

Europe's energy future: in the dark

▶ Dieter Helm

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The European commission's new energy plan falls far short of the integrated, long-term strategy that the continent needs, says Dieter Helm.

For most of its history, the European Union has got by without an energy policy. Energy, to the extent it has raised serious problems - as in the Opec years of the **1970s** - has largely been a national affair. Each country has looked to its own sources of supply, and each has tried at one time or another to have an element of self-sufficiency.

All that has now changed: Europe finds itself increasingly dependent on imported gas, and in large measure from a troublesome source: Russia's Gazprom. Such dependency has been manifest in Ukraine's dispute with Russia in **January 2006** and Belarus' in **January 2007**. In each case - gas and oil respectively - Russia cut off suppliers, albeit briefly, and in both cases the "price" of agreement included ceding control of pipelines. What's more, Russia's foreign policy towards its southern neighbours around the oil- and gas-rich Caspian sea has become more strident, with **Georgia** (literally on occasions) in the firing-line.

These Russian **moves** have been a wake-up call for the European commission. Security of supply can no longer be left merely to market forces. In itself, this would merit a European energy policy, but there are two other reasons why such a European policy is needed: the shift of networks to the European level, and climate change.

The reason why policy was national for gas and especially electricity was that the transmission networks were defined at the national level. There was therefore no major physical European dimension. Within countries, high-voltage grids connected power stations to customers, and natural gas was developed in the Netherlands and **Britain** - with the home markets very much in mind.

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Now that too has changed: European countries can be linked up so that a wide diversity of fuel sources is available to be dispatched, and the security of each is mutually supported by its interconnected European neighbours. For example, all France's neighbours could, in principle, tap into its nuclear stations, whilst small markets such as Ireland can benefit from Northern Irish and British supplies. And, on gas, long pipelines can bring natural gas through many countries to final customers. There now is the possibility of a European grid and a European pipeline system, and hence the physical internal energy market is a practical option, with potentially enormous benefits to the European Union as a whole.

The second additional reason for a **European energy policy** is climate change. As a global, public bad, national action on climate change is very limited in its impact. Europe, on the other hand, is much more significant, in terms of its total emissions, and its ability to help forge an international agreement and to run broad initiatives such as the **EU Emissions Trading Scheme**.

A post-merger dilemma

So there is good reason to have a European energy policy and the commission deserves credit for both recognising the need and - in its strategic energy review published on **10 January 2007** - for trying to put one together. But intention is not the same thing as delivery, and the European commission's latest effort - the **"January package"** - provides a very incomplete answer. For whilst the key questions relate to security of supply, network investment and what to do about climate change, the commission's answer is overwhelmingly all about competition, and in particular the forced divestment of transmission networks (termed ownership unbundling) from the large energy companies, so that networks are owned by different investors to power stations and supply businesses.

The argument in favour of ownership unbundling is that, by separating out networks, competition can flourish, since large

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incumbents cannot inhibit rivals and new competitors from accessing networks and hence customers. But whilst network access is a necessary condition for new entry, it is not sufficient, and it does not follow that there will actually be more competition as a result.

If the commission really wants competition then it will have to break up generation too, bear down on the vertical integration between generation and supply, and tackle supplier market power too. This is very demanding, and there is no evidence to suggest that the commission, having allowed the merger wave to create a small number of dominant companies, is really going to split up generation and supply, even if Germany and France agree to the network divestment (itself questionable).

The commission presided over the major concentration of the energy sector, and now that there are few players left in the competition, it probably does not have the radical enthusiasm to undo the damage its merger policy has done. It is probably too late to have a fully competitive **market**. Oligopoly is here to stay.

A competition conundrum

Whatever the outcome of the competition initiative in the January package, it is far from clear how exactly competition deals with the three main problems identified above: Russia and security of supply, completing the European grid, and climate change.

First, on Russia, the commission's policy appears to be that more atomistic competition should be created inside Europe as an answer to facing up to **Gazprom's** enormous monopoly power. But smaller European companies are hardly going to find it easier to bargain with the largest gas monopoly in the world. Indeed, the best way to face up to Gazprom might be to act in unison - to create a monopsony (a buyer's monopoly) of suppliers.

The commission seems to want this - to itself be the face for negotiating with Russia on behalf of European energy companies. This could be done whilst reducing the concentration, but it would be very demanding to then sort out the allocation of contracts between players. In practice what is actually going on is that each company is negotiating its own deals, backed by its own government.

Germany and Italy have done bilateral deals, and France is following on. Gazprom is very successfully pursuing a "divide-and-rule" **strategy**. So whatever the benefits of breaking up Europe's large

energy companies, Europe cannot in itself help facing up to Russia.

Second, on the networks, these are *natural* monopolies. Thus competition is not relevant: they are regulated, and investment with a view to Europe's needs as a whole will require a European dimension to their regulation and development. Here, there is a benefit from ownership unbundling of networks - that the networks' owners can then cooperate together to take forward the development and coordination of the European grid. It makes this task easier because the owners do not have other distractions, and the enormous task of harmonising pricing principles, access terms and coordinating investment can be pursued in earnest.

The commission is right to highlight the importance of European regulation, however politically inconvenient transferring more powers to the centre might be at a time when tentative steps are being made to resurrect parts of the European constitution.

Third, on **climate change**, the irony here is that whilst the commission preaches the merits of competition generally, when it comes to climate change it proposes all sorts of **interventions** to prevent competition undermining its preferred technologies. The most obvious case is renewables, where the commission already has directives in place to reserve a share of the market to pre-empt competition from other fuels, and indeed it then defines renewables in such a way as to preclude competition within the zero-carbon sources from nuclear power. Quotas for bio-fuels are imposed too.

Whilst it is true that the EU Emissions Trading Scheme is an important part of the commission's strategy, and that requires competition for it to be efficient, the competition that matters here is in the generation market - and as noted above, the radical steps necessary to break up generation are not on the agenda.

At heart, urgent

Thus, having recognised the need for a European energy policy, the dominant part of the January package is but a small part of the answer. The big questions for Europe - how to secure supply in the face of import **dependency** on Russian gas, and how to radically address climate change - remain largely untouched by the ownership unbundling.

On the former, the commission is yet to sketch out its strategy for the new **partnership and cooperation agreement with Russia** when the current one expires on 1 December 2007; on the latter,

the commission has suggested a 20% target for 2020 (or 30% if the United States follows suit), but perhaps understandably has yet to explain how it will get there.

Thus, when the January package is put to the EU summit on **24-25 March 2007** under the **German presidency**, it is unlikely to provide the answers that European leaders are looking for. Indeed, much effort is likely to be focused on trying to come to a compromise over unbundling, which will distract from what ought to be the main focus of debate - how to deal with Russia and what to do about climate change after the current Kyoto targets (and the EU Emissions Trading Scheme national-allocation plans) run out in **2012**.

The commission deserves credit for beginning to take energy policy seriously, and there are a number of measures buried in the January package with considerable merit. But it is a long way from a joined-up European energy policy, and the core problems are urgent.



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