private international law. A good example is the case brought by the German gas importer RWE, where Gazprom has been forced to pay substantial compensation, because the court has accepted part of the companies' arguments against unjustified clauses in Gazprom's standard supply contracts (Reuters 2013). These disputes, between companies, can also impact the maneuvering rooms.

## **Conclusions**

East-West competition with hard and soft power and law, take place at all levels and forms. With the creation of the Eurasian Economic Union (EEU) between Belarus, Kazakhstan, Armenia, Kyrgyzstan and Russia in 2015, Russia established an institution much similar to the EU (Single Market, common currency etc.), with Russian language and headquartered in Moscow. Former president of Ukraine Viktor Yanukovich submitted an application to join the EEU in 2013 as an observer to pursue further integration with Russia, and, hence, to abandon the association agreement with the EU. The move was a decisive factor for the Euromaidan protests in Kyiv which eventually ended his term as president, and made him escape to Russia. The following Russian annexation of Crimea and military operation in Ukraine led to Western sanctions of Russian individuals, companies and officials while Russia responded with sanctions of food imports from the West. As part of this conflictual picture, Russia

turned its attention to Asia and wrote several agreements with China in 2015, aiming at deeper economic (and political) ties between the two countries intending to make Russia less economic dependent on the West.

In spite of these continued rivalries, as for any trade, exchanging resources from regions of relative abundance to regions of relative scarcity has the potential to improve efficiency and increase welfare for all. Sales of gas from Russia to the EU are to the benefit of both. However, while other international economic exchange mostly is covered by international (hard) law (mainly the WTO), trade and investments in natural resources are only modestly regulated. Michele Ruta and Anthony Venables (2012:20) note that for natural resources in general the incentives for beggar-thy-neighbor policies are significant and that “both importers and exporters have instruments – which are outside WTO disciplines -- which they can use to manipulate trade flows and prices in order to meet domestic objectives.” In this context, while Russia attempts to use the power of single countries’ one-sided import dependency for their economic and political benefit, the EU is trying through several directives, most importantly the TEP, to establish competition rules that will assure a less dominant power to Gazprom in its market. Both the EU and Russia are using their national political and legal maneuvering rooms without necessarily encompassing related international rules. The EU considers itself entitled to regulate the activity of any doing economic activities within the area of the SM. Russia, as a member to WTO, consider itself entitled to use an international maneuvering room to pressure the EU into not elaborating rules that can undermine what has been agreed on in the international trade negotiations and their defined national interests. In the EU, a common assumption is that external relations can be governed in the same way as internal EU affairs and handled similarly by law and institutions regulating economic activities as the EU does for member states. Viewed from this perspective, energy in East-West relations should be treated as just another commodity with policy harmonization across the Community such as privatization programs and market liberalization followed by structural adjustments. In this language, assumed monopolists such as Gazprom for gas and OPEC for oil as external suppliers of energy are largely considered the problem of market failures. Market imperfections connected to pipeline transportation of gas, transit, and external suppliers need be fixed by regulatory and legal measures. At the same time, the Russian realist perspective sees the importance of a political control of gas pipelines and energy transit as a measure to secure both economic and military positions.

In a traditional realist perspective the EU can be considered a weak organization with its intergovernmental structure and absence of financial resources or interventionist measures to address industries and economic policy. These have largely remained the competencies of individual member states. When meeting Russia’s hard military and economic (energy) power, Goldthau and Sitter (2015) argue that the EU’s soft power is shaped and supported by its market position, determined by both its size and the suppliers depending on it, and the quality and strength of its regulatory power. Harsem and Claes (2012) outlines that Russia can exercise power based on its energy resources while the EU can compensate for its lack of power with other trade related capabilities. Without clearer international law



directly regulating the exchange, the powers meet today mostly in bilateral arrangements to solve economic disputes. Naturally, the EU and Russia have different perspectives on how natural resources should be dealt with in the first place. On the one hand, since the EU is a major importer, it would appear that the absence of a free market would hurt its economic and political interests. On the other hand, Russia perceives natural gas as bearing an important competitive advantage that the country should use to bring prosperity. The case brought by Russia under the WTO against the EU and the one brought by the Commission against Gazprom touches “unfinished” business regarding natural gas prices, transit, and market dominance. Beyond that, it is a consequence of previous failed attempts to reach consensus under the ECT or through the EU-Russia energy dialogue.

A possible strategy for Russia could eventually be to accept EU rules while simultaneously finding ways to maintaining state control over profits, infrastructure and gas sales. Such national promotion over industrial sectors that a country considers essential may often be possible by ways of implementation of rules and compensatory policies. For example, when Norway as the second largest energy exporter to the EU eventually adhered to SM rules and regulations in the early 2000s, it introduced a number of compensating policies to maintain the ability to reach national policy goals.<sup>19</sup> National promotion of own industries can also be achieved by “hidden” measures and “clever” adaptation to agreed rules, perceived as a steadily increasing challenge to trade negotiations and their implementations for countries participating in both the WTO and the EU. When situations or interests differ the processes of harmonization between policy form and process often trigger diverging national interpretations, innovative implementation, compensatory policies, and create the potential for different policy content. For many countries involved in economic integration processes, different national policy goals and practices are often sustained in spite of common rules and regulations. The degree of (real) political convergence between integrating economies depend on national situations and preferences, path dependencies, ideological divisions in political practices, regulatory interpretation, policy implementation, policy substitution and policy innovation (Austvik 2015:118).

Hence, the struggle between open and restrictive trade may take place as an open debate in the WTO, the EU, in a PCA, and before an agreement is signed, and then continue through more innovative forms after its ratification. All countries want to receive the benefits of market access for and political influence over, and in support of, its industries adapted to their unique national situations, without experiencing corresponding retaliation from other member countries. Realist-liberalist Joseph Nye

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<sup>19</sup> Norway objected and resisted against what was considered a threat to national interests when it had to implement EU competition rules and energy directives since the late 1990s. Ultimately Norway accepted the new EU rules of game. The result was that the state gained a more regulative than interventionist role, in accordance with EU principles. However, two new fully state owned companies was introduced, Petoro for state ownership of petroleum fields, and Gassco for the control of gas transportation infrastructure, as well as a new regulatory scheme for gas transportation (GasLed). In the sum of all changes, the Norwegian state could remain the main rent collector in the sector, control the infrastructure; and largely continue in the role as a political industrial entrepreneur and innovator when considered desirable and/or necessary (Austvik 2010:118-121).

(2015) argues that states must physically protect themselves against other states, forces, and preferences and, as much as possible, maintain power dominance, under which order may persist under liberal international trade systems. In complex policy matters with large differences between countries, policy harmonization easily becomes more concerned about form and process than hard realities, if implemented at all. The processes are not hierarchical or discrete, but appear rather as continuous sequences of negotiations, interpretations, adaptations, and compensatory policies (Dolowitz and Marsh 2000:15, Heichel, Pape and Sommerer 2005). The actual outcome will often be second best in economic terms, but perhaps one that ranks better than the measurement from economics in a long-term social and political context as defined by parties involved.

Taken together, Russia may not *de facto* accept and change the way it organizes its domestic energy policy and external natural gas export policy into a mirror (Second Image Reversed) of how the West regulates its own economy and society, even if the country eventually should face it *de jure* in terms of international hard law. The economic, commercial and political particularities of the energy industry in its interactions in transnational, state and international affairs in East-West energy trade must be weighed in to check what might work. In this complexity, Rawi Abdelal (2013:423) suggests that firms rather than countries are in the center of East-West energy trade and these seek sociological conventions on the way on their own. Andrey Kazantsev 2012:7) argues that “under current circumstances, personal connections with Russian leaders should be practiced in order to diminish risks, better understanding of potential dangers of networking with Russian elite helps to avoid some of them.” Path-dependencies from industrial and personal relationships having formed East-West energy trade over decades, in addition to its politicization on country levels, indicate that a full Westernization the Russian energy sector may not be possible, perhaps even not desirable for the EU. In its simplest “non-politicized” regulatory form, it seems unlikely that an EU-styled unbundling and privatization scheme would work in Russia. A pragmatic optimal degree of convergence between the East and West in the natural gas sector must take into consideration its particularities. This optimum should represent the maximum degree of policy harmonization in and convergence if formalities and realities should be close.

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