



# The European Commission vs. Gazprom: An Issue of Fair Competition or a Foreign Policy Quarrel?

Nicolò Sartori

## Abstract

The proceedings opened by the European Commission against Russia's gas giant Gazprom for allegedly violating European Union competition rules is likely to have a considerable impact on the future of EU-Russia relations. There are widespread concerns that the probe will contribute to consolidating Russia's apparent zero-sum game approach to foreign policy, thus risking to undermine its long-established energy relationship with the EU. However, while involving risks, the Commission's inquiry also presents itself as a unique opportunity to reorganize Gazprom's business structure in Europe and eventually help both Gazprom itself and EU buyers to best adapt to a rapidly changing global gas market.

**Keywords:** *European Union / Energy supply / Natural gas / Russia / European Commission / Competition / Antitrust*

## The European Commission vs. Gazprom: An Issue of Fair Competition or a Foreign Policy Quarrel?

by Nicolò Sartori\*

### Introduction

On 4 September 2012, the European Commission (EC) antitrust branch opened formal proceedings against Gazprom, the Russian state-controlled energy giant, for allegedly violating European Union (EU) competition rules<sup>1</sup>. The initiative - which is likely to ascend to notoriety as the *antitrust clash of the decade*<sup>2</sup> - is the last act of a long and troubled energy relationship between the EU and the Russian company.

From the EU's perspective, the investigation into Gazprom is a legally due action, whose rationale is to ensure fair competition in the European gas market, which historically has been characterized by national monopolistic regimes and in certain countries is still dominated by powerful incumbent energy companies. In line with its institutional role as keeper of EU treaties, the Commission has not only monitored and sanctioned non-compliance with EU competition laws, but has also championed efforts at deeper integration of European markets, including in the utilities sector. Specifically, the EC has pushed for greater liberalization of energy markets through the adoption of a sector-specific regulatory regime. Initiated in the early 1990s, the liberalization process has seen the progressive introduction of regulations aimed at ensuring the benefits of an integrated and competitive market - in terms of both security of supply and competitive prices - for European consumers.<sup>3</sup>

Joaquín Almunia, EC Vice President and Commissioner for Competition, has taken care to emphasize that the Commission is not investigating Gazprom for any political reason, but simply because we have to make sure that the company has not abused its dominance in upstream gas supply markets?<sup>4</sup> In other words, according to Commissioner Almunia, the EC's initiative should be understood as a purely technical-bureaucratic procedure entirely dependent on the Commission's mandate to ensure fair competition in the EU. That mandate is indeed one of the defining features of the Commission, which holds significant powers not only to monitor but also to enforce

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\* Nicolò Sartori is Researcher in the Security and Defence Area at the Istituto affari internazionali (IAI).

<sup>1</sup> Case No. 39816: *Upstream gas supplies in Central and Eastern Europe*, [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_39816](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_39816).

<sup>2</sup> Alan Riley, "Commission v. Gazprom: The Antitrust Clash of the Decade", in *CEPS Policy Briefs*, No. 285 (31 October 2012), <http://www.ceps.eu/node/7433>.

<sup>3</sup> For an overview of the EU legislative initiatives for the establishment of the internal energy market see the website of the European Commission DG Energy:

[http://ec.europa.eu/energy/gas\\_electricity/internal\\_market\\_en.htm](http://ec.europa.eu/energy/gas_electricity/internal_market_en.htm).

<sup>4</sup> Joaquín Almunia, *Better working markets at the service of growth* (SPEECH/12/653), 2nd International Competition Forum, Warsaw, 27 September 2012, [http://europa.eu/rapid/press-release\\_SPEECH-12-653\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-12-653_en.htm).

compliance with EU competition laws. The extent of such powers can be appreciated if one considers that the EC acts, at one and the same time, as policymaker (thanks to its power to initiate the legislative process) as well as investigator and judge (a reflection of its strong antitrust competencies). For years that approach has been backed by both the European General Court and its superior appeal body, the European Court of Justice (ECJ), which explicitly refer to the principle of fair competition as a “fundamental objective” of the Community, or as a “general principle of EU law”.<sup>5</sup> Global players the size of Microsoft, Intel and General Electric - among others - have all experienced the iron fist of the Commission firsthand.

By contrast, Russia sees the antitrust move as a political “attempt [...] to pressure Gazprom and influence prices and the result of commercial negotiations”.<sup>6</sup> The EC investigation can hardly be taken light-heartedly by Russia’s political elite, since Gazprom is a state-controlled firm in which top Russian officials (elected and unelected) have a stake and which plays a significant role in the country’s foreign policy. Russia’s leaders themselves openly acknowledge that energy - which contributes to around half of Russia’s federal budget - is a critical asset both domestically and on the international stage. On the home front, energy-originated money is spent on welfare programmes that Russia’s government considers essential in ensuring social stability, while internationally Russia’s huge resources contribute to securing its role as a leading global player.

The critical importance of energy for modern Russia was highlighted by no other than President Vladimir Putin himself, who in his 1999 doctoral dissertation referred to Russia’s oil and gas industry as a means to strengthen Russia’s hand on the international stage.<sup>7</sup> Since 2004, the Russian government has enforced this principle by taking over control of the energy sector with the establishment of national champions. Gazprom, which owns 70 percent of Russia’s natural gas reserves, plays a pivotal role in this scheme. As Alexander Medvedev, Director General of Gazpromexport, once remarked: “as the Russian state owns 50.02 percent of Gazprom Group, it is hardly surprising that the majority shareholder takes an interest in the company’s operations”.<sup>8</sup> It should really come as no surprise then that, seen from Moscow, the EC investigation looks like a political attempt to curb Russia’s interests in Europe, rather than a due procedure against a potential violator of technical regulations.

This paper tries to shed light on the implications of the Commission-Gazprom clash by describing, first, the nature and the drivers of the EC initiative in the context of the

<sup>5</sup> Ben Van Rompuy, “The Impact of the Lisbon Treaty on EU Competition Law: A Review of Recent Case Law of the EU Courts”, in *Antitrust Chronicle*, Vol. 12, No. 1 (Winter 2011), <http://ssrn.com/abstract=1970081>.

<sup>6</sup> Catherine Belton, Alex Barker and Joshua Chaffin, “Kremlin Shield from EU Probe”, in *The Financial Times*, 11 September 2012.

<sup>7</sup> Martha Brill Olcott, “Vladimir Putin and the Geopolitics of Oil”, paper prepared for the Baker Institute research project on *The Energy Dimension in Russian Global Strategy*, October 2004, <http://bakerinstitute.org/publications/vladimir-putin-and-the-geopolitics-of-oil>. See also Harley Balzer, “The Putin Thesis and Russian Energy Policy”, in *Post-Soviet Affairs*, Vol. 21, No. 3 (July-September 2005), p. 210-225.

<sup>8</sup> Alexander Medvedev, “Is Gazprom’s Strategy Political?”, in *Europe’s World*, No. 9 (Summer 2008), p. 63, [http://www.europesworld.org/portals/0/PDF\\_version/EW9\\_FINAL\\_ENG.pdf](http://www.europesworld.org/portals/0/PDF_version/EW9_FINAL_ENG.pdf).

broader EU-Russia gas relationship. Secondly, it analyses Russia's reaction to the investigation with the aim of evaluating whether the issue can eventually be solved through formal EU antitrust procedures or warrants the activation of foreign policy dispute settlement practices.

## 1. The Commission's proceedings against Gazprom

At the end of September 2011, EU antitrust officials made unannounced inspections of the premises of energy companies in ten Central and Eastern European member states. Eleven companies confirmed to have been subject to controls, including Gazprom-controlled Gazprom Germania in Berlin and Vemex in Prague.<sup>9</sup> The Commission's action was aimed at verifying whether these companies had engaged in anticompetitive behaviour in breach of EU antitrust rules or, alternatively, whether they had information concerning such activities.<sup>10</sup>

Almost one year later, on 4 September 2012, the EC opened a formal proceeding to investigate whether Gazprom is abusing its dominant market position in Central and Eastern Europe's gas supply markets.<sup>11</sup> The Commission claims that information gathered during the 2011 inspection may point to three potentially anticompetitive practices that are in breach of Art.102 of the Treaty on the Functioning of the European Union (TFEU): market partitioning, barriers to supply diversification, and unfair pricing.<sup>12</sup> The initiation of proceedings does not mean that the Commission has conclusive evidence of infringement, but simply that it will further investigate the case as a matter of priority.

In the past the EC has been particularly active in this domain through investigations into big European energy companies such as Italy's ENI, France's Gaz de France (GDF), and Germany's E.On and RWE, as well as major foreign suppliers (see below). The Commission's effort to correct these uncompetitive practices, therefore, is not an isolated proceeding against Gazprom but part of a broader antitrust effort which has involved many key operators active in European energy markets.

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<sup>9</sup> Other energy companies involved in the investigations are RWE AG and E.ON Ruhrgas in Essen, RWE Transgaz in Prague, E.ON Magyarország in Budapest, OMV and Ecomgas in Vienna, PGNiG in Warsaw, LietuvosDujos in Vilnius, and SPP in Bratislava.

<sup>10</sup> EU, *Antitrust: Commission confirms unannounced inspections in the natural gas sector* (MEMO/11/641), 27 September 2011, [http://europa.eu/rapid/press-release\\_MEMO-07-186\\_en.htm](http://europa.eu/rapid/press-release_MEMO-07-186_en.htm).

<sup>11</sup> EU, *Antitrust: Commission opens proceedings against Gazprom* (IP/12/937), 4 September 2012, [http://europa.eu/rapid/press-release\\_IP-12-937\\_en.htm](http://europa.eu/rapid/press-release_IP-12-937_en.htm).

<sup>12</sup> According to Art.102 of the Treaty on the Functioning of the European Union (TFEU), "Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts." See TFEU, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:en:PDF>.

### 1.1. Market partitioning

Gazprom is suspected of having hindered the free flow of gas across EU member states by introducing “destination clauses” in its supply contracts. Such clauses - prohibiting a buyer from re-selling purchased gas to third customers in different countries - have the potential to divide (or “partition”) the EU single market into various national sub-markets.<sup>13</sup> Market partitioning is not only incompatible with European competition law, but also in contrast with the EU’s commitment to fully integrating national markets by 2014.

This is not the first time that the EC has stepped in to address the issue. A negotiation to abrogate the “destination clauses” was already started in 2001, in the framework of the EU-Russia Energy Dialogue. In 2003 the Commission reached a settlement with both Gazprom and Italy’s energy giant ENI, which agreed to remove a number of market-dividing clauses from their existing contracts<sup>14</sup>. In 2005 it was the turn of the Austrian energy company, OMV, which agreed to cancel the clauses from its supply contracts with Gazprom<sup>15</sup>. Investigations also concerned contracts for supply between the Netherlands’s Gasunie and Gazprom, although in this case the Commission did not find evidence of any territorial sales restrictions<sup>16</sup>. The Commission’s investigations on destination clauses do not exclusively concern Gazprom, but also other major foreign suppliers such as Algeria’s Sonatrach<sup>17</sup> and Nigeria’s LNG<sup>18</sup>, as well as European gas majors such as GDF.<sup>19</sup>

### 1.2. Barriers to supply diversification

Gazprom is also suspected of having prevented the diversification of gas supply by denying access to its pipeline network to third-party gas suppliers. Gazprom’s conduct is believed to be in breach of the so-called Third Party Access (TPA) regime,<sup>20</sup> set up by the European Gas Directive of 1998<sup>21</sup> and further refined and articulated by the second and third energy law packages (Directives 2003/55/EC<sup>22</sup> and 2009/73/EC<sup>23</sup>,

<sup>13</sup> Jonathan P. Stern, *The Future of Russian Gas and Gazprom*, Oxford and New York, Oxford University Press, 2005, p. 132-133.

<sup>14</sup> EU, *Commission reaches breakthrough with Gazprom and ENI on territorial restriction clauses* (IP/03/1345), 6 October 2003, [http://europa.eu/rapid/press-release\\_IP-03-1345\\_en.htm](http://europa.eu/rapid/press-release_IP-03-1345_en.htm).

<sup>15</sup> EU, *Competition: Commission secures improvements to gas supply contracts between OMV and Gazprom* (IP/05/195), 17 February 2005, [http://europa.eu/rapid/press-release\\_IP-05-195\\_en.htm](http://europa.eu/rapid/press-release_IP-05-195_en.htm).

<sup>16</sup> EU, *Commission reaches breakthrough with Gazprom and ENI ...*, cit.

<sup>17</sup> EU, *Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts* (IP/07/1074), 11 July 2007, [http://europa.eu/rapid/press-release\\_IP-07-1074\\_en.htm](http://europa.eu/rapid/press-release_IP-07-1074_en.htm).

<sup>18</sup> EU, *Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG* (IP/02/1869), 12 December 2002, [http://europa.eu/rapid/press-release\\_IP-02-1869\\_en.htm](http://europa.eu/rapid/press-release_IP-02-1869_en.htm).

<sup>19</sup> EU, *Commission confirms that territorial restriction clauses in the gas sector restrict competition* (IP/04/1310), 26 October 2004, [http://europa.eu/rapid/press-release\\_IP-04-1310\\_en.htm](http://europa.eu/rapid/press-release_IP-04-1310_en.htm).

<sup>20</sup> The refusal to grant access has in the present case also been tackled as a potential abuse or a restrictive concerted practice.

<sup>21</sup> EU, *Directive 98/30/EC concerning common rules for the internal market in natural gas*, 22 June 1998, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998L0030:en:NOT>.

<sup>22</sup> EU, *Directive 2003/55/EC concerning common rules for the internal market in natural gas and repealing*, 26 June 2003, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0055:en:NOT>.

<sup>23</sup> EU, *Directive 2009/73/EC concerning common rules for the internal market in natural gas and repealing*, 13 July 2009, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009L0073:en:NOT>.

respectively). The TPA regime mandates incumbent market operators to provide new suppliers and shippers with unhindered access to their pipelines system.

In the past, the EC struggled to correct this particular typology of uncompetitive practice. At the end of the 1990s the Commission opened an investigation against five big European companies - including Gasunie, GDF, and Germany's BEB, Ruhrgas and Thyssengas - for their refusal to grant a Norway-based subsidiary of Marathon, a US firm, access to their European gas pipelines.<sup>24</sup> In 2005 the Commission launched an *Energy Sector Inquiry*,<sup>25</sup> which was followed by a number of individual antitrust investigations targeting energy incumbents in various member states. Investigations, which formally started in 2007, involved Belgian monopolist Distrigas,<sup>26</sup> Germany's RWE<sup>27</sup> and Italy's ENI,<sup>28</sup> all charged with preventing other suppliers from entering their national gas markets in violation of EU rules. In 2008 it was GDF that came into the spotlight for allegedly barring foreign companies from "downstream supply markets for natural gas in France",<sup>29</sup> while in 2009 Germany's E.ON was charged by the EC of abusing its dominant position by refusing to ensure long-term access to its gas transmission system to other suppliers.<sup>30</sup>

### 1.3. Unfair pricing

Finally, the Commission claims that Gazprom imposes unfair prices on customers by selling its gas through long-term *take or pay* contracts which link the price of gas to the price of oil. According to Commissioner for Energy Günther Öttinger, "[Russian] gas in some member states is up to 30 percent cheaper than in other member states"<sup>31</sup> due to such practices.

*Take or pay* contracts are agreements in which the buyer agrees to purchase a specific amount of gas or to pay a fee if part of this gas is not purchased. The price of gas sold through a *take or pay* contract is generally oil-pegged, reflecting a long-established policy by EU countries aimed at securing long-term natural gas contracts. Under this scheme - adopted not only by Gazprom but also by major producers such as

<sup>24</sup> Case No. 36246: *Marathon/Ruhrgas/GDF et alia*, [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_36246](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_36246).

<sup>25</sup> European Commission, *Decision initiating an inquiry into the gas and electricity sectors pursuant to Article 17 of Council Regulation (EC) No 1/2003*, 13 June 2005, [http://ec.europa.eu/competition/sectors/energy/inquiry/14062005\\_decision\\_en.pdf](http://ec.europa.eu/competition/sectors/energy/inquiry/14062005_decision_en.pdf).

<sup>26</sup> EU, *Commission market tests commitments proposed by Distrigas concerning its long-term gas sales contracts in Belgium* (IP/07/490), 11 April 2007, [http://europa.eu/rapid/press-release\\_IP-07-490\\_en.htm](http://europa.eu/rapid/press-release_IP-07-490_en.htm).

<sup>27</sup> EU, *Antitrust: Commission initiates proceedings against RWE Group concerning suspected foreclosure of German gas supply markets* (MEMO/07/186), 11 May 2007, [http://europa.eu/rapid/press-release\\_MEMO-07-186\\_en.htm](http://europa.eu/rapid/press-release_MEMO-07-186_en.htm).

<sup>28</sup> EU, *Antitrust: Commission initiates proceedings against the ENI Group concerning suspected foreclosure of Italian gas supply markets* (MEMO/07/187), 11 May 2007, [http://europa.eu/rapid/press-release\\_MEMO-07-187\\_en.htm](http://europa.eu/rapid/press-release_MEMO-07-187_en.htm).

<sup>29</sup> EU, *Antitrust: Commission opens formal proceedings against Gaz de France concerning suspected gas supply restrictions* (MEMO/08/328), 22 May 2008, [http://europa.eu/rapid/press-release\\_MEMO-08-328\\_en.htm](http://europa.eu/rapid/press-release_MEMO-08-328_en.htm).

<sup>30</sup> Case No. 39317: *E. On gas foreclosure*, [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_39317](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_39317).

<sup>31</sup> Andrius Sytas and Henning Gloystein, "EU says Russia must accept its gas market rules", *Reuters*, 14 September 2012, <http://www.reuters.com/article/2012/09/14/eu-gas-gazprom-idUSL5E8KE9YZ20120914>.

Sonatrach and Norway's Statoil - suppliers are assured of constant demand so that they can plan multi-year investments, while supply guarantees for twenty or thirty years allow the buyers to adopt long-term downstream strategies.

However, such practices are now widely believed to produce unfair extra-rents for suppliers and higher gas costs for European consumers. Before the probe into Gazprom, the EC never examined the *take or pay* clause and the oil price linkage used by these companies in their supply contracts. Until recently the German Federal Court of Justice was the only public authority in Europe that had the opportunity to examine the legality of oil price-based adjustments.<sup>32</sup> It found that they offer the possibility of an illegitimate increase in suppliers' profits, since the price of oil is the sole variable used for the price adjustment of the contracted gas.<sup>33</sup> Recently, RWE Transgas, the Czech Republic's leading gas importer, won a dispute with Gazprom over gas pricing contracts: an Austrian court ruled that the Czech company does not have to pay for unused gas under the *take or pay* principle.<sup>34</sup>

## 2. Gazprom's interests in the EU

Russia and Europe have developed a time-proven gas partnership which dates back to 1969, when ENI signed a twenty-year deal with the Soviet Ministry of Foreign Trade for the supply of a total of a hundred billion cubic meters (bcm) of natural gas. Since the collapse of the Soviet Union, Russia has exported to Europe more than two trillion cubic meters (tcm) of natural gas, a 73 percent increase since the early 1990s.<sup>35</sup> Today Gazprom is the main single gas supplier of the EU. With an annual export of roughly 113 bcm, it accounts for 33 percent of EU gas imports and 24 percent of its total consumption<sup>36</sup>. However, Gazprom depends on the EU for its sales as much as the EU relies on it for its gas supplies. The Union is by far the largest and most lucrative market for Russian energy exporters.<sup>37</sup> In 2011, 54 percent of total Russian gas exports went to EU countries, with Germany alone accounting for 15 percent of Gazprom's total sales.<sup>38</sup>

<sup>32</sup> In the past decades oil and natural gas were considered close substitutes for purposes like heating or electricity generation. Today, however, the actual degree of substitutability between the natural gas and oil has substantially decreased, and oil price indexing is believed to be a tool used by suppliers to maintain gas prices high.

<sup>33</sup> Kim Talus, "Long-term natural gas contracts and antitrust law in the European Union and the United States", in *The Journal of World Energy Law and Business*, Vol. 4, No. 3 (September 2011), p. 279-280, <http://dx.doi.org/10.1093/jwelb/jwr015>.

<sup>34</sup> Alexey Filippov, "Czech company wins case against Gazprom over 'take or pay'", in *Russia Today (RT)*, 25 October 2012, <http://rt.com/business/news/czech-rwe-gazprom-dispute-212>.

<sup>35</sup> Tom Smeenk, *Russian Gas For Europe: Creating Access and Choice*, The Hague, Clingendael International Energy Programme, July 2010, p. 231-232, <http://www.clingendael.nl/publications/?id=8038>.

<sup>36</sup> See ENI, *World Oil & Gas Review 2012*, September 2012, <https://www.eni.com/world-oil-gas-review-2012/wogr.shtml>.

<sup>37</sup> See sales and revenues data in the latest Gazprom Databook:

<http://www.gazprom.com/investors/reports/2011>. In 2008 Europe accounted for 32 percent and 68 percent of Gazprom's sales and revenues, respectively. See Tom Smeenk, *Russian Gas For Europe: Creating Access and Choice*, cit., p. 220.

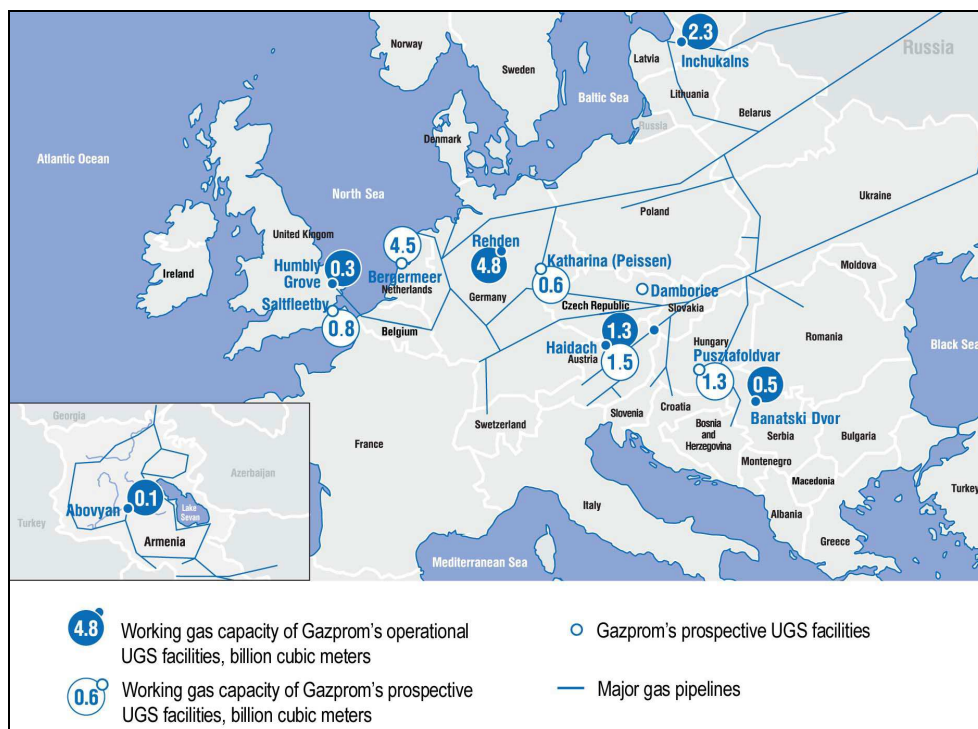
<sup>38</sup> See ENI, *World Oil & Gas Review 2012*, cit., p. 85-87.



Against this backdrop, it comes as no surprise that Gazprom policy and business planners have worked out an industrial strategy aimed at securing the company's position in EU markets. A key component of it are Gazprom's massive investments in European midstream and downstream sectors.

In the *midstream* domain, Gazprom has promoted the diversification of export routes and the realization of its own pipeline capacity in the EU. Gazprom's Yamal-Europe, Nord Stream and the yet to be completed South Stream pipelines have all been conceived as a way to consolidate and expand Gazprom's position of power in the lucrative German and Italian markets. In addition, the pipelines are also meant to reduce Gazprom's dependence on Ukraine, which has so far been the main transit country for gas flowing from Russia to the EU (to a lesser extent, the same reasoning applies to Belarus, also a transit country for Russian exports). Finally, Gazprom has worked on establishing its own pipeline capacity in the EU by purchasing shares of Germany's Wingas, the interconnector between the United Kingdom (UK) and Belgium, and potentially in the BBL pipeline from the Netherlands to the UK (Gazprom has an option for 9 percent of BBL in exchange for an equivalent number of shares of Nord Stream).

**Figure 1.** Gazprom's gas storage capacity in Europe



Source: Gazprom, *Underground Gas Storage Facilities*, <http://www.gazprom.com/about/production/transportation/underground-storage>.

As for the *downstream* market, the Russian company has intensified its acquisitions in the storage sector, which allows it to handle seasonal variations in consumption more efficiently as well as sudden flow interruptions during peak seasons (see Figure 1).



From 2006 to 2011, the company's gas storage capacity in Europe increased from 1.4 to 3.0 bcm<sup>39</sup>, in line with its target to reach 5 bcm by 2015. Today, Gazprom operates (via Wingas) the German gas storage in Rehden (the largest in Europe, with a volume of more than 4 bcm) and the Haidach storage facility in Austria (2.6 bcm). The company is currently participating in the construction of another facility, Katharina, near Bernburg in Germany, and by 2014 will acquire further 1.9 bcm of storage capacity in the Dutch Bergermeer gas storage centre. Finally, under a lease agreement with the Netherlands' Vitol, Gazprom has ensured access to 75 percent of the Humbly Grove facility in the UK, until 2016. The Russian giant is also considering taking part in further gas storage projects in Austria, Belgium, Czech Republic, France, Romania, Slovakia and the UK. Deeper penetration into EU markets is also being achieved through marketing and trading activities and equity acquisitions in power and industrial enterprises heavily reliant on Russian gas.

These business strategies are commonly referred to as horizontal and diagonal integration. While they have contributed to creating a strong EU-Russia energy interdependence, the unbalanced nature of Russia's gas relations with its EU customers has become a cause of ever growing concern in Brussels, not least because the Kremlin-directed Gazprom has often been seen to use energy supplies as a foreign policy weapon.

As Table 1 shows, Gazprom's market share varies significantly across EU countries. In terms of absolute value, Germany and Italy are the largest consumers of Russian gas. However, Gazprom is relatively stronger in Central/Eastern Europe. Although the absolute volumes supplied are considerably smaller, Gazprom provides Central and Eastern European countries with a proportionally much higher amount of gas. In fact, while Western European consumers have progressively developed flexible and diversified supply policies, in countries such as the Czech Republic, Estonia, Latvia, Lithuania and Slovakia, the Russian giant still holds a monopolistic position.

According to Russia's detractors, this is the result of Gazprom's strategy to divide the EU in two parts. On the one hand, the company is said to have developed preferential bilateral relations with key Western European customers, to which it gives some concessions, particularly granting cheaper gas prices and better contractual conditions. On the other hand, Gazprom is said to have established unfair business practices resulting in heavy dependence and higher gas prices in Eastern Europe, in order to preserve Russia's economic leverage and exert its political influence on the region. This approach would help explain the gas prices differentials - hardly attributable to market forces - between Russia-friendly powerhouses such as Germany and weaker and "Russia sceptic" countries such as Lithuania.<sup>40</sup> From this perspective, the EC's investigation into Gazprom's potential abuse of its dominant position is not only legally due, but can also be seen as a means to rectify a strategic imbalance which Russia has helped create and from which it has greatly benefited at the expense of eastern European citizens.

<sup>39</sup> Gazprom, *Annual Report 2011*, p. 57, <http://gazprom.com/f/posts/51/402390/annual-report-2011-eng.pdf>.

<sup>40</sup> Jan Techau, "Russia's Geopolitical Gazprom Blunder", in Judy Dempsey's *Strategic Europe* Blog, 6 November 2012, <http://carnegieeurope.eu/strategieurope/?fa=49911>.

**Table 1.** Imports of gas from Russia: absolute values and % of total consumptions

Country	Imports from Russia (bcm)	Share of total national consumption (%)
Austria	6.10	65.7
Belgium	0.29	1.5
Bulgaria	2.77	85.5
Czech Republic	8.86	100.0
Estonia	0.62	100.0
Finland	4.04	100.0
France	6.13	14.5
Germany	30.49	40.0
Greece	2.65	58.2
Hungary	5.11	45.8
Italy	19.18	25.0
Latvia	1.70	100.0
Lithuania	3.42	100.0
Luxembourg	0.28	22.7
Netherlands	1.98	4.8
Poland	9.87	64.0
Romania	2.98	21.8
Slovakia	5.79	100.0
Slovenia	0.42	47.7

Source: ENI, *World Oil & Gas Review 2012*, cit., p. 66, 85-87.

### 3. Russia's reaction to the EC investigation

On 11 September 2012, just a week after the formal opening of the proceeding to investigate Gazprom's business practices in the EU, Russian President Vladimir Putin signed the executive order "On Measures to Protect Russia Federation Interest in Russian Legal Entities' Foreign Economic Activities".<sup>41</sup> On the basis of this measure, "open joint stock companies on the list of strategic enterprises<sup>42</sup> and their subsidiaries should supply *information on their activities* [...] upon request from the authorities and agencies of foreign countries, international organisations, associations and groups of foreign countries, only subject to prior consent of a respective federal executive body authorised by the Russian Government". Moreover, these "strategic companies" need

<sup>41</sup> Russia Presidency, *Executive order on measures protecting Russian interests in Russian legal entities' foreign economic activities*, Moscow, 11 September 2012, <http://eng.news.kremlin.ru/news/4401>.

<sup>42</sup> Strategic enterprises are companies carrying out business activities in strategic sectors, including services provided by natural monopolies. These activities include trunk pipeline transportation of crude oil and oil products, transportation by rail, television and radio broadcasting in certain territories, and the deployment, construction, commissioning and decommissioning of nuclear installations. For a complete list of strategic enterprises see Hogan Lovells, *The Law on Foreign Investments in Russian Strategic Companies*, December 2011, <http://www.hoganlovells.com/newsmedia/pubDetail.aspx?publication=7442>.

government approval before making amendments to contracts concluded with foreign partners, or before selling financial assets and property abroad. The federal executive bodies appointed by the government, Putin's executive order instructs, "must refuse to grant [their] consent to these actions to proceed if they could harm Russia's economic interests". In short, Putin's decree aims at insulating Russia's strategic enterprises operating abroad from legal inspections and rulings, requiring them to obtain government permission to disclose information to foreign regulators, modify contracts and sell assets abroad.

While the Kremlin considers the EU antitrust initiative "an attempt [...] to pressure Gazprom and influence prices and the result of commercial negotiations, which is clearly in breach of market principles",<sup>43</sup> and therefore contests it in economic terms, Putin's executive order in fact formalizes the primacy of the Kremlin's strategic interests over business ones. This is no novelty for Russia. After all, the executive order just contributes to strengthening government control of strategic activities, in keeping with the 2008 Strategic Enterprises Law.<sup>44</sup> This piece of legislation explicitly requires prior government approval for direct or indirect acquisition by a foreign investor of "control" over strategic enterprises, included subsoil strategic companies.

Putin's executive order, however, goes much further, and could have a very negative effect on the capacity of Russian companies to do business abroad, not only in Europe. In the EU context, the president's intervention not only limits Gazprom's capacity to operate freely in its key export market, but could be seen as an admission that the company has something to hide. In that sense, it could work as a further spur to the Commission to dig as deeply as possible into Gazprom's businesses in Central and Eastern Europe. At the global level, Putin's move could harm Russia's strategic companies (not only Gazprom), which obviously have to operate according to the laws of foreign countries. The provision, for instance, would undermine Gazprom's capacity to do business in key energy producing countries such as Norway, Algeria, Venezuela and the United States (US), or major consumers such as China and India. According to Putin's decree, indeed, any single administrative procedure or business agreement requiring the company to provide information to foreign agencies or regulators is expected to be conveyed to Moscow for government evaluation and approval, which will evidently greatly complicate relations between Russian companies and their foreign partners.

For these reasons, it is unlikely that the executive order will be applied in full to all foreign activities of Russian strategic companies. If it were, this would sensibly damage Russian business and negatively affect Russia's appeal as a commercial partner around the world.<sup>45</sup> Its full application in the European context is also questionable. The executive order will probably be applied in specific circumstances considered sensitive by the Russian political elite.

<sup>43</sup> Catherine Belton, Alex Barker and Joshua Chaffin, "Kremlin Shield from EU Probe", cit.

<sup>44</sup> Russia, *Federal Law No. 57-FZ* on "Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defence and State Security", 29 April 2008, [http://en.fas.gov.ru/legislation/legislation\\_50727.html](http://en.fas.gov.ru/legislation/legislation_50727.html).

<sup>45</sup> Konstantin von Eggert, "Due West: Putin's Intervention in Gazprom Probe Set to Backfire", *RIA Novosti*, 14 September 2012, <http://en.rian.ru/columnists/20120914/175955751.html>.

Irrespective of whether Putin's order will be applied in full or only selectively, Russia's vigorous reaction has elevated the EC-Gazprom legal dispute from the technical-bureaucratic level to the political-strategic one. In so doing, the Kremlin is perhaps counting on the fact that its strong ties with the EU's big gas consumers, most notably Germany and Italy, may help shelter Gazprom from the effects of the investigation. In the meantime, Moscow has also sent some more conciliatory messages to EU headquarters. At the end of September, news reports circulated that Gazprom might eventually agree to break up its vertically-integrated structures in the EU (according to a procedure known in EU jargon as "unbundling").<sup>46</sup> While unconfirmed officially, Gazprom would reportedly be ready to create two separate entities, possibly registered in Switzerland, of which the first would manage transport and storage operations in Europe and the second would deal with gas trading and marketing activities. Gazprom would maintain ownership of the two subsidiaries, even though they would be legally independent companies operating under strictly autonomous administrative, management and accountability procedures. All these activities are currently managed through Gazprom Germania GmbH, a company fully controlled by Gazprom's subsidiary Gazpromexport, which in turn holds all Gazprom's assets in EU countries. Such a move would align Gazprom with the EU Third Energy Package's unbundling requirements while also providing some shelter from the competition investigations launched by Brussels.

#### 4. The way ahead

If the aforementioned reports were to be confirmed, Russia's response to the EC's initiative would combine political toughness with business concessions. The direct intervention of President Putin has made it plain that the Kremlin is determined to keep full control over Gazprom's activities. Furthermore it has revealed that any potential openings and compromise solutions, such as the possibility of unbundling Gazprom's activities in the EU by creating two separate companies, would be ultimately driven by the Kremlin, given the extensive power that Putin's executive order has given the government in approving the sale of parts of Russia's strategic companies.

In ordinary energy antitrust cases, the EC generally reaches compromise solutions through the adoption of "commitment decisions".<sup>47</sup> This legal mechanism ensures a settlement when the investigated party is willing to cooperate with the EC and commit to meeting the EC's concerns. This is what happened in the majority of the antitrust cases discussed above, some of which involved Gazprom. But this investigation is of a different nature, because of both its magnitude and its political implications. The key question is therefore whether Gazprom (read: the Kremlin) is willing to agree to a settlement of the dispute along parameters set by the EU antitrust authority.

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<sup>46</sup> "Gazprom plans reform of assets to avoid EU probe", in *Russia Today (RT)*, 20 September 2012, <http://rt.com/business/news/gazprom-eu-probe-gas-anti-trust-610>.

<sup>47</sup> Commitment decisions are established by Art. 9 of the Council Regulation No. 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, 16 December 2002, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003R0001:en:NOT>.

Traditionally, Russia has tried to use its close relations with key European countries such as France, Germany and Italy to protect Gazprom from the Commission's technical proceedings. Today, however, the balance seems to have tilted conclusively in favour of the EC, which makes it unlikely that Russia and its closest EU partners can agree upon a compromise over the Commission's head. Russia would make a mistake if it were to underestimate the EC's powers in enforcing antitrust rules. In the absence of a settlement, the case is likely to evolve into a complete European antitrust process. This would probably lead to an EC "prohibition decision"<sup>48</sup> by which the Commission would impose financial penalties on the company. Gazprom would then challenge the Commission's decision, and the case would in all likelihood end up before the ECJ. This would hardly be an ideal scenario for Gazprom, given that the Commission has not lost an abuse-of-dominance case since EU antitrust rules first entered into force in 1958. A ruling by the ECJ is therefore likely to lead to a break-up of Gazprom's business structure in the EU or a multi-billion euro fine.

To make things worse for Gazprom, its business model is challenged in the EU not only by the Commission and on a legal basis, but also by market operators on an economic basis. Before the official opening of the antitrust investigation, key European gas buyers had become increasingly vocal in their complaints about Gazprom's contractual practices now under the Commission's scrutiny. Upon the periodical review of supply contracts, EU gas buyers protested against the financial unsustainability of the whole oil-linked pricing framework so dear to the Russian energy giant (as well as to other suppliers such as Sonatrach and Statoil). In October 2012, for instance, ENI's chief executive officer Paolo Scaroni publicly said that the Italian company might not renew its *take or pay* contracts with its Russian and Algerian suppliers, signalling the intention to rely more on spot pricing<sup>49</sup>. It therefore looks like Gazprom and other suppliers will hardly be able to avoid revision of their pricing mechanisms in gas contracts, irrespective of the outcome of the EC's antitrust investigation.

These circumstances should encourage Russia to abandon its zero-sum game mentality, according to which any change in Gazprom's business model would invariably be negative. On the contrary, Russia should find some common ground with the Commission and other European partners in order to reform the long-established EU-Russia energy relationship. A substantial adjustment has been made necessary by the ongoing dramatic changes in the global gas market brought about by the US-driven shale gas revolution and the growth of trade in liquefied natural gas (LNG). Although at a slower pace than in the North American or East Asian markets, such a transformation of the energy equation is also affecting European markets, which are becoming increasingly liquid and competitive. These developments are likely to put the current gas supply model (long-term contracts, with *take or pay* clauses and oil-pegged prices) under severe pressure and to increase Gazprom's vulnerability in the absence of a substantial review of its business strategies.

The EC's probe, therefore, could act as a driver for a reorganization of Gazprom's activities in Europe which is also being requested by its traditional EU partners. It might

<sup>48</sup> Prohibition decisions are established by Art. 7 of the Council Regulation No. 1/2003.

<sup>49</sup> "ENI CEO says mulling not renewing take-or-pay contracts", *Reuters*, 10 October 2012, <http://www.reuters.com/article/2012/10/10/eni-idAFL6E8LAGAP20121010>.

represent the occasion for the Kremlin to establish a dialogue with Commission officials, with a view to seeking a win-win solution for both parties. Given the interdependence between the Russian and European gas sectors, the mutual benefits of a stable relationship between the parties cannot be underestimated. The traditional model based on long-term contracts and oil-indexed pricing has ensured such stability, its geopolitical side-effects notwithstanding. But now that the sustainability of that model is ever more doubtful, the wisdom of an (at least partial) reform of Gazprom's business model is based on an economic, and not only a political, rationale. The Commission's investigation could turn into either a positive driver for consensual change or, alternatively, an unwelcome and inopportune (given both Russia's and the EU's economic difficulties) element of tensions in EU-Russia relations.<sup>50</sup>

The Kremlin will be pivotal in determining the future trajectory of Gazprom's relationship with EU gas buyers. Given that its European partners cannot stop the Commission's antitrust initiative, Moscow can either choose cooperation with the Commission or appeal to its "friends" in the attempt to deflect the Commission's requests as much as possible.

The best-case scenario would be the adoption of an EC "commitment decision" accompanied by concrete action to deepen the EU-Russia Energy Dialogue. This should not only imply the acceptance of unbundling rules, but also the adoption of a series of measures aimed at genuinely reinforcing the energy ties between Europe and Russia. The establishment of a solid mutual investment regime in the respective energy sectors, or the indexing of long-term supply contracts to market gas prices, are only two cases in point.

However, the Kremlin could also opt for a strategy of confrontation. Russia's non-compliance with the Commission's requests and the ECJ's verdicts would likely exacerbate tensions with the EU and pave the way for a major political clash. A break-up in the EU-Russia energy relationship would be a losing option for everybody. As far as the EU is concerned, looser ties with its greatest gas supplier could impair or at any rate undermine its security of supply, exactly when the world is moving towards larger consumption of gas and greater competition to ensure resources. Clashing with the EU over gas would be unwise also for Russia, which can count on no more reliable consumer than the EU, its efforts at liberalizing the energy market notwithstanding.

Possible alternatives include a strategic second-best for both the EU and Russia. An increase in LNG purchases seems the most promising solution for the EU to handle a potential standoff with Russia. In spite of a recent boom, however, the LNG market still seems far from being supplied and liquid enough to meet European needs. China offers Russia a possible alternative destination to Europe. However, while bilateral relations with Beijing have improved recently, putting its security of demand in the hands of its rising Asian neighbour still represents a strategic risk for Russia. In

<sup>50</sup> One example: long-term contracts have always been justified by Russians with the need to underpin the development of new gas resources. Despite this, and despite the huge cash inflow derived from gas exports, in the 2000s Gazprom's output remained stable, while both the internal and the EU demand started increasing. See Boris Nemstov and Vladimir Milov, *Putin and Gazprom*, Moscow, 2008, [http://www.europeanenergyreview.eu/data/docs/Viewpoints/Putin%20and%20Gazprom\\_Nemtsov%20en%20Milov.pdf](http://www.europeanenergyreview.eu/data/docs/Viewpoints/Putin%20and%20Gazprom_Nemtsov%20en%20Milov.pdf).



addition, Russia would need time and money to re-structure its transport system eastward (currently it mostly runs west). EU energy purchases still provide Russia with a better chance to keep state coffers filled with energy-originated cash. The antitrust move by the Commission, if it really forces a restructuring of the Gazprom business model and allows for greater access to EU downstream markets, could even lead to an increase in Russian energy revenues.

## Conclusions

The so-called *antitrust clash of the decade* between the European Commission and Russia's state-run energy giant, Gazprom, is expected to affect the future of EU-Russia gas relations deeply. Should the Kremlin bow to the Commission's authority to rule over Gazprom's activities in Europe, the supply model that has characterized the European gas market in the past decades would radically change. Gazprom's compliance with EU antitrust rules may lead to the establishment of a clearer business framework, paradoxically strengthening mutual confidence between the parties. Stronger EU-Russia ties would possibly limit the effects in Europe of the transformations underway in the global gas markets - particularly the growth of LNG trade. To ensure such developments, however, political dialogue between Moscow and the European capitals is needed so that the Kremlin's strategic concerns can be harmonized with the Commission's requests, many of which Gazprom finds extremely difficult to stomach.

If, on the contrary, Moscow decides to openly challenge the European Union, refusing to reach a settlement with the EC and ignoring the ECJ's sentences, the ensuing clash would immediately take on a geopolitical dimension, as EU member states could not but be involved. A strategy based on gathering support from its closest allies in the EU, while engaging in a harsh legal battle with the Commission, would seriously risk undermining the stability of the EU-Russia energy relationship. Under these circumstances, any attempt by Russia's European partners to lobby Brussels to halt the antitrust proceedings would probably fail, not least because the member states have no legal power to do that (and in any case there would not be a majority of member states willing to interfere with the Commission's action). The collision would accelerate the transformation processes in the European gas market along different models, probably based on greater reliance on LNG and necessarily premised on a more diversified set of suppliers. However, there is no guarantee that this adjustment, which would in any case take time and money, would achieve the level of stability that the EU thinks is necessary for securing its energy supplies.

A clash with the EU would also weaken Russia's attempt to become the world's main energy exporter. The Kremlin is aware of the mutual benefits accruing from a stable EU-Russia gas relationship. It should put its Cold War era zero-sum game mindset aside once and for all and accept the fact that the rule of law, rather than political relations, constitutes the most solid basis for that relationship to endure and prosper in the future. It should therefore abandon any hope that the antitrust proceeding can be stopped in other ways than by reaching a settlement with the Commission, even if this were to involve the unbundling of Gazprom's vertically integrated structure. While Gazprom would lose its dominant position, it could still benefit from reforming its

business model because it would gain more access to EU midstream and downstream markets. It is high time that the Russian leadership comes round to appreciating that playing by the rules of the EU energy sector might well be in harmony with its strategic calculations.

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Via Angelo Brunetti, 9 00186 Roma  
Tel.: +39/06/3224360 Fax: + 39/06/3224363  
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