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Prioritization in EU Energy Policy

Energy Security First, then Energy Union

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Cover photo credit: European Union. “Towards an Energy Union” banner displayed on the Berlaymont building in Brussels, Belgium.

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EXECUTIVE SUMMARY

The European Commission's new "Energy Union" Communication purports to provide the Union with a comprehensive energy strategy. It aims to simultaneously push forward the climate change agenda, thereby improving the level of energy efficiency, launch a major infrastructure program, enhance supply security, and complete the energy single market. All of these objectives are necessary. The danger, however, is that the European Union (EU)'s key energy security risk—the supply threat from the Russian Federation—is not prioritized amid the Communication's broader objectives.

This paper argues that the Commission, in developing its Energy Union work program, needs to focus its efforts on delivering a number of key solutions to the states at risk because of Russian supply dependency. This prioritization involves focusing on key cross-border infrastructure projects, bringing the EU's energy liberalization rules into full effect, and in part working with non-EU partners, such as Ukraine and Turkey, to help them improve their own and the EU's supply security.

This does not mean that the EU should forget about its broader objectives. This paper argues that by focusing on creating a deep, liquid, and integrated European gas market first, Europe can more easily deliver all of its other key energy objectives. A deep, liquid, single market in gas will create a more secure and competitive gas market. It will enable faster cuts in C02 emissions as less efficient and more polluting coal-fired power stations become uncompetitive and are taken offline. Further cuts in C02 emissions can follow from cross-subsidizing renewables from lower gas prices and from the development of a more sophisticated and interconnected power grid.

INTRODUCTION

The European Commission's "Energy Union" Communication, published on February 25, 2015, purports to provide the European Union (EU) with a comprehensive energy strategy.[1] The Communication aims to simultaneously push forward the climate change agenda by deploying more renewables, while improving the level of energy efficiency, launching a major infrastructure program, and completing the energy single market. All of these objectives are necessary to establish a functioning, dynamic, liquid, and modern European energy market. The danger, however, is that the European Union's key energy security risk—the supply threat from the Russian Federation and in particular the risk related to the dominant natural gas supplier, the Kremlin-controlled energy giant Gazprom—is not prioritized amid the Communication's broader objectives. Currently, the significant supply risk falls upon a group of states in Central and Eastern Europe, the Baltic states, and Finland.

This paper argues that the European Commission, in developing its Energy Union work program, needs to focus its efforts on delivering a number of key solutions to the affected states. Some of these solutions involve specific cross-border infrastructure projects. Others involve forging ahead with particular elements of the Energy Union, for instance, the completion of the single market in gas. Part of the solution lies in working with non-EU partners, such as Ukraine and Turkey, to help them improve their own supply security as well as the EU's.

Focusing on the key energy security risks provides a sound base for the development of the rest of the EU's Energy Union project. Over the last decade, the EU has struggled to develop an energy policy that simultaneously meets the goals of affordability, sustainability, and security. By focusing on the EU's supply security in gas first, the EU can put itself in a position whereby all three goals can be met, as the creation of a deep liquid natural gas market across the continent will make it much easier to deliver the affordability and sustainability goals.

Part one of this paper briefly describes the Energy Union proposals by the European Commission on February 25; part two examines the scale of the supply security threat from the Russian Federation; part three looks at potential solutions and countermeasures; and part four considers how to integrate the energy security objectives with the broader objectives of the Energy Union.

1 Communication from the European Commission, *A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy*, COM (2015) 80 final, February 25, 2015, http://ec.europa.eu/priorities/energy-union/docs/energyunion_en.pdf.

ENERGY UNION

Following the occupation and annexation of Crimea by the Russian Federation, then-Polish Prime Minister Donald Tusk, writing in the *Financial Times* in April 2014, called for an EU Energy Union.[2] He emphasized the need to tackle the EU's substantial supply dependence, particularly with respect to the Russian Federation's dominance of the supply of natural gas. His central proposal was that the Energy Union should operate as a single, collective purchaser for natural gas.

From the beginning, there were considerable reservations about the viability of Tusk's proposal.[3] Although it is true that Central and Eastern Europe, the Baltic states, and Finland are substantially dependent on a single supply source for natural gas, the same is not true of Western Europe. Northwest Europe is blessed with a number of regional liquefied natural gas terminals, as well as diverse supplies of gas from Russia, Norway, and domestic sources. Equally, the Iberian Peninsula has substantial liquefied natural gas (LNG) capacity as well as pipeline feeds from Algeria. Even parts of Southern Europe, particularly Italy, have diverse sources of supply from domestic, North African, and Russian gas. None of these states have any interest or need for a collective purchaser arrangement for gas supplies. In addition, Western European states would be concerned that such an arrangement may have the perverse effect of stunting upstream investment in supplier countries. It is also not obvious how any group of customers could run a collective purchasing operation without falling foul of EU competition rules, in particular, the prohibition on restrictive practices contained in Article 101 of the Treaty on the Functioning of the European Union (TFEU).

Furthermore, there remains a compelling argument that the most effective way to decrease the supply dependence of the states of Central and Eastern Europe is to extend and complete the single market in natural gas eastwards.

The Commission's 2015 Energy Union Communication does not take a particularly enthusiastic view of the single collective purchaser proposal:

> *The Commission will assess the options for voluntary demand aggregation mechanisms for collective purchasing of gas during a crisis and where Member*

2 Donald Tusk, "A United Europe Can End Russia's Energy Stranglehold," *Financial Times,* April 21, 2014, http://www.ft.com/intl/cms/s/0/91508464-c661-11e3-ba0e-00144feabdc0.html#axzz3YhqRARau.
3 Marco Giuli, "The Energy Union: what is in a name?," European Policy Center, March 2015, http://www.epc.eu/pub_details.php?cat_id=4&pub_id=5413; Kosciuszki Institute, "Energy Awakening of Prime Minister Donald Tusk," June 2014, http://ik.org.pl/test/cms/wp-content/uploads/2014/06/Press-release-from-GLOBSEC-2014.pdf; Jakob Schlandt, "Energy Union Helps Stop Erosion, but Grand Scheme Will Fail," *Europolitics*, 2015, http://europolitics.info/energy/energy-union-helps-stop-erosion-grand-scheme-will-fail.

> *States are dependent on a single supplier. This would need to be fully compliant with WTO rules and EU competition rules.*[4]

It is also important to note that the proposed all-EU collective purchaser mechanism proposal does not address the immediate energy security problems of the specific states at risk in Central and Eastern Europe. However, neither does the text of the Energy Union Communication. Instead, it broadens the Energy Union so that it includes almost every aspect of energy policy.

The Communication identifies five mutually reinforcing dimensions of the Energy Union, designed to bring greater sustainability, energy security, and competitiveness. These are:

- energy security, solidarity, and trust;
- a fully integrated European market;
- energy efficiency;
- a decarbonization of the economy; and
- research innovation and competitiveness.[5]

There are also apparent contradictions in the text of the Communication between the climate change and energy security objectives. At the beginning of the Communication paper, the Commission announces that "to reach our goals we have to move away from an economy based on fossil fuels."[6] However, a significant part of the Communication then proceeds to discuss how to develop a more diverse supply base for fossil fuels consumed by the European Union.

EU'S ENERGY UNION COMMUNICATION DOES NOT AMOUNT TO AN ENERGY STRATEGY FOR THE EUROPEAN UNION.

The Communication draws upon previous EU documents for a plethora of energy infrastructure projects. It lists 248 energy infrastructure projects deemed "Projects of Common Interest," as well as a shorter list of 33 projects identified from the Commission's 2014 European Energy Security Strategy paper. It is unfeasible to prioritize or finance a list of 33 energy infrastructure projects in the next 5 years, much less the 248 identified as Projects of Common Interest.[7]

A number of more concrete and deliverable objectives are identified. These objectives include strengthening the Commission's powers in negotiating intergovernmental energy-supply agreements, creating regional electricity and gas markets, and interconnecting 10 percent of installed electricity capacity in each member state by 2020. The creation of regional electricity and gas markets is already underway, led by EU and national energy regulators, and under pressure from market actors who can see commercial advantages in larger markets. More progress on regionalization and these other more concrete objectives are achievable within a five-year timescale.

While it discusses the completion of a single market in gas, the Communication does not discuss the high levels of resistance to EU open market rules in some states. As discussed more extensively below, this resistance ranges from member states failing to fully apply the rules of the third energy package, to state owned energy companies thwarting market access to new market entrants, to states allowing EU funds to sit on the table rather than deploying those funds to build new interconnectors which would open up local markets.[8]

A significant amount of the Communication appears to be a wish list. There is no explanation for how to develop an external energy policy or how to prioritize relations with energy suppliers. Additional funding sources for infrastructure, energy efficiency, and renewables projects are unclear.

In sum, the Communication does not amount to an energy strategy for the European Union. It confuses objectives and lacks prioritization on the key energy security objectives that Donald Tusk originally raised.

4 European Commission, *Framework Strategy for a Resilient Energy Union with a Forward Looking Climate Policy*, op. cit., p. 6.
5 Ibid., p. 4.
6 Ibid., p. 2.
7 Ibid., p. 8.

8 The "third energy package" is a series of reforms enacted by the European Union in 2009 that have the effect of requiring member states to provide access to competitors to gas pipelines and power networks across the EU; they require steps to be taken to separate the pipelines and power networks from gas suppliers and generators and impose transparency in tariff regimes.

DEALING WITH THE EU'S KEY ENERGY SECURITY THREAT

Tusk had good reason to raise the issue of Russian gas supply dependency. While Western Europe has slowly liberalized its energy markets over the last two decades in the face of EU liberalization rules and the threat of antitrust action, the same has not been true of Central and Eastern Europe. Until the creation of interconnectors allowing gas from Western Europe to enter Central Europe and LNG terminals coming online in Poland and Lithuania, the only source of gas for most states in the region was Gazprom. Because of the Russian Federation's inherited Soviet pipeline networks, storage facilities, and long-term supply contracts, the Russian Federation, and Gazprom in particular, has obtained unprecedented economic power in Central and Eastern Europe. The Soviet-era pipes moved from east to west with no pipelines providing an alternative source of supply in any other direction. The pipelines over which Russian gas travelled across Europe were often controlled by a consortia in which Gazprom and its allies owned controlling shares. The long-term supply contracts allowed Gazprom to deliver almost all of the natural gas required, effectively foreclosing the market to third parties. Gazprom's economic power was reinforced by the oppressive duality of take and pay clauses (a specific volume must be taken, and if not taken, paid for) and destination clauses (gas could

Box 1. Reverse Flow & Ukrainian Supply Security: An Accidental Bonus of EU Energy Liberalization

The January 2009 Ukraine/Russian gas crisis led to a two-week supply cut off of Russian gas to the European Union. The EU responded to the crisis with a raft of measures. These included a €1,300 million European energy recovery fund to build interconnectors and turn single directional pipelines into pipelines that could flow gas in both directions. The EU also introduced the Gas Supply Regulation, which required all new cross-border pipelines to operate in both directions (bi-directional flow). In addition, the European Commission pushed ahead with its gas liberalization legislation requiring unbundling of pipelines from gas supply, open access to pipeline networks, and tariff transparency. In addition, some member states opened tenders to establish liquefied natural gas (LNG) terminals.

In effect, these measures have put in place the foundations of a single market in gas across the continent. North-West Europe is now deeply integrated. Central and Eastern Europe are beginning to see some benefits from the first west-east connections and LNG terminals, with more to follow. However, even with the first of these interconnectors coming into operation, such as the German-Polish interconnector, new market opportunities have been opened up and, in particular, opportunities to reduce Gazprom's market dominance.

The most dramatic effect is seen not in the EU but in a non-EU country, Ukraine. As these measures began to be put in place, the Ukrainian government realized that there was a possibility of obtaining gas from the EU at cheaper prices than the gas that it obtained directly from Gazprom. The gas was largely Russian gas, say sold to German companies at $340 per thousand cubic meters, when Ukraine was paying closer to $400. Gas would be sold to a German company, but once the title passed to the German company it could be resold and "reverse flowed" back to Ukraine through some of the new interconnectors built with the support of EU funds. A small level of investment was required to permit bi-directional flows at the Ukrainian border and Ukraine was able to access the European market.

The reverse flow capacity to Ukraine significantly increased in 2013 when an under-used capacity pipeline between Ukraine and Slovakia was upgraded to flow gas in either direction. It is now possible for Ukraine to obtain 15 billion cubic meters (bcm) from that pipeline route alone. In 2014, Ukraine received approximately 5 bcm from the EU and saved $500 million compared with buying an equivalent amount of gas from Gazprom. In 2015, Ukraine plans to acquire at least 15 bcm of gas from the EU, out of a total import requirement of 26 bcm.

Gazprom facilities along the Moskva River. *Photo credit*: Greg Westfall.

not be resold to a third party in another state) in all of its long-term supply contracts. The European market was fragmented on purely national territories, so Gazprom could indulge in price discrimination at will. For example, contrary to any rational commercial logic, the prices of customers closer to Moscow were usually higher than those farther away.[9] Moreover, outside of Romania, domestic natural gas production was minimal.

This economic power traditionally gave Gazprom and the Russian Federation substantial political influence across the region. The threat of a cut-off, or simply the magnitude of Russian intervention into any local Central and Eastern European (CEE) state's largest industry, caused governments great concern as to Russian intentions and actions. Cut-offs have also not been as rare as is sometimes suggested. While Western Europe has only ever had two cut-offs—one in 2006 and a much more serious one in 2009—states in Central and Eastern Europe and the Baltic states have been cut off over forty times between 1991 and 2004.[10]

The threat of a cut-off is not a thing of the past. In April 2014, Russian President Vladimir Putin sent a letter to eighteen EU states indicating that gas supplies to Europe may be cut again as a result of disputes with Ukraine, despite a transit guarantee from Ukraine.[11] In October and November 2014, Turkey saw its gas supplies along the trans-Balkan route cut by 50 percent. Unsurprisingly, after two months of decreasing supplies, Ankara agreed to the building of a new Russian pipeline through Turkey, to be called "Turkish stream," in early December 2014. Gas supplies were restored after the deal was announced.[12]

Since the 2009 crisis, the EU has begun to tackle the threats posed by Gazprom to the security of supplies. The Union adopted the Gas Supply Regulation that requires all new cross-border pipelines to have reverse flow capacity. The European energy recovery program has spent €1,300 million on building new cross-border interconnectors and providing reverse flow capacity.[13] The Commission adopted a decision to establish an information exchange on energy agreements with third state energy suppliers.[14] The EU also finally enacted the third energy package, which requires third party access to supply networks, transparent tariff regimes, and nondiscrimination between gas suppliers and, by doing so, opened the route to ending the exclusive control of local gas markets by dominant suppliers or vertically integrated utilities.[15]

9 The most noticeable and longstanding exception to this pattern of Gazprom energy pricing is Belarus.
10 Robert L. Larsson, *Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier* (Stockholm: FOI—Swedish Defense Research Agency, 2006), http://storage.globalcitizen.net/data/topic/knowledge/uploads/20110731213514705.pdf.
11 "Putin's Letter to European Leaders on Ukraine's Gas Debt," Reuters, April 10, 2014, http://www.reuters.com/article/2014/04/10/us-ukraine-crisis-russia-gas-letter-idUSBREA391DB20140410. The point here is that there was no threat of a gas flow cut from the Ukrainian side. The new Ukrainian leadership had made it clear that all transit flows would be honored.
12 Karen Strumond, "The Reality behind Russia's Turkish Stream," *Washington Review of Turkish and Eurasian Affairs*, February 2015, http://www.thewashingtonreview.org/articles/the-reality-behind-russias-turkish-stream.html.
13 The legal structure for the Energy Recovery Program can be found in the European Parliament and Council Regulation EC 663/2009, "Establishing a programme to aid economic recovery by granting Community financial assistance to projects in the field of energy," OJ (2009) L200/31, July 31, 2009, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32009R0663.
14 Decision of the European Parliament and Council "establishing an information exchange mechanism with regard to intergovernmental agreements between Member States and third countries in the field of energy," 994/2012/EU, OJ (2012) L299/13, October 25, 2012, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32012D0994.
15 The piece of legislation in respect of the gas market is European Council and Parliament Directive 2009/73/EC "concerning common rules for the internal market in gas," OJ (2009) L211/94, July 13, 2009, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:0136:en:PDF.

These measures have had some effect as Gazprom has not been able to make full use of the Nordstream pipeline in the way it had hoped due to EU liberalization rules, which require that part of the capacity of a new pipeline must be made available to competitors. Natural gas flowing through the Nordstream pipeline has ironically also ended up becoming a source of "reverse flow" gas back into the CEE states as a result of the interconnectors brought online since 2009. Poland, for instance, can now receive gas on reverse flow from Germany. As more interconnectors have been put in place, reverse flow gas has reduced the supply dependency of several states. Most significantly, Ukraine received 5 billion cubic meters (bcm) from EU states via lower prices than if it had directly bought gas from Gazprom.[16]

GAZPROM'S MARKET DOMINANCE REMAINS SUBSTANTIALLY ENTRENCHED ACROSS THE REGION.

Nevertheless, Gazprom's market dominance remains substantially entrenched across the region. EU member states have not fully complied with the terms of the third energy package, and the European Commission has had to bring several infringement proceedings against a non-member state in the European Court of Justice. In addition, a significant number of key interconnectors across the region have not been completed. Senior EU official Brendan Devlin recently pointed out that in some EU states, particularly in the Balkan region, no final investment decisions have been made to execute the building of key interconnector infrastructure, even when EU funding was available to assist such work.[17] There is concern that a major factor in this failure to take up available EU funds is Russian pressure. Another factor is opposition from local supply companies, who see interconnection (quite correctly) as additional competition threatening their margins.[18]

This supply dependence is likely to grow, given falling European domestic production. Furthermore, dependence is compounded by the legitimate fears of greater Russian aggression, following the annexation of Crimea and the occupation of parts of eastern Ukraine.

16Vladimir Socor, "Ukraine Rapidly Dismantles Gazprom's Supply Monopoly," Eurasia Daily Monitor, vol. 12, no. 65, Jamestown Foundation, April 8, 2015, http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=43764&tx_ttnews%5BbackPid%5D=7&cHash=30ee75ae8f38d8eb4db36cd 3339e3ad5#.VUDsciFVikr.

17 "Bulgaria Lacks Political Will to Build Interconnectors, Says Commission," *Euractiv*, March 6, 2015, http://www.euractiv.com/sections/energy/bulgaria-lacks-political-will-build-interconnectors-says-commission-312709.

18 This is an overlooked but important reason for opposition to EU energy liberalization. It is often not just Russian interests but local commercial interests that oppose liberalization. Dominant local utilities with a long-term supply contract with Gazprom may well be content to maintain the status quo.

PRIORITIZING ENERGY SECURITY IN THE EU'S ENERGY UNION

Given the significant threat posed to EU supply security from Russia, this paper argues that the European Union's initial Energy Union measures need to first focus on addressing energy security.

These security measures should include full compliance with the liberalizing provisions of the third energy package. The directives of the third energy package were enacted in 2009 and were supposed to have come into force in all EU member states by March 2011. But by September 2011, the Commission found that nineteen member states had failed to transpose the legislation into national law. Only accelerated legal procedures ensured that at least technical compliance was achieved in almost all member states by October 2014.[19] However, while transposition has formally taken place in almost all cases, the Commission has had to open a second set of proceedings against almost all member states for the incorrect transposition or application of the third energy package. Although the Commission has focused solely on those violations that are key to market liberalization, such as the failure to unbundle networks from supply and generation, failure to ensure independence of the national energy regulator, and failure to apply consumer protection standards, it still faces a considerable degree of resistance from a number of member states.

This lack of compliance with the third energy package is in part due to the complexity of the EU energy directives, bureaucratic lethargy, resistance from local energy interests who see market opening measures a threat, and pressure from Russia.

The Commission and the member states must urgently address the failure to comply with the third energy package. Much of this failure comes from Central and Eastern Europe. Other regions such as Northwest Europe have less reason not to comply as they already have substantially open and liquid trading markets.

The underlying concern is that even if full and correct technical compliance with the letter of the directives is achieved, actual application of the third energy package will be, in far too many states, too weak to provide meaningful market openings. One option that is briefly raised in the Commission's Communication and that is worth developing is to broaden the powers of the EU's Agency for the Cooperation of Energy Regulators (ACER).

19 European Commission, *Enforcement of the Third Internal Energy Market Package,* SWD (2014) 315 Final, October 13, 2014, http://ec.europa.eu/energy/en/topics/markets-and-consumers/single-market-progress-report.

ACER was created under the third energy package to coordinate the national energy regulators and play a central role in developing the rules underpinning the operation of the EU's energy market.

It would be possible to increase ACER's capacity to undertake supervision and support of the national energy regulators. ACER could be given powers to oversee the development of a gas and electricity single market. However, the extent to which member states will accede to giving ACER significantly greater powers than it already has is open to question.

One approach that the Commission has successfully deployed in the past is to initially rely on its antitrust powers rather than on its regulatory powers under ACER. The advantage of relying on its antitrust powers is that there is no doubt to the Commission's authority in deploying them. The Directorate-General (DG) for Competition should consider running a second Energy Sector Inquiry to ensure that all illegitimate barriers are removed from the EU's single market.[20] The point here is that, where a dominant energy company is involved, what often constitutes a breach of the EU's liberalization rules is also likely to constitute a breach of the abuse of dominance provision of Article 102 of the TFEU. Faced with a second Energy Sector inquiry, the member states may look more favorably on granting ACER greater regulatory powers rather than have DG Competition deploy its effective but blunter weaponry.

Aside from removing legal barriers, the European Union also needs to focus on a few key natural gas infrastructure projects to ensure physical interconnection. Some of these are already underway and should be completed during the course of the Juncker Commission ending in 2019. However, funding needs to be put in place, location disputes minimalized, and political resistance from local monopolies and Russian interests overcome.

In this author's view, the key infrastructure projects are the connectors and LNG stations in the Baltic states, Finland, and the North-South Corridor, as well as the connectors between Ukraine and Greece, which connect Ukrainian gas flows to the Greek LNG terminal at Revithoussa.

The Baltic states, once the most gas-dependent region in the European Union, are arguably no longer so dependent. The floating regasification facility at Klaipeda, Lithuania, came on stream in 2014 with a capacity of 2 bcm (rising to 4 bcm by the end of 2015).[21] In addition, the Gas Interconnection Poland-Lithuania (GIPL) is due to be completed by the end of 2019. This will provide a physical pipeline interconnection between Poland and Lithuania. Initial capacity will be 2.3 bcm, which could be expanded to 4.5 bcm.[22] A further pipeline, the Balticconnector, will connect Finland and Estonia and will have a capacity of 2 bcm.[23] The Balticconnector is due to be completed by 2020. Smaller interconnectors are planned to strengthen supply connectors among the three Baltic states.

The LNG terminal at Klaipeda and the interconnectors will have a substantial effect on the Baltic and Finnish gas markets. The total gas market in the Baltic states is at most 6 bcm, with a farther 3 bcm in Finland. By 2020, the full capacity of GIPL and the LNG terminal will be able to replace 70 percent of the supply across the Baltic and Finnish markets, where until recently Gazprom provided 100 percent of gas consumed in the region.

However, from a supply security perspective, although Klaipeda and GIPL will leave Gazprom a significant market share, they will only do so if both Klaipeda and GIPL are able to operate at full capacity. This is a compelling argument for the construction of another LNG terminal. EU funds could be provided for a further terminal. Unfortunately, a dispute between Estonia and Finland on the location of the terminal has delayed its construction. The European Commission has made it clear that it will only fund one terminal, and both states will have to support it. This dispute is delaying a major additional source of supply security capacity for the region. In developing the Energy Union, one option would be for the Commission to propose the enactment of a regulation where a time frame for the resolution of such cross-border "location disputes" would be provided, after which the dispute would be subject to compulsory arbitration. This would create an incentive for a speedier resolution and help ensure that the key parts of the energy security infrastructure are put in place.[24]

Of equal importance is the North-South Corridor, which would link the Polish LNG terminal at Swinoujscie with an LNG terminal on the island of Kirk in Croatia, using a series of interconnectors that are able to provide gas in

20 It is often overlooked in discussions of EU energy liberalization policy development that the Commission has two mechanisms for opening markets. The first is by legislation, the second by litigation through application of its formidable antitrust powers. It is no coincidence that the first Energy Sector Inquiry was launched in 2005 in conjunction with discussions on a third energy package. The prospect of a further round of inquiry, which focuses on noncompliance with the energy liberalization rules of the third energy package but deploys the Commission's powers of investigation and enforcement under the competition rules could provide Brussels with a significant lever to obtain additional powers for ACER.

21 Rokas Masiulis, "Klaipeda LNG Terminal-the Gamechanger in the Baltic Region," Baltic Rim Economies, reposted by the Lithuanian Energy Ministry, November 3, 2014, https://www.enmin.lt/lt/apie_energetika/detail.php?ID=3780.

22 Gaz-Systems SA, "Gas Interconnection Poland-Lithuania (GIPL), Results of Business Case *Analysis,* Warsaw, 2012.

23 European Commission, *List of Projects to be Submitted as Projects of Common Interest*, Brussels, 2013.

24 Any member state that sought EU funding for an energy infrastructure would have to agree to compulsory arbitration. It is not unreasonable to argue that if funding is required from the EU budget, then time periods for negotiating location and project readiness would have to be complied with, and if negotiation fails the dispute should be subject to compulsory arbitration.

both directions.[25] The interconnector, which is slated for completion this summer, will have a capacity of 5 bcm. In addition, interconnectors are being put in place as far as the Croatian border. The major difficulty appears to be in respect to Croatia, where disputes with major Hungarian energy investor Magyar Olaj (MOL), as well as legislation which undermines EU energy liberalization, will make it very difficult to attract investors to the Croatian market and make the EU wary about providing funds for a new LNG terminal. The Commission has opened an investigation into infringements of the EU free movement and liberalization rules in Croatia.[26] However, unless the disputes are resolved quickly, it is likely that the southern end of the North-South Corridor will languish.

The other major pipeline route under construction is the Trans-Anatolian Natural Gas Pipeline (TANAP)/Trans Adriatic Pipeline (TAP) in the Southern Corridor. This will bring natural gas from Azerbaijan, across Turkey and Greece, and into the southern Balkans and Italy. By 2019, 10 bcm of gas will have arrived in a region where Gazprom was traditionally the only domestic gas supplier. In a second wave of development, the pipeline can be upgraded to provide 20 bcm after 2020. Given the small size of the Southern Balkan market and Gazprom's dominant market position, TAP will have a greater impact than first appears. The major role of the European Commission over the next five years in relation to the Southern Corridor will be to ensure the delivery of the project, over and above the operational requirements. There are a number of threats, including the new leftist government in Greece, which may wish to impose more onerous conditions on TAP, which passes through its territory.

Given Southeast Europe's dependence on Russian gas, an additional infrastructure priority is developing full reverse flow capacity from the Ukrainian border to Greece. This is significant because of the supply dependence in the region. Reverse flowing gas from Ukraine or bringing non-Russian gas from the Revithoussa LNG terminal west of Athens (most of its 5.3 bcm capacity currently remains unused) can potentially overcome this supply dependence.

With a fully connected and fully reverse flow pipeline system, gas can potentially flow from Ukraine to Greece, through Romania and Bulgaria, introducing new gas supplies across the region. The major political challenge to this system has been the attitude of the Bulgarian government to developing interconnectors. As explained above, even where EU funding has been made available for interconnectors, Sofia has not been forthcoming with decisions to proceed. There is now a question as to how far the new government in Athens would be willing to support connecting the LNG terminal to the Balkan pipeline network. On the one hand, doing so would generate landing and transit fees for the LNG terminal and promote the position of Greece as an energy hub. On the other hand, the increasingly pro-Russian government may not want to undermine its developing relationship with Moscow.

An additional source of gas for the Balkan region could be Ukraine, which is already the recipient of reverse flow gas from a number of European countries. Much of this gas is in fact Russian gas, which is resold and then physically or virtually reverse flowed back to Ukraine at lower prices than those that Ukraine pays for gas from Gazprom itself.

The reverse flow of the main Slovakian-Ukrainian pipeline could provide a substantial additional supply of gas. This pipeline has an approximately 80 bcm capacity. There is a transit contract between the Slovakian pipeline operator and Gazprom for all of the capacity. However, Gazprom does not use anything like the 80 bcm of actual capacity under contract. The Ukrainians have asked to reverse flow approximately 30 bcm. However, the Slovakian pipeline operator has refused to do so, citing the capacity contract with Gazprom. However, the EU's liberalization rules have "use it or lose it" provisions, which suggest that the Slovak operator ought to release that capacity. In addition, as Gazprom is a dominant player in the gas supply market, "capacity hoarding"—sitting on capacity that a competitor could use but the dominant player does not use— could potentially constitute a prima facie breach of the EU's competition rules. At the very least, the European Commission's antitrust arm, DG Competition, should investigate the refusal to reverse flow gas supplies on the Slovak pipeline system.

This is not just a matter of Ukrainian energy security. With substantial additional reverse flow supplies, Ukraine can supply Balkan countries such as Romania, Bulgaria, and Greece, states in Central and Eastern Europe, and Turkey. Such a substantial reverse flow would make a significant difference to the region's supply security. Clearly, interconnectors are required, and there are a number of political and technical problems to overcome. However, the European Union needs to recognize that, given the potential supply security gains, the effort to reverse flow the Slovak interconnector and ensure full reverse flow through the Balkans to Greece is worthwhile and should be prioritised.

Furthermore, Turkey could access the Slovakian reverse flow facilities through the Balkans. Doing so would allow Turkey, which is currently 60 percent dependent on Russia for its gas supplies, to reduce that dependence. This is an important issue for Ankara, especially following the reduction in gas supplies to Turkey in October and November of 2014.

25 For a discussion of the prospects of the North-South Corridor, see Atlantic Council and Central Europe Energy Partners, *Completing Europe: From the North-South Corridor to Energy, Transportation and Telecommunications Union* (Washington, DC: November 2014), http://www.atlanticcouncil.org/publications/reports/completing-europe-from-the-north-south-corridor-to-energy-transportation-and-telecommunications-union.
26 Jake Horslen, "European Commission to Probe New Croatian Natural Gas Market Regulation," ICIS, April 9, 2014, http://www.icis.com/resources/news/2014/04/09/9770833/european-commission-to-probe-new-croatian-natural-gas-market-regulation/.

WITH SUBSTANTIAL ADDITIONAL REVERSE FLOW SUPPLIES, UKRAINE CAN SUPPLY BALKAN COUNTRIES SUCH AS ROMANIA, BULGARIA, AND GREECE, STATES IN CENTRAL AND EASTERN EUROPE, AND TURKEY.

In addition to securing the natural gas single market's legal and physical opening in the most Gazprom dependent parts of the EU, Brussels also needs to focus on securing new sources of natural gas supplies in its Energy Union proposals. The Commission's Energy Communication paper only briefly discusses new sources of supply. The major pipeline options for additional natural gas supplies are from Algeria and Norway. Algeria, in particular, has substantial additional resources, which could potentially be brought on stream. However, there are a range of issues, from security to domestic tax regulations, which have held back any significant increase in Algerian production so far.[27] The Commission and the member states need to work with the Algerian government to remove the principal obstacles to increasing gas production.

New sources of LNG can provide another source of gas. LNG can flow north and east across the Spanish-French border due to significant Spanish LNG capacity. Spain and France have increased interconnection capacity, permitting more natural gas to flow north, amounting to 7 bcm. Equally, the United Kingdom can provide from its own substantial LNG terminal fleet as much as 25 bcm of reverse flow interconnector capacity across the channel. As more interconnectors are put in place, LNG from Western European terminals can reach a greater proportion of Central and Eastern Europe.

LNG may well be the key to a substantial degree of alternative natural gas supplies. As more LNG comes on stream from around the world, including from the United States, Chinese economic growth slows, and Japan begins to bring its nuclear power stations back online, there is likely to be substantial additional liquidity in the natural gas market. Furthermore, as Asian LNG prices are linked to oil prices, the fall in oil prices will make the European market more attractive to LNG suppliers.[28]

Shale gas could play a potentially significant role in European gas supply. Unfortunately, very little development has occurred so far, with no field developments reporting significant commercial flows of gas. Shale gas development will hopefully prove successful in the next decade or so. Based on current trends, it is unlikely to result in any significant impact before 2020.

If the European Commission and the member states focus on fully completing the single market in natural gas, improving access to alternative sources of supply, and completing key infrastructure projects, the EU can remove the major source of supply dependence by the end of the mandate of the current Commission in 2019.

27 Tim Boersma, "Algerian Field Report: Developing Shale Gas in North Africa," *Markaz* (blog), Brookings Institution, March 24, 2015, http://www.brookings.edu/blogs/markaz/posts/2015/03/24-algeria-field-report-shale-gas-boersma.

28 For an overview of global LNG markets see International Gas Union, *World LNG Report-2014 Edition*, http://www.igu.org/sites/default/files/node-page-field_file/IGU%20-%20World%20LNG%20Report%20-%202014%20Edition.pdf.

PUTTING IN PLACE THE BUILDING BLOCKS FOR THE ENERGY UNION

At first glance, focusing on the natural gas issues of the most Gazprom-dependent states seems fraught with difficulty. Most member states, whether in Western or Eastern Europe, would be opposed on principle to extending the powers of the EU in the energy sector. Yet, without greater EU supervision, it is difficult to see how a genuine single market in natural gas will come into being. This argument however does not account for the effects of the Russian annexation of Crimea and invasion of parts of eastern Ukraine. Those acts, combined with an aggressive Russian hybrid campaign against the European Union and the member states, have made the Union much more willing to contemplate the idea of significant market reform to reduce supply dependency. Furthermore, as explained above, the European Commission in the short term has the capacity to deploy its formidable antitrust powers in the energy sector to make up for a lack of sufficient European regulatory powers.

The infrastructure program can also assist the European Union in building political support for greater energy integration in the parts of the Balkans that have recently been opposed to any effective measures in this sector. One of the problems for the European Union has been that what the EU has been able to offer is very limited in comparison to what Gazprom has been prepared to offer. For example in Bulgaria, all that the EU has offered has been the funding of relatively small interconnectors. By contrast, the Russian side promised at the very least participation in much bigger projects, Southstream and now Turkish stream. A much larger project in the Balkans involving greater throughputs of gas to Greece and Turkey, with consequently larger transit fees, will make it easier to bring the reluctant Balkan states on board.

Dealing with the supply security of the states most dependent on Russian natural gas also provides a fundamental building block for accomplishing most of the remaining energy objectives of the European Union. For example, focusing on natural gas can lead to advances in the Union's ambitious decarbonization project. If the EU builds an integrated gas market with free flows of gas supplies between states and diverse sources of supply available, it will make the market much more competitive. Full and complete liberalization will both lower prices and increase the size of the European market as gas pushes coal out of the European supply mix. The reduction in the use of coal will partly achieve the goal of decarbonization. Moreover, lower gas prices will permit member states to more easily fund the increase of wind and solar capacity, for which natural gas can provide a ready back up. Europe's Energy Union can be built on the back of a deeply liquid and interconnected natural gas market.

In such a scenario, Russia could ultimately play a significant role. It remains the largest holder of proven reserves in the world. Faced with a liquid, open, and growing gas market, it could either ignore the profitable opportunities to enter the market or re-engineer its business model to prosper. In essence, Russian gas businesses would have to adopt a low price and high volume business model to succeed in the European market. There would be no supply security threat at this stage, as the EU market would be interconnected and have access to a diverse supply of gas. While Russia could succeed in that market, the success would be commercial and not political. Russian gas supplies would be as apolitical as Russian coal or oil supplies.

The United States can play a very significant role in supporting EU efforts at ensuring its supply security and the Energy Union. The United States is on the way to becoming a major exporter of LNG. From a European supply security point of view, the larger the export supply base, the better. Streamlining and permitting systems for LNG liquefaction plants and granting the equivalent of free-trade agreement (FTA) status to all NATO allies would provide Europe with a major additional source of supply in the coming years.[29] US finance capital, as illustrated in the recent Atlantic Council report on the North-South Corridor, can also play a major role in funding new EU energy infrastructures and completing the single market in gas. Finally, the United States can support the efforts of its European allies and EU institutions in dealing with the political blockages to supply security, as described above, both within and outside the EU.

29 For a further discussion of the questions surrounding LNG exports see, "Koranyi Testifies before Senate Energy Committee on LNG Export Legislation," Atlantic Council, January 29, 2015, http://www.atlanticcouncil.org/news/in-the-news/koranyi-testifies-before-senate-energy-committee-on-lng-export-legislation.

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