The European Union Energy Policy

David Buchan assesses Europe's collective 'inaction'

Collective measures are supposed to carry greater weight and speak louder than individual action. That is largely why countries join the European Union. But in the crisis over Russian gas shipments across Ukraine, the joint pleadings of the final customer, the EU, fell on deaf ears in Moscow and Kiev. Of course, if Russia and Ukraine were determined to quarrel, an outsider could not force them to agree – not even an EU of 500 million people that is both disputing countries' main market. Yet inside Europe too the EU has also done precious little, in terms of organising gas sharing arrangements or creating gas interconnections, to help its gas-bereft member states. What gas sharing has taken place has been organised bilaterally between Czechs and Slovaks, and between Austrians and Slovenes.

In fulfilling its potential to add value to member states' energy and climate policies, the EU has a very mixed record. This is one of the themes of my forthcoming book for the Oxford Institute for Energy Studies. Table 1 suggests how performance measures up against potential in EU energy policy. It does not attempt to be scientific, but rather a spur to thinking about the EU's relevance to energy policy (or the gap between potential and performance). Potential is obviously harder to judge than performance, because it is what might have happened rather than what has. Assessment of potential must also pay some regard to past history and present necessity, because these factors shape what is legally and politically possible today.

Of the three policy areas topping Table 1 and also topping the EU agenda, climate change gets the highest potential rating. This is because where EU-level action is considered essential – and in the case of climate change even action on an EU scale is too geographically limited – necessity tends to override politics and legalities. That said, the December 2008 reforms to EU climate change policies showed the clear political imprint of the current recession, even though the reforms themselves chiefly relate to the period 2012–2020. A combination of poorer EU states in central and east Europe and of major exporters led by Germany lobbied successfully to continue getting free carbon emission allowances (for an analysis of the December 2008 climate change agreements, see my comment on OIES website). The reason for the somewhat lower potential rating of EU internal market policy (A-) in Table 1 is that there is still some national resistance to EU designing energy market blueprints, although EU legislators expect to reach final agreement in spring 2009 on further liberalisation rules for gas and power markets.

Table 1: Buchan's Benchmark

EU policy	*EU potential*	*EU performance*
Climate change	A+	A–
Internal market	A–	B+
Security of supply	B+	D
Nuclear power	A–	D
Renewable energy	A–	C
Energy R & D	B+	C
Energy efficiency	B	C

Source: author

In energy security, however, to talk of national resistance to EU involvement is an understatement. Rather, it has been national insistence (from most member states) that the EU stay out of this area. This is why I rate EU energy security potential at B+, despite the theoretical market power of 500 million consumers over outside suppliers. To the extent that member states have in the past been ready to make international arrangements to handle energy security, they have preferred to do it outside the EU – through the International Energy Agency to which 19 of the 27 EU states belong. For the IEA deals only with emergency oil stock level and sharing. IEA membership never posed any conceivable supranational threat to national sovereignty over energy resources or control of national energy mixes in the way that many EU states imagined might arise if energy security were written into EU treaties as a clear EU competence. For instance, the UK, long content with its oil stock commitments to the IEA, bridled until very recently at the prospect of a clear EU treaty competence on energy, out of fear that 'Brussels' might force it to share North Sea oil and gas reserve, as it has had to do with fish stocks. This will change with the Treaty of Lisbon, if ratified in a second Irish referendum later this year. The Lisbon treaty carries language, for the first time, tasking the EU with 'ensuring security of energy supply in the Union', and, again for the first time, put this and other energy references currently scattered around EU treaties into a separate treaty article.

You might have thought that this dry business of treaty-writing might have been driven faster by events on the ground, such as EU enlargements and Russian energy cut-offs. The eight central European and Baltic states entered the EU in 2004, and Romania and Bulgaria in 2007, bringing with them their fears of over-dependence on Russia for energy, and for gas in particular. Lending substance to these fears were the brief interruptions of Russian energy through Ukraine in early 2006 and through Belarus in early 2007. Yet by the time of the first total and prolonged cut-off of Russian gas flow through Ukraine in January 2009, precious little provision had been made at the EU level for any serious disruption.

The best measure of this has been the foot-dragging in revising the EU's astoundingly complacent Gas Security Directive of 2004. This is still the basis of EU action in this area, and even

with the present gas crisis is unlikely to be changed before 2010–11. In 2002 the European Commission proposed that every member state take measures to protect gas consumers, mainly households with no possibility of fuel switching, if the country's largest single source of supply were cut off for 60 days. The Commission left to member states how to ensure this – through storage, or flexible production or gas sharing with neighbours. The proposal was not too prescriptive; it did not call for minimum storage levels.

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Yet lobbied by the gas industry, the European Parliament effectively neutered the draft directive in 2003, questioning the very need for it. The German MEP who was the parliament rapporteur on the directive, said at the time 'no difficulties in the field of gas supplies have ever arisen which would be comparable to the oil crises' of the 1970s (that had led to the IEA's creation). This was a true statement in 2003. Nor was the rapporteur out of line with conventional wisdom of the time (and even now) in saying gas supply should be more secure than oil supply because there was competition between gas exporters and not a cartel, and because of mutual dependence between buyers and sellers of gas cemented in long-term contracts. Yet everyone knew in 2003 that the east Europeans would join in 2004 and everyone knew the new arrivals had particular energy security anxieties. So the European Parliament and the Council of Ministers (which in 2003 was only too delighted to agree with MEPs that the Commission leave gas security to member states) should have catered for the special energy concerns of their east European partners about to join them.

However, even after the 2006 and 2007 interruptions set off alarm bells, many member states dozed on. In April 2008 the Commission asked member states about revising the 2004 directive to improve national gas security measures across the EU. But the only one of the 27 governments to show any real interest was Poland (which incidentally has also tried to involve Nato in energy security); most others, and especially Germany, reiterated that gas security was more a matter for industry and governments than for the EU. In January 2009 of course they all speak differently. EU energy ministers have now asked the Commission to 'speed up' revision of the 2004 directive.

Although there are no quick fixes to energy security, EU governments and legislators are now likely to go along with Commission proposals on alternative energy infrastructure and sourcing inside and outside the EU. Though the EU got some responsibility for encouraging trans-European energy networks in the 1992 Maastricht treaty, Brussels has never had money to do this, beyond paying for the odd feasibility study. Now there is talk that energy infrastructure should figure high in a Euros 5bn EU contribution to the general fiscal stimulus to the European economy. Up to now the EU has had no role in the sensitive matter of siting energy pipelines and pylons, which is entirely a national responsibility. But the Commission has appointed 'coordinators' as go-betweens to help governments resolve impasses over cross-border interconnectors. And even before the 2009 gas crisis, the Council had asked the Commission to examine ways of 'streamlining' planning of EU-wide energy systems.

The January 2009 crisis not only calls for measures to improve Europe's internal resilience to external energy shocks. It also requires fresh thinking about, and maybe fresh money for, alternative gas sources. The case for Gazprom's proposed direct routes to the EU via Nord Stream and South Stream may be strengthened, though this will depend on final evaluation of Russia's and Ukraine's respective roles in their quarrel. The previously weak case for the Nabucco project to bring non-Russian gas to Europe has clearly improved.

There is also the wider question of whether Europe can improve its bargaining position with outside suppliers by pooling its demand with collective purchases of gas. The Commission has suggested the creation of a 'Caspian Development Corporation' to pool enough demand for Nabucco to make that pipeline worth building. Such an idea would have to be squared with EU competition rules and energy liberalisation goals. But it could be part of a package of measures that might at last help the EU to make up for lost time – and to close that gap between potential and performance.



Giacomo Luciani focuses on the gas supply security issue

The Russian–Ukrainian gas crisis of 2009 will have far reaching consequences in several directions, but surely it has served to highlight the contradictions and pitfalls of EU gas supply policy. The Commission seems intent to move swiftly to promote a selected group of projects, which are expected to address the issue. Gazprom too is expressing the intention of moving with similar boldness to promote its own strategic projects. We are moving into uncharted territory, and decision makers may not be fully aware of the implications of decisions they might soon be making.

The EU approach to the gas market has been dominated by the objective of establishing an integrated, competitive and transparent European gas market. A corollary of the wider objective of establishing a single

European market for energy – itself a corollary of the overarching objective of establishing a Single European Market, which is the very raison d'être of the European Union – the integrated gas market, together with the parallel electricity market, has been the cornerstone of European energy policy for the past 15 years at least.

Born out of the wish to promote European competitiveness (part of the perennial competition with the USA) and of the perception that Reagan and Thatcher-style gas deregulation and market liberalisation could make a significant cost difference to industry as well as families, the objective of the integrated, competitive, transparent European gas market has been elevated to the status of solution to all gas supply problems.

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Specifically, with respect to security of supply, it was felt that the creation of the European gas market would offer a superior solution to the old web of bilateral relations between gas-exporting and gas-importing companies, based on long-term take or pay contracts with destination clauses (restrictions) and exclusive use of dedicated transmission facilities.

The reasoning has been that an integrated European gas market would have such huge dimension and such extraordinary liquidity – because of the very large number of final clients and competing suppliers – that any producer outside of the EU would be attracted to exporting towards Europe. Consequently, Europe would no longer need a procurement policy, because the market would automatically attract the most competitive supplies, and suppliers would be ready to bear the cost of investment required to reach the market and the price and volume risk involved (both substantially mitigated by the liquidity of the market).

Whether this vision is sound or not we shall probably never know, because the integrated gas market is not there and in all probability never will be. After all, not even the USA has a truly integrated gas market, as domestic interconnections serving some states are notoriously insufficient.

The integration of the European market has been hindered by the lack of investment in essential interconnections and the limited capacity of existing ones – combined with the non-cooperation of gas industry incumbents, occasionally supported by the hostility of environmental groups to new pipelines. The expectation that private investors would be keen to promote new interconnections proved entirely ill founded.

In fact, when consideration is taken of the crucial characteristics of the gas industry, the outcome is hardly surprising. Gas transmission requires very substantial up front investment, and is only attractive if a guarantee exists that capacity utilisation will soon reach a very high level. Interconnecting two gas markets, each of which has supplies from the same sources and at comparable conditions (hence with little or no price differential) is unlikely ever to be attractive, because the risk of insufficient utilisation is very high. The UK Interconnector attracted private investment exactly because the rules of the game were so strikingly different in the UK and the Continent – opening the door to the possibility of arbitraging prices and volumes. But within the Continent, conditions are widely similar: in addition, incumbent companies have no appetite for competing with each other (in fact experience has shown that they would not export to the UK even in the presence of a significant price differential, simply because that is not their way to go about business…). Interconnections which might come to be used only at times of crisis, or in any case rarely, have no chance of attracting private investment.

As this became increasingly clear, the Commission has moved in the direction of strengthening regulators, and establishing a European regulating body by enhancing cooperation between national regulators. In addition, it promoted ownership separation of the gas grids from other gas industry's activities, or, as second best, separation of management of the gas grids from ownership of the same. The regulators, in this approach, would be empowered to mandate the realisation of interconnections which gas companies would not spontaneously promote.

This approach finds an obvious obstacle in the fact that the importance of gas in the national energy balances of individual EU member countries varies widely. In some countries gas is an important fuel for power generation, in others it is not at all. In some countries gas is an important source of home heating in winter, in other countries (and climates) this may be just a marginal consideration. In addition, it is generally accepted that gas is not a necessary component of energy supply, and several regions are not linked to their country's respective national grid at all. Just to name one example, Sardinia is not connected to the Italian gas grid, and has no supply of methane. Consequently, the exposure to the risk of gas supply interruptions is far from uniform, and for certain countries or regions within countries this might not be a concern at all. How are the Commission or the European regulator going to decide which interconnections truly are needed?

Furthermore, who will be asked to foot the bill of interconnections primarily motivated by security rather than commercial considerations? If the market and private initiative decide, the question does not arise at all. But if regulators mandate an outlay which the market does not fully justify, a decision must be made on how this is going to be recouped. Security might be improved only for one of the two countries to be interconnected: will that country pay the whole cost?

As for external supplies, new projects have been implemented which were supported by strong economics. At least three new suppliers (Qatar,

Egypt and Libya) have established export projects to European markets. Algeria has inaugurated a new pipeline across the Mediterranean, expanded the capacity of older pipelines, and is expected to launch a further new pipeline to Italy (the GALSI project). This proves that new supply projects will attract investment when they are sound.

In December 2008, the European Council endorsed the European Economic Recovery Plan, within which €3.5 bn. is allocated to energy investment. As I am writing these lines, the Commission just announced that it 'proposes to use Euro 1.750 billion of the stimulus set out in the recovery plan to inject the necessary resources into key strategic interconnections. The Commission has used the second Strategic Energy Review (SER 2) to guide the choice of projects. The SER 2 has already identified a number of projects to address shortcomings and exploit opportunities, highlighting Baltic Interconnection, a Southern Gas Corridor, liquefied natural gas (LNG), the Mediterranean, Central and South-East Europe, and a North Sea offshore grid. The proposal of a Regulation establishing a programme to aid economic recovery by granting Community financial assistance to projects in the field of energy includes the list of about 20 projects that address the objectives of security and diversification of supply, both for gas and electricity, as well as maturity that allows works to begin quickly.' (Press release of Jan 28, 2009 MEMO/09/36) In this context, it appears that the Commission might invest €250 million in the Nabucco pipeline project in order to speed up its implementation. In addition, the European Investment Bank has said that it is ready to finance up to 25 per cent of the cost of the project. (Financial Times, 28.01.09)

On the one hand, this new, more aggressive approach may well succeed in getting some of the projects out of the doldrums in which they have been bogged down for years. On the other, offering public funding to some projects and not others clearly constitutes interference with the level functioning of the market, and is bound to discourage new projects down the road. The approach consisting in selecting specific projects as being strategic and extending special support is incompatible with a transparent and competitive market.

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Support from public funding, in the shape of equity or credit, is very much welcome, but should be extended on the basis of transparent criteria applied to all. It may be acceptable to give greater support to projects that connect new suppliers, or improve security by opening alternative routes with reduced dependence on transit countries, or simply constitute a diversification of transit countries. However, differential treatment of projects should be in any case rooted in clear and quantitative criteria.

This discussion is of direct relevance to Gazprom and the two strategic projects that it is pursuing in association with European partners: the North and the South Streams. Neither project serves the purpose of linking a new supplier to the European market: indeed both are tools for Gazprom to defend its market position in Europe. Yet, both projects constitute a significant form of diversification from excessive dependence on transit across the Ukraine, and reduce the number of transit countries (the North Stream can supply Germany with no transit country at all; the South Stream can supply Italy with two – new – transit countries rather than three).

The Nabucco project promises to link new exporting countries to the European market, but the actual availability of gas from these countries is in doubt. Given that it would be politically incorrect to acknowledge that Nabucco is about importing Iranian gas, we are left with uncertain supplies of gas from Azerbaijan, Turkmenistan, Egypt or Iraq. Lack of reliable gas supplies is a main reason why Nabucco has been unable to make much progress so far.

The emphasis on expanding LNG regas capacity is rather more coherent with the ideal of creating an integrated and competitive market. Greater reliance on LNG supplies with multiple entry points would provide the European network with a source of flexibility alternative to greatly expanding interconnections. Uniform facilitation of regasification terminals still constitutes interference with the free functioning of the market, but is more justified than supporting a specific pipeline.

Financial support to LNG regasification terminals might be extended in exchange for control of a share of capacity, which might then be auctioned off on a short-term basis in order to encourage new entrants and flexibility. In order to promote private investment in terminals, extensive exceptions to TPA obligations have been offered to new projects. This is indeed necessary to avoid free riding on the part of some importers, but limits flexibility of supply and access of new entrants. Public support in exchange for capacity, later to be made available to the highest bidder, seems a preferable alternative.

If the ideological approach is set aside, and pragmatism prevails, we may still see value in the concept of a less regulated European gas market. It would be paradoxical that in order to achieve competition and integration, we would end up resorting to massive regulation, administrative imposition of investment and preferential funding to politically selected strategic projects. A more sensible approach must be found, combining public funding and support to investment on the basis of transparent and universally applied criteria in order to achieve the required degree of supply diversification and flexibility.

