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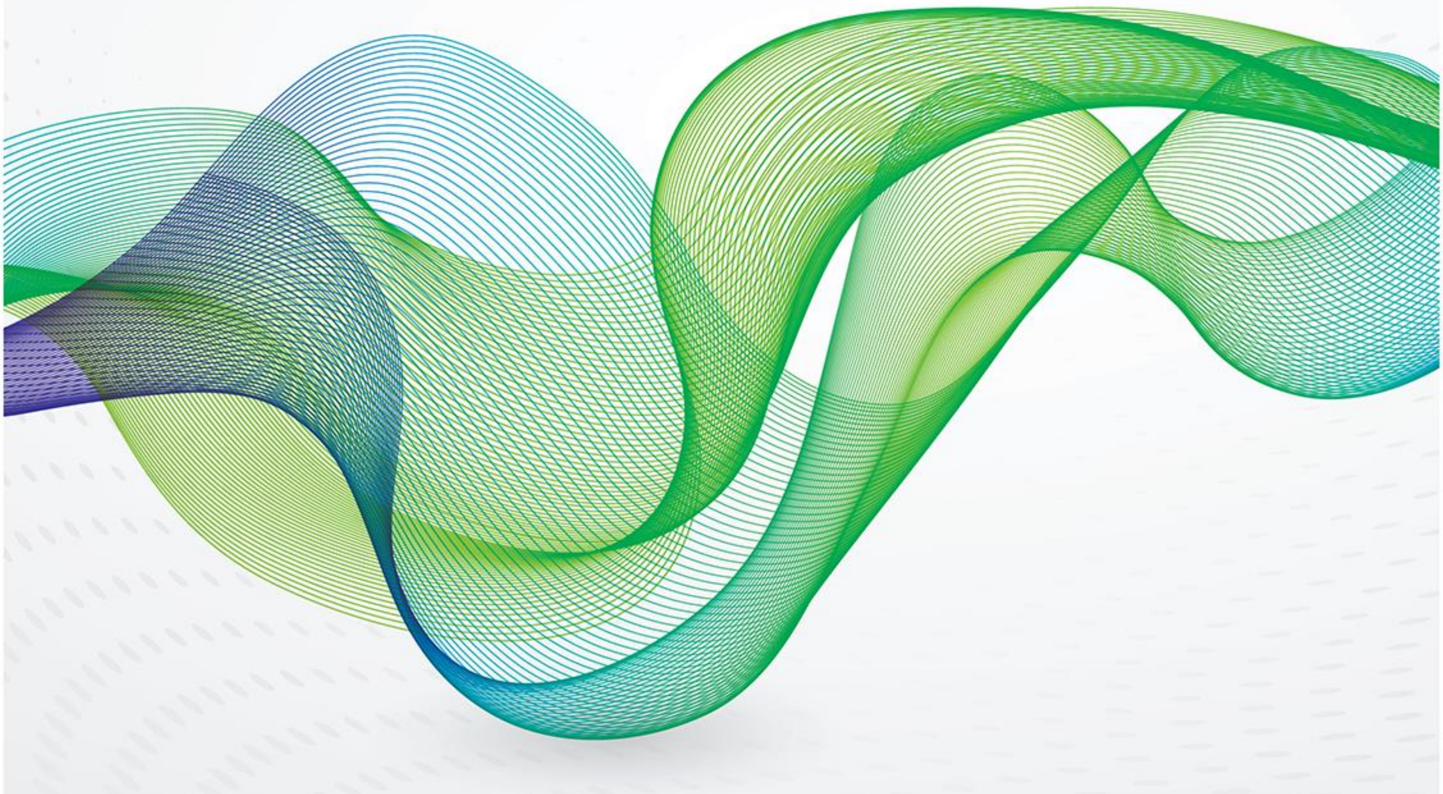
Europe's Energy Union: a problem of governance



OXFORD ENERGY COMMENT

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Introduction

On 25 February 2015, the European Commission put forward a proposal for an Energy Union in a document entitled 'A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy.' As the title indicates, it was an ambitious document. It called on the European Union (EU) to achieve a 'fundamental transformation' of Europe's energy system to reach the goal of a 'sustainable, low-carbon and climate-friendly economy that is designed to last'. To do so, it said that 'we have to move away from an economy driven by fossil fuels, an economy where energy is based on a centralised, supply-side approach and which relies on old technologies and outdated business models. We have to empower consumers through providing them with information, choice and through creating flexibility to manage demand as well as supply. We have to move away from a fragmented system characterised by uncoordinated national policies, market barriers and energy-isolated areas.'

The Commission was looking for an ambitious European initiative on which all member states could work together. The time may well have seemed ripe for this – in other areas (treatment of asylum seekers; Greece and the Euro) the wider European project seemed to be stuttering. But in relation to energy, European countries have a common goal of decarbonisation, and face common challenges in areas like security (the original idea of an Energy Union had been put forward by Donald Tusk, then Prime Minister of Poland, in response to the Ukraine crisis and worries about European dependence on Russia for its gas supplies).

Yet, energy has for many decades been less 'European' than most other policy areas. Member states enjoy considerable autonomy – indeed they have a Treaty right to determine their own energy mix. Policy developments at the European level have therefore in the past tended to stem from non-energy agendas – such as the single market and the environment – resulting in accusations that the Commission has developed a 'silo mentality' and has failed to integrate its overall approach to the energy sector. In any event, the need for action on an EU energy policy was not seen as pressing during the long period of low energy prices and abundant supplies during the 1990s. However, the higher prices of the 2000s and renewed security concerns such as those prompted by the Ukraine crisis, along with the need for fundamental changes in the energy sector to deliver decarbonisation, have since pushed energy policy up the agenda again and underlined the need for a common European approach.

So the Commission's initiative made sense in principle – they had identified a need for a more European approach and circumstances seemed favourable for a collective push forward. But they faced a problem which, this Comment argues, underlies the whole initiative – governance[1]. How can this more collective approach be developed in a situation where the EU and the Commission enjoy few powers (and only limited 'competence' in a formal sense)?

Need for a common European energy policy. In fact, despite the shortage of formal competence, the European Union can (and does) pat itself on the back for what it has achieved so far in reducing greenhouse gases and decarbonising its energy system. However, the picture, as set out in the latest assessment of progress towards the goals the EU has set itself, is not as rosy as it may seem at first sight. For 2020, the EU is over-achieving on emission reductions (but this is mainly due to depressed economic activity as distinct from EU policy), is on target in deploying renewable energy (but at significant cost in subsidy), and is under-achieving in energy efficiency (partly due to exaggerated expectations)[2].

[1] The challenge is examined in more detail in *Europe's Long Energy Journey – Towards an Energy Union?* by the authors of the present Comment in a book to be published on 21 December by the Oxford University Press for OIES.

[2] State of the Energy Union 2015, COM (2015) 572

There is widespread acceptance that the EU could do much more – while also controlling the cost, and improving the reliable supply, of energy – if the EU's 28 states were better at pooling their energy resources and policies. This is what the Energy Union plan, as drafted by the European Commission and broadly endorsed by EU governments, seeks to achieve. It aims to meet the desire of Poland and other east European states to improve their energy security, and the ambition of west European states to accelerate decarbonisation. It also appears to have some popular support. An average of 72 per cent of Europeans have declared themselves in favour of a common energy policy; even in the UK, the least enthusiastic country after the Czech republic, backing for a common energy policy runs at 60 per cent[3].

The problem of governance. So, if Energy Union has this level of support, what can be the problem in implementing it? Why do we argue that governance is the hole in the heart of the Energy Union plan?

The difficulty arises from the fact that the aim of the Energy Union is not just the mere re-branding of existing policies that it is sometimes dismissed as. It is also an attempt to reconcile the growing tension between the long-standing EU policy of energy market liberalisation and the new imperative to intervene in the energy market to achieve specific climate-related outcomes of emission reduction. One particular problem for a multi-state federation like the EU is that while it has had a common template for market liberalisation, based on removing government intervention in energy (as in other sectors of the European economy), some form of market intervention is needed to secure emission cuts – and it has in practice mostly been undertaken by national governments operating their own separate renewable subsidy schemes. Part of the Energy Union plan is an attempt to bring some common order to these renewable schemes, yet it has had to accept that European unity has not reached the point where individual governments are ready to help support each other's renewables in joint subsidy schemes. Another problem is that the steady influx of target-driven renewables into economies with flat or falling electricity demand has effectively killed the prospects for new investment in precisely the conventional generation that renewables need as back-up reserve. The remedy for this, again awkwardly for the EU, has been national – a variety of different schemes to preserve back-up capacity.

The policy part of governance. Reconciling these tensions and contradictions is part of the governance problem. One straightforward starting point would be to focus on policy: effective supervision and coordination of a common energy policy has to be based on having the right policy instruments to supervise and coordinate. As part of the Energy Union initiative, the EU therefore needs to be (but does not in practice seem to be) considering whether it has the right policies.

It has one European level instrument, the emissions trading system, which it regards as its 'flagship' policy and still sees as the Energy Union's key route to decarbonisation. The ETS works well in theory – it has laudable design characteristics in being market-friendly, technology-neutral and EU-wide. But it has had little impact in practice – prices have been low and volatile. It has failed to change the energy mix of generators or the behaviour of energy users to any significant extent, and is unlikely ever to prove effective in incentivising new low-carbon investment. Even if the reforms currently being introduced to the ETS succeed in raising the carbon price, no one expects that it will reach the sort of level needed to give a rate of return that would satisfy financiers lending to low-carbon projects (which would probably require a price of well over €100 – something that is never going to be acceptable to countries like Poland). In practice the 'heavy lifting' in relation to investment in low carbon sources has been undertaken by the national renewable support schemes – they fragment and distort the single energy market but there is no prospect that member states would be willing to abandon these schemes as long as the only alternative is to rely on the ETS.

The problems caused by the dependence on such support schemes are not just ones of market fragmentation. The Commission has acknowledged another key symptom – the support schemes lead to a dysfunctional electricity market where the influx of zero marginal cost, intermittent renewable power has dragged wholesale prices down to a point where no unsubsidised generator can earn a living, but

[3] Eurobarometer opinion survey, July 2015.

where the cost of renewable subsidy is raising retail prices to levels that have sent households and companies squealing to their governments for relief. (The Commission's acknowledgement that electricity markets are broken is not very direct: the tenor of the Energy Union plan is still along the lines of 'maybe the traditional electricity market is broken, but we still hope it isn't'. The Commission put forward proposals for relatively minor changes to existing market structures in July of 2015, but at the same time published a staff paper calling for a much more fundamental rethink, so its true attitude remain unclear. However, although it has promised to come forward next year with proposed legislation on a 'new market design' it seems unlikely at this stage that it is prepared to consider major changes).

Ideally, if the Energy Union really meant a union, EU governments would pool their resources to create a common, EU-wide scheme for supporting low carbon investment (as the Commission has, vainly, proposed in the past). But this would involve revising the EU treaty article that protects national sovereignty over countries' energy mix, and such a revision is not on the cards. Taken at face value, this would seem to make the governance problem insoluble. But in fact, with more imaginative thinking, there could be ways round the problem – it could for instance be bypassed by a move towards new policy instruments such as tradable carbon intensity obligations. These would offer the opportunity for introducing a Europe-wide approach, within existing Treaty constraints, and would not threaten member states' ability to make their own energy choices[4]. At the moment, however, the Commission, despite its ambitious rhetoric, has shown no inclination to engage in any serious consideration of EU policy instruments.

The process part of governance. Where the Commission has excelled itself, in a bureaucratic sense, is on process. It has had to accept the decision by EU governments that governance of the Energy Union will, from 2020 on, be based on the 'building blocks' of national climate, renewable and energy efficiency programmes. So the EU executive is setting out to try to standardise these building blocks, so far as possible, in the hope that they can be used to construct a Lego-like Energy Union out of separate elements.

In its State of the Energy Union report last month, the Commission set out a complex matrix of 'trajectories' and 'indicators' for member states to follow in designing their national post-2020 energy and climate plans. The starting point of the trajectories is a national fact sheet for each of the 28 countries setting out their current energy situation, and a reference scenario extrapolating current trends into the future. Then each national plan will have to show its trajectory of progress towards the five broad 'dimensions' of the Energy Union – improvements in energy security, market integration, energy efficiency, decarbonisation, research and development - and to produce a further scenario showing the impact of its national plan on its energy situation. In addition, national plans are to measure progress according to a list of 23 indicators considered relevant to the five dimensions – for instance, the share of imports in the context of energy security, percentage of renewables in relation to decarbonisation, energy use per square metre in residential housing in relation to energy efficiency, and the rate of clean energy patent applications in relation to R and D. The Commission has said that next year it will produce further guidance, and a template, for national plans which are to be ready by 2018, operational by 2020, and thereafter updated every two years. Yet, at the same time and with no apparent sense of irony, the Commission also says it will make a legislative proposal next year to 'streamline' member states' current reporting requirements to Brussels on energy and climate issues.

It is easy to see why, faced with the Energy Union governance challenge, the Commission has gone into bureaucratic overdrive to shape national planning to its liking. However, there is a risk of revolt, both from the two-thirds of EU member states that currently have no long term national energy plans to 2030 and will therefore be starting planning almost from scratch, and from the smaller number of

[4] This and other proposals for policy approaches which might offer scope for making progress towards an Energy Union are discussed in more detail in our book.

countries which have sophisticated energy planning procedures of their own and which will see all this as more unnecessary red tape from Brussels.

In any event, none of these trajectories or indicators will be legally binding on individual member states in the way that their current national renewable targets for 2020 are. The Commission's hope is that it can cajole and chivvy countries to do better by naming back-sliders in its annual State of the Energy Union reports, the first of which came last month[5]. It did so, in terms of telling various countries that they 'need to assess whether their policies and tools are sufficient and effective in meeting' various objectives. Whether such countries feel any shame, and therefore any impulsion to change policy, on being thus cited only time will tell.

The problem is not just one of formal power – it is also one of understanding the policy context. Underlying many of the current problems in energy markets is the failure to recognise that energy is a system and that an intervention in any particular area has repercussions elsewhere, often leading to the need for further interventions. One example has been the way in which support for renewable sources has undermined electricity markets and has led to the need to introduce capacity mechanisms in many countries across Europe. Another is that the strategy of decarbonising electricity first, while sensible in itself, might actually be undermining the second stage of European decarbonisation – electrifying other sectors like transport and heat. The more policy costs are loaded on to electricity, the less attractive is switching out of other sources and into electricity. Similarly, demand-side policy focuses almost exclusively on energy efficiency, which has only an indirect link with decarbonisation (and may in some circumstances discourage it). What is needed instead is an integrated approach to demand-side policy, including the encouragement of demand-response, fuel-switching and low carbon networks. In general, energy policy needs to be considered in a holistic manner, not as an exercise in assembling a series of individual building blocks or as a pick-and-mix assortment including something for everyone. The Commission's approach of building up from national plans, even if it keeps the EU on track towards its targets in a formal sense, will do little to develop a coherent overall approach to policy.

2016 – year of delivery. What is clear is the Commission's desire to lay out as fast as possible, within the time-consuming constraints of EU policy-making, all the aspects of the Energy Union, in the hope that individual member states can see that all their differing interests are being catered to. Maros Sefcovic, the Commissioner responsible for the Energy Union, has said he sees 2016 as 'the year of delivery for the Energy Union'. To placate Poland and other east Europeans who already think the Energy Union is straying too far from its original gas security rationale, next year will see a Commission strategy paper to increase imports of liquefied natural gas and legislation for greater transparency in international gas negotiations. To satisfy west European countries worried about the increasing mess in their electricity market and/or wanting to accelerate decarbonisation, the Commission has promised legislative proposals in 2016 to re-design the electricity market, to revise current renewable and energy efficiency directives, and to strengthen the role of the Agency for the Cooperation of Energy Regulators (ACER).

Regional cooperation. One further Commission initiative promised for 2016 is 'guidance to strengthen regional cooperation'. The Commission regards regional cooperation as part of the governance system for the whole Energy Union of all 28 states. To push progress among groups of states as a means of achieving an advance among all might seem bizarre – and it is; the obvious risk is that regional cooperation could lead to balkanisation rather than integration. It is, however, part of a pattern of Commission behaviour in which Brussels looks favourably on regional energy initiatives when progress at the level of the EU-28 seems blocked, and then drops interest in this the moment that EU-wide legislation appears possible. For instance, the enthusiasm of the Commission for regional initiatives

[5] State of the Energy Union, COM (2015)572

waxed strong in 2005-6, only to wane in 2007 when it saw a chance to get the EU's Third Package of energy market legislation approved, which it did in 2009.

The Commission's revived enthusiasm for regional cooperation stems partly from an awareness that it needs some path-finder states to pioneer, and spread, solutions to the challenges of the Energy Union. And it believes it has found just such a path-finder group in what it called the Pentalateral Energy Forum. The 'Penta Forum' started in 2005, as its name suggests, with five states – Germany, France and the three Benelux states – though several others have joined since. It has spearheaded integration of the electricity market in which the day-ahead power markets of 22 states are now coupled, and it is working on trying to do the same for the short term intra-day power market that is of particular relevance to fluctuating renewables. The Penta Forum is also working on regional assessments of generation adequacy and possible cross-border coordination of capacity mechanisms. The Penta Forum, according to one of its officials, 'aims to provide guidance for the Commission and the EU as a whole and to act as a laboratory for market design'. There is a risk, however, that given the political dominance of the Penta Forum countries, it may pre-empt thinking about design solutions suitable for all EU-28 members.

Other regional energy groupings in the EU are more limited in that they focus on regional infrastructure needs – on Baltic states' gas and power links to the rest of the EU, on a North Sea electricity grid for offshore wind turbines, on Iberia's electricity connection with France, and on gas pipeline interconnections in south east Europe. All are useful. However, none of them including the Penta Forum can bridge Europe's fundamental weakness, in the context of this month's international climate negotiations – the divide between a western Europe which wants a high carbon price and eastern Europe which wants a low carbon price for the foreseeable future. The latter region is led, on energy and climate issues, by Poland. Poland is decarbonising; the coal share in its electricity mix is now 83 per cent, down from 95 per cent a decade ago. But the decline is from a very high level and will remain gradual. Moreover, Poland has just elected a conservative euro-sceptic government inclined to extract concessions from, rather than make concessions to, the EU.

Conclusion. In promoting the Energy Union concept, the Commission and a few member states clearly see it as a possible success story that can improve the image of a European Union that is finding increasing difficulty in dealing with pressing issues of monetary integration, immigration and terrorism and coping with the rise of populist euro-scepticism in many member states. A weaker EU clearly needs a new project, and the perception of that need is reflected in majority opinion poll support for a common energy policy. However, precisely because the EU has grown weaker, the Energy Union project may be hard to deliver.

It is also difficult to see how real progress can be made as long as the Commission is reliant on a 'bottom-up' approach, dependent on the actions and policies of individual member states, over which the Commission has little control. Unless the Commission can grasp the policy nettle, and initiate a programme of fundamental policy analysis and development to match its ambitious goals, the Energy Union is likely to mean only a (little) more of the same – or even, given the lack of clear governance, a little less.