



DANISH INSTITUTE FOR INTERNATIONAL STUDIES
STRANDGADE 56 • 1401 Copenhagen K
+45 32 69 87 87 • diis@diis.dk • www.diis.dk

DIIS Brief

Trade-offs in European energy policy

On choice, losses, gains, and how to have a go on both the swings and the roundabouts

Svend Aage Christensen
January 2008

Abstract:

In the spring of 2007, a trio of researchers put forward five proposals for optimising the EU's energy policy. The European Commission had published its framework for an energy policy in January 2007, and now, in the autumn of 2007, the European Commission has been presenting its proposals in more detail. The stage is set for heated discussions. The research trio believe, amongst other things, that existing policies for the internal market and competition regulations provide an immediately accessible framework for an energy market on a European scale, and should be implemented in full. In other words, they are opposed to the trends towards re-nationalisation and protectionism that characterise parts of the debate.

Introduction

In January 2007, the Commission presented its long-awaited Energy and Climate package to promote a common energy policy for the EU.¹ According to the Commission President, José Manuel Barroso, the energy package represents a long-term vision for a new energy policy in Europe. Its goal is to create a sustainable, secure and competitive energy supply. The new policy was launched amidst great fanfare at the Council meeting in March 2007 and was backed by the heads of government. Throughout the autumn, starting 19 September 2007, the Commission is putting forward a number of proposals for implementation of the visions contained in the energy package.

If we look back at past history, the Single European Act from 1986 did not originally provide for the creation of an internal energy market. Attempts to include an energy chapter in the Maastricht Treaty (1992/1993) and the Amsterdam Treaty (1997/1999) failed due to Member States' divergent interests and structural differences in their energy markets. However, the gradual implementation of the internal market led to the first halting steps in the liberalisation of the electricity market (1997) and the gas market (1998). The five proposals put forward by the European Commission on 19 September 2007 can be seen as the culmination of the efforts of more than a decade to liberalise the internal energy market.

At present, energy policy is something of a diplomatic dead-end in relations between the EU and Russia, trench warfare has broken out on reforms to Europe's internal energy market and there is concern about the distribution of the burden of meeting the energy policy's environmental ambitions. Since 2005, the concept "economic patriotism" has been added to the European debate. The phrase was first used by the French Prime Minister Dominique de Villepin. Since then, 11 sectors of French industry have been declared strategic areas where the state can intervene if it is in the security interests of the state to prevent a foreign takeover. The question is whether the trends towards re-nationalisation and neo-protectionism will grow to become a problem for the further development of the internal market.

Current global economic integration underlines the importance of creating a secure, competitive and environmentally responsible energy future for Europe.

The Commission and the Council appear to believe that initiatives in these three areas will be inter-supportive and that the EU will be able to achieve the necessary compromises, but the energy policy does not really address where the trade-offs and priorities, both individual and collective, can be implemented within the three areas. The Commission's vision of a European energy paradise, where the wolf shall dwell with the lamb, and the leopard shall lie down with the kid, and the calf and the young lion and the fatling together, will probably persuade only few.²

Before this is taken as a criticism, it must be remembered that new EU policies often feel somewhat rough-hewn at the beginning and only mature gradually. This is of course connected with the fact that new policies in important areas almost always entail significant political and practical difficulties. It can also be politically expedient to draw a veil over the policy difficulties. In the European debate, where fear and insecurity seem to be easier to sell than hope and confidence, this is not necessarily a negative thing, and is even welcome under certain circumstances.³ However, it should also be noted in all fairness that in its more analytical contributions to the public debate, the Commission has of course made no secret of the immense difficulties facing the energy policy.

Earlier in 2007, three researchers, two of whom have spent time as EU insiders, made a laudable attempt to analyse and systemise the energy policy's difficulties from a positive standpoint in relation to the EU's energy policy. In substance their proposals are in many ways similar to those which the Commission is expected to put forward in autumn 2007. The three researchers are Lars-Hendrik Röller who recently was appointed rector of the European School of Management and Technology (ESMT) in Berlin, and who is also a senior fellow at the Bruegel think-tank in Brussels; Juan Delgado, a researcher at Bruegel; and Hans W. Friederiszick, Head of the Department for Competition Analysis at ESMT. Between 2003 and 2006, Röller was the European Commission's first Chief Competition Economist. In this capacity he used economic analyses as a basis for the inspection of company mergers, cartel investigations and to check market abuses and state subsidies. Friederiszick worked with Röller at the Commission. This trio of authors believe that, in order to create an analytical framework which can be used to convince Member States of the advantages of tackling the problems at European level, it is first necessary to understand individual Member State's different standpoints and interests.

The report by the group of three makes the EU's energy policy easier to understand by setting out what are the choices and costs.⁴ It therefore merits a short presentation for a

Danish audience. As the report itself is over 60 pages, we only have room for a little taster here. The basic idea is to let the report speak for itself. My summary of the report therefore does not necessarily convey endorsement on my part. In some cases, I have found it necessary to insert a short comment.

The tripartite report concludes that, whilst a European energy policy is obviously not a magic bullet, it can potentially make the many difficult and expensive choices facing Europe in the energy sector less burdensome and less costly than if individual countries seek to resolve these problems at national level. The trio name five policy areas in which national choices can be made easier by instigating a joint European approach: 1. the internal market, 2. a network of energy regulators (regulating authorities), 3. political framing of the energy sector (e.g. the broader political context for relations between the EU and Russia), 4. choice of energy mix, and 5. a European plan for development of new technologies. The conclusions relating to the five areas are given at the end of this document.

Losses and gains in relation to the different choices - trade-offs

As mentioned before, the Commission's energy paper sets broad objectives in three main areas, as if it was a given fact that the three policy areas were inter-supportive. This however, is only the case if very broad, long-term objectives are put in place. While the rosy picture this paints may be politically and bureaucratically expedient, the authors consider it an analytical weakness as the idyll stifles debate and makes it difficult to obtain a systematic grasp of the losses and gains that lie behind the concrete, more short-term management of priorities between the three areas. The authors believe that the Commission's somewhat tautological deliberations that an efficient market, functioning well, can fulfil all three objectives at the same time, are not conducive with regard to establishing a productive political debate.

The authors show that if a party such as the Commission defines the objectives sufficiently broadly, the choice between gains and losses is eliminated as only gains accrue from implementation of such broadly defined objectives. If competitiveness is defined as general, long-term economic efficiency, it is difficult to find any losses relating to it and a choice is therefore taken away. If however we define competitiveness as industrial profitability, the choice between losses and gains in the three policy areas is once again relevant. For example, the prioritising of environmental policy goals could

increase industry's costs and thereby reduce competitiveness. The same happens if we define competitiveness objectives on the basis of consumer interests. This can also involve a choice between losses and gains in the areas in question. If, for example, we increase the percentage of renewable energy in the energy mix, the average energy price may increase, because renewable energy is for the moment more expensive than energy from conventional energy sources.

By emphasising the choice between losses and gains, the authors can construct an energy policy index, which makes it possible to illustrate trade-offs in a number of areas and obtain a picture of the very great differences between Member States.

The basic idea behind making the choices clear and illustrating the tension between the objectives in order to achieve better results in the future may seem obvious, maybe even banal, but it did not make an impression on David Buchan, the author of a refreshing "Oxford Energy Comment" dated August 2007. He writes that each of the three policy areas contains enough problems in itself to restrict progress. The English author suggests that so far the problem is less EU policy areas overlapping each other than the 27 EU member states with their divergent attitudes towards Russia, competition and green priorities.⁵ Meanwhile, it is precisely this difference between the Member States which the trio's approach captures and operationalises in respect of establishing a rational, transparent discussion process and softening up some of the hard choices Member States have to make, using a European approach.

Losses and gains: relaxing national choices and trade-offs

Lets us look at three examples where countries can make choices, which result in gains for one energy policy objective and losses for another.

- Countries can be tempted to support the establishment of large integrated national energy companies and weaken competition in order to promote adequate investment and secure access to primary energy sources. In this case security of supply is prioritised over market competition. (The authors express politely, but as far as I can see without much support, the viewpoints of the large EU energy companies in particular, and to a certain extent Gazprom, that they must have a certain amount of security and protection in the market in order to make large, long-term investments in production and infrastructure attractive. There are at least two controversial assumptions here: firstly that monopoly

status will drive investment, secondly that monopolistic status will be better in terms of security of supply than an efficient free market. It can also be noted that when presenting this contradiction, the authors use the introductory words "Countries can be tempted to..." which supposedly is an indication that they do not support the monopolistic protectionist urge which some Member States are clearly influenced by. Around these subjects some of the most heated discussions this autumn regarding the EU's energy policy will revolve: unbundling (separation of large companies into a supplier component and an infrastructure component), protection of EU companies from foreign investments, in particular from Russia and the Middle East, discussions of the special features of the energy sector and why and to what extent it should be treated differently to other sectors, etc.).⁶

- To increase security of supply, countries can be tempted to promote the use of conventional energy sources and undermine environmental policy. Being generous with CO₂ permits is one of the ways this occurs. What you lose in relation to the environmental objective, you gain in security of supply.
- Finally the environmental policy has costs that may be transferred to higher energy prices which can then affect a national economy's competitiveness. Member States are therefore tempted to weaken their environmental policy (or limit the effect of environmental costs on energy prices) so as not to compromise the competitiveness of the domestic economy. Environmental policy is therefore weakened in order to make gains in relation to the economy's competitiveness.

The trio of researchers' main thesis is that these trade-offs are also found at European level. The EU's energy policy will not open any doors to an energy policy paradise, but shaped correctly can perhaps solve some of the conflicts that cannot be cleared up at national level and relieve/reduce the costs of others.

A joint policy: simplifying the choice between the swings and the roundabouts

The trio believes that a European approach can relax energy policy choices and relieve tensions in three ways.

- Size/scale/weight - Europe's size gives it increased strength both economically and politically ('to speak with one voice')

- Heterogeneity/comparative advantages - Europe's differences can be turned to a comparative advantage.
- Coordination - European countries can coordinate their policy and thereby relax national choices.

Three examples illustrate how the authors envisage this softening could function:

1. *The choice between competitiveness and security of supply.* The conflict between competition in the short term and a stable and secure energy sector in the long term does not disappear simply because it is addressed at European level, but a cohesive and proper regulation of the European market can contribute to reducing the insecurity of current and future regulation and create suitable conditions for long-term investments.

By increasing market size, the European solution allows European companies to grow without compromising competition. A well-connected, well-integrated internal European market also promotes diversification of supply sources and thereby reduces the power of supply monopolies. (See comment in the box below under Proposal I).

2. *The choice between security of supply and environmental considerations.* The contradictions between the two approaches certainly do not vanish into thin air when the issue is addressed at European level. But at European level, countries can use their comparative advantages and are not just reliant on their own investments and resources in their efforts to satisfy both security of supply and environmental considerations (sustainability).

3. *The choice between environmental considerations and competition considerations.* Improved options at European level for financing renewable energy initiatives and for a more consistent allocation of CO₂ emissions permits will reduce the current dislocation caused by heterogeneous mechanisms, and will improve the distribution of environmental costs between countries.

This will not however alter the fact that the environmental costs could still place European firms in a worse position than their competitors outside the EU. The only solution to this problem lies in wider international environmental cooperation.

Conclusions

The tripartite report emphasises that the European energy policy's most important function is to cushion the difficult and expensive choices which Member States would otherwise face alone. The report discusses five policy areas, in which this is assumed to be the case. As mentioned before, they are the internal market, a pan-European structure of energy regulators, political framing, energy mix and finally research and development.

The authors set out their proposals as follows:

PROPOSAL 1:

The existing policies for the internal market and competition regulations already provide an immediately accessible framework for an energy market on a European scale. They do not have to be amended in response to the energy challenge. On the contrary, they should be implemented fully at European level in order to avoid sub-optimal national solutions caused by national trade-offs. (If the researchers are correct, this will be a very important argument in the autumn debates. Proposals are already under discussion to block Gazprom's investments in the EU, a step we cannot take without coming into conflict with our own ideology. Katinka Barysch, chief economist at the Centre for European Reform, supports the researchers' optimistic assessment. She believes that the only way forward is to ensure that Gazprom complies with European regulations when making investments. She also believes that the EU has the necessary tools to ensure free competition, transparency and fair play. In March the competition commissioner Neelie Kroes was asked to investigate whether Gazprom's increasing importance as a player could be an impediment to liberalisation of the energy market. When President Putin apparently complained about this, Angela Merkel is said to have responded that he should consider it an honour to be treated in the same way as Microsoft. In Katinka Barysch's opinion, if Europeans are worried about Gazprom's role, they should accelerate liberalisation of their own gas market. On 19 September, the Commission is issuing a new draft on the unbundling which will prevent any one company from being solely responsible for the production, transport and sale of energy. At the present time Germany and France have opposed the unbundling. Barysch believes they must change course. By giving competitive energy companies access to European pipelines, the unbundling would almost exclude market abuses by large, vertically integrated companies – not just on the part of EU companies, such as Gaz de France and Eon-Ruhrgas – but also Gazprom. Barysch also states that a further advantage of this solution is that more competition might reduce profits in the distribution market (downstream) so much that Gazprom might lose interest in investing in the EU and instead invest⁷ in the domestic market in Russia, where the need is very great).

PROPOSAL 2:

A pan-European network of energy regulators should be established. The regulators must cooperate closely and the system must have a strong EU authority that can function as a backstop and last resort if required.

PROPOSAL 3:

To succeed in reducing negative interference from the political markets in the energy market, a significant political framing is required. The EU should speak with one voice to provide an umbrella protecting Member States' external security of supply. The weight of individual Member States in conducting implementation of this policy must necessarily differ.

PROPOSAL 4:

Instead of symmetrical quotas per country, which are economically inefficient and difficult to implement, the environmental targets should be set at EU level and the burdens shared according to national circumstances. The incentives for complying with the goals should be market-based. A system of tradeable green certificates would be a suitable and economically effective mechanism for ensuring that national policies are in accordance with the common objectives.

PROPOSAL 5:

Research should focus on development of the most promising domestic energy sources, but should at the same time be coordinated at EU level to exploit synergy and combine efforts in comparable projects.

We now have the remainder of 2007 and part of 2008 up until the meeting of The European Council in Brussels in March 2008 to evaluate how the research trio's proposals compare with the proposals the Commission is presenting in the coming months, and assess the fate of the Commission's proposals. The spectacle of most immediate interest is how the duel will pan out between those who believe that the internal market alone can satisfy energy requirements and those who tow a more protectionist line.

The outcome of the battle might also lead to a more rational and coherent relationship between the EU and Russia and define where on the hope-confidence-fear scale individual EU members position themselves in relation to this vital part of the EU's energy policy.

1 *En energipolitik for Europa*, KOM (2007) 1 (current edition). For more recent information on the EU's energy policy in Danish, see *Europæisk energipolitik – den nødvendige debat*, by the Danish European Movement's thinktank Yes to Europe, published 10 April 2007, and Ole Vigant Ryborg, *EU-Kommissionen klar til energislagsmål*, in *Mandag Morgen*, 17 September 2007, pp. 21-24.

2 Isaiah, 11, 6-9.

3 There are not many works dealing with confidence building in international energy policy. One such is *Energy Sovereignty* by Danila Bochkarev og Greg Austin. *Restoring Confidence in a Cooperative International System*, EastWest Institute Policy Paper 1/2007.

4 Lars-Hendrik Röller, Juan Delgado and Hans W. Friederiszick, *Energy: Choices for Europe*, in Bruegel Blueprint Series, 2007. Viewed 29 August 2007 at

http://www.bruegel.org/Public/fileDownload.php?target=/Files/media/PDF/Publications/Blueprint/BP_energy.pdf - in the current document called "Tripartite report".

A more detailed indexing of Member States' energy situations and their dependency on energy imports can be found in Jacques de Jong, Hans Maters, Martin Scheepers and Ad Seebregts, *EU Standards for Energy Security of Supply* (update), The Hague, Clingendael Institute/ Petten, Energy Research Centre of the Netherlands, CIEP/ECN, April 2007, 101 pp. Viewed 29 August 2007 at <http://www.clingendael.nl/ciep/publications/2007/>

5 David Buchan, *Europe's mid-summer blues*, Oxford Energy Comment, August 2007. Viewed 29 August at

http://www.oxfordenergy.org/pdfs/comment_0807-1.pdf

6 See, e.g. Katinka Barysch, *Reform is the answer to Gazprom*, Financial Times, 2 September 2007.

7 Katinka Barysch, quoted article.