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Europe's mid-summer blues

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The European Union faces a difficult autumn in trying to carry forward its three-pronged energy policy. For what the Brussels Commission launched with fanfare in January 2007, and EU leaders endorsed with equal fanfare in March, has become bogged down in a diplomatic impasse with Russia, trench warfare over reforming Europe's internal energy market, and growing nerves about how to share the burden of meeting the EU's climate change ambitions.

Each of these policy areas – energy security, competitiveness and emission reduction – contains enough intrinsic problems to impede progress. Fears that these policies might contradict and undermine each other are so far largely unrealised. It is true that Europe's big incumbent gas companies are resisting structural reform, such as selling off or unbundling their transmission networks, partly on the grounds that they need to stay big to bargain on gas supplies with Russia's Gazprom. Equally, however, Brussels has argued ownership unbundling would ensure that Gazprom can never extend its vertically integrated monopoly into the EU.

So far the problem is less policies cutting across each other than the 27 EU member states, with their differing views on Russia, competition and green priorities. But they have a common failing in saving energy - the one way to serve all three stated EU goals of energy competitiveness, security and emission reduction. Electricity consumption is still growing in Europe, despite a Commission action plan for a 20 % cut in energy use by 2020. The reality of increasing energy consumption underscores the need to ensure that that extra energy is as secure, cheap and clean as possible.

Security.
The energy security issue boils down to gas, and (though Europe has many other suppliers that ought to minimise the concern) to Russia. Germany had hoped to use its EU presidency in the first half of 2007 to launch negotiations for a new EU-Russia agreement that would include some of the trade and investment protection principles that Moscow had baulked at in the Energy Charter Treaty. This hope died when Poland put a block (for unrelated trade reasons) on starting a new negotiation, and when Baltic tensions with Moscow also soured an EU-Russia summit in May that produced nothing. The chill in UK-Russian relations – linked to the Lugovoi

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extradition affair rather than the contractual difficulties of BP and Shell in Russia – also makes early negotiations for a new EU-Russian accord unlikely.

Another reason is that Brussels is now in a muddle about demanding reciprocity from Moscow. For while Moscow has been steadily squeezing western companies, such as BP and Shell, out of majority equity stakes in Russia's upstream, Gazprom is moving into Europe's downstream by starting some direct sales to customers in Germany, France and Italy. These countries' big gas companies regard ceding Gazprom part of their market as a price worth paying for having secured long term contracts to import Gazprom gas into the mid-2030s. The EU's two biggest importers of Russian gas – Germany's Eon and Italy's Eni – have also signed up to building the Nord Stream and South Stream pipelines to carry this gas more directly to their markets, thereby making the EU's central European members (most of whom are wholly dependent on Russia for gas) more nervous about being bypassed.

To correct this imbalance, EU leaders and officials have been talking of the need for reciprocity with Russia. But there are two snags. First, the Russians claim to operate reciprocity already; they have offered minority upstream stakes to Eon and Eni. Yet what Brussels wants is a general legal framework and freedom for EU investors in Russia. Second, the EU cannot play hardball on reciprocity because its own rules forbid discriminating against investors of any particular nationality.

One way of getting at the problem might be to introduce a vetting process on investments by state-controlled companies (a category into which Gazprom fits) and sovereign wealth funds. Germany's Chancellor Angela Merkel has proposed this idea for EU consideration, along the lines of America's Committee on Foreign Investment in the US. One reason for this proposal is that Germany is made nervous by the proposal for ownership unbundling. If this proposal ever got onto the EU statute book, it could result in major parts of the German electricity grid and gas pipe network coming on to the open market.

Structural reform.

The Commission believes that the common denominator to many energy market abuses is the energy suppliers' ownership of transmission networks that they can use to exclude competitors. Therefore the best structural remedy is to force them to sell off the networks. Such "ownership unbundling" (OU) was, the Commission said in January, its preferred option, a long way ahead of its second choice of "independent system operators" (ISOs); this would allow integrated companies to keep property title to transmission networks, but require these networks to be operated and developed independently by others.

Six months on, a sort of stalemate on these proposals has developed. In the two bodies that must pronounce on any legislation, there is a clear majority in favour of OU in the European Parliament and a narrow majority in the Council of Ministers. But not, in the Council, a sufficient qualified majority to overcome the strong opposition of France, Germany and some small states. The Commission's competition division continues to pound away with piecemeal anti-trust action, starting cases in May against Germany's RWE and Italy's Eni for keeping rivals off their gas networks, and in July cases against Electricite de France and Suez for abuse of dominant position in

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power markets and against Eon and Gaz de France for colluding not to compete with each other. But the competition directorate maintains that, whatever the outcome of these investigations, the best and fastest way of removing the conflict of interest inherent in owning transmission is legislation to require stand-alone networks.

The Commission has said it will produce formal draft legislation in late September. What will it do? Proposing the OU option alone might invite deadlock, and eventual defeat, in the Council. But one plausible compromise might be to propose OU as the basic default mode, but allow countries to let their companies choose an ISO provided it met certain conditions of independence, perhaps approved by the Commission.

Climate change.

It was in this area that the March 2007 summit of EU leaders provided the most striking endorsement of Commission proposals. It approved a triple set of targets for the period beyond the existing Kyoto protocol: reducing overall EU emissions by 20 %, raising renewables' share in collective EU energy consumption to 20 %, and increasing the part of biofuels in each EU state's total road transport fuel to 10 % - all by 2020. But now the reckoning has set in.

Of the three targets, biofuels risks being the most counter-productive. If not approached with caution about cost, sustainability and a sensible import policy, it could do more environmental damage than good, and at great expense. But it is not a target that sets EU states wrangling with Brussels and each other, in contrast to the other two targets that involve a degree of burden-sharing.

EU officials are currently trying to re-think what the emissions trading scheme (ETS) should look like after 2012. One of their ideas is to make the caps in this cap-and-trade system cover sectors of the economy rather than, as at present, member states. This might remove some of the sectoral distortions in the current system (whereby, for instance, Germany is more generous, for social reasons, in giving permits to its coal-fired power stations than the UK is to its coal-fired generators). It might also take some of the national politics out of the allocation process by putting the burden-sharing onus onto Brussels bureaucrats who would allocate permits within, say, the electricity or cement sector across Europe.

However, the burden of sharing the effort on renewables will be allocated nationally. EU leaders already showed their anxiety about this at their March summit, which mandated the Commission to take account of member states' starting point in renewable energy, further potential, nuclear contribution (in the case of France) and relative wealth. This political special pleading is making it hard for Brussels officials to rely on the classic modelling exercise they carried out for the 2001 renewables directive. Countries were then relatively relaxed because the 2001 measure contained only voluntary targets, and then for renewable electricity alone.

Essentially, this modelling involves increasing the marginal cost of conventional energies and seeing what this does to the relative economics of renewables. But this produces results that are now considered awkward – too little in biofuels (because of the expense) and high targets for countries with high potential such as east Europeans.

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The latter have plenty of biomass but are relatively poor, and will complain about doing more than richer west Europeans.

So a cruder solution is gaining political traction. This would involve asking every EU state for a 13 percentage point improvement in its renewable performance – this being the difference between the EU's current 7 % average of renewables in overall energy consumption and the 20 % goal. This plan would avoid argument over modelling assumptions, but it would also penalise countries that have already done a lot and/or those with little extra potential.

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