How to Beat Goliath

An EU Energy Union to Fight Russia’s Gas Monopoly

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In April, former Polish Prime Minister Donald Tusk published an article in the Financial Times, urging Europe to create an energy union to safeguard against possible energy blackmail by Russia. Reminding readers of disputes in 2006 and 2009 between Moscow and Kiev over gas prices that led to temporary shortages and sharp increases in prices in Europe, Tusk argued that “a dominant supplier has the power to raise prices and reduce supply.” He continued that “the way to correct this market distortion is simple. Europe should confront Russia’s monopolistic position with a single European body charged with buying its gas.”

Tusk, who is currently president of the European Council, puts forth a much-needed common energy policy, but his proposal would be difficult to implement for a number of reasons. For one, an energy union would initiate a diplomatic energy battle between Poland and Germany, whose energy policy, Energiewende, remains inextricably linked to a direct supply of Russian gas. Second, Tusk’s proposed structure abandons many of the ideas that provided a framework for considering an EU energy union in 2007 and 2008, such as lowering carbon emissions and diversifying energy suppliers. Finally, gas is much more complex than other natural resources, such as uranium, that Europe has previously tried to collectively manage.

UNEQUAL LEVERAGE

Russia supplies more than one-third of Europe’s oil, and slightly less than 30 percent of its gas, but some countries rely more heavily than others on Russian sources. The Baltic states such as Estonia, Latvia, and Lithuania, for example, as well as Bulgaria, Finland, and Slovakia depend on Russia for all of their gas consumption. Greece and the Czech Republic import 70 percent of their gas from Russia, whereas Austria, Germany, and Poland depend on Russian gas for just under half of their annual consumption. Belgium and the Netherlands import only five percent of their gas from Russia, and Cyprus, Denmark, and Sweden import no gas from Russia at all.

As a result, Russia can dictate prices to overly-dependent countries such as Latvia and Lithuania, knowing that they have no alternative (though they may be less reliant now since Lithuania opened a liquified
natural gas terminal in Klaipeda earlier this month with enough storage capacity for its Baltic neighbors). But Germany or Austria could turn to other suppliers if Russia imposed unreasonable prices. In 2012, for example, Gazprom—Russia’s largest natural gas supplier and one of the largest gas companies in the world—charged Germany 15 percent less than Lithuania. As Gunther Oettinger, vice president of the European Commission for Energy, observed [4], “The greater the monopoly of Gazprom in individual countries, the higher the price it can charge.”

For its part, Germany is able to negotiate favorable long-term contracts with Russia for its gas supplies. Several large German companies such as Wintershall and E.ON Ruhrgas have secured access to Russia’s natural gas reserves and a dedicated pipeline, Nord Stream, delivers gas from Russia directly to Germany via the Baltic Sea. Given these convenient arrangements, Germany is in no hurry to support a hard-nosed campaign for EU energy security against Russia.

Other large, state-owned companies in Germany’s energy sector also regard Tusk’s proposal with ambivalence, even though a union might work to their benefit since a large European gas purchaser would allow it and the rest of Europe to secure supplies at lower prices. As long as their close relationship with Russian suppliers continues, these big gas companies will resist all proposals to open the market to further competition.

NEIGHBORLY SPATS

Inside the EU, Germany and Poland also clash when it comes to their national energy policies. Through its policy of Energiewende, which was officially introduced in 2000 after a 30-year period of debate and discussion about environmental sustainability, Germany sought to tackle global warming. Since then, Germany has tried to reduce its CO₂ emissions and, between 2005 and 2010, successfully did so at a rate of one percent a year. (Unfortunately, however, CO₂ emissions appear to have increased every year since then by the same percentage.) Germany also tried to limit its dependence on coal and increase the share of electricity produced by renewable sources from 16.4 percent of its total consumption in 2010 to almost 25 percent in 2013.

With its deep-rooted distrust of Russia, Poland relies heavily on coal—a natural resource that it can harvest from its own mines—as its primary source of energy: around 54 percent [5] of total consumption. Consequently, Poland’s imports of Russian gas amount to less than one-fourth of Germany’s.

Given its reliance on coal, Poland actively resists overtures from the EU to further reduce carbon emissions. Unlike other EU countries, especially Germany, where sustainability and diversifying resources dominate discussions about energy policy, Poland focuses on energy security. The country relies on outdated energy infrastructure, particularly in the production, transmission, and distribution of electricity. Not only are Polish power plants inefficient, they also lack the capabilities required to meet the EU’s strict emissions rules. Over the next three years, Poland will have to close its most inefficient power units, abandoning 6,000 megawatts of output or almost 20 percent of the country’s installed capacity.

Not surprisingly, as the EU makes the transition to more sustainable fuel sources, Poland’s representatives
in the European Parliament have consistently voted against the European Commission’s energy plans. They have often stood alone in their opposition. Now, as the transition to a low-carbon energy environment is becoming inevitable in Europe and throughout the industrialized world, Poland faces a prolonged and extremely expensive challenge to wean itself from its dependence on coal. That is why Tusk is advocating for Europe to take full advantage of available fossil fuels like coal. He reasons: “We need to fight for a cleaner planet, but we must have safe access to energy resources and jobs to finance it.”

Even if Tusk’s proposal furthers the energy-related interests of his own country, he is right that Europe cannot pursue sustainability without considering its economic impact. As mentioned earlier, Germany’s earlier efforts to reduce carbon emissions have been undone in the last five years. Further, Germany derived 45.5 percent of its energy requirements last year from coal, the highest level since 2007. It also lost nuclear sources of energy when, in reaction to Japan’s Fukushima nuclear disaster in March 2011, the German government closed eight of the country’s nuclear power plants. It plans to close the remaining 17 by 2022. As a consequence, electricity from German nuclear plants has fallen to 15.4 percent of total consumption from 22.5 percent in 2010.

Even though Germany has increased its use of renewable sources to generate electricity, wind and solar power are unstable generators that increase the risk of blackouts. Volatility in production from renewable sources can be offset with coal and gas, but gas has grown too expensive in relation to the price of electricity produced. Although gas generates about half the emissions of coal, producers cannot afford to rely on it without substantial subsidies. Using coal, energy companies in Germany earn approximately €5 ($6.3) per megawatt hour and lose €17 ($21) per megawatt hour producing electricity from gas. While the share of German electricity generated from renewable sources is approaching 25 percent, the remaining 75 percent is environmentally burdensome, and the uncertainty of supply combined with the intention of shutting down its nuclear power sources will further increase Germany’s reliance on coal in its electricity production.

OVERTURNING TABLES

In addition to addressing energy security and economic stability throughout Europe, Tusk’s proposal also presents a barely disguised counterattack on Europe’s current energy and environmental goals for this year and 2030.

As it currently stands, EU energy policy is based on a 2006 green paper [6] that lays out a strategy for creating sustainable, competitive, and secure energy by promoting renewable energy sources, building an internal energy market, and fostering energy solidarity among member countries. In 2007, the EU passed legislation that incorporated many elements of the green paper.

While the EU recognizes that overreliance on Russia as a supplier of natural gas is one of its biggest energy concerns, its policies to reduce this vulnerability have contributed to Europe’s lag in industrial competitiveness and failed to bring down high energy prices.

To reduce Russian gas dependence, in 2008, the European Commission adopted measures to reinforce its
relationships with supplier nations, enhance the security of transit channels, and accelerate development of energy-related infrastructure, especially pipelines. The effectiveness of this plan depends on the level of solidarity among EU member states and their acceptance of diverse sources and suppliers of energy, especially natural gas. To this end, EU policy has focused on interconnection with Baltic states; construction of a southern corridor to transport gas from the Caspian Sea and the Middle East; construction of liquid natural gas terminals to reduce reliance on gas shipments to Mediterranean ports from Iran, the Middle East, and sub-Saharan Africa; and a unified network from north to south for the transmission of electricity and gas. Meanwhile, advances in technology now permit the shipment of liquid natural gas over large distances, which gives the EU access to natural gas supplies from Australia and the United States.

Although these measures may provide a possible solution to the EU’s energy concerns, they have no immediate impact on energy prices, which remain much higher in Europe than in other parts of the world. Industrial and household consumers pay twice as much for electricity in the EU, for example, as they do in the United States, and the price of natural gas is three to four times higher in the EU than it is in the United States or Russia. Among other things, these costs put the EU at a considerable comparative disadvantage in attracting investors in energy-dependent industries. The high prices of European energy reflect not only Europe’s dependence on offshore energy supplies from Algeria, Nigeria, Norway, Qatar, and Russia, but also the EU’s ambitious and binding commitments regarding energy efficiency and fighting climate change.

In this sense, the economic logic of Tusk’s proposal for a common European gas purchaser is simple: One large customer can negotiate much better terms with a supplier than dozens of small customers on their own. A single entity formed under an energy union would balance the scales against Gazprom, allowing the two sides to negotiate on equal footing. Once this occurs, Europe could begin to break the Russian monopoly on gas supplies and open its energy marketplace to free competition.

But the implementation of his proposal is much more complicated. Tusk compares his energy union with the European Atomic Energy Community (Euratom), an organization which acts on behalf of all EU nations in purchasing uranium for European nuclear power plants, assists in negotiations with suppliers, and ensures that customers have equal access to supplies while adhering to the principles of energy security. However, centralized purchasing of natural gas is much more difficult. Unlike uranium, quantifying future demand for gas requires much more complex calculations, and the security of regular supply in an open marketplace depends on much greater market flexibility.

These inherent difficulties in creating an energy union are not grounds for dismissing Tusk’s proposal. But a central purchasing mechanism, operating under the supervision of the European Commission, can only succeed under three conditions. For one, the mechanism must not replace but work in conjunction with free-market trading at virtual gas hubs. Second, the mechanism must negotiate only long-term contracts, which would inject some transparency into the highly secretive process of drafting gas contracts; Gazprom often inserts secret clauses into its contracts with customers like Germany that sign onto 25-year-long deals. Third, the mechanism should not prevent private European companies from competing for market share, nor should it jeopardize free access to the market by only granting access to...
large energy suppliers.

ONE PRICE FOR ALL

On a visit to Poland earlier this year, Gunther Oettinger, the EU's commissioner for energy, showed his support for the creation of an energy union. “We want a uniform gas price in the European common market,” Oettinger said after his meeting with Tusk. Acknowledging that EU member states currently buy Russian gas on the basis of bilateral contracts with Moscow and pay different prices, Oettinger said common purchases would improve the EU's negotiating power, cut the price, and prevent Russia from using gas prices to further its political objectives. “The game of ‘divide et impera’ [divide and rule] by Moscow cannot be and will not be accepted by EU member states,” he said.

Furthermore, although the EU accounts for 80 percent of Russia's total gas exports, and Russia depends on oil and gas to generate about half of its total budgetary revenue, it could still use oil and gas as a political weapon if, in the future, it is able to secure alternative markets for its resources in China, Japan, and Korea, and increases its ability to transport gas by ship.

Tusk's proposal would also promote faster interconnection of the European gas market and promote greater cooperation among EU nations. It may also provide more leverage when it comes to greater transparency in enforcement of energy-related deals between Russia and Ukraine. The EU must take a firm stand in enforcing the responsibility of Russia to comply with its contract to deliver gas to Ukraine, a responsibility that Putin seems to have deliberately neglected over the last six months. Further, Russia must not use its bilateral dispute with Ukraine as an excuse to disrupt gas delivery to Europe.

A formalized energy union, while challenging, is possible. Europe has reached similar agreements in areas such as nuclear fuel supply and banking policies, despite initial concerns that such arrangements would be impossible. If nothing else, Tusk's proposal succeeds in drawing attention to one of Europe's most serious strategic problems: Russian gas dominance. And it could not have come at a better time.