Contribution of the Clingendael International Energy Programme (CIEP), The Hague, The Netherlands to the consultation process on the Green Paper A European Strategy for Sustainable, Competitive and Secure Energy COM (2006) 105 final

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1. Introduction:

Energy has been rapidly elevated on the national and EU political agenda. Increasing energy prices on world markets, partly due to high political risk premiums on energy, increasing demand in newly emerging economies, under-investments in all parts of the value chain, rising cost of new oil and gas flows, issues with respect to access to resources and markets, and renewed sentiments of energy or resource nationalism have contributed to the intensifying international and European energy debate. Since 2005 a certain degree of willingness among the MS began to develop to achieve closer cooperation on energy policy issues. In the Council meeting of 23/24 March 2006, when discussing the latest Commission green paper[1], they called for an ' Energy Policy for Europe'. However, from the statement of the Austrian chair, it is also clear that the 'Energy Policy for Europe' has to be realised within the confines of the current competencies of the EU. Furthermore, the statement of the Austrian presidency[2] after the Council meeting, stressed that the national sovereignty on key strategic decisions such as the choice of energy mix - including nuclear – would be preserved at the member state (MS) level.

The sovereignty issue over energy has cropped up repeatedly in the history of European integration.[3] Based on the 1994 upstream directive, access to upstream activities in the MS

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[1] A European Strategy for Sustainable, Competitive and Secure Energy COM (2006) 105 final

[2] Presidency Conclusions- 23/24 March 2006; 7775/1/06 REV 1.

[3] Also in the so called 'upstream directive' 94/22/EC, OJ L 164, 30/6/1994, p.0003-0008, the sovereignty of MS issue was addressed. In this directive the sovereignty over hydrocarbon resources on the MS' territories was confirmed and allowed MS to determine their own depletion policy but also

could be denied to third countries or third country nationals on the ground of national security. The national agenda in energy has always been important and based on the statement of the Austrian Chair, this has not much changed. The primary energy mix of the EU MS varies widely and MS also differ widely on what their preferred energy mix is for the power sector. Moreover, also in terms of import dependency there are persistent structural differences among the MS. How can and want the MS to shape their energy policy in the context of the new internal and external challenges?

These challenges are fashioned by the more numerous membership of the EU and the larger variety in approaches, preferences and strategies, by the larger dependence on imports from third countries, by the competition for resources with other consuming countries and regions and by the foreign policy dimensions that shape energy relations today.

2. Issues:

In this contribution, we will first focus on the general expectation and message that the current green paper has raised. The expectations were high due to several reasons: a new sense of urgency to manage the energy agenda as a result of high oil and gas prices, the competition for scarce resources with other consuming countries, among which India and China, the changing geopolitical climate, the upcoming resource nationalism in some producing countries, the instability of the Middle East, a resource rich region, the expected decline in non-OPEC production and the subsequent larger dependence on OPEC, the increasing import dependency of the EU in oil and gas, and more.[4] The 2000 green paper on security of supply and the subsequent conclusions had already unearthed many of the challenges that lay ahead of the MS. Any new green paper after that one would have to answer to the raised expectations of an *integrated approach* on the internal market, security of supply and the environment, and that inconsistencies among these three policy areas and approaches would be tackled. An intense energy debate was suggested to help overcome the MS reluctance to create a common energy framework that would be suitable dressed up with competences. Such a debate would not only involve discussing the internal market design and would have to include a thorough analysis of the value chain of energy, its

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allowed MS to refuse access to and exercise of these rights to any entity which is effectively controlled by third countries or third country nationals, on the grounds of national security.

[4] *Study on Energy Supply and Geopolitics*, final report, January 2004, TREN/C1-06-2002, CIEP; Coby van der Linde, *Energy in a Changing World*, Clingendael Energy papers 11; Femke Hoogeveen and Wilbur Perlot, *Tomorrow's Mores, The International System, Geopolitical Changes and Energy*, CIEP, all available at www.clingendael.nl/ciep/publications.

organisation, the dynamics within and between the various energy resources and the interaction with demand and supply management. With more and more energy imported from third countries[5], energy policy in the MS and the EU would increasingly require an external relations approach with regard to securing non-EU primary energy supplies for the EU. The lack of a consistent external energy policy and the weaknesses still prevalent in the common foreign policy approaches posed an additional challenge to the new green paper.[6] These issues had not become easier to tackle with the 2004 enlargement of the EU, and the entry of eight East European countries that are highly dependent on Russian resources.

With EU oil and gas production in decline and the subsequent growing dependency on energy supplies from third country producers, it requires a different match up or approach of internal and external energy policy.[7] A mere add on of external energy policy to the existing internal energy policy will **not** overcome the inconsistencies but rather reinforce them. Internal EU energy policy has up till now been mainly concerned with facilitating efficient distribution, conversion and sales of energy, which really implies a focus on the mid- and downstream part of the value chain, while upstream policies and more importantly connecting the upstream and downstream parts of the value chain in terms of organisation and regulation were not addressed. Upstream policies were either left to the national MS policies, at the MS' insistence, or left to international market developments, i.e. relying on large international oil companies to supply the market. The international oil companies encounter increasing difficulties to access new reserves and if they can access new reserves, they come at a much higher cost than before. Moreover, from the IEA projections we learn that OECD energy supplies are expected to decline and that resources that can be developed through Foreign Direct Investment (FDI) elsewhere cannot be expected to compensate for this loss. Instead, more and more oil and gas supplies are offered on the international market by national oil/gas companies (NOC's). The latter's assertion of sovereignty over energy resources was one thing, but increasingly they also assert management of the value chain. This is most pertinent in the gas sector. It is therefore important, to review the approach to internal and external energy policies in this new context.

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[5] IEA, World Energy Outlook 2005.

[6] AER/AIV (Dutch Energy Council/Council for International Security Issues), *Energised Foreign Policy*, 2006, www.algemene-energieraad.nl

[7] AER (Dutch Energy Council), *Gas for Tomorrow*, 2005, www.algemene-energieraad.nl

3. **Political message**:

Perhaps the green paper was not intended as a political document, but after the gas crisis between Russia and the Ukraine in the beginning of the year, the green paper became an important political document, particularly with regard to the external energy (gas) relations. Prior to the crisis, the impact of the internal gas market on the interests of third country suppliers had been intensely discussed without much progress. This exchange intensified in the weeks after the crisis. *It is therefore a pity that the Commission chose to present this green paper first and foremost as a paper addressing internal market issues and that this opportunity to reach out to the EU external energy suppliers was missed*.

Reversing the order of the topics presented in the paper, and thus starting off with external energy relations, would already have been an important political signal that the EU takes it external energy relations very serious indeed, despite the importance of the outstanding internal market issues. Third country energy exporters to the EU are concerned about access to the EU market, long term contracting, and regulatory approaches that may befit the EU energy markets but do not necessarily represent the approach nor preferences of the (gas) exporter countries sovereign interests.[8]

That third countries have reason to be worried was underlined by the invitation of the Council, by word of the Presidency Conclusions to: “Developing a strategy for exporting the internal energy market approach to neighbouring countries.” The message that came across was therefore not a message of cooperation and seeking structural win-win solutions for both producer and consumers but rather fed into the suspicion of gas producing countries that only EU interests are pursued.

Third country producers that mainly derive their political and strategic importance from their energy resources seem, at the moment, particularly sensitive to energy policy measures by consumer countries that could thwart their ambition to play a more prominent role in managing the value chain. At the same time, consumer

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[8] Coby van der Linde, Aad Correljé, Jacques de Jong en Christoph Tönjes, *The paradigm change in international natural gas markets and the impact on regulation,* for the WGC2006, www.clingendael.nl/ciep/publications

countries are sensitive to changes in the organisation of the upstream sector that would increase security of supply risks. Their call for more access for FDI is not only based on their believe that competitive conditions throughout the value chain create efficient energy industries, but is also derived from their preference on non-politically attached suppliers. The reality is that the international political and economic system and the rules of the game belonging to that system, are less a given than previously thought.[9] It is not certain that important producer countries, under more uncertain international relations, will soon fully embrace the market as the coordination mechanism, but rather may prefer for the time being a more politically controlled attempt at reforming the economy. The political experience in Russia with liberalisation of the oil sector is, among other things, likely to have resulted in the backlash on market reforms in the energy sector and the wish of the central government to exert greater control. In this sense, the proposed strategic partnerships offer opportunities for dialogue that bridge these different approaches in the coming years.

4. State of the discussion:

The current green paper on energy (A European Strategy for Sustainable, Competitive and Secure Energy COM (2006) 105 final) mainly addresses the same issues raised in a previous green paper, namely Towards a European strategy for the security of energy supply Com (2000) 769 final. To some extent, the 2000 green paper presented a more balanced view on how to manage the trade offs between the internal energy market, the environment and security of supply than the current paper, perhaps because it took a longer term view as opposed to the current green paper in which longer term and short term issues are mixed.

The new green paper does not show how to strike the balance between competition, sustainability and security. This is largely due to the fact that each issue in the 2006 green paper is addressed separately, and insufficient argued attention has been given to the interdependencies that arise from the internal market, environmental policies and external energy relations. For instance, high prices are helpful in energy

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[9] Coby van der Linde, *Energy in a Changing World*, inaugural speech University of Groningen, 22 November 2005, www.clingendael.nl/ciep/publications

saving and the introduction of cleaner fuels, but do not serve the consumers' short term interests; a stable and intense relationship with a large energy supplier, which supplies a large share of the market may help security of supply, but may limit diversity of resources and competition on the market. What we do know is that the internal market approach alone will not secure results in the other policy areas. The market is a coordination mechanism for scarce resources but cannot by itself produce the transition to a larger sustainable fuel base nor generate consistent crisis policy mechanisms or other public goods such as long term security of supply.[10] The large time lag between investment and consumption, the dedicated assets in an energy system and the life of the capital goods creates a different market organisation and development than what can be found in a market for consumer goods.[11] The interaction between the market and government intervention should reflect these dynamics.

EU energy policy must seek for positive trade offs among these policies rather than approaching them from predominantly the competences of the internal market alone. The current green paper does not reflect enough awareness that internal energy policy and external policy-making require a fundamental willingness to weigh the costs and benefits of balancing the policies, to consider adapting policies to the developments in the international markets, to accept that there are more models of competition and that policy-making should also attempt to synchronise with sector developments to let markets develop. On weighing the costs and benefits of policy-making, the past rather unyielding approach to long term contractual arrangements, for instance, for the sake of the consumer, does not concur with the cost of obliging all MS to maintain strategic gas reserves. Other flexible options, such as stimulating dual-firing capacities, are considered for security of supply policies, but are not considered to be part of crisis management policies. The strategic energy review can be helpful in learning more about other MS energy options and mechanisms to deal with market disturbances. However, it should not be used to create a one solution for

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[10] Dieter Helm, *Russian Gas, Ukraine and Europe's Energy Security*, openDemocracy, 20 January 2006.

[11] Dieter Helm, *European Energy Policy: Securing supplies and meeting the challenge of climate change*, New College, Oxford, 25 October 2005.

all approach[12] but as a learning and information tool. The market will greatly benefit from these insights. It all comes down to creating a proper mix of market and government instruments to optimize the balance between the market and public interest issues, such as security of supply, and understanding that the asymmetries in fuel mixes and import dependencies require different local policy mixes. In a recent study by CIEP and Energy Research Centre of the Netherlands (ECN), an attempt was made to quantify security of supply measures in a market environment.[13] Although this approach and discussion is only a beginning in tackling this complex issue, it is clear that a more thorough understanding of the interlocking dependencies within our energy systems, the costs and benefits of various policy options, and the impact at the MS level, will greatly help in finding balanced trade offs.

Seeking positive trade offs and synergies can truly help convince MS that a balanced approach is best left to the Community and that national interests can be enhanced by a Community approach. However, these benefits must be demonstrated by sound and workable proposals and not mere words alone. The outcome of the discussion in the Council, to stress the sovereignty over energy supplies and energy mix is a telling signal that support for a common energy framework is far from accepted.

5. Real debate:

The 2000 green paper also concluded that: "The European Union must take better charge of its energy destiny. We are obliged to acknowledge that, despite the various crises besetting the European economy in the last thirty years, there has been no real debate on the choice of energy resources and even less an energy policy regarding security of supply." (p.3) The current green paper does address the issue of an external energy policy but with respect to the choice of energy resources, the Council, according to the Presidency Conclusions of 23/24 March 2006, has again

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[12] Dieter Helm, *Environmental Audit Committee, Memorandum of Evidence*, New College, 16 November 2005

[13] See *EU Standards for Energy Security of Supply*, Jacques de Jong, Hans Maters (CIEP), Martin Scheepers and Ad Seebregts (ECN), The Hague, Clingendael Institute/ Petten, Energy Research Centre of the Netherlands, CIEP/ECN, June 2006, ECN-C-06-039/CIEP, 68 pp (available at www.clingendael.nl/ciep).

underlined Member State sovereignty over primary energy resources (including nuclear) and the choice of energy mix. The MS wish to keep the right to intervene in the fuel mix, in addition to their right to employ their own depletion policies.

The MS wish to maintain sovereignty over the energy mix without interference of a common energy framework, just as much that they wish to let the market work without such a framework. The consequence of this decision to acknowledge this sovereignty reflects the absence, as referred to in the 2000 green paper, of a real debate on energy market framework. Such a debate is a prerequisite for understanding the current and future dilemmas and to properly enable policy-makers to make the trade offs between the market, security and the environment.

Such a debate should bring forth the proper arguments why and how a common energy framework would work best for the EU and its MS. The emergence of ‘a new energy landscape’, (which is introduced on the basis of a few short and general bullet statements and without referring to the 2000 green paper) must provide the conclusive argument why a common energy framework is the only answer. That appears to be a rather slim argument. Europe owes is to itself to conduct a thorough and real debate on energy market models and energy frameworks. In such a discussion the Commission should demonstrate what the positive trade offs for individual MS of EU policy-making could be and uncover those policy areas where asymmetries in benefits and costs for individual MS lie in order to give an honest account. Only then the long-standing reluctance[14] of MS to give up sovereignty over energy policy matters could be overcome and a transfer of more competency to the Community level will truly be possible.

It is a pity that the ‘new energy landscape’ did not lead to an effort to engage a real energy debate, given the international context and given the asymmetries in structural import dependence among the MS. Issues such as energy and

[14] Rene Lefeber en Coby van der Linde, Europese Integratie vergt Energie(k) beleid, in: *SEW (6) juni 1987* en nawoord*, in : SEW 7/8, juli/augustus 1987*; Coby van der Linde and Rene Lefeber, International Energy Agency Captures the development of European Community Law, in *Journal of World Trade*, vol. 22. no. 5, October 1988.

competition, the impact of buyer's and seller's markets on the robustness of the EU market model, competition for external energy resources, the trade offs between environment, security and the market, which crisis management policies, what is needed in an external energy policy deserve such a debate.

6. **Convergence or divergence:**

The reluctance of the MS to transfer their competency in energy matters fully to the EU level is understandable against the background of the important role that governments play in facilitating trade in energy. It is an illusion to think that the market can fully replace the role of the government in energy, as much as it is an illusion that government alone can operate the energy sector. The energy sectors are a typical example of a sector where government and markets meet continuously, for instance to issue permits for pipelines, generation capacity, LNG terminals, influence the energy mix and negotiate complex gas trade deals with governments and companies from third countries. The market and government do not have strictly defined spheres of operation but rather function in a dynamic relationship, where market is introduced where government used to rule and *vice versa*, depending on the prevailing political and economic conditions. The boundaries are therefore unclear and need to be confirmed or adjusted continuously, while at the same maintaining a stable and predictable investment climate.

The EU market model is not yet set in stone. Policy-makers, politicians, regulators, academics, companies and other organisations differ in what they see as the preferred market structure or market model and the way in which security of supply and environmental policies and the costs they incur, should fit into this framework. More importantly, MS are still uncertain how the framework will deal with the asymmetric security off supply risks and different energy mix preferences.

The differences of opinion are strengthened by the different national interpretations of the directives on national market models. Among the MS and other stakeholders, the preferences vary between those that are proponents of de-integration of the value chain and those that favour more integration of the value chain, and they vary between those that prefer a national champion and those that do not. Very often in the EU debate, those that are proponents of a certain level of integration of the value chain are denounced as being anti-competitive, thus denying the merits of models of competition in which for instance vertically integrated firms compete for markets. The level of integration or de-integration (or unbundling) can be particularly important with a view on efficiency and reliability of the European energy sector. Particularly with regard to the dependency on foreign supplies in markets that are very concentrated and/or suffer from resource nationalism, a certain degree of purchasing power on the part of companies can help secure flows for the European market. Such a model, with larger companies competing for resources and markets, is possible within the rules and regulations of the EU. It is clear that some MS prefer this model over a market structure that is more atomised.

The discussion about the preferred organisation structure of the market also reflects the desire to capture both short term and long term benefits in an industry that has typically longer term cycles. The outcome of this struggle also impacts on the way the external energy relations are conducted because of the apparent attempt to move the long term costs on to third countries. Both consumer and producer countries are engaging in rent-seeking behaviour. The producer countries are aware of this process to offload the long term costs of security of supply on them and respond with strategies that secure their return on investment in production and transportation. Forward vertical integration and producer co-operation become options in the face of developments in consumer markets that appear to make the costs and benefits of the energy trade become unbalanced.

Denouncing the proponents of a certain level of integration of the value chain in gas and power markets as anti-competitive or as supporting the incumbents' interests is not very helpful in a debate about which market structure or model would help to optimise the trade off between the priorities of energy policy (price, security and environment). Rather, by effectively only accepting a discussion as valid as long as they address the unbundling of the value chain, or reduces the market position of incumbent companies, makes policy-makers and certain stakeholders blind for other, perhaps more political astute, solutions. In the words of the Commission/SG/HR for the Council: " External energy relations cannot be separated artificially from the wider question of what sort of energy policy the EU and its Member States want." However, we cannot expect third countries to wait indefinitely for this discussion to produce a result and in the meantime not pursue their own interests. The EU has shown a certain insensitivity to neighbouring third country protests that they wish to maintain sovereignty over production, the fuel mix and their external relations too. Rather than seeking agreements on how best to link up two different regulatory models and helping further external energy relations, the EU has persisted in promoting the dominance of its model over the models chosen in other jurisdictions. In the words of the Commission/SG/HR for the Council: " This could be achieved (well-functioning world markets, author) by the EU extending its own energy market to include its neighbours within a common regulatory area with shared trade, transit and environmental rules. More widely, the EU should advocate reciprocity in market opening and respect for market rules: non discrimination, competition, transparency and enforcement." The point is not that this goal is wrong, but that producer countries, among which Russia, cannot be satisfied in their desire to receive a proper long term return on their investments. The investment efforts of producing countries to guarantee future supplies are enormous and must be realised within the constraint of majority ownership to the producer state. Because many of the producer countries, including Russia, have many other sectors of society competing for investments, the concern is understandable from the perspective of their national interest.

The sort of regulatory power play that the EU wishes to engage in could of course bring a desired result, but it is a risky strategy, particularly when we have to conclude that the sellers' market has strengthened the producer countries in their resolve to manage their part of the value chain.

The green paper and the documents and statements following the green paper show some sensitivity to this jurisdictional dilemma but the construction of the EU itself and the political position of the MS prevent resolving this issue. The strategic partnership has not yet been showered with content.

7. **Oil and gas value chains**:

The point of departure in creating the internal energy market has been the gas and electricity end-consumer market as it was organised in most MS by *local public distribution companies*. Taking the relatively small public distribution companies as a point of departure for regulation of, in particular, the gas value chain (as far as that chain falls under the jurisdiction of the EU; i.e. foreign production and sovereignty over production and depletion policies in MS) is a completely different approach than the one prevalent in other fossil fuel markets.

The oil value chain is largely self-regulating. Risks, investments and competition are managed through international vertical and horizontal integration, and mergers and take-overs along the value chain. Why gas is not treated like the other fossil fuels, particularly as international oil companies perceive gas also as their core business and develop business models based on their experience in the oil industry, is increasingly hard to understand against the background of the development in the international gas market. The differences between the power sector and the gas sector are also interesting from a market organisation point of view.

Electricity production is relatively local to the market it wants to serve and can take gas, oil, nuclear, bio-fuels and coal as an input. Some plants have dual-firing capacities. The markets for input fuels, except for gas, are largely self-regulated or at least are not part of the internal energy market regime. The inputs can compete for access to the power market. This competition depends on the price, CO_2-emissions, investment cost and output flexibility, depending on which market segment the plant wants to serve. Electricity networks were and still are mainly a national affair, with few interconnections. These interconnections are and need to be enlarged to allow electricity to be traded across Member State borders and increase efficiency. Other differences that warrant a special regulatory treatment of electricity are: electricity cannot be stored and therefore requires a different value chain management and electricity cannot be transported over long distances as compared to primary fuels. The 'revolution' in the organisation of the electricity sector in the past 30 years is that local, sometimes city specific, companies were linked in larger national networks, and are now increasingly integrated in cross border networks to capture economies of scale and scope. TPA helped to connect consumers to markets for power production outside the local and increasingly national network. In this case, taking the end-consumer as a point of departure increased efficiency.

Gas is increasingly produced outside the EU and the value chain of gas shows many similarities with the oil value chain, albeit with oil markets being further down the evolutionary road. Gas has recently been developing, because of the growing importance of LNG, into an international market for gas. Prices will increasingly be determined in the international market. At the current prices, LNG from any source can be delivered almost anywhere in the world, although producers will remain sensitive to the length and cost of the trading route. This sensitivity exists because the cost of setting up an LNG train is still high compared to oil tanker trading. The flexibility of oil trading is partly due to the availability of oil tankers and existing wide spread capacity for oil processing. Any tanker can be diverted to any market to fetch a higher price.

In the oil sector, the value chain is to a large extent part of vertically integrated companies that explore, produce, transport, process and distribute oil products in many countries around the world and thus also manage their risks in the oil value chain. The international oil sector is considered competitive and rightly no intentions in the EU exist that wish to separate oil production and export transportation from processing. Crude oil is traded before and after processing, and refineries can be built without asking for exemptions to the Commission, at the risk of the investor. Furthermore, the international oil companies are considered important market participants that help secure flows of oil to the EU market and that have become experts in dealing with oil market related risks. As a matter of fact, access to reserves (for these companies) is a main issue in external energy relations in order to support the efforts of the international oil companies.

Compared with oil, gas is still a relatively young international market and LNG a youthful offspring. Gas transport used to be very inflexible and depended largely on pipeline routes from gas fields to regional markets. Only recently, LNG has added to the flexibility of sources with the possibility to transport gas overseas at a competitive price. However, LNG terminal capacities are only developing. In the future, when more shipping and terminal capacities are available around the world, trading before and after the terminal can materialise on a wider scale than currently possible. *The question is how these capacities are best allowed to materialise, through the international market or through regulation?* Currently, the European Commission treats for instance LNG terminals as part of the pipeline network on which a TPA regime rests (like electricity). Already the Commission had to acknowledge (for political and economic reasons) that export pipelines and terminals could best be exempted from TPA in order to attract investors in these capital intense projects. The fact that they opted to continue the exemption policy and not for a general ruling that any investor who wants to build a terminal and could get a permit from the local planning commission, could build one, shows that government and Commission wish to keep their options open for management of the market for LNG terminals. Apart from the question whether they are equipped to sufficiently synchronize their decisions with international gas market developments, exemptions can also make the governments and Commission susceptible to lobbying for specific stakeholder interests.

The green paper could, on this relatively small issue, have shown its intentions to create a positive investment climate and, like the US authorities in their Hackberry decision, could have announced that TPA is not applicable to LNG terminals. Moreover, such a signal would have been important for public and private foreign stakeholders too and could have taken away some of the concerns of third country exporting countries on access to the EU market.

8. Paradigm Change:

The concept of the internal market has been designed in an energy buyers market, which by hindsight created favourable conditions for the structural changes envisaged. At the time, in oil and gas, the domestic production levels were substantial and in electricity production spare capacity was available. In such circumstances, it is easy to imagine that with ample supplies available, removing barriers to trade and with competition in and between MS, the energy industries could become more efficient. However, ample supplies are a precondition for competition in the mid- and downstream to materialise to produce the price levels for consumers that reflect the efficiency gains. It is in this context that a wish to break up long term contracts and destination clauses arise, because consumers do not have to pay for long term security of delivery and supply nor for the investment risks. In a seller's market however, particularly when at the same time domestic supplies are declining, ample supplies are no longer available and competition for scarce resources can actually produce higher prices when security and investments become priced in again. An important precondition for the internal market, as it was politically imagined, is now missing. The gas market, like oil, has also changed into a seller's market, and gas producing countries seem careful to avoid investing in speculative export capacities. Competition has now moved from the mid- and downstream part of the value chain to the upstream part of the value chain and has changed from competition for consumers to competition to secure enough supplies to the market. It is in such a market that the conditions that suppliers wish to attach to their deliveries become important again, particularly when certain consuming parties are keen to secure long term supplies and it is harder to play producers off against each other.

Ownership of reserves is significant too because national depletion policies, investments and demand and supply developments do not necessary match the needs of the EU market. Most of the oil and gas reserves in the world are preserved for development by national oil/gas companies and only about a third is available for foreign direct investments. The current debate between the EU and its external suppliers is a debate over who can capture the economic rents, where end-user taxes compete for the consumers' wallet with premiums on prices. In a buyers market, it is usually the consuming countries that capture these rents (through taxes and excises/duties and the benefit of low prices) and in a seller's market it is usually the producer country that can capture a large share of these rents.

The producer countries have no interest in creating over-supply, which is very costly, and therefore wish to assure market access for their product, security of demand, either through long term contracts or the ability to vertically integrate into the consumer market. Due to the (partial) state ownership of many producer country oil and gas companies and the idea that foreign governments will use their ownership to further the national interests runs counter to the idea of open markets with a level playing field.[15] The resistance to mergers and takeovers by (partly) state-owned companies can be explained from the fear for foreign political pressure. The paper of the Commission/SG/HR for the European Council phrases their fears as follows: "Increasing dependence on imports from unstable regions and suppliers presents a serious risk. Some major producers and consumers have been using energy as political lever. Other risks include the effects on the EU internal market of external actors not playing by the same market rules nor being subject to the same competitive pressures domestically." Although not mentioned, this section summarises the discussion about Russia after the gas crisis at the beginning of 2006. Yet, the green paper, at the same time, calls for a strategic partnership with Russia. With so much distrust present in the EU administration, one must fear for the outcome of the discussions on the new Partnership and Cooperation Agreement.

From this perspective, long term gas contracts between upstream suppliers and mid- and downstream companies in the EU, endorsed by the Member State governments, where price and volume risks are shared, all over a sudden could become an attractive alternative to the potential political arm wrestling between the EU and Russia.

It is unfortunate that the 2006 green paper avoids discussing the changing energy landscape and the consequences for the functioning of the internal market. A document that would have addressed the paradigm change more thoroughly could have made a more serious step towards outlining a strategy to secure supplies for the European market in these new circumstances. By not clarifying these issues, it may have convinced MS to hang on to their competencies in energy. Moreover, the external energy relations in the near abroad of the EU seem to be dominated by the idea that exporting the internal market rules to jurisdictions outside the EU, regardless of their phase of development and preferences for their national energy industries, will solve that what is not solved within the EU.

[15] An external policy to serve Europe's energy interests, paper from Commission/SG/HR for the European Council, 2 June 2006.

9. The boundaries of the EU and external relations

Energy policy making increasingly includes foreign policy issues. A strategic partnership with Russia cannot be considered without firm ideas about the foreign policy approach to the Caspian Sea region, the Caucasus, Belarus and the Ukraine. Also the discussions with Turkey about EU membership, however far away from consumption, also influence the foreign policy approach to Russia. Moreover, the issue of where the EU begins and where it's membership will end are at the root of any successful partnership with Russia. Europe must be able to define and present itself to any potential partner. And again competency plays a role too.

In the paper from the Commission/SG/HR for the European Council of 2 June 2006, the legitimate rights of MS to pursue their own external relations for securing security of energy supplies, in addition to their rights over supplies and the energy mix, is confirmed. This greatly limits the possibilities to come up with a common energy structure in which solid external energy relations can be embedded and that goes beyond voluntary and, sometimes, menu driven co-operation. Large MS will consider their external energy policy as part of their foreign and security policy, and prefer different outcomes from MS that pursue only an external energy policy. In this respect larger MS are no different from the US, China and Russia. The different approaches with respect to Russia by various MS are telling in this regard; some wish to secure their energy and other political and economic interests by strong bilateral ties, while others are indifferent because they rely less on these relations.

Since the 1990s, foreign relations on the post-Cold war European continent have exhibited rather digital characteristics, a country is a potential Member State or not. This digital approach to relations on the continent have replaced the more diverse relations among European countries in the period prior to 1990, when free trade agreements and other types of relationships tailored foreign relations. Apart from the internal difficulties that enlargement has brought the EU (institutional and support), the fact that the (politically inspired) enlargement strategy was not sufficiently backed up with a strategy for relations with important non-potential MS now haunts policy-makers, particularly when those countries are important energy resource holders.[16]

Moreover, the EU has attempted to export its *acquis communautaire* in energy matters to these same non-potential MS without showing the positive trade offs, both in energy and in the wider political and economic relations, to those third countries. Rather, the only reasoning seemed to have been the positive trade off for the EU that increasingly realised that they did not have jurisdiction over the upstream part of the value chain. This attitude of the EU has fed the idea in potential partner countries that strategic partnerships with the EU serve only the interests of the EU and are not based on equality or win-wins for both sides of the partnership. It is no wonder that in his summary of the G8 Summit Putin refers to the interests of the producers to share risk in the face of the huge investment requirements: " We also stressed the need for better risks sharing between all stakeholders in the energy supply chain through economically sound diversification between different types of contracts, including market-based long term and spot contracts, timely decision-making and appropriate adherence and enforcement of contractual agreements."

The green paper stresses that the regular talks with various producer groups, such as OPEC, should be continued. They should be seen as important instruments to create trust among producers and consumers. The Commission is right in stressing the importance of these relations. However, at some point, discussion partners of the EU expect to talk with mandated delegations and it is in its mandate that the EU's external energy relations are weak. In a world where the economy can talk, the construction of the EU is strong, in a more politicised world, the construction of the EU, which is not a state, become a weakness. Together with the undefined borders of the EU, the construction of the EU itself is the main hindrance to external energy relations. Recently, a discussion about solidarity and reciprocity has erupted in the EU with regard to the contracts with Gazprom to swap upstream and downstream assets and jointly built new pipeline capacity (NGEP and possibly Blue Stream II). Member States need to facilitate business-to-business contracts by using their

[16] Coby van der Linde, *Energy in a Changing World*, Inaugural lecture 22 November 2005, Clingendael Energy Papers no. 11 at www.clingendael.nl/ciep/publications

government-to-government relations, thus assisting companies active in their market. These agreements are a signal that MS, when their long term gas supply is concerned, are pursuing their own strategies and are either not (any longer) waiting for EU external energy policies to emerge or influence the outcome of this process by setting their own 'fait accompli'.

10. Concluding remarks:

The green paper offers many opportunities for balancing internal and external energy policy. The strategic energy review is such an opportunity to learn and uncover information about the diverse energy economies of the MS and their asymmetric import dependencies. It will allow bottom up approaches to emerge and it will help to prevent a one solution for many problems approach to come about. Yet, a lot of work still needs to be done to provide a sound foundation for a consistent EU energy policy framework to come about.

Markets alone cannot provide the MS with security of supply nor with a more sustainable energy mix. The uncertainty about the energy policy framework and the way it will help to connect third country supplies with EU downstream activities is growing. The IEA stresses the large need for both upstream and downstream investments. These investments will not sufficiently come about in an environment of political and regulatory framework uncertainty. External energy policy-making should help overcome the barriers between energy jurisdictions and not raise new ones. Sharing risks and benefits from interdependent energy relations seem a reasonable point of departure for building stronger relations, while at the same time, also display patience with the speed at which economic reforms in producer countries can and will be implemented.

The green paper is in many ways an announcement that energy will be featuring on many future agenda's because building an energy framework that promotes the market, secures supplies and reduces the carbon content is not something that can be created overnight. A more profound discussion on what exactly the energy framework is supposed to deliver is a precondition to enable the appropriate use of competition and foreign policy instruments.