Poland's Energy Union proposal: a fair deal for both the EU and Russia?

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In April this year, Polish Prime Minister Donald Tusk published a column in the Financial Times calling for the creation of an Energy Union based on six pillars with the goal of making energy more competitive and secure in the EU and its neighbourhood. Its most ambitious part would consist in setting up "a single European body charged with buying [Russian] gas."[1]

The accompanying non-paper prepared by the Polish Ministry of Foreign Affairs and aimed at "addressing the EU's energy dependency challenges"[2] explicitly underlines the motivations and fears behind the proposal: the EU and other member countries of the Energy Community are "vulnerable to political pressure due to [their] high dependency on oil and gas imports," especially from Russia, and this in turn has made the EU's "efforts in the current [Ukrainian] crisis ... less effective."

It is added that "Central and Eastern European (CEE) countries are particularly exposed to [these] risks" because of their higher dependency on Russian gas. Besides the political factor, price discrimination applied to these countries, charged "on average 10-15% [more] than ... German and other Western European customers," and generates distortions of competition between industrial companies across the Single Market.

[1] Donald Tusk, "A united Europe can end Russia's energy stranglehold," *Financial Times*, April 21, 2014, accessed August 8, 2014, http://www.ft.com/cms/s/91508464-c661-11e3-ba0e-00144feabdc0.html

[2] Polish Ministry of Foreign Affairs, "Roadmap towards an Energy Union for Europe Non-paper addressing the EU's energy dependency challenges," May 21, 2014, accessed August 8, 2014, http://www.msz.gov.pl/resource/34efc44a-3b67-4f5e-b360-ad7c71082604:JCR

While it immediately appears that not all Member States would equally benefit from the creation of a common mechanism to buy energy resources from third countries, Poland's proposal has been generally received in a positive manner in national capitals. It looks indeed very timely in the context of rising tension with Russia..

Moreover, the European Commission, in a first-of-its-kind European Energy Security Strategy, committed itself to "assess options for voluntary demand aggregation mechanisms that could increase the bargaining power of European buyers."[3] The newly elected President of the Commission Jean-Claude Juncker also declared his support for a "new European Energy Union" which would inter alia "unite our negotiating power vis-à-vis third countries."[4]

Though *there's many a slip 'twixt the cup and the lip*, Poland's Energy Union plan seems at this point to have more chances of success than the European Energy Community (EEC) project started four years ago by Jerzy Buzek, then President of the European Parliament, and former President of the Commission Jacques Delors. The EEC was also to make the EU able "to engage in coordinated energy purchasing"[5] but never became a reality.

In the meantime, energy prices have turned more critical as the EU is struggling to get back on the growth path while the crisis in the Ukraine has made it more difficult to argue that Russia can be a "normal" and reliable partner. Even the Commission's European Energy Security Strategy points out the dependence on Russian imports in a distinctive way compared with other supplying countries.

Nevertheless, for such a "collective purchasing mechanism" to be actually brought to life, several questions must first be answered. A potentially divisive issue among Member States would inevitably be prices: how much would 1,000 cubic meters of gas bought by an EU-wide body cost and what would be the difference with today's prices paid by

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[3] European Commission, "Communication from the Commission to the European Parliament and the Council. European Energy Security Strategy," COM(2014) 330 final, Brussels, May 28, 2014, accessed August 8, 2014, http://ec.europa.eu/energy/doc/20140528_energy_security_communication.pdf

[4] Jean-Claude Juncker, "A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change. Political guidelines for the next European Commission," Strasbourg, July 15, 2014, accessed August 8, 2014, http://ec.europa.eu/about/juncker-commission/docs/pg_en.pdf

[5] Jerzy Buzek and Jacques Delors, "Full text of the Buzek and Delors Declaration on the creation of a European Energy Community," Brussels, May 5, 2010, accessed August 10, 2014, http://www.europarl.europa.eu/former_ep_presidents/president-buzek/en/press/press_release/2010/2010-May/press_release-2010-May-4.html

importers and, to a large extent, still linked to national markets?

Second, what would the relations between an EU Gas Supply Agency[6] and domestic energy companies, mainly operating under private law, look like? What about the existing contracts between these companies and external suppliers, some having been signed for a twenty-year period, thus until the 2030s?[7] Would the EU body have a monopoly over all gas imports or only on long-term supply contracts?

Finally, what would be the reaction of supplying states, especially Russia, which is clearly targeted in Poland's proposal? Would the creation of an EU cartel of gas consumers lead to the transformation of the Gas Exporting Countries Forum into a real "gas OPEC" with increased market power? Or can it actually help stabilizing relations with suppliers and saving long-term contracts which have been made weaker over the last few years because of the shrinking costs of liquefied natural gas (LNG) production and the shale gas bonanza on world markets?

Our argument is that a collective purchasing mechanism would be profitable to the whole EU in the short run because of enhanced bargaining power and lower prices. Even in the longer term, if it is presented as an instrument of cooperation rather than competition with supplying countries, including Russia, it can unlock the investments needed to exploit new fields and build adequate transmission infrastructure to consuming states.

When talking about security of supply, one should not forget that "political pressure" is but one of the possible threats and that physical unavailability – or availability at an unaffordable price – also puts security of supply at risk. Considering the relatively cheaper prices enjoyed by European importers in comparison with their Asian competitors and the enormous investment needs in Russia to modernize its pipeline network and bring new gas fields on-stream (one trillion dollars by 2030 according to the International Energy Agency,[8] 590 billion dollars in the view of the Russian Ministry of Energy[9]), it is in the interest of the EU to continue buying gas from Russia and make sure that its production and export capacities stay in line with EU demand.

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[6] Sami Andoura, Leigh Hancher and Marc van der Woude, *Vers une Communauté européenne de l'énergie : un projet politique*, Paris, Notre Europe, 2010.

[7] Catherine Locatelli, "Gazprom's export strategies under the institutional constraint of the Russian gas market," *Cahier de recherche*, n°6 bis, Grenoble, Laboratoire d'économie de la production et de l'intégration internationale, May 2008, accessed August 9, 2014, http://edden.upmf-grenoble.fr/IMG/pdf/CL-CR6bis-08_gazprom-export_opec-review.pdf

[8] International Energy Agency, *World Energy Outlook 2011*, Paris, 2011.

[9] Ministry of Energy of the Russian Federation, *Energy Strategy of Russia for the period up to 2030*, Moscow, Institute of Energy Strategy, 2010.

Buying Russian gas in common, at what price?

Despite the European Commission's long determination and efforts to build an EU's Internal Energy Market, the lack of infrastructure connecting national energy networks and the enduring dominance of former state monopolies in their respective countries of origin are still obstacles to the completion of a real level playing field for utilities and energy end users, whether they be businesses or households.

This is even more characteristic of the gas market, where two thirds of the EU's consumption are covered by imports which are structurally more rigid than e.g. oil trade because of pipeline transport systems and associated long-term contracts. In addition, Russia, which alone contributes to 40% of the EU's total gas imports, is said to "politicise" energy trade in a sense that it would apply price differentiation between national utilities not purely on economic but also on political grounds.

The Commission's interventions have already contributed to limit this kind of behaviour, for instance through the ban of so-called "destination clauses" from certain contracts between Gazprom and European utilities – they forbid gas re-export to other countries, thus partitioning the Internal Energy Market. Moreover, new developments in shale gas production and LNG export have empowered utilities to successfully renegotiate prices with the Russian gas giant. Nevertheless, price discrimination persists and may create distortions of competition for the most energy-intensive industries.

Were gas from third countries to be bought by a "single European body," it would not necessarily mean that all utilities across the EU would be charged the same price. Transmission tariffs would in fact remain but they would be comparatively less significant than the effects of price differentiation and could be more easily regulated. The most important wild card therefore is the price that this collective purchasing mechanism would be able to negotiate with Gazprom or other supplying companies.

Some commentators in the press argued that it would be in between what is currently charged to most favoured consumers and less privileged countries, meaning that the first would lose while the second would win. This reasoning would make it more difficult for such a proposal to be adopted because the most favoured Member States, mostly located in Western Europe, may not be ready to pay a higher price for gas on pure grounds of solidarity with the rest of the EU.

It sounds hardly economic, however, that for the same total amount of gas bought, the price would not actually be *lower* when one single buyer takes it all than in a situation where several smaller companies buy only a fraction of the whole. Stronger market power but also, *ceteris paribus*, less transaction costs with one contract to negotiate and manage instead of many: at worst, the current lowest price would be extended to the whole EU; at best, it would be even smaller due to economies of scale. The final figure would depend on the negotiation process with suppliers.

The role of EU domestic energy companies

Nonetheless, price cannot be considered in isolation from another variable, i.e. quantity. Though the shrinking costs of LNG transport have given the possibility to European energy companies to rely more on spot markets and trade with overseas producers, EU gas imports remain dominated by long-term contracts and pipelines, which make transactions more rigid but at the same more predictable and secure.

Usually, these long-term contracts set minimum quantities to be bought, in order to pay back the very high capital expenditure necessary to exploit gas fields and build pipelines thousands of kilometres long. Even if consumers do not need so much gas in a given year and have no possibility of storage, they have to pay nevertheless for this minimum quantity according to the so-called "take-or-pay" clause. Companies negotiating with suppliers have therefore a strong incentive to assess the evolution of demand very carefully, otherwise they may end up wasting tens of millions of euros in compensation.

A possible EU Gas Supply Agency would have to be designed in such a way that domestic energy companies would still be responsible for the quantities of gas they contract on, while leaving the agency some room of manoeuvre for striking deals with suppliers based in third countries. They could, for instance, become its shareholders and actually control it or they could take an active part in the decision-making process of a public agency.

To limit the risk of overbuying, the Agency would not need to be given full monopoly over all gas transactions with external suppliers. It is enough to deal with long-term contracts, purposely covering only a part of assessed needs. Domestic energy companies would fill the gap with resources bought on spot markets, where price discrimination or targeted supply disruptions are much more difficult to trigger thanks to competition.

A more delicate issue concerns existing contracts between these companies and suppliers, as some are to last until the 2030s. They will have to be transferred to the Agency and renegotiated in light of the new mechanism, which will not be an easy task. In this situation, the EU may have to seek a compromise with Gazprom on certain legal proceedings in order to ensure a smooth transition to the collective purchasing mechanism model.

Relations with supplying countries: cooperation or competition?

Why would the Russian gas major agree to cooperate in this area, given that the EU Gas Supply Agency sounds explicitly targeted against Russia and would diminish its capacity to "divide and rule" through granting privileges to certain EU Member States and punishing others with discriminatory measures?

That is why, despite the Ukrainian crisis, European leaders should not lose sight of the long-term prospective where Russia, whether we like it or not, will probably stay our neighbour, a UN Security Council permanent member and will still hold a quarter of proven gas reserves.[10] The EU should be tough in adopting sanctions with immediate or very quick effects in order to force the Kremlin to be more constructive in the Ukrainian issue, but it would be foolish to base long-term strategies on the assumption that Russia will remain in isolation forever.

Such a premise would also make the support in the EU for Poland's proposal less likely, as some Member States have very special bilateral relations with Russia and might not accept, even in the context of the Ukrainian crisis, a mechanism overtly hostile to Moscow (at least in the wording) being put into place. Indeed, despite the appearances, it could actually be very beneficial to both sides.

Observing the past fifteen years, one may come to the conclusion that Russia's energy sector has become stronger and stronger with the consolidation of the oil and gas business under state authority, the completion of the Nord Stream and the signing of a historical gas deal with China a few months ago. At the same time, on the EU side, energy dependence has stiffly risen, the shale gas revolution failed to deliver and the Nabucco pipeline project, which was one of the rare "geopolitical" plans of the Commission, has been buried.

This is to omit, however, that the abundance of gas on world markets due to the shale revolution and technical progress in LNG transport, combined with the Commission's activism in investigating Gazprom, have significantly contributed to changing the rules of the game: prices have become lower, the oil indexation formula is losing relevance and abusive provisions such as the destination clause or the take-or-pay system are being excluded from contracts.

[10] Claude Mandil, *Sécurité énergétique et Union Européenne. Propositions pour la présidence francaise*, April 21, 2008.

In Russia, long-term perspectives are under threat because of the lack of capital and technology, reinforced at the moment by economic sanctions on certain Russian banks and the export ban on some equipment useful in the oil and gas industry. In parallel, most gas fields currently under exploitation have been brought on-stream in the 1970s and are now on the decline. Despite promises of "modernisation," the Russian economy is still heavily dependent on raw material exports and dropping revenues may have an adverse effect on the economic and political stability of the country in a not so remote future.

This is not necessarily in the interest of the EU. After all, since Western Europe and the USSR started to trade gas in the 1970s, Moscow has been (most of the time) a very reliable supplier, including after the collapse of the Soviet bloc. This win-win business has ensured the EU relatively low prices – in comparison for example to Asia – and stable deliveries while being at the same time very profitable for Russia. The ten-year negotiation with China shows that diversification in the direction of Asian customers is harder than it looks.

Therefore, in a fast-changing environment, the creation of an EU Gas Supply Agency should not be seen as an instrument to break dependence on Russian supplies. Properly framed, it could be a tool to consider interdependence as a mutually beneficial game: lower and more equal prices for EU Member States in exchange for renewed "security of demand" guarantees which will provide investors with adequate incentives to finance the exploitation of new gas fields and adaptation of transport networks. In other words, engage rather than isolate, in accordance with the general principles of the EU foreign policy.