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“Energy”: a cross-cutting influence on EU widening and deepening

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What impact will volatile energy prices have on European prosperity? What are the EU's real priorities within its energy policy, and what should they be? Does a common approach to energy policy make sense, given the structural differences between national energy markets? Is a fully integrated European energy market a necessary condition for a common European energy policy? Is it feasible at all? How far should integration of energy policies go? How economically and environmentally sustainable is Europe's energy supply? What trade-offs does EU energy policy have to reconcile? How dependent is Europe on Russian gas and oil? What is the relationship between today's geopolitical conflicts and energy supply security? What are the future spheres of conflict? Does the EU have viable alternatives and how costly are they?

These are among the most challenging issues confronting the EU at present, reflecting the cross-cutting influence of energy and the policies that relate to it on the future of European integration. The choices the EU makes on energy will have a bearing not just on the Union's economic prospects and its sustainable development strategy, but will also have a wider resonance for political and institutional relations with the EU's neighbourhood and the wider world. Indeed, as Carlo Trojan of the Dutch Energy Council argued at a recent workshop¹, energy is a policy area in which the EU is an especially significant agenda-setter, with energy, as a policy field, having a profound influence on how the EU evolves. For Trojan, the challenges posed by the need for further harmonization in environmental and energy issues are likely to become an acid test of future EU integration. As such, energy will be a key driver in the coming years of EU widening and deepening, the two processes central to the analysis of European integration carried out by the EU-CONSENT network of excellence.

This briefing note draws extensively on the papers presented at the workshop and the lively discussions that took place during it. In an attempt to capture the cross-cutting influence of energy issues, it appraises energy's recent and prospective impact on the EU's evolution from a number of perspectives that bear on energy policy. The note starts by looking at how EU energy policy has addressed the issue of energy security, a topic that has plainly moved rapidly up the policy agenda in recent years as the energy price has risen and supply risks have been accentuated. Second, the note considers the geo-politics of energy and the implications for the EU's evolving neighbourhood and common foreign policies. The third issue addressed is climate change which calls not only for fundamental rethinking of the EU's model of economic development so as to move towards more sustainable forms of economic activity, but also for a common EU approach to international efforts to mitigate carbon emissions. The interplay between energy market integration and competitiveness is a fourth area discussed.

Security of energy supply

Since the first Green Paper on energy policy in 1995 the EU's goals have been environmental sustainability, security of supply and the establishment of an internal market for energy. The Energy Policy for Europe, mapped out by the European Council in March 2007, paved the way for the Union to develop the policy tools to achieve these goals. After proposing the third legislative package for the completion of the internal energy market and adopting the "20-20-20" strategy, the third pillar was recently considered with the EU Energy Security and Solidarity Action Plan. Many of these measures draw on cutting-edge research into European energy policy and represent appropriate answers to recent challenges. Yet their effectiveness is contingent on the willingness of actors at all levels to implement them.

A secure energy supply is economically and socially vital and requires long-term planning and investment. However, there are many facets of security that have to be considered, not all of which are readily quantifiable and some of which require subjective assessments to be fully understood. A useful starting-point for elucidating the elusive character of energy supply security and its implications for processes of widening and deepening in Europe is to look at sector-specific risks in European energy markets². For example, there are distinct political and economic implications of sector-specific risks in different energy sources, such as gas and nuclear energy. These include the nature of trading relationships, and the reliability of production and distribution systems.

The recent volatility in oil prices has clearly been disruptive to the EU economies, but underlying it is a crucial change over the last decade in the world's oil and gas market structures from a buyers' to a sellers' market. This change has come about partly because of the progressive decline of buffer capacity that used to be provided by suppliers such as Saudi Arabia, but has also been caused by the rapid acceleration of demand from emerging markets such as China and India³. These trends call into question some of the principles that have been central to EU energy policy. In particular, they suggest that a policy of market opening and integration is no longer enough and that, instead, the EU has to adopt a more strategic view of energy supply. This will not be easy, if only because of the differences between Member States in preferred energy mix and standpoints on common as opposed to bilateral supply deals. Nevertheless without a common approach that goes beyond the completion of the internal energy market and the nascent sustainable energy policy, the EU's vulnerability from its lack of leverage on energy supply security is likely to persist. At the heart of the debate about energy supply security is Europe's growing import dependency. Energy supply security is a strong shaping factor on other energy-related policies.

Much of the actual or potential energy supply for Europe is located in the countries of the Commonwealth of Independent States (CIS), for several of which energy is the dominant sector of the economy. The results of a recent Commission study highlight some of the policy implications, both for the EU and these CIS countries⁴. For the former, the options for diversification in sources of supply are

¹ "Energy": a cross-cutting influence on EU widening and deepening, workshop held on the 12th of November, 2008 at CEPS in Brussels as part of the Work Package VI, on *Economic and Social Policies*, of the EU-CONSENT network of excellence, funded by the European Commission under the 6th Framework Programme

² Presentation at the workshop by Arianna Checchi, CEPS, Brussels

³ Presentation at the workshop by Iain Begg (European Institute, LSE) in which he both commented generally and introduced key ideas from a paper by Jacques de Jong and Coby van der Linde (Clingendael International Energy Programme, the Hague).

⁴ Presented at the workshop by Lúcio Vinhas de Souza (DG ECFIN, European Commission)

evident, yet the fact that the supply is constrained by available transit routes is an important issue for the European Neighbourhood Policy (ENP). In particular, the interdependence between Russia as the main CIS producer and exporter and the EU as Russia's main outlet and revenue source has to be stressed. Future prospects for the CIS countries as regards energy production and consumption are characterised by large uncertainty, partly because of differences in the measurement of stocks and potential output. There are also diverse risks affecting CIS energy supply to the EU, resulting from variations in production and consumption patterns, under-investment in pipelines, regional crises, monopolistic behaviour, or the consequences of energy markets reform in the EU itself.

The geo-politics of energy and EU interests

Energy security is manifestly at the heart of many of the EU's strategic relationships with other parts of the world and risks that the EU faces. One class of risks derives from geo-political uncertainties, not least in the Black Sea region, part of the EU's immediate neighbourhood which is simultaneously a potential threat to stability and the key to promoting European supply security as emphasised in a paper she entitles the 'Great Energy Game' by Adina Crisan⁵. Russia and the EU have a special relationship rooted in energy, yet it is one that has seen rising tensions in recent years, whether between the two as strategic partners or internally within the EU where there are conflicting views among member states on how to engage with Russia. Europe's growing dependency on Russian oil and gas has created some vulnerability, but has also prompted a search for alternative supply channels that could be contrary to Russia's interests. Ukraine, too, is a pivotal actor and the workshop discussion revealed points of conflict between Ukraine and Russia which must be taken into account in EU policy-making.

A key playing field in the energy game is gas supply crossing or circumventing the Black Sea to enter the EU via South-eastern Europe where there are competing pipeline projects. One, promoted by Western interests is Nabucco which aims to supply the EU from the resource rich Caspian Sea and thus to diversify EU gas supply and import routes, thereby reducing dependency on Russia. The competing (Russian-backed) project, South Stream, would maintain Russian dominance in European gas supply by short-cutting certain transit countries and undermining the feasibility of Nabucco. Development of South Stream is well ahead in this game, whereas Nabucco is still no more than a prospect. Merging the two projects could be an option, although it would require significant political concessions on all sides.

From the perspective of the key transit countries further issues arise, and research suggests they have yet to harness their geopolitical role comprehensively⁶. Manifestly, the region plays a significant role as an energy junction and bridge between Asia and Europe. However, the Black Sea region (as well as the Balkans) appears not to have escaped fully from the Russian sphere of special interest. Moreover, the strategic role of two of the new EU member states (Romania and Bulgaria) has to be stressed, as both could be vital as alternative energy bridges to the Black Sea. In all these respects the ENP is, or ought to be, a crucial part of the EU's external energy relationships and *vice versa*.

Stefano Silvestri⁷ emphasised that energy security is not just an economic matter, but also impinges on hard security, though not so much as a military requirement (as in earlier periods) as one that shapes alliances. An implication is that improved understanding is needed of energy as a security issue, and as an influence on geopolitical developments. This, in turn, should be a factor in how energy policy develops. A further point highlighted by Silvestri is the role perception plays in all energy issues, notably in the external dimensions: it has been common to portray certain international players as *powerful* or *fearful*, but these designations often owe as much to perceptions as realities. In his opinion, energy security matters do not follow established equations, and actors can change roles. From this perspective, EU relations with Russia can be seen from two conflicting viewpoints, either regarding Russia as threatening or merely self-securing. The mutual interdependencies between Russia, the EU and transit states like the Ukraine were the subject of lively discussion during the workshop, revealing the depth of feeling about energy politics on issues such as the pricing of energy, whether (or under what conditions) energy can be used as a weapon for advancing a country's foreign policy interests, and whether the available supply of gas (and oil) justifies multiple supply routes.

Sustainability in an era of accelerating climate change

The science behind the link between carbon emissions from use of fossil fuels and climate change is now widely accepted, and the search for ways of mitigating carbon emissions is having an increasingly marked effect on energy policy. Dealing effectively with climate change will oblige the EU to make progress on both internal and external climate policies⁸. In the medium-term, key priorities are the negotiation of a successor to the Kyoto Protocol, which expires in 2012, and the adoption of the EU climate action and renewable energy package with its 2020 deadline. But the much more demanding challenge of stabilising atmospheric carbon concentrations by 2050 also has to be confronted and in relation to this, the strategic energy review package presented in mid-November suggests a number of ways forward. The long-term energy agenda the European Commission has proposed a new energy package focusing on the issue of energy security including a strategy to establish energy solidarity among the member states.

For the EU, climate change will require delicate and difficult diplomacy. In this regard, the EU can build on its track record in international climate policy and its internal regulatory advances, both of which show European leadership in promoting change, despite the avowed reluctance of many partners. For EU citizens concerned about self-interest, clear synergies exist, for example between the EU's concern about import dependency and its aim to reduce fossil-fuel related emissions, and there are substantial market opportunities for EU companies from carbon mitigation. However, the EU's ability to provide a robust lead in global climate policies will depend partly on whether it succeeds in adopting the climate action and renewable energy package currently under negotiation. In this respect Carlo Trojan highlighted the Council as the centre of negotiation, as close collaboration between the member states cannot be taken

⁵ College d'Europe, Bruges

⁶ Presentation at the workshop by Elisabeth Yoneva (University of National and World Economy, Sofia)

⁷ President of the Istituto Affari Internazionali, Rome, in a commentary presented at the workshop

⁸ Paper by Louise van Schaik and Karel van Hecke (Clingendael European Studies Programme, the Hague), presented at the workshop by the former

for granted and requires continuous adjustment. Today's combination of various environmental goals and energy policy has been a success as a form of integration, but needs continued effort. More generally, the character of European integration will be reflected in how successful the EU is in managing the transition to a low carbon economy, its ability to organise an external representation and to agree on a common and coherent position on climate change policies, externally and internally.

Constitutional dimensions to energy policy also deserve attention, especially around the issue of whether competition and strategic investments in energy can be reconciled within the EU legal framework⁹. To make progress, market and environmental concerns have to be brought together to promote the goal of sustainable development by accounting for the management of risks related to climate change. Internalising environmental costs along with mitigation and adaptation measures can be the tools to achieve these goals. Lombardo argues that member states' resistance towards increased European energy competence, as well as the fragmentation and compartmentalization, has inhibited the development of EU energy law. Changes in EU energy law foreseen by the Lisbon Treaty may help to achieve the EU's energy policy trinity by creating an *ad hoc* legal energy competence, increasing the legal base for environmental considerations, and the subsequent strengthening of the EU institutions. A further intriguing issue is the sustainability of integration of EU environmental and energy policies in the absence of full constitutional authority in these core processes. Arguably, even without the Lisbon Treaty, politics can lead the way, if other legal measures are adjudged to be sufficiently robust to provide for a common basis of policy-making.

There are also challenges of implementation, especially around emissions trading and efforts to establish an effective price for carbon emissions. In particular, there is no carbon price for natural gas in sectors which are not covered by the EU Emission Trading Scheme, an omission which distorts investment choices¹⁰. One answer is to introduce such a price for building-related gas use, as it represents one of the main sources of greenhouse gas emissions that can readily be abated. Consumers would face new incentives to modify their domestic behaviour in the context of most member states' gas import dependency and the relative potential for climate change mitigation in the domestic gas use. The necessary technologies for the reduction of building-related energy use already exist at a cost-effective price.

Energy and European competitiveness

The drive to create a single energy market in Europe has long been seen as a necessary step towards making the EU more competitive and thus lowering costs. However, creating a single market can also be seen as a strategic imperative influencing competitiveness through giving the EU bargaining power in assuring a stable supply of energy. Here, again, the link with strategically important energy suppliers, above all Russia, is evident. In this regard, the impact of the third legislative package for the internal energy market has the potential to promote a coherent approach among the member states towards Russia, as the fragmented energy markets and a lack of coordination can be seen as a primary source of differences in preferences and strategies¹¹. Grätz argues that it is not dependency on Russian gas that accounts for the current deadlock of divergent member state interests, as the Union as an entity is not overly dependent, despite significant asymmetries in the dependency of individual member states on Russia. Moreover, he points out that the institutional features of an increasingly integrated market would bolster the EU's bargaining potential if it embraced the common interests of the member states. Still, problems remain unsolved in the third internal market package, such as the proposed national way of unbundling and the abandonment of the reciprocity clause.

Conclusions

The workshop revealed conflicting views on the way forward for energy policy and on the emerging balances of power and interests, all of which are germane to the future development of EU policy-making. Most of the questions initially raised have no permanent or simple answers. Central to this workshop were questions about the real role of Russia in international energy diplomacy (and the best approach of the EU towards Russia), the need for a primacy of one of the EU's policy dimensions, the potential for future integration, given the structural differences, the importance of energy issues within the EU Neighbourhood Policy, and the feasibility of 'speaking with one voice'. Two conclusions deserve to be stressed. First, perception is a crucial element of energy policy-making and its analysis. Second, one of the few certainties regarding energy is that it will change the character of the EU. Borrowing a phrase from the paper by de Jong and van der Linde, energy policy has arguably become a litmus test for the future direction of the EU; as such it is a topic that will be at the heart of future trends in widening as well as deepening.

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¹⁰ Presentation at the workshop by David Ellison and Attila Hutyecz (Institute for World Economics, Budapest)

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