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## *EU External Energy Policy – Between Market and Strategic Interests*

By Ernest Wyciszkievicz

### Introduction

The EU external energy policy is still in the making and the ultimate outcome is as yet uncertain. The process was launched by the European Commission in 2006 under the catchy slogan “to speak with one voice” on issues regarding relations with the major oil and gas producers, consumers and transit countries. In order to reach this ambitious goal two obvious preconditions will need to be met: (1) achieving genuine coherence between the relatively well-developed internal and the underdeveloped external aspects of energy policy, and (2) overcoming national discrepancies to allow member states to internalize Community objectives and interests.

True unity does not depend on intergovernmental political consensus solely. Many technical, physical, economic, regulatory and legal conditions regarding the shape of the energy system and the market have to be met as well. That is why a well-functioning, competitive internal market is seen as a prerequisite for the emergence of a real external energy policy. Equally important is the establishment of an effective common foreign policy within the EU governed by a proper institutional and legal framework. Otherwise, any effort to integrate policies where national interests prevail would inevitably fail. The likely result would be an imitative policy based on the lowest common denominator, and sensitive and troublesome issues would be put aside.

### Background

To begin with, the root causes of the current state of affairs must be identified and it must be considered as to whether conditions have changed sufficiently to suggest the need for any adjustments. External energy policy has not been developed yet - there are three interdependent reasons. The first one is structural. The Community has not been equipped with any specific powers explicitly related to energy, therefore it acted upon competences derived mainly from its internal market, competition and environment. Until now, developing energy relations with third countries depended on the will of national governments, which, and this is the second reason, have generally been reluctant to confer any additional powers to the EC. Energy diplomacy has been traditionally perceived as being too closely related to national sovereignty to allow the Commission to proceed on its own. Last but not least, there has been a general lack of interest attributable to relatively stable international political and energy environments in the 1990s. The impression was created that any problem concerning energy, including security issues, could be solved by market forces alone.

### Changes in international setting

The driving force behind the enduring debate in the EU on external energy policy is the constantly changing international setting. Without going into details, these changes include: (1) imminent competitive pressure from new actors with rapidly growing demands for energy (China, India); (2) growing importance of producers along with declining EU market power; (4) rising EU dependence on energy imports from politically unstable or potentially unstable regions and, finally, (5)

ever more assertive behavior by large producers looking at energy through the prism of security and politics rather than the market.

Under these circumstances, EU energy security depends largely on strengthening the ability of the Community to react jointly to new challenges. This can be achieved only through a blend of external and internal measures. A market-oriented approach is not in itself an effective policy for states playing by completely different rules. The official conclusion drawn by the EC and its member states is that the EU needs a comprehensive energy policy with strategic considerations so that it is able to act globally as a fully integrated entity. This consensus, however, has not led to any significant structural adjustments within the EU. The status quo, in terms of the division of powers, has been maintained in the Reform Treaty, which reconfirmed a state's right to "determine conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply". In other words, one should expect bilateralism to flourish with no end in sight. Without any intervention the picture will probably be as follows. The Commission (and some member states, such as Poland) will be calling repeatedly for more unity in relations with suppliers, whereas other members, especially the large ones, will go on solving their own problems unilaterally without taking into account either the Community's or the other members' interests.

## State of affairs

### *Dialogues or monologues?*

Since the end of the 1990s, the EU has been trying to strengthen relationships with major producers, consumers and transit countries by establishing bilateral and regional dialogues and developing a multilateral framework. Yet the results of EU-Russia, EU-Algeria, EU-China, EU-OPEC, EU-GCC dialogues – to mention just a few of these initiatives – have been meager. The latest example is the energy part of the EU-Central Asia strategy prepared and adopted during the German presidency in 2007. It is a typical exercise in wishful thinking rather than a fully-fledged strategy with achievable objectives and implementation measures. Once again, the EU has demonstrated the "no sticks, no carrots" syndrome. Existing inequities between the EU and the oil and gas producers becomes abundantly clear when one tries to weigh Russian undertakings in the EU and its vicinity in the last couple of years (the Burgas-Alexandroupolis oil pipeline, North and South Stream gas pipelines, expansion into storage and downstream sector in the EU, prolongation of long-term contracts) against the negligible effects of EU activity in the Caucasus and Central Asia. In short, major oil and gas producers see benefits offered by the Europeans as unattractive, their demands as too intrusive (such as linking human rights issues with economic support) and whatever leverages they have as too weak. Aside from these political and institutional constraints, the EU is too financially and organizationally deficient to promote its strategically-oriented initiatives such as its diversification projects, attempts to modernize energy sectors in third countries and attempts at achieving reciprocity in market access.

### *External projection of internal market*

The predominance of nationally-oriented approaches to member states' relations with major resource-rich countries led the Commission to turn to its traditional area of responsibility, namely internal market policy. The plan now is to extend the "common regulatory area" beyond the EU borders to build immediate surroundings that are stable and predictable. This approach stems directly from the concept of the EU as 'normative power'. External projections of energy market and governance rules have already been identified as the driving force behind the uncompleted Energy Charter Treaty process. More recent illustrations of these projections are: the Energy Community Treaty (extending EU energy *acquis* to the Balkans), the Baku Initiative (incorporating the Commission, the Caspian littoral states and their neighbours), the Black Sea Synergy (energy constitutes just one fraction of it) and European Neighbourhood Policy, with its growing energy component. In a basic sense, "exporting" internal market regulations is about creating interconnected regional energy markets as a starting point towards building a pan-European market. The aim is also to inject more transparency into inter-state energy relations in order to minimize the risk of disruption of energy supply arising from the immediate neighbourhood of the EU. The word 'immediate' is crucial here, because this kind of foreign policy by proxy has serious limitations. What may be attractive to the Balkan countries or to Turkey (be it their EU membership perspective or another form of enhanced cooperation) is neither appealing to nor accepted by increasingly self-confident,

resource-rich countries. In fact, EU policy is often interpreted by these nations as purely geopolitical in nature, wrapped up in the guise of norms and values. This conclusion may be drawn from the observation of existing controversies within the EU itself in regard to market liberalization. Due to current inadequate political and financial incentives, the strategy of exporting the EU system of governance can work only in the case of the Balkans, Turkey and maybe later with Ukraine and South Caucasus. Major suppliers of oil and gas to the European market such as Russia, Algeria, Nigeria, the Middle East and Central Asian countries are not going to play by EU rules any time soon. These nations tend to conceive of energy cooperation in geo-strategic terms because their very survival is dependent on the steady inflow of revenues from energy exports.

### *Internal market as security provider and political leverage?*

The EU's optimistic assumption that it is relatively easy to encourage other nations to follow market logic in energy policy as a rational alternative to the logic of geopolitics turned out to be naïve. Increasingly assertive energy producers and consumers look at energy through the lens of national security interests. Interestingly, the same tendency can be found in the EU, where "economic nationalism" in the energy sector has been on the rise for some time. The latest demonstration was the 'merger battles' between energy national incumbents supported by their home governments (see E.ON/Endessa and GdF/Suez/Enel cases). So, instead of replacing the string of isolated national markets with the European single market, the EU has witnessed the ascension of the European oligopoly composed of several large national companies seeking to control the market and to preserve the current state of fragmentation. As the internal energy market inquiry of 2007 revealed, formal liberalization had not been followed by real competition due to several obstacles: excessive market concentration, extensive barriers to entry for newcomers and lack of transparency. The consequences for the gas sector in particular are well-known: distorted investment incentives and underdeveloped interconnections between national systems with limited cross-border trade. This situation affects security since it makes unfeasible any coordinated response to the potential interruption of natural gas supplies similar, for instance, to the International Energy Agency response mechanism for oil emergencies.

In response to these shortcomings, the Commission released the new liberalization package in September 2007. The focal point of the package was "ownership unbundling" aimed at splitting up vertically integrated companies by separating transmission assets from production and supply so as to increase access to networks for new entrants and boost competition. Other proposed measures included improving cooperation between national regulators and transmission operators to create true European energy systems with no bottlenecks or regulatory discrepancies. This seemingly purely domestic issue of restructuring the domestic setting, if adopted, could have significant security implications both internally and externally.

When it comes to internal concerns, new measures are aimed at ensuring security through the establishment of integrated systems capable of absorbing a potentially serious supply shock, no matter if the cause was deliberate political action, technical breakdown or natural disaster. The assumption is that a well-functioning and competitive market is essential to securing a level of investment sufficient to upgrade and expand infrastructure (in particular cross-border connections and diverse import corridors), which in turn are fundamental to the arrangement of any kind of joint crisis management and solidarity mechanisms. The Commission chose the 'unbundling' method to change the system.

This approach has been sharply criticized by Germany, France and their followers. One of the arguments was that forcing companies to sell off network assets would weaken their bargaining positions in relation to non-EU suppliers and therefore would affect the supply security of the whole EU. There has also been a stormy debate over the economic and financial consequences of the unbundling process. It is the dubious method that has been challenged, however, not the desirable outcome. The responsibility for ensuring security of supply should be shared between all actors: the Community, member states and companies. And it is necessary for each side to accept some trade-offs and concessions. It would certainly not be enough to rely entirely either on the state-centered logic or on the management of an industry focused only on cost-effectiveness. There is an urgent need to create and enhance the link between soft external and intrusive internal measures.

It is in this context that the Commission tried to smuggle a bit of 'foreign policy' into its internal market package of 2007, through the so-called 'third party clause'. The EC proposed a series of measures to restrict non-EU companies' access to the EU's energy sector, in particular to networks. Any company from the third country would have to "demonstrably and unequivocally comply with the same unbundling requirements as EU companies" to acquire transmission networks. Additionally, the

Commission sought to ensure real reciprocity in terms of market access and investments. Those countries denying access to EU companies would be deprived of the right to act without restraint on the European market. Access to networks would be given only after a special agreement between the EU and the country in question is signed. This provision, once adopted, would provide the Community with more power to control the bilateral energy dialogues. This seems like a method to by-pass present political obstacles in order to formulate more assertive Community policy towards external energy actors and to protect the EU from unwanted external activities driven by strategic rather than economic motives. This effort is worth recognition, though it is still highly uncertain whether member states are ready and willing to accept such a precedent.

## Recommendations

**To enhance external coherence.** It is necessary to combine the EU's traditional normative policy based on the promotion of values and its model of governance with strategic thinking focused on Community interests. This seems essential in order to secure the availability of energy supplies in the long run. The EU should be more assertive in presenting its interests clearly to all major producers. It should identify conflicting and overlapping interests with actors such as China, Russia and the US. Assuming that external energy policy should be an integral part of the CFSP, much will depend on how the modifications introduced by the Reform Treaty will be exploited by the new High Representative for EU Foreign Policy. Undoubtedly, his/her personal preferences are going to be decisive on certain matters. Also worth considering is how to enhance the Community dimension in contractual arrangements between the member states and suppliers. The Commission should be entitled to make the contracting parties remove all anti-competitive elements, such as destination clauses.

**To address internal diversity.** The existing gap between internal and external measures contributes to many inconsistencies in the emerging European energy policy by creating conflicting objectives and overlapping responsibilities for the various stakeholders. Clearly, to speak with one voice externally the Union must be adequately integrated within. This integration depends not only on overcoming political obstacles, such as differing national interests and perceptions, but equally on creating adequate economic, regulatory, technical and physical conditions (for example, to make possible the redirection of gas flows within the EU). Nonetheless, one must be aware that achieving true political unity is highly unlikely in the foreseeable future due to numerous obstacles of both an objective and subjective nature. The former embrace different energy mixes, import dependency rates, levels of diversification and, therefore, vulnerability to disruptions, while the latter refer to diverse threat perceptions and attitudes toward non-EU energy actors, for example Russia. External energy policy will remain a state prerogative for many years to come, but certain legal measures should be introduced to restrict an individual nation's room to maneuver. Security of supply can no longer be considered only a national issue. First and foremost, any action taken by any member state in the energy sector should by no means violate the security interests of any other member state, let alone contravene the Community objectives. And if this were the case, then the Community should have the power to take adequate measures. Here, the crucial problem is to construct an accepted methodology that will identify risks and threats, their likelihood and scale (European, regional, national), and to arrange responses, along with the designation of the responsible actor and the political mandate to react. Such a mechanism should be prepared carefully so as not to let any member abuse it in order to block important undertakings.

**To make solidarity work.** The need for action in the spirit of solidarity is unquestionable. Yet, for now, attaching too much importance to it can have adverse effects. With no infrastructure in place, this principle will remain on paper, which can widen the credibility gap. Conversely, an obligatory solidarity mechanism may send the wrong signals to some countries which in turn may abandon expensive modernization of their own energy systems and count on "free-riding" when a crisis occurs. However, the EU members, in particular those most vulnerable to disruption, may expect effective common protection mechanisms in the face of external risks in return for conferring upon the Community additional control over domestic energy affairs. Otherwise, they may revert to purely national measures resulting in energy de-integration. It would surely make the EU more vulnerable to external actors, who would benefit directly from intra-European disunity. It is necessary to focus on the creation of common ground in terms of regulations and standards, functional market-based mechanisms, and sufficient physical and technical links. True unity in the field of external energy policy can be possible only after achieving real integrity within the EU.

The scale of the would-be European common energy market combined with the collective character of a would-be common energy policy could transform the EU into a real energy power. It could easily use market access and the principle of reciprocity as a policy tool. It could speak with one voice in bilateral or multilateral talks through one agent – most probably through the High Representative. The problem is how to surmount the intrinsic contradiction between the image of the EU as civilian power focused on shared norms and consensus and the energy politics of ‘sticks and carrots’, which demand a strategic background. It would be helpful for the EU to modify its image a bit by adding new elements so as to be treated more seriously both by non-EU actors and by its own members.

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