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## Turning a Weakness into a Strength

A smart external energy policy for Europe

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**Coby van der Linde**  
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IFRI  
27 RUE DE LA PROCESSION  
75740 PARIS CEDEX 15 - FRANCE  
TÉL. : 33 (0)1 40 61 60 00 - FAX: 33 (0)1 40 61 60 60  
Email: [ifri@ifri.org](mailto:ifri@ifri.org)

IFRI-BRUXELLES  
RUE MARIE-THÉRÈSE, 21  
1000 - BRUXELLES, BELGIQUE  
TÉL. : 00 + (32) 2 238 51 10  
Email: [info.bruxelles@ifri.org](mailto:info.bruxelles@ifri.org)

SITE INTERNET : [www.ifri.org](http://www.ifri.org)

# Contents

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<b>EXECUTIVE SUMMARY .....</b>	<b>2</b>
<b>TURNING A WEAKNESS INTO A STRENGTH: A SMART EXTERNAL ENERGY POLICY FOR EUROPE .....</b>	<b>7</b>
<b>Introduction .....</b>	<b>7</b>
<i>A new agenda.....</i>	<i>8</i>
<i>Long term and short term goals.....</i>	<i>11</i>
<b>A Changing International context .....</b>	<b>13</b>
<i>Changes in the EU.....</i>	<i>13</i>
<i>Changing Energy Market Circumstances.....</i>	<i>14</i>
<i>A new international order?.....</i>	<i>16</i>
<i>Do US interests run parallel to the EU's? .....</i>	<i>19</i>
<i>Impact of the collapse of the Soviet Union .....</i>	<i>21</i>
<i>Influences of Diversity on the discussion .....</i>	<i>23</i>
<i>Can the EU afford to sit on the geopolitical fence? .....</i>	<i>25</i>
<b>Strategic foreign energy policy instruments .....</b>	<b>27</b>
<i>Is the current external energy toolset still sufficient?.....</i>	<i>29</i>
<i>Preconditions for an external energy policy .....</i>	<i>30</i>
<i>Prevention instruments.....</i>	<i>35</i>
<i>Deterrence .....</i>	<i>39</i>
<i>Containment .....</i>	<i>41</i>
<b>Smart external energy diplomacy .....</b>	<b>41</b>
<b>Conclusion .....</b>	<b>42</b>

## Executive Summary

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Energy policy objectives and the suitability of traditional instruments to achieve them are currently under review. The main goals are to improve the balance among the three priorities of energy policy-making, to make a transition to both a more sustainable energy mix and, at the same time, improve the security of that mix during the transition to it. Notice that the EU energy policy does not cover the full set of energy policy instruments, particularly those in the security of supply. Correspondingly, the EU toolset does not compare to the range of instruments available to the member states, yet these national instruments have lost effectiveness as a result of the closer integration of energy markets in Europe. At a minimum, the EU and the member states should acknowledge these gaps and the divergent abilities of the individual member states in order to overcome these policy gaps.

Given the confessed urgency of the energy and climate agenda, the EU policy efforts, as proposed in the 20-20-20 programme, demonstrate that the transition to a more sustainable energy mix is an important long-term goal, which combines climate change and certain long-term security of supply policy dimensions. However, this is a policy that will only produce result in the longer term. In EU external energy policy-making, an alternative should be found to coercing reluctant member states into accepting the usually top down, generic approach of the EU and into giving up competencies that serve national interests. This pragmatic route to policy-making could be to explore a path that turns EU weaknesses in the foreign and energy policy sphere into strengths by the smart use of diversity, asymmetry and subsidiarity in a bottom up, more tailor-made approach. Remember, the EU has extensive experience in building coherence by using harmonization, coordination and only then unification. This approach is known as the economist approach to integration.

Only in recent years, after the economic and monetary union and enlargement processes required a more expedient procedure for political and strategic reasons, did the monetary or big bang approach to policy-making make its appearance in European Union policy-making. The question is if the big bang approach is suitable for

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*Coby van der Linde is the director of the Clingendael International Energy Programme since September 2001.*

breaching the national resistance to unification of foreign and security policies, and in effect evolving beyond *the economic project* Europe has always been. Perhaps the more evolutionary approach, and allowing member states to find their own efficient and appropriate solutions for (mostly localised) security of supply issues, is the best tactic that at a minimum keeps the momentum going and allows for a search for cost efficient solutions. Different energy mixes and asymmetric exposure to disruption risks might require different policies rather than just one.

The changes that took place in the international energy markets around the turn of the 21<sup>st</sup> century did, however, impact the ability of the European market to deal with these changes. The confidence that market principles would be the guide to balancing supply and demand was challenged when it became clear that producer governments began to actively manage the energy value chain. Furthermore, the preoccupation with internal market discussions and the environment overlooked both legitimate producer country concerns about security of demand as a result of the EU market design, and the impact of climate change policies on their main source of income. The changes in the international energy markets and the renewed importance of the *modus operandi* of politics as opposed to economics in energy diplomacy, have in a sense led to a more prominent role for nation states within the EU, because the EU is not a state. This complicates the development of an EU external energy policy.

In the new make-up of the world's economic and political systems, *energy is both an economic good, a strategic good, and a geopolitical power tool*. Producing countries are aware of their position and are, more than ever before, in a position to generate maximum political and economic benefits for their own states and economies from energy. This awareness of the properties of oil and gas as an economic and strategic good and geopolitical power tool implies that investment and production levels will be maximised to first serve the interests of the producer state(s) and their state companies, not automatically for the good of the world economy.

The main energy concern of the US is not so much energy dependency, but first and foremost its dependency on oil imports, now euphemistically called liquid energy in order to include biofuels. The member states are comfortable with the arrangements in the International Energy Agency on oil security and the crisis mechanism, due to the continued limited political and strategic role of the EU in securing oil flows. The coalition on oil crisis management has been a great benefit for European countries and at a relatively low cost could benefit from the US foreign policy efforts to guarantee oil flows. Although the benefits of the International Energy Agency (IEA) go undisputed, the policy of the US in Iraq created unease among European and Asian countries.

The energy security debate in the EU has focussed mainly on the flow of natural gas, the limits to diversification (due to the regional context of the market and the inflexibility of pipeline routes), and the supply and transportation monopolies of state gas companies (Russia, Algeria).

In the 1990s, Russia became an important energy supplier for the EU member states. The Eastern European countries had been the traditional importers of Russian energy, but increasingly Western European countries also imported their oil, gas, coal and electricity. Most of these imports had to flow through infrastructural corridors that were constructed to serve the Comecon countries' energy needs and the gas export contracts. This led to immediate worries about security of transit. From an overall EU perspective, diversification of routes, even if it involves one supplier, will reduce the risk of supply disruption. The commitment of a supplier to supply a market also increases when large investments have been made to reach that market. Valuation of this interdependency has not always reached the awareness of the European public, leading to a discussion focussed on conflicting interests and not on the obvious shared interests that can balance the relationship between the EU and Russia.

The emphasis on economic issues in Europe, exemplified by the deepening of integration and enlargement, has sidetracked the discussion at the EU level from geopolitical issues and the strategy to defend security interests. European leaders have failed to properly communicate the implications of the changing international context and the role they want to claim for Europe, while public support is a crucial underpinning for any stepped up international engagement other than trade and investment. The instrumentation of foreign and security policy has become limited as a result, and any different level of engagement would require an investment in building public awareness and support for this new role.

Do the geopolitical circumstances warrant a revision of the European design from a predominantly economic organization to a new one that includes political and strategic issues. The question surrounding the development of an EU external energy policy is whether energy diplomacy can be developed without such a new design or if energy diplomacy should be used to develop one, without the other elements of a full foreign and security mandate in place.

Despite the foreign policy initiatives in the new treaty, which is yet to be tried and tested, the Commission fails to secure the foreign policy powers needed to compete with the member states for supremacy in this domain. That said, developing a common foreign policy is going to take a lot of time, particularly in highly controversial areas, and areas where national interests are deemed to be at stake. It is unlikely that a common foreign policy will develop quickly enough to deal with the current strategic energy policy issues, let alone to have policies in place to deal with the energy crunch the IEA has cautioned about.

From the above, it is already clear that the EU has not yet developed a full policy toolbox to underpin any full-fledged external energy policy. Yet, even if the member states have a more complete toolbox, market integration has rendered this box less efficient. That is why a smarter use of the tools at both levels makes sense. Yet before an external energy policy can come about, there are certain preconditions that must be considered. In the absence of these conditions, there is a distinct danger that the calls for 'one voice' are for public consumption only, and not meant to be taken seriously.

For member states to cooperate and, perhaps in time, relinquish some of their sovereignty in the foreign (energy) domain, the absence of a crisis mechanism that fairly distributes costs and benefits between the member states (perhaps along the lines of the IEA method of cost distribution), and that helps to reduce the cost of risk management at the member state level, is a major (political) stumbling block for any EU initiative in external energy policy to become successful. While transition to a low carbon economy is a long-term containment policy, the short and medium-term risks are not covered. A crisis management mechanism could become the (political) minimal requirement for all member states in order to support strategic external energy relations and the accompanying investment strategies of companies. Such a mechanism would necessarily be best implemented within an European Union minimum framework setting for reasons of cost and benefit distribution (and the avoidance of free riding on other member states' national energy security policies) and to create a level of political comfort for the external energy policy initiatives.

What can the EU do now to prepare the ground for a more European based energy policy? Possible Commission actions are rather mundane and could and should have been done at the beginning of the liberalisation process in the first place, because they are part and parcel of a properly functioning market: 1. provide the market with transparency on flows and prices, 2. lay the groundwork for creating some sort of benchmark for security of supply, 3. set up a peer-review system for member states to look at each others' arrangements. With this set, the EU can begin to build - based on its coming shared responsibility - and develop an external energy policy, not the other way around. The Commission has not yet made a convincing case to member states to relinquish their national oriented policies while their oil policies are secured in the International Energy Agency. The absence of a crisis management policy is particularly important for smaller or follower member states, while large member states are better positioned to secure their energy interests, despite the decline of the national instruments' effectiveness due to the internal market.

The European Union should therefore recognise that the current incomplete powers granted to it in the field of energy and the strategic foreign policy dimensions will take a long time to develop into what can be considered 'one voice'. The Commission can start

by enhancing transparency and begin to prepare the ground for a crisis mechanism. They should focus on stimulating the member states and the companies in a race to the top, and reward best practises, bottom up rather than top down. It is also important that the development towards a low carbon economy, as the European Union's long-term containment policy, is made an integral part of security of supply approaches. A smart crisis mechanism is the basis for external energy policy to be developed on, not the other way around.



# Turning a Weakness into a Strength

## A smart external energy policy for Europe

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### *Introduction*

In the past few years the EU energy policy has slowly begun to take shape. The internal energy market was propelled forward by the implementation of an internal market and competition policy rules on the energy sector. After the Russia-Ukraine gas crisis of 2006, the motivation to formulate an external energy policy gained significance. With this progress in the process of EU energy policy-making, however, the discussion about its direction and design at the EU level and among the member states has also become more contested and politicized. This affects not only the discussion on the internal energy market structure but also the place and function of the European energy sector in the newly evolving post-cold war international economic and political system.

The three priorities of energy policy - reasonable prices, security of supply and the environment - are the bedrock of policy-making, although the emphasis on types of instruments can vary substantially. The stability of the pursuance of these three priorities does not, however, reflect their relative importance in the past. Since 1973, when most current policy tools and instruments were developed, the emphasis on one or another has defined the direction of energy policy-making. In the 1970s and early 1980s, security of oil supply issues were dominating energy policy in the OECD countries. The establishment of the International Energy Agency (IEA) and the agreement to participate in the International Energy Programme (IEP) in 1974, under which the oil crisis management mechanism of the Agency falls, is witness to this. Diversification of source and origin were also widely used policy instruments aimed at reducing the vulnerability of oil shocks and at achieving reasonable pricing by increasing non-OPEC supplies and turning away from oil in power generation to coal, nuclear and later gas. In the 1990s, under different market conditions, the emphasis shifted to the reduction of energy's environmental footprint and to energy prices and achieving reasonable prices for consumers by liberalising the gas and electricity markets.

Typically, policy-making could be designed such that two out of the three priorities could be easily pursued, but the achievement of the third goal would be very difficult to attain. There is a natural tension between the pursuance of all three priorities at the same time, because security of supply and the environment usually involve higher costs.<sup>1</sup> There is also a difference in the time frame among the energy policy priorities, with the particularly short-term properties of energy prices. For instance, as part of a diversification policy, the contribution of coal to the energy mix could be increased, because coal is much more widely distributed throughout the world than oil and gas, and therefore more secure. But the environmental constraints limit the contribution of coal to the energy mix as long as the CO<sub>2</sub> problem has not been resolved. Also, because CO<sub>2</sub> is not properly priced, the fuel of choice for electricity generation still reflects this imperfection in many countries, while for instance in France, security of supply considerations created the basis for the large contribution of nuclear energy to the mix. In other countries, different choices were made that perhaps suited the security of supply considerations of the past, but are now in conflict with the current climate change policies. Energy policy is therefore not static but dynamic, and although the priorities themselves are not changing, the governments' choice of policy instruments through time is.

### **A new agenda**

Energy policy objectives and the suitability of traditional instruments to achieve them are currently under review. The main goals are to improve the balance among the three priorities of energy policy-making, to make a transition to both a more sustainable energy mix and, at the same time, improve the security of that mix during the transition to it. Prices are left to the market, although currently there are growing concerns about the increasing imbalance between demand and supply growth, state intervention in other countries such as subsidies on energy products in, for example China, and the state investment policies of producing countries, limiting access to resources of (certain) international energy companies.

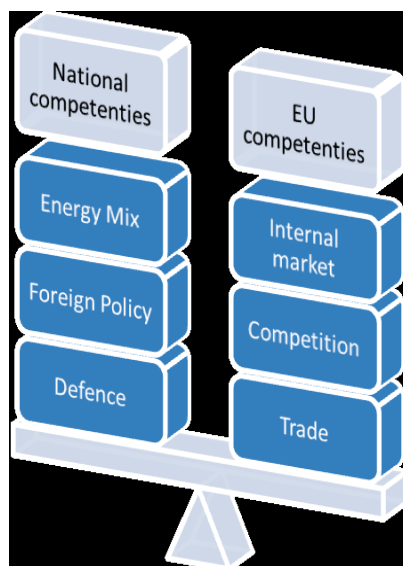
In 'An Energy Policy for Europe' (Com (2007) 1), the new EU policy goals are reflected in the Commission's '20-20-20' policy in 2020, reflecting the efforts to achieve a low carbon economy and a more sustainable and diverse energy mix. Security of supply is indirectly covered by converting demand to other energy sources and by a reduction of the import dependency on only a few suppliers. At the same time, these longer-term (climate change) goals must be achieved in the short-term oriented market order. Notice that the EU energy policy does not cover the full set of energy policy instruments,

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<sup>1</sup> CIEP, "Study on Energy Supply Security and geopolitics," prepared for DGTREN, TREN/C1-06-2002, ETAP programme, January 2004 (<[www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)>), pp. 63-69.

particularly not in security of supply. Correspondingly, the EU toolset does not compare to the member states' range of instruments, while the member states have experienced a loss in national instruments effectiveness as a result of the closer integration of energy markets in Europe. At a minimum, both levels should at least acknowledge these gaps and the divergent abilities of the individual member states in order to overcome these policy gaps.

**Figure 1: National and EU Competencies**



The new policy goals of the EU need to be translated to the member states' national energy policies. Member states remain in charge of the composition of the energy mix and will therefore seek different solutions to comply with the EU goals. For the EU, it is important that for the coherence of energy policy-making, internal EU policy-making and external policy is connected. This is where it becomes complicated, since both elements of internal energy policy-making and external policy-making do not fully belong in the authority of either the Commission or the member states. Energy will become a shared responsibility when the Lisbon Treaty comes into effect. Recall that member states have remained in charge of the composition of their national energy mix (with the potentially distorting consequences for the internal market), of their energy resource management (including the conservation of energy endowments; distorting potential supply in the short term) and of their foreign and security policies (although cooperation in NATO, UN and other international institutions influences the potential scope of these competencies). Member states are not responsible with regard to trade and competition policy, and their monetary and fiscal policies are also bound to EU or central bank discipline. While trade policy is an EU power, stimulating trade relations is usually a member state undertaking. In general, the EU sets or shapes the member states economic policy-making into an EU mould, but particularly in the

foreign relations area, this mould is still in a pre-infant stage. With regard to control over competition, this applies to competition beyond the national markets of member states, not to competition within them, although some overlaps are now beginning to appear. In the past, this has stimulated or at least given room to companies with a strong national base, or national champions, that used the internal market to expand their interests in other member states. Also in energy we have seen a consolidation, first in the member state markets and then in the internal market.<sup>2</sup> Although very few companies or sectors are nationally oriented, it does limit the reach of EU competency. The energy dossier is laced with many examples of these complex authorities, which compete for attention in addition to normal market and government failures and international developments.

With regard to external energy policy-making, particularly of the mixed or non-economic or political-strategic kind, (foreign and security policy and trade promotion) the competency is fully with the member states. In the 1990s, when security of supply was neither a political issue nor an issue left to the market to resolve, the competency issues were less relevant than today. The changing international economic and geopolitical relations after the demise of the Soviet Union, the opening up of China and the politicizing of energy relations in more recent years have caused this issue to gain significance. It is exactly the politicizing of energy relations that will make striking a proper balance between internal and external interests and policy-making difficult in the current stage of EU development. Too many internal issues have been left unresolved, such as the absence of crisis management policies at the member state level, let alone that they are becoming coordinated at the EU level in power generation, gas, coal, and new energies, which should have run parallel to the market liberalisation process. In the amply supplied markets of the 1990s, policy-makers could rely on the market to deal with security of supply issues. Currently, the large member states such as Germany, Italy, France and the UK rely heavily on their foreign and security policy and trade promotion efforts to secure energy flows to their markets. Still smaller member states may experience more difficulty in developing effective national policies or cannot bear the cost on their own, and may have to align themselves to either a larger member state's policy or aim for EU action to further its interests. The larger member states or member states with strategic assets in the energy sector (such as the Netherlands) may view the EU as diluting their interests with those of smaller states or states with deficient energy diplomacy instruments.

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<sup>2</sup> Coby van der Linde, "External Energy Policy: Old Fears and New Dilemma's in a Larger Union," in: *Fragmented Power: Europe and the World Economy*, Andre Sapir (ed.), Bruegel, Brussels, 2007 (<[www.bruegel.com](http://www.bruegel.com)>)

The market responds incompletely to price signals when it comes to longer-term issues such as security of supply. Another complication is the asymmetric exposure to political and economic risks due to import dependence and dependence on only one or two suppliers. This is relevant for the gas and oil markets, but also for certain geographic subdivisions of the market, such as the new member states in Eastern Europe, where coal and electricity imports from neighbouring countries also play a regional role on top of oil and gas issues. Both Russia and Algeria are important gas suppliers to the EU and subsequently supply the Eastern, Northwestern and Southern European gas markets, causing a concentration of only one, perhaps two suppliers. In a situation where domestic production is in decline, the import dependency on these suppliers will increase. Russia is also an important oil and coal supplier to the European market. In 2004, the share of Russian oil in EU oil consumption was 26%, Russian gas was 29% and coal was 8%<sup>3</sup>.

From data accompanying the 10 January 2007 energy package 'An energy policy for Europe' (SEC (2007) 12) we learned that the composition of energy mixes in Europe is still very diverse, and will remain so in the foreseeable future. Imports are concentrated but diverse as well, due to the economies of supply and existing infrastructure. Although the energy mixes and infrastructure will adapt to new market realities over time, the existing structure of the energy economy of the member states is rather inflexible in the short and medium -term. Unsurprisingly, no common external energy policy will change that, even if the member states all of a sudden could find common political ground in their foreign policy orientations. It is only through investments and new economies appearing in the energy market that the mechanisms of an already dynamic market structure will change. To be sure, the infrastructure *in situ* will continue to determine the economics of routes but also the site of new infrastructure (pipelines and regasification terminals) through their economic life.

### **Long term and short term goals**

Given the confessed urgency of the energy and climate agenda, the EU policy efforts, as proposed in the 20-20-20 programme, demonstrate that the transition to a more sustainable energy mix is an important long term goal, which combines climate change and certain long-term security of supply policy dimensions. However, this is a policy that will only produce results in the longer-term. Meanwhile, the security of supply agenda will also have to deal with issues that are in the short and medium -term, since switching to other sustainable fuels has not yet materialized. The warning in the IEA World Energy Outlook 2007, that an energy crunch (serious mismatch between demand and supply) is possible in the next ten years, will necessitate

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<sup>3</sup> SEC (2007) 12.

security of supply policy-making with more immediate results. Naturally, the question is how the member states will go about the shared responsibilities and particularly how much of their security of supply policy instruments they wish to coordinate with other member states in an EU approach. Particularly with regard to external energy policy-making, a call for 'one voice' is propagated. What does 'one voice' mean and which instruments could be implicated is the subject of this paper. Particularly in the foreign and defence policy sphere the diversity among the member states is large and could be a potentially serious stumbling block for external energy policy-making at the EU level.

In EU external energy policy-making, an alternative should be found to coercing reluctant member states into accepting the usually top down, generic approach of the EU and into giving up competencies that serve national interests. This pragmatic route to policy-making could be to explore a path to turn EU weaknesses in the foreign and energy policy sphere into strengths by the smart use of diversity, asymmetry and subsidiarity in a bottom up, more tailor-made approach. Remember, the EU has had extensive experience in building coherence by using harmonization, coordination and only then unification. This approach is known as the economist approach to integration. Only in recent years, after the economic and monetary union and enlargement processes required a more expedient procedure for political and strategic reasons, did the monetary or big bang approach to policy-making make its appearance in EU policy-making. The question is if the big bang approach is suitable for breaching the national resistance to unification of foreign and security policies, and in effect evolving beyond *the economic project* Europe has always been. Perhaps the more evolutionary approach, and allowing member states to find their own efficient and appropriate solutions for (mostly localised) security of supply issues, is the best tactic that at a minimum keeps the momentum going and allows for a search for cost efficient solutions. Different energy mixes and asymmetric exposure to disruption risks might require different policies rather than just one. Impatience with the integration process in general would be a bad guide, when it results in member states being pushed beyond what they perceive is efficient and appropriate in their situation. The risk is that policy-making that should take place at the EU level becomes stymied, and perhaps mired in endless discussions without much concrete results.

Impatience, however, can be partly explained by the complexities connected to the larger membership, - directing 27 countries into a coherent approach - partly by the asymmetric interests in a national or a supra-national approach that can also serve to socialize the cost of security of supply, and partly by the switch in approach to integration in general in the 1990s from an economist approach (evolutionary) to a monetarist approach (big bang). With the consummation of the Eastern enlargement, the appetite in Brussels for a continued monetarist approach to



integration might not have been satisfied. But the new challenges, such as in the energy dossier, should at least result in considering the beaten path of gradualism. It is the result that counts.

In summary, the issues of developing a coherent external energy policy for Europe can be divided into: the changing international context; the changing international energy markets; a changing internal EU context; and the instrumentation of external energy policy.

Before turning to the instrumentation of a smart external energy policy, the current context of this policy must be explored to better understand the challenges and opportunities.

## ***A Changing International context***

### **Changes in the EU**

The liberalization process of the EU energy markets, which started in the 1990s, was an integral part of the effort to both deepen integration (the realization of the monetary and economic union in 1999), to enlarge the EU (witnessed by the accession of 12 new member states in 2004 and 2007), and was in part the response to the post-Cold war changes on the European continent. These sweeping institutional changes in the make-up of the EU were mostly absorbed by the market, where the larger size and the introduction of new technologies stimulated new structures in many sectors.

In the energy sector the changes were slower, due to the diversity in organisation and (mostly public) ownership structure in the member states, the variation in fuel mixes, and the fact that fossil fuels had to be largely imported. In many member states, utilities were in central or local government ownership or control, and constituted the energy mix part of government planning rather than market preference. Some member states produced coal, oil or gas domestically, while others were structural importers. The fuel mix of the electricity sector often reflected the availability of domestic energy resources, and employment issues weighed heavily on fuel mix choices. Most member states had linked the various regions in a network infrastructure, sometimes with links to neighbouring countries for reasons of security of delivery. Liberalisation was meant to introduce competition across member states' borders and to use the existing plants and infrastructure more efficiently.

The creation of a level playing field turned out to be much harder in a sector where local preferences for fuels, ownership structures, resource endowments, environmental constraints and wider socio-economic interests continued to exist. It was also clear that in a situation of greater competition, energy mix planning by the government would become more difficult if not impossible, unless

permits for certain types of generating plants were issued and/or liabilities for the storage of waste material (nuclear and CO<sub>2</sub>) carried. However, this would also impact the level-playing field. Many of these issues were conceivably expected, but were perhaps seen as surmountable further along in the liberalization process. The main thrust of the operation was to work out the initial inefficiencies and overcapacities at the member state level and to deliver these efficiency gains to consumers. Neither the fuel and energy mix, nor the security of supply was really an issue in the buyers' market of the 1990s. However, with the liberalization of the EU energy market, the focus of security of supply implicitly shifted to a focus on securing flows rather than controlling and planning (internal) flows.

### Changing Energy Market Circumstances

Unfortunately, the completion of the internal energy market in 2007 had to be accomplished under much different circumstances than those that had prevailed in the 1990s, at the beginning of the process.<sup>4</sup> Energy prices began to increase almost concurrently with the long expected decline in EU energy production from 2003 onward. Particularly the decline in gas production in the EU was worrisome, because much of the new capacity additions in the 1990s were gas-fired power stations. Gas is relatively clean with respect to CO<sub>2</sub> emissions, and was abundantly available. The switch to gas in the UK also rid the power sector of industrial actions in the coal sector, and in other countries the switch to gas was seen as an economical way of achieving the Kyoto emission targets. With ample supplies available and much more within the EU's economic reach, confidence in the propensity of the market to absorb any changing circumstances, including growing import dependence, was great.

The changes that took place in the international energy markets around the turn of the 21<sup>st</sup> century did, however, impact the ability of the European market to deal with these changes. The confidence that market principles would be the guide to balancing supply and demand was challenged when it became clear that producer governments began to actively manage the energy value chain. Although governments have always been very involved in the energy sector, both as a producer and as a regulator in order to capture the economic rents somewhere along the value chain, the nature of government involvement became income and national interest driven. In the amply supplied markets of the 1990s, the market was seen as being able to balance every country's demand and supply. But when the geopolitical situation tensed after 9/11/2001 and markets became tighter (partly as a result of low investments in the 1990s), the short-term nature of the market was deemed imperfect in its propensity to signal in this sector with long lead times. The ownership structure of reserves and production was organised

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<sup>4</sup> IEA, *World Energy Outlook 2005, 2006 and 2007*, Paris, IEA, 2005, 2006, 2007.



along national interests, while trade, processing and distribution was organised along private international interests. In this tighter market, private international oil companies renewed their efforts to engage in backward integration, while state or semi-state companies from producing countries were eager to engage in forward integration.<sup>5</sup> At the government level, these movements were translated into security of supply and demand. Producer governments were concerned that their one-product-economies and/or government energy income would be threatened by the climate change policies of the OECD countries as a result of CO2 taxes; while consumer governments were concerned that supply policies would perpetuate a situation of a sellers' market and make their economies politically vulnerable. The latter became more important after 9/11/2001, when wider security issues came to the fore. The 'War on Terror' has sharpened divisions in the world, and also strained old coalitions over the way the new threat of Islamic extremists should be handled. The differing views on the system of international relations, the balance between hard and soft power, and the role and function of international organisations showed a much greater uncertainty about the future of the entire international system than previously assumed. Energy increasingly became one of the battlegrounds of the shifting power relations in the world.

With this growing tension on international energy markets, newly emerging energy importers were keen to gain a stake for their national companies, independent of the international companies. They also began to more actively promote their own national interests in the international energy supply, either by ownership or control over energy reserves, or by otherwise influencing energy flows. Particularly, state owned or semi-state owned companies from newly emerging countries received a wide variety of investment enhancing benefits, such as cheap loans, protected home markets, investment packages in non-energy sectors, etc., that changed the competition with the international oil companies for scarce equity oil or gas in their favour.<sup>6</sup> International oil companies increasingly experienced difficulties in replacing their production with new reserves. OPEC countries already had limited the foreign direct investment opportunities in oil production, but after 2000, other countries, such as Russia and the Caspian Sea countries, as well as in Latin America, also began to set stricter terms on new oil field exploitation rights. A similar development has now also impacted the development of new gas flows. The flow of oil and gas, which in the 1990s had appeared to be mostly market driven, was soon back in the realm of governments, both producer and consumer. This development ran counter to the developments in Europe, where efforts to liberalise and perhaps privatise, were just getting under way.

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<sup>5</sup> See Roland Götz, *European Energy Foreign Policy and Russian Natural Gas*, paper for IFRI Conference 31/1 and 1/2/2008, Brussels.

<sup>6</sup> *Financial Times*, 10-1-2008, *Superannuated*, p. 12.

The somewhat contested debate about the market design among member states in recent years has resulted in a European energy discussion that appears to take place with little consideration to the rest of the world. The preoccupation with internal market discussions and the environment overlooked both legitimate producer country concerns about security of demand as a result of the EU market design, and the impact of climate change policies on their main source of income. Meanwhile, international oil and gas markets were changing rapidly and new structures began to appear. The role of the traditional international oil companies was becoming more marginalised and new entrants from emerging economies were taking over as the carriers of new energy relations. These relations combined the national interests of producer and consumer governments with new types of agreements among their companies. With the shift of energy relations from a sole commercial activity to a wider interest serving activity, and with energy relations politicised, the EU as an economic project or construction was less adequately suited to promote European energy business interests. The importance of government-to-government relations to business-to-business contracts fell completely in the realm of the member states. Importantly, the EU is not a state and therefore cannot be expected to perform this function. The EU has its role to play in dialogues with other international groupings, such as OPEC or the International Energy Forum, but where trade, investment promotion and foreign policy is concerned, the member states as states are an efficient tool. Because of the diversity, it is very difficult for *the* EU, if it could, to represent the diverse European energy business interests at a political and strategic level. The changes in the international energy markets and the renewed importance of the *modus operandi* of politics as opposed to economics in energy diplomacy, have in a sense led to a more prominent role for national states within the EU. This complicates the development of an EU external energy policy.

Together, the rise of Russia as a major player on the international oil and gas scene, the renewed power of the OPEC, and the impact of newly net-importing countries such as China and India, have restructured the organization of international energy markets. Energy and controlling the flow of it has become a major determinant for new power relations in the world. Both the market and political tools are used to influence flows to the various consumer markets.

Before discussing the options for an EU external energy policy and the instrumentation of such a policy, it is important to assess the scope and scale of the changes in the international energy situation, international relations and the impact on energy policy options.

### **A new international order?**

The period from the end of the Cold War in 1989/1990 until the 9/11 attacks on New York and Washington were, by hindsight, an interbellum, separating a world structured on competing economic

and political systems - the market oriented economies and the planned economies, each with their own institutions, political systems and alliances - and the world of today. Today's world is less structured in terms of economic and political systems, although economies meet in overlapping economic interests in the international markets, but also compete in terms of promoting their strategic economic interests.<sup>7</sup> In terms of political systems, the demise of the planned economy as a political system did not imply conformity to the democratic and market-base model of the OECD countries.<sup>8</sup> Instead, autocratic or authoritarian types of government have successfully developed their own model to reform the previous communist countries, such as in China and Russia, and they also developed their own approach to internationalisation and integration into the world economy, not necessarily following the rules and norms of the OECD-countries. These new models attempt to combine economic growth strategies with central government control over the reform processes, with the main goal being to also manage the social balance. In Russia, this model appeared after the chaotic political and economic period following the demise of the Soviet Union, while in other countries other internal circumstances have led to similar, more controlled state centred approaches. In countries such as Venezuela, other forms of populist autocracy are developing. Iran has also developed its own model. These new regimes share a strong orientation on promoting government or state interests, often endorsed as a way to limit control over the domestic socio-economic processes, thus integrating, on their own terms, into the world economy, accepting only part of the rules and norms presented by the US or 'the West'.

Rather than unipolarity or globalisation the world is moving towards multipolarity, in an economic sense as well. Economic nationalism, at least for the time being and particularly in the strategic area of energy, will continue to be a fact of life. This is partly due to the large economic rents present in the energy value chains that can easily be taxed away without hindering the sector from producing. The fiscal benefits of energy draw the attention of all governments, but the properties of energy as a strategic and geopolitical 'good' also explain government involvement. Furthermore, energy is a basic input in the economy, and reserves, production and consumption are not distributed evenly throughout the world. Energy resources derive not only economic benefits but also store political value or power. In the new make-up of the world's economic and political systems, *energy is both an economic good, a strategic good, and a geopolitical power tool*. Producing countries are aware of their position and are, more than ever before, in a position to generate maximum political and

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<sup>7</sup> "Energy in a Changing World," CIEP 2005 (<[www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)>)

<sup>8</sup> Rawi Abdelal and Adam Segal, "Has Globalization Passed Its Peak?," in: *Foreign Affairs*, January/February 2007.

economic benefits for their own states and economies from energy. This awareness of the properties of oil and gas as an economic and strategic good and geopolitical power tool implies that investment and production levels will be maximised to first serve the interests of the producer state (s) and their state companies, not automatically for the good of the world economy. Collectively the producer countries benefit from tight markets or a sellers' market. Spending needs could breach the collective goal when short-term income needs override the longer-term strategic interest. The ability of states to play their 'energy card' will also depend on the political stability and internal political support for the state's strategy. The weakness of the longer-term strategy could be that citizens or groups demand too much 'paying off' for their support, forcing the state/government to sacrifice long-term goals for short-term stability. Another outcome could be producer states developing competing interests in securing certain markets.

At the moment, the US position as the main geopolitical power is challenged by the effective use of economic or soft power by China, India, Brazil, Russia, and the Gulf oil producing countries. The impact of the sub-prime loan crisis has created an opportunity for sovereign funds to acquire assets in the heart of the international financial centre. In this sense, they are gaining the much-desired access that they have never before had. At the same time, the American economy and the dollar, which has served the role of reserve currency for so long, is also challenged. The benefits from financing foreign endeavours through the reserve currency role of the dollar may come to a partial end as other currencies increase their activities in this area. The political impact of the US policy in the Middle East on its economic and strategic alliances has been substantial. The alliances were important in the past for the US to perform its role as a hegemon, while support for the hegemon offered benefits to the alliance countries. With the recent more unilateral approach of the US, these alliances have been weakened, largely because the US failed to take the economic and political interests of its allies into account, for instance when it engaged in Iraq. It created greater uncertainty within the allies about the US performing its traditional role, and also among others that indirectly benefitted from the umbrella of the US protection of oil flows policy.

Since 2003, China and India have actively developed their own security of supply policies and rapidly increased their stake in foreign oil reserves and production around the world. The fact that they were prepared to create security of demand and were willing to invest in other parts of the producer countries' economies, without the pressure on the local political system, has eroded the ability of the US (and its allies) to enforce their rules. For the EU and Japan, a difficult situation is emerging in determining if and to what extent the US can still generate the security of oil and gas flows in the current geopolitical situation. Although security of supply is prioritised on the political agenda, hesitancy regarding the direction of such a policy is

obvious. Currently a certain degree of distance and separate national approaches are beginning to appear, suggesting that within the traditional Western alliance doubts about the benefits of their ties with the US are also beginning to appear. If the US values the traditional Western alliance, sensitivity to these countries interests should become a priority for the new President.

New energies, such as biofuels, also have the potential to develop into strategic goods, although competing interests among producers could render this tool less efficient than in oil and gas. Yet, when these new energies harbour sufficient rents for both investors and governments, a similar structure of private and government involvement could arise. Note that also in biofuels, which are a transition to other solutions for liquid energies or transportation fuels, (temporary) scarcity could occur, either in energy or food supply, as a result of government intervention.

Coal currently has the disadvantage of its high carbon emissions, but when CO<sub>2</sub> is properly priced and Carbon Capture and Storage (CCS) is out of the infant industry stage, coal could develop similar properties to oil and gas, although the wider distribution of reserves could limit its strength as a geopolitical power tool.

Consumer countries are particularly interested in maintaining sufficient flows of energy to satisfy their demand, preferably at reasonable prices. Producer countries are interested in sufficient flows of income over a longer period of time. Governmental intervention (in the broadest sense, varying from subsidies, to domestically produced energy, to market regulation, to blocking ownership change, to military intervention) becomes more likely when supply can no longer meet demand and certain flows are not available to the highest bidder. Energy flows thus become a subject of geopolitical power politics.

### **Do US interests run parallel to the EU's?**

The main energy concern of the US is not so much energy dependency, but first and foremost its dependency on oil imports, now euphemistically called liquid energy in order to include biofuels.<sup>9</sup> It is the dependence on transportation fuels that drives the foreign (energy) policy of the US, and oil security was always a part of the larger strategic security concept. For the EU, the issue includes the supply of energy to the power and industrial sectors (predominantly concerns about gas, but with a growing tightness of coal markets, they will soon be included), and although not prominently voiced, also to the transportation sector. Deepening integration and enlargement of the EU has increased the importance of mobility, and therefore the oil security issues, although less debated than gas, should soon feature higher on the EU's agenda.

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<sup>9</sup> National Petroleum Council, *Facing the Hard Truths about Energy*, July 2006.

The US policy was focussed on guaranteeing the flows of oil - witness their security command structure that includes a command for the Middle East and a recently established African command, underlining the growing importance of African oil. Guaranteeing the flow of oil is important for international markets to function and works well in a situation where oil producers have sufficient supply to meet demand. This situation persisted from the early 1980s until 2003/2004, and deftly absorbed the shift in ownership of oil reserves and production from the international oil companies towards the producing countries in the late 1970s/early 1980s. The special relationship with Saudi Arabia was an important part of the security of oil flow approach because Saudi Arabia, as the world's largest swing supplier, could in concert with the US, ensure that oil flows continued and markets functioned. The ability to guarantee flows changed for several reasons already stated, and has resulted in a reorientation of the US, but also of its allies, including the EU.

The debate in the EU has focussed mainly on the flow of natural gas, the limits to diversification (due to the regional context of the market and the inflexibility of pipeline routes), and the supply and transportation monopolies of state gas companies (Russia, Algeria). For that reason, a gas-security approach on the part of the EU would initially focus mainly on North Africa and Russia. The regional properties of such an approach would put gas security in the realm of the EU, through its neighbouring countries' policies and member states' bilateral arrangements with these countries when it comes trade and investment promotion.

The member states are comfortable with the arrangements in the International Energy Agency on oil security and the crisis mechanism, due to the continued limited political and strategic role of the EU in securing oil flows. The IEA was founded in response to the oil crisis of 1973/74. The coalition on oil crisis management has been a great benefit for European countries and at a relatively low cost could benefit from the US foreign policy efforts to guarantee oil flows. Although the benefits of the IEA go undisputed, the policy of the US in Iraq was perceived as running counter to European (and Asian/Chinese) interests. In the 1990s, the US, and even more so Europe, switched away from Middle East oil as much as possible and increased their supplies from Africa, and in the case of Europe, from Russia as well. China's dependence on oil from the Middle East has increased its strategic interest in the region, and China is increasingly uncertain about the flow of oil and ability (and willingness) of the US to guarantee this flow for it. The war in Iraq was a major motivation for China to step up its security of supply policies. For this reason, China has very quickly improved its strategic interest in the Middle East and in other producing regions. Its position in Africa has become particularly strong.

The strong growth of energy demand in China and India also has profound consequences for the climate change debate. In 2007, China surpassed the US as the world largest emitter in absolute



terms. The IEA predicts that by 2015 the US, China and India will be responsible for more than 50% of world's CO<sub>2</sub> emissions. The strategic post-Kyoto discussions therefore must include China and India, despite their lower per capita emission rate. The position of the EU, favouring a cap and trade system, is different from the position of the US and the two Asian countries, which seek technological solutions. Transatlantic relations over climate change have been strained by the decision of the Bush Administration not to ratify the Kyoto Protocol. Because climate change and energy (oil) security policies merge in foreign energy policy, the differences over climate change policies could be yet another hairline fracture in Transatlantic energy cooperation.

The recent debates about security of supply in the US and EU have been limited to either oil or gas. This has created a gap in the perception of immediate shared interests, but also has caused a division in the position towards Russia. The different perception of the most urgent security of supply issues could grow into a loosening of the coalition on energy. The EU however could not easily replace the benefits from the IEA or would want to replace them, with energy issues now involving different energies, and becoming more diverse and complex, including different approaches to energy dependence and climate change. It is likely that the urgency of gas security could propel the EU in a different direction with respect to this resource, and to its own gas security, separate from the US. The EU and the member states might have to decide eventually what the value of an energy coalition is with the US, or with other potential partners, unless it can again successfully combine its different energy and climate change interests with the interests of the US.

### **Impact of the collapse of the Soviet Union**

The collapse of the Soviet Union and its satellite countries organized in the Comecon impacted the EU substantially, both its economic structure and its political identity. In the 1990s, Russia became an important energy supplier for the EU member states. The East European countries had been traditional importers of Russian energy, but increasingly West European countries also imported their oil, gas, coal and electricity.<sup>10</sup> Most of these imports had to flow through infrastructural corridors that were constructed to serve the Comecon countries' energy needs and the gas export contracts. This led to immediate worries about security of transit. It was clear that both Belarus and Ukraine, as former Soviet Union and CIS countries, would not be part of the Eastern European enlargement process, and therefore missed political and economic direction and discipline in their transition. Russia itself was weakened in the 1990s and only when oil prices began to increase after 1999 did the economy recover. With the Putin presidency also came political and institutional

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<sup>10</sup> "EU Energy Policy Data," SEC (2007) 12.

direction, which ended the period of unhindered cowboy capitalism. Attracted by potential energy income and leverage, Russia began to restructure its energy industries away from full privatization, setting limits to (foreign) private capital. Russia then became increasingly concerned that it would experience difficulties in reaching the lucrative EU market, at least on terms that suited Russia's interests best. Currently exports to Europe account for 27% of Russian gas sales and 60% of Gazprom revenues.<sup>11</sup> It is precisely in this sphere of access to markets and to supplies from the Caspian Sea region that the EU (and the US) is challenging Russian domestic security of supply with alternative pipelines routes and access regimes.<sup>12</sup> The Ukrainian 'orange' revolution exposed the vulnerability of the gas corridor and both Russia and the EU began to further their own interests in influencing the countries' direction. Without the necessary demand security and stable routes to the European market, Russia will first seek diversification of transit routes and markets before committing to other investments in the gas value chain. Both Nord Stream and the proposed South Stream fit in this strategy. The importance of oil and gas in the domestic structural growth plans and in Russia's re-emergence on the international stage has become a vital driver in Russia's future foreign and economic policy.

The efforts of developing alternative routes to the Ukrainian and Belarus corridor have created a major fissure between some of the Eastern and Western member states. Governments that support joint ventures of Gazprom with German, Dutch, French and Italian companies are in effect favouring a policy that secures gas supplies through integration into the value chain. Bulgaria is the most recent country to adopt this strategy and hopes to expand its role as a secure transit alternative. At the same time it gains security for its own supplies with its role as a gateway for oil and gas to southern European markets. Developing alternatives to the large dependence on the Ukrainian corridor would reduce the security of transit risk for the EU, but at the same time it also reduces both the economic benefits from transit and the political power to hinder certain Eastern European countries that are on the Ukrainian route. Uncertainty about Ukraine is causing both economic and political difficulties in the energy dossier, and a reduction of transit risks has consequences for the position of EU member states on that main trunk line. In the discussion over the Nord Stream pipeline, Poland and the Baltic states were not convinced of the security they can derive from their EU membership, and instead have mainly relied on relations with the US and on their NATO membership for their security (also witness the proposed Polish participation in the US missile plans). This has caused a serious rift in relations with Germany, but also has blocked

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<sup>11</sup> IEA, "Natural Gas Market review 2007," *Security in a globalising market to 2015*, OECD/IEA, Paris, 2007, p. 130.

<sup>12</sup> *World Gas Intelligence*, "Russia's Central Asian Score," vol. XVIII, no. 20, May 16 2007, p. 1.



negotiations for a new strategic partnership between the EU and Russia. The new Polish government is trying to repair this situation and bring Poland back into the discussion. Those East European countries that are not connected with the Ukrainian corridor seem to prefer developing their position as an alternative gas transfer linchpin and fully embracing their soft power strategy. From an overall EU perspective, diversification of routes, even if it involves one supplier, will reduce the risk of supply disruption. The commitment of a supplier to supply a market also increases when large investments have been made to reach that market. Valuation of this interdependency has not always reached the awareness of the European public, leading to a discussion focussed on conflicting interests and not on the obvious shared interests that can balance the relationship between the EU and Russia. That does not imply that the concerns of individual member states should not be addressed. Energy policy instruments other than, or in addition to, those used for external energy policy are available to address these issues.

### **Influences of Diversity on the discussion**

The changing international economic and political environment caused energy to quickly rise on the political agenda, both in the member states and in the EU. With growing uncertainties over security of supply, the structural dependency of some member states on one or two suppliers, climate change policies, and the realisation that competition policy alone cannot guarantee security of supply (nor a transition to more sustainable energy mix for that matter), but that other policy instruments are required, the debate among the (group of larger) member states on the merits of a full-blown EU energy policy becomes politicized. Some member states promote strong EU companies that can engage in joint ventures with other international (state and/or private) companies to secure the flow of energy. Others, mostly smaller Eastern member states, want to establish first and foremost a crisis management policy within the EU. Small countries have a lot to gain from collective crisis management policies because their markets (and often their companies) are too insignificant to influence or engage in security of supply strategies and the great costs involved. They can opt to use their internal political power to leverage their position in the external energy relation debate. In particular, some Eastern European countries have used their powers to influence the start of negotiations between the EU and Russia, and are also disrupting pipeline investments between European companies and Russia's Gazprom to underscore their concern about security of supply. The message that can be derived from this is that the larger member states that engage in external energy relations and support their businesses to generate the flow of energy towards the European market must do so in a manner that satisfies the local security concerns. A crisis management mechanism could become the (political) minimal requirement for all member states in order to support strategic external energy relations and the accompanying

investment strategies of companies. Such a mechanism would necessarily be best implemented within an EU minimum framework setting for reasons of cost and benefit distribution (and the avoidance of free riding on other member states' national energy security policies), and to create a level of political comfort for the external energy policy initiatives.

For certain member states the design of the internal market becomes an integral part of the debate on external energy policy, depending on their national preferences, bilateral relations and energy mix. Hence, debates over the merits of the EU market design and the external energy policy approach are made highly complex because of discussions about national interests, national and/or EU champions, member states with strong companies and member states with weak companies, and small and large member states. Differences in foreign policy approaches (on Iraq for instance) and in the vision of what the EU will or must be in the future (membership), where Europe starts and the role of the US, the level of intensity of the alliance with the US (and the role of NATO), to name a few, begin to seriously blur the debate.

The reasons that the EU internal discussion is becoming much more political are thus diverse. First, the energy industries in the member states were for a long time part of the socio-economic and political organization and construction of the member states. The EU policy measures are increasingly breaching this traditional socio-economic construction, and are replacing it with a new European construction. Yet, this European construction still falls short in providing the necessary political anchors (function of a state), which makes it difficult for member states to accept a transfer of powers to the EU level. For instance, member states carry some of the liabilities of the energy industries, such as for storage of nuclear waste and perhaps in the future for sequestered CO<sub>2</sub>, which will remain at the state level. Second, the energy mixes of the member states are diverse both in the distribution of the various sources of energy and in their import-dependency. Sovereignty over the energy mix remains with the member states. The contribution of nuclear to the energy mix is highly controversial in some member states and less so in others. The political preferences for a certain mix of energy sources limits the level playing field among the various energy resources, and also determines the 'trade off' between desired mix and import-dependence. The asymmetry in structural and strategic import-dependency lies at the core of the different external energy policy approaches. Third, the member states have different foreign and strategic policy traditions and were part of diverse alliances in which their policies were formed. Moreover, the member states are sovereign in their foreign and strategic policies, and although cooperation in the EU is promoted, the differences are vast, not only between the 'Old' and the 'New' member states, but also within these groups. Many EU member states were at one time or another either part of a certain alliance, occupied, a colonizer, an invader or neutral.

A complex set of relations has survived from these historical roles in current member states' foreign policy orientations. The knowledge and experience base in the member states is diverse, and other policy-making tools, such as development aid, educational exchanges, trade and investment promotion, cultural links, etc, are part of the foreign policy family of instruments. Yet, there remain many fault lines for continued diversity in foreign and strategic policy-making among the member states.

Perhaps the key fault line seems to be the relationship with the US in the post-9/11 period. After the initial support in the wake of the 9/11/2001 attacks in New York and Washington, the run up to the invasion of Iraq in 2003 created deep divisions among member states over their support for US foreign and security policy.

### **Can the EU afford to sit on the geopolitical fence?**

The strategic behaviour of the US in the Middle East and Central and East Asia will have a strong impact on the oil and gas (LNG) security of both Asian consuming countries and Europe. The fact that the 'regime change' approach in Iraq and Afghanistan did not immediately create stable and safe havens in the region, but internally unstable states, both requiring long term intervention forces to make them and their economies functional again, implied a wider engagement than European countries were willing to provide. This had to do with a different assessment of the risks and the effectiveness and availability of foreign policy tools.<sup>13</sup> In the absence of hard power, the instruments of soft power are emphasised. As a contrast with the employment of US hard powers, the soft powers have actually gained strength. The American administration is now suffering from their unilateral rush into these problem areas and is also losing domestic public support for a drawn out engagement. However, American withdrawal under the current circumstances will significantly increase the security of energy flow risks for both Asian and European countries. European countries and the EU (but also Asian countries) will at some point be confronted with this new strategic dilemma on how best to secure European energy flows in those new circumstances. It is quite possible that fence sitting is not an option and that engaging with soft power falls short of reducing the risk. This implies that one of the major consuming blocs (EU, China, India) or a regional power or group (for instance Iran or the Shanghai Cooperation Organisation, SCO) will or must become involved.

The engagement of European countries in Afghanistan, by elevating the mission to the level of NATO, has not removed the differences of Transatlantic opinion about how best to tackle Islamic

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<sup>13</sup> CIEP, "Study on Energy Supply Security and geopolitics," prepared for DGTREN, TREN/C1-06-2002, ETAP programme, January 2004 (<[www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)>), pp. 56-57.

extremists (in Afghanistan and elsewhere) and other failed states in strategic (economic) locations around the world. Currently, the entire zone from Pakistan to the Horn of Africa is unstable, with problems spilling over to energy-rich countries in the region. Both the stability of the countries in the Caspian Sea region and of the Gulf Cooperation Council could be jeopardized by conflicts in neighbouring countries and for this reason the US, EU, Russia and China have vital interests at stake, including the flow of energy. This has translated into intense American, Russian and Chinese involvement in the region. The Shanghai Cooperation Organisation (SCO) could become increasingly important in maintaining stability in Central Asia. Some EU member states have also become intensely engaged, either in Iraq or in the NATO operation in Afghanistan, but this engagement is not supported by all member states nor connected to EU policies. The US initiative to enhance its missile defence system by placing radar and missile installations in Eastern Europe in order to increase defence against Iran has divided Europe because of its impact on Russia and the EU-Russia relationship. Extending NATO membership to include former Soviet Union states, such as Georgia, has further sharpened relations with Russia, while the overtures of Ukraine towards the EU and/or NATO are also straining regional relations. The remodelling of institutional relations on the European-Asian continent in the 1990s and early 'noughties' have also bolstered new Russian foreign and strategic policy initiatives in the region, or the Near Abroad as it is called. Relations in the Caspian Sea region have particularly been emboldened.

Apart from the alliance in the North Atlantic Treaty Organisation, European countries have always relied predominantly on their soft powers as the driver for foreign policy: the EU itself is the best example. Only France and the United Kingdom maintained their strategic capacity, to use in certain parts of the world that are of particular interest to them or to provide a countervailing power within NATO. Due to this mainly soft power tradition and the success of this approach in defusing conflict on the European continent and the removal of the Cold War threat, the member states are suffering from a lack of public support for intensely engaging their militaries, particularly after 2003 when it involved operations led and/or initiated by the US. The NATO operation in Afghanistan is the first with a wider European involvement.

The emphasis on economic issues in Europe, exemplified by the deepening of integration and enlargement, has sidetracked discussions on geopolitical issues and strategies to defend security interests at the EU level. This discussion about roles and functions in the geopolitical context was a national affair. In many member states, the peace dividend was 'sold' to the public in such a way that security forces would only be needed to put out 'small human rights fires' and that the economization of international relations itself, i.e. globalization, would largely guarantee the pursuit of peace and prosperity. The changing geopolitical circumstances have not yet

resulted in a different debate in European society. Rather, the growing uncertainties, both political and economical, have created a breeding ground for the public to disengage and fear international developments, and increasingly focus on protecting the local society. European leaders have thus failed to properly communicate the implications of the changing international context and the role they want to claim for Europe. Public support is a crucial underpinning for any stepped up international engagement other than trade and investment. The instrumentation of foreign and security policy has become limited as a result, and any different level of engagement would require an investment in building public awareness and support for a new role.

The instability in certain parts of the world, jeopardizing the vital energy interests of, in this case, energy consuming countries, could force the EU to engage in strategic geopolitical matters that go beyond the peace-building operations that European countries prefer to be engaged in. The question is then if the geopolitical circumstances warrant a revision of the European design from a predominantly economic organization to a new one that includes political and strategic issues. The question surrounding the development of an EU external energy policy is whether energy diplomacy can be developed without such a new design or if energy diplomacy should be used to develop one, without the other elements of a full foreign and security mandate in place.

### ***Strategic foreign energy policy instruments***

The external energy discussion in Europe is for the most part a debate on how to formulate a strategic foreign policy in which energy (and climate) plays an important but not exclusive role. Regional foreign relations, where energy already plays an important role, is not an area of policy-making that is exclusively in the realm of the EU. The strategic positioning of the EU in regional foreign relations (neighbouring countries policy) cannot be separated from the relationship with the US and the US positioning towards North Africa, Turkey, Belarus, Ukraine, Caucasus and Russia. Also, the relationship with Middle East will largely be determined by the role of the US in the region. The cooperation or competition with Asian countries in the field of energy, notably India and China, will also be influenced by the US. The room to manoeuvre outside the US national interests is less prominent than perhaps thought. Not because the EU member states cannot redefine their foreign relations orientation but because they do not have the sufficient hard power needed to claim a role independent of the US with the same relationship structure. Alternatively, loosening Transatlantic ties to make space for an independent EU foreign policy would imply rather large investments in the hard power capacity. The political and economic costs of both strategies will be a dilemma for any EU foreign policy development.

Interestingly enough, the hard power of the US has proven to be less effective than perhaps thought, and the soft power of countries such as Russia and China are much stronger than anticipated. The economic tools of these countries have proven to be very effective in undermining to some extent the US position (and of its companies) in Africa, Latin America and Asia. The soft power is mainly geared towards economic issues, and energy is an important part of these relations. The fact that certain crucial upstream technologies were spun off from the interests of the large international oil companies in the 1990s, has helped to improve the skill-level in national oil companies. The capacity to develop resources themselves created the opportunity for companies from emerging countries such as China to offer alternative partnerships when needed: they offer an exchange of access to resources for access to markets. In effect, China has used the US' tough stance on accepting its norms (democracy, human rights, governance) to create a less demanding alternative for local elites. In the wake of Chinese and Indian oil companies, other companies follow with their investment capital, spreading their activities to a much wider range of economic sectors. Also, the EU supports implementing the US-based norms - although not by military means - completely in accordance with its own Lisbon agenda. As a result, it might not be ideally positioned to undertake a swift change in approach to these countries.

The question is, then, how the EU or the member states hope to manage their strategic interests in the newly emerging international order, and which coalition, if any, would best serve the EU (energy) interests.

The debate is not only between the diverse member states, but also between the Commission and the member states. The Commission will first and foremost make proposals with a heavy top down orientation, partly because this is the function of the Commission (although with the renewed emphasis on subsidiarity they could also better work with that concept); partly because the Commission as a bureaucracy finds justification in expanding its powers; and partly because when leadership is lacking or divided among the Council members, the Commission tries to fill the gap.

This complex debate has also become a discussion about power: power of the individual member states, power of and in the Council, power of the Commission, power to determine the outcome. From the Commission's recent proposals in the third package, it is clear that its view on the design of the internal energy market is becoming divorced from the interests of the large member states. We see evidence of this in the disputed proposals for unbundling, and the view on energy relations with, for example, Russia, demonstrated by the so called 'Gazprom clause'. The Commission could apparently no longer make proposals that represented the common denominator among the (main) EU member states. They did however try with the alternative to unbundling to create something everyone could live with, but they have made (or felt compelled to make) a clear choice in



their preferred orientation. To some extent, this is a risky strategy because member states could create coalitions with other member states against the approach of the Commission. The ensuing debate is not only a time and energy consuming exercise, with few winners, but could also seriously delay important parts of the energy and climate change agenda that get caught up in the fray.

Despite the foreign policy initiatives in the new treaty, which is yet to be tried and tested, the Commission fails to secure the foreign policy powers needed to compete with the member states for supremacy in this domain. That said, developing a common foreign policy is going to take a lot of time, particularly in highly controversial areas, and areas where national interests are deemed to be at stake. It is unlikely that a common foreign policy will develop quickly enough to deal with the current strategic energy policy issues, let alone to have energy policies in place to deal with the energy crunch the IEA has cautioned for. The open question is what other options can be pursued?

### **Is the current external energy toolset still sufficient?**

The external energy policy toolbox<sup>14</sup> consists of prevention and deterrence instruments, multilateral cooperation and agreements (IEA, IEF), broader foreign policy, (bilateral) economic relations, trade policies, diversification of energy sources and origins, and foreign direct investments. Deterrence tools include security policies, sanctions, UN Security Council measures, and strategic alliances (NATO). When these policies fail to prevent energy scarcity, internal measures need to be applied to limit the impact on the economy. These policy instruments can be divided into containment policies and crisis management policies. These policies consist of diversification of the energy mix, stimulation of domestic production, energy system flexibility, standby arrangements, energy saving, strategic reserves, energy sharing (among coalition partners) and wider demand management policies. The use and effectiveness of these instruments depends on the priorities, the coalition or organizations the country is a member of, and the political and/or economic importance of the country. In general, security of supply policies involve some intervention in the market, usually at a cost.

From the above, it is already clear that the EU has not developed a full policy toolbox yet to underpin any full-fledged external energy policy. Yet, even if the member states have a more complete toolbox, market integration has rendered this box less efficient. That is why a smarter use of tools at both levels makes sense. Yet before an external energy policy can come about, there

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<sup>14</sup> CIEP, "Study on Energy Supply Security and geopolitics," prepared for DGTREN, TREN/C1-06-2002, ETAP programme, January 2004 ([www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)), pp. 115.

are certain preconditions that must be considered. In the absence of these conditions, there is a distinct danger that the calls for ‘one voice’ are for public consumption only, and not meant to be taken seriously.

**Figure 2:  
Instruments of Energy  
Policy making**

Prevention	Deterrence	Containment	Crisis management
<ul style="list-style-type: none"> <li>• Foreign policy</li> <li>• Energy mix</li> <li>• International cooperation (UN, IEF,</li> <li>• Diversification to source, origin and routes</li> <li>• Strategic agreements</li> <li>• Trade policy</li> <li>• Investment</li> </ul>	<ul style="list-style-type: none"> <li>• UN Security Council</li> <li>• NATO</li> <li>• Strategic alliances</li> <li>• Unilateral deterrence</li> <li>• Sanctions</li> </ul>	<ul style="list-style-type: none"> <li>• Strategic reserves</li> <li>• Transition to more sustainable energy system</li> <li>• Diversification</li> <li>• Domestic production</li> <li>• Energy system flexibility</li> <li>• Energy saving</li> </ul>	<ul style="list-style-type: none"> <li>• Oil-IEA/IEP</li> <li>• Gas, coal, etc: nothing at inter or intra level; national?</li> <li>• Demand management</li> <li>• Sharing of scarcity</li> <li>• Strategic reserves</li> </ul>

Source: CIEP, Study on Energy Supply Security and geopolitics, prepared for DGTREN, TREN/C1-06-2002, ETAP programme, January 2004 ([www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications))

### Preconditions for an external energy policy

For member states to cooperate and, perhaps in time, relinquish some of their sovereignty in the foreign (energy) domain, the absence of a crisis mechanism that fairly distributes costs and benefits between the member states (perhaps along the lines of the IEA method of cost distribution), and that helps to reduce the cost of risk management at the member state level, is a major (political) stumbling block for any EU initiative in external energy policy to become successful. While transition to a low carbon economy is a long-term containment policy, the short and medium term risks are not covered. The comfort level of certain Eastern European member states in particular would improve substantially with a minimum level of shared crisis management capacities in Europe. This would help them overcome the risk of asymmetric exposure to a disruption by a single supplier and/or single transportation route. Some of their concerns stem from their relatively brief histories as sovereign nations, the adaptation to rapidly changing economic circumstances, including those of oil and gas value chains, and their short



experience in the EU, which offers a different institutional framework for their political system and economy. The absorption into the internal energy market discipline with an energy system based on a different regulatory framework, and without some form of a safety net in place, was perhaps an omission in shaping the proper conditions for accession. The EU itself was essentially offered as a safety net, which would have sufficed in the buyers' market of the 1990s, but proved inadequate in the sellers' market in the period after 2003. Most of the conditions were negotiated in a completely different energy environment, including the organisation of energy trade with Russia, their main supplier.

That said, their options to diversify origin and routes are (commercially) limited at the national and perhaps even regional level. With limited economic options in arranging alternative supplies and limited possibilities in the short term to adapt the energy mix, smart positioning and a realistic approach will be crucial for them to overcome the current lack of a safety net. At the same time, engaging other member states in establishing a crisis management framework is vital. As relatively small member states they had a lot to gain from sharing security risks. Nevertheless, potential market based opportunities also ought to be secured and not excluded on political grounds, particularly not when the interests of the larger member states are potentially held hostage and disregarding those options would potentially increase the cost of energy security. In the current make-up of the EU, a small member state representing relatively small economic interests cannot realistically expect the larger member states or groups to forego pursuing its or their own interests and then to carry part of the cost of self-inflicted higher security of supply risks. Moreover, an Energy NATO, as was suggested, does not sit easily with the market system, the institution make-up of the EU (as a primarily economic organisation), or with building long term, stable energy relations based on integration of the value chain and energy economies. It also politicises energy relations where other member states are engaged in building these new economies. Small member states or small sub-markets often find themselves in a 'follower position', such as with energy relations between the EU and Russia. This brings both benefits and disadvantages. Nonetheless, smaller member states in the past very often managed to maximise their position in relation to the larger member states, when negotiating their support. Concretely, with regard to the gas transportation routes, the Baltic States and Poland can opt to increase the political and economic cost of Nord Stream and not participate or cooperate. Or they can opt to maximise their benefit from participating in this joint Russian-European venture. In the latter case, they can reduce their risk exposure to a single route (Ukrainian corridor) and find shelter in the route diversification already taking place. More proactive integration of their energy infrastructure in the arrangements that are being developed for the larger sub-markets in the EU would help bundle their economic and strategic interests to those of larger member states and their companies. Alternatively, they could

seriously sideline themselves when the benefits to the larger member states to carry their plans forward are greater than the cost of frigid internal relations with those smaller member states. In the case of Poland and the Baltic States, they were well positioned to negotiate additional energy security guarantees from both Germany and Russia for their cooperation. It seems that the new Polish government is trying to capture some of the lost strategic ground in the negotiations.

Apart from the specific case of the Nord Stream pipeline, it was already argued that the internal energy market and the international oil and gas sellers' market create sufficient ground to explore the merits of a basic internal crisis management policy for the EU. This policy, including demand management, seems like a necessary precondition for any initiative on external energy policy. It is needed in order to secure support from the member states and to close the policy gap in the internal energy market. The analogy with the oil crisis mechanism of the IEA's IEP, where member states remain sovereign over their energy policy and yet manage to share risks and costs in oil security, is the best example that comes to mind. The EU should be encouraged to establish something comparable on a regional scale for Europe or even for those parts of Europe that wish to go forward with this. What must be avoided, however, is a long discussion about the competency issue, free riding, burden sharing, etc. Instead, the EU and member states should focus on results, i.e., a reduction of risk to make member states more comfortable with EU policy initiatives. So far, the EU has not made a compelling case that their approach can address the individual member state security of supply concerns.

What can the EU do now to prepare the ground for a more European based energy policy? What the Commission can do to make a difference is, perhaps fortunately, not of sweeping political significance, and does not require grand political statements. Possible Commission actions are rather mundane and could and should have been done at the beginning of the liberalisation process because they are part and parcel of a properly functioning market: provide the market with transparency on flows and prices; lay the groundwork for creating some sort of benchmark for security of supply; and set up a peer-review system for member states to look at each others' arrangements. With this initial foundation set, the EU can begin to build - based on its coming shared responsibility - and develop an external energy policy, not the other way around. Thus, the Commission should first gather information on exactly what crisis mechanisms are in place in the member states. Second, they should gather information on how the market has organised or contracted for security of delivery. Third, they should develop an open information channel, analogous to the information the Energy Information Agency in the US, which played a crucial role after hurricane Katrina in providing information about capacities and prices on a daily basis. Transparency is crucial. Fourth, they should set up a peer review system among the member states. Fifth, they should develop a

security of supply index that functions as a benchmark or guideline for member states to evaluate their own and others' systems and solutions. Sixth, the Commission should be sensitive to the regional solutions or arrangements that are already part of the member states' security of supply package. Seventh, they should be perceptive to security of supply risks in relation to the measures of achieving a low carbon economy that will become the backbone of containment policies. Old risks can easily be replaced by new ones. Eight, develop a smart crisis mechanism, which is developed from the bottom-up, maximises the use of market-based solutions, is cost efficient, and avoids heavy bureaucracy. Stimulate member states in a race to the top, and make clever use of new technologies.

Member state authority should therefore be the point of departure for cooperation, and the joint interests in cost and risk reduction are to be used as the main drivers in producing the crisis management policy. Also, a crisis mechanism in the EU must, apart from oil, which is covered under the IEA policy, avoid a fuel-by-fuel approach since it would be more costly to achieve. Instead, efficiencies are possible by smartly combining the diversity of the energy mix, allowing gas security to be served by dual-firing capacities and by using the cheaper strategic oil reserves. It would be absurd to assume that all oil or all gas flows would be disrupted at the same time. A crisis mechanism, properly conceived, will be able to absorb a disruption of some size for a relatively short duration. As long as the member states can show that they can meet some security of supply standard<sup>15</sup>, they can expect solidarity. A crisis management mechanism arrangement per fuel, such as for gas (and perhaps also some arrangements for electricity, although electrons currently travel shorter distances) could be more complicated and more costly to realize than the oil crisis mechanism, because it is more expensive to store gas and electricity (in hydro for instance) and the infrastructure to effectively share scarcity might not presently be available. Given the expected higher cost of gas and electricity security, the EU ought to come up with a smart system for the use of diverse energy mixes and efficiencies. This can be achieved by employing the available technical and economic possibilities, first in the market (for instance interruptible demand, standby contracts), and as a last resort among governments (drawing on available reserves, mothballed capacities, etc), while actively managing demand.

Moreover, a crisis mechanism could also help overcome the uncertainties about the market design, where discussions about vertical integration and the wish of some for strong European companies, threatens to become a drawn out battle of wills between the Commission and certain large member states. The success of the

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<sup>15</sup> *EU Standards for Energy Security of Supply (update)*, Jacques de Jong, Hans Maters, Martin Scheepers en Ad Seebregts, (EN) CIEP, The Hague, Clingendael Institute/ Petten, Energy Research Centre of the Netherlands, CIEP/ECN, April 2007, (<[www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)>).

IEA is that it recognizes the importance of oil security for strategically important member countries. Although the mechanism does not provide them with the full service security of protecting or maintaining oil flows that they feel responsible for (i.e. securing sea routes for instance), it does make oil and oil products available through sharing in case of a regional or compartmentalized problem; it creates a strategic coalition, strengthening the political and economic importance; and it provides security to the smaller 'follower' states. This formula could be emulated within Europe and could be the solid foundation needed for the development of more cooperation in external energy policy-making.

The bad news is that energy security, both internal and external, is either going to be more costly to achieve than in previous decades or the energy security situation will become more uncertain. Governments must decide what the cost of increased risk is in terms of prevention, containment and crisis management policies, or in terms of the impact on the economy (society) with no particular safeguards in place. The consensus is that policies should be implemented, but the discussion on costs, benefits and method of adoption has not truly commenced.

#### *Smart crisis management*

Smart crisis management could progressively link the progress member states make in the transition to a more sustainable energy system, in the sense that it contributes to the cost reduction of traditional security of supply measures. A dynamic benchmark of a security of supply index<sup>16</sup> would help determine obligations in terms of traditional measures. Here, the EU could immediately play an important role in gathering the information and organising the system for compliance. In a dynamic security of supply indexed system, new economies throughout the value chains can be considered, and the information can be used to determine what the economic and political risks are. Currently, all the risks seem politicised and the member states are in danger of overreacting, burdening the market with a much higher cost base, and in general impeding regular market solutions.

Another opportunity is to incentivise the member states to connect investing in transition policies - which is the long-term solution to reduce the risk - to a crisis mechanism by fiscal stimulation. The more energy efficient and clean a member state becomes, the more tradable 'drawing rights' on a European energy security fund a member state is allocated. These 'drawing rights' can help finance the purchase of, for instance, gas in crisis situations. A benchmark could be the European average index, which would move with improvements in sustainability. The problem of new member states with inefficient energy systems could be solved by creating a special investment instrument to help them begin. When new member

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<sup>16</sup> *Ibid.*

states score low on the index, they can draw on an investment fund to reduce their exposure to risk by investing in sustainable, preferably domestically/regionally/European produced energies that are available in their market.

Another smart instrument, as was already mentioned, would be to replace the traditional fuel-by-fuel approach and allow the member states to develop an integrated policy<sup>17</sup>, tailored to their energy mix and particular demand and supply structure. Member states should not be forced to hold certain strategic stocks in gas or coal, or to oversize certain capacities and employ a fuel-by-fuel security policy. Rather, they should be stimulated to develop synergies, cost efficiencies, flexibilities and any other solutions that reduces their overall exposure to security of supply risk and that allow them to make efficient choices. For instance, the cost of underground storage of gas varies among member states. If a member state can reduce the cost of storage by storing oil, over-sizing non-gas electricity capacity, installing dual firing capacity, and installing wind, solar or hydro capacities to replace imported gas, this should all count towards the index that determines the measures to be taken.

A final smart instrument, in addition to the integrated energy security approach, would be to allow member states to bundle their efficiencies and synergies, as long as they can show that energy security is improving and that they are not free riding on other member states.

## Prevention instruments

The calls for 'one voice' appear to only relate to the possible coordination of certain prevention policies, in particular with regard to Russia (although a rift in approach and aim is obvious among the member states) and perhaps the Caspian region. But because details are lacking on what exactly the Council's 'one voice' consists of, it is quite possible that most of these calls are wishful thinking and for current political consumption only. Towards the Middle East or Africa, foreign policies are fundamentally dissimilar, and often, traditional relations with countries preceded the EU/EEC. The UK cannot be separated from its relationships with the Commonwealth countries, while France has similar ties to its former colonies. The special relations that certain member states have with other countries cannot easily be transferred to the EU level because they do not fit in the EU context, nor can they rely on long standing experience, contacts and interests. Contrary to the special relations going back to colonial times, where the pain of the 'divorce' has on both sides been more or less been dealt with, the relations of the Eastern European and Baltic

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<sup>17</sup> See also summary of: CIEP, "Study on Energy Supply Security and geopolitics," prepared for DGTREN, TREN/C1-06-2002, ETAP programme, January 2004 (<[www.clingendael.nl/ciep/publications](http://www.clingendael.nl/ciep/publications)>)

states with the countries in their previous alliance have not yet turned into special relationships, but are rather a source of tension since political and economic ties that still exist need to be adapted to the new situation. In that sense, enlargement has for the time being 'burdened' the EU's relations with Russia with an unfinished divorce settlement. These past alliances have complicated, for example, the traditional relationship between Germany and France - but also Italy, the Netherlands, and Austria - with Russia. But the foreign and economic ministries of these countries seem to be able to overcome these difficulties with greater ease than the EU. It therefore seems rational to use the ministries of certain member states, and not declare them running counter to the EU interests (or interests of certain member states). Rather, they should be encouraged to work for dual benefits, for national and European interests. It is also conceivable that member states could cooperate and coordinate their efforts in workable coalitions to further national and wider European interests. A good example is the Nord Stream pipeline, which has featured high on the agenda of the EU (pre-enlargement) and Germany, but is now causing internal friction (post-enlargement). The Commission could help the Council in overcoming this friction by pointing out the long standing importance of the route and the fact that it helps to bring more gas to Europe and reduces the transit risk, but also by initiating a crisis management framework. The latter is more important for security of supply and is also more effective in dealing with the asymmetries in exposure to disruption risks and the diversity of the energy mixes than the current 'nice words' on one voice. Poland perhaps phrased it too politically or confrontationally, and its communication was certainly devoid of subtleties towards other member states. In essence though, it pointed out the foremost weakness of energy policy in Europe: not the lack of an external energy policy but the lack of a crisis mechanism.

Adaptation to the major political and institutional changes on the European continent takes time. The enlargement process implied that the new member states adapted with a 'big bang', and not in a more gradual manner. Despite the current formal situation, implanting the new situation into the 'genes' of society and into foreign policies takes much longer. Also, Russia had to adapt to the new situation in Europe and deal with the economic realities of new state borders, while both economic and physical infrastructures reflected the old make up. The fact that EU membership is not clearly defined and that countries belonging to the former Soviet Union, other than the Baltic States, are also contemplating the possibility of membership, complicates relations with Russia, as the main country in the Commonwealth of Independent States. The desire of some CIS countries to become members of the North Atlantic Treaty Organisation is another foreign policy complication that burdens relations. Patience and understanding for each other's interests can in time overcome tension and sensitivities. Given the substantial changes over the past 15 years, the relative harmony in which they can occur is a success for all European countries. It should be clear,



however, that the changes harbour both costs and benefits, and the distribution should be perceived as fair in order to maintain good foreign relations.

The fact that Russia is a major energy exporter to Europe and that it also has vital interests in the Caspian Sea region underlines the importance of making the EU-Russia relationship a success. The EU's concerns over security of supply and Russia's worries over security of demand are potentially mirror images of each other and one could complement the other. Security of transit is a shared concern, although their approaches to reducing the risk have been dissimilar so far. Another reason the EU-Russia relationship must be a focal point is the overlap in the EU's neighbourhood policy and Russia's near abroad policy. Again, these could potentially be developed into comparable interests, or become a source of discontent and competition. Europe is quite experienced in managing its structural import dependence, while maintaining a clear view on its own interests. But with regard to energy producers, including Russia, they sometimes neglect to acknowledge the national interests of the producer state.

That both the EU and Russia do not automatically have similar interests makes efforts in foreign policy all the more important. If the EU and the member states want to stabilise relations with Russia and structure them in a strategic cooperation agreement, it would be wise to avoid unnecessary irritations and instead employ a goal oriented approach. An instrument that would benefit such an approach is to use the strong ministries of member states with long standing and solid bilateral relations, which could help both the Commission and the Council get closer to an agreement. The fact that three EU countries already discuss in a tripartite coalition with Iran shows that the method is not unheard of or unacceptable to other member states. Particularly a small group of member states preparing the political ground could be helpful in the development of 'one voice' approaches to energy with various producer and consumer countries. Because other member states must be able to accept the outcome, the negotiating member states should be sensitive to their needs without them becoming stumbling blocks or veto's. Other countries or regions, where the foreign policy approach is not immediately clear among the member states, could also be approached in this manner, as long as it is clear that ultimately, the relationship will be upgraded to the EU level. Using the national foreign and energy policy administrations also brings much expertise to the European table. Furthermore, energy companies that need government-to-government relations in order to conclude business-to-business contracts can communicate through their national administrations. When successes follow, the confidence in EU external energy policy-making will grow. Given the divergence in energy mixes, energy import dependence and asymmetric exposure to risk, the evolutionary approach appears to be a route that can remove resistance to increasingly combining bilateral approaches in an EU external energy

policy. Particularly in the use of prevention instruments, when crisis is still far away, this approach could build confidence both in the EU and with foreign countries.

After all, the gradual approach does not imply that all instruments can be effectively used as before. Typical security of supply policies such as diversification of source and geographic origin have become limited in their effectiveness as a result of climate change policy ambitions and restricted investment opportunities for private capital to boost reserves with foreign reserves. The policy toolset that had been successfully applied in the late 1970s and 1980s would not suffice. The EU member states did not have a new 'North Sea' at its disposal, and in addition, oil and gas supplies were bound to become more concentrated in only a few major exporting countries. Out of these, the Middle East continued to be a high political risk. This was further emphasised after the 9/11 attacks on the US, and the subsequent interventions in Afghanistan and Iraq. For the EU, the energy reserves of Russia and the Caspian Sea region gained strategic importance with supplies from the Middle East at risk and other regions, such as Africa and South America, being competed over by the US and China. The proximity of Russia and the Caspian Sea region to the European market and the fact that the production facilities were already connected to the European market through the former Soviet Union oil and gas infrastructural system, justified the interest. Yet, Russia and the Caspian Sea countries increasingly began to develop their own designs on how best to exploit their energy resources, and these designs have not always matched with the European drive for liberalisation. The European concern about the reorganization of the energy value chain in the most important exporting countries to the EU is understandable. The EU and the member states must, if and when energy flows are jeopardized as a result, defend the interests of all member states.

The differences in satisfying national interests should be resolved, not by forcing the organization model of the energy industry on each other, but by building upon joint interests. The joint ventures between the Russian company Gazprom and European energy companies (both in Europe and in Russia) can be seen in two different ways: as a successful route to closer integration of energy economies, or as a power struggle to gain dominance over each others' market model. In the EU, the presumption is that Russian companies will always aim for dominance over the European energy sector, while the presumption in Russia is that the EU wants to fragment Russian industry. The EU should at least show some confidence in the member states and the EU's competition laws, and in its regulatory capacities.

Europe was a successful formula because the integration created economic value for member states and for those who wished to operate on European markets. Through the integration of economies, joint interests also became durable in more difficult times. It would be a shame if the European Union experience, which



culminated in the deepening and enlargement of recent years, was ultimately the harbinger of impatience and conceit about other sovereign countries' reform processes and national interests choices.

### *Smart prevention*

Smart prevention is designed to ensure that the European economy is attractive to supply because of macro-economic stability, a stable currency, and a stable regulatory and investment climate. For energy suppliers to prefer the European market, a fair price and a stable volume are important. Also, suppliers must be able to contract their supplies with reliable counterparts in the market, so the size and scope of European companies should reflect to some extent the size and scope of the suppliers. Suppliers must also be able to invest in bringing their product to the end-user, so vertical integration is no problem as long as companies do not dominate all or parts of the market and abuse their position. Smart prevention includes sensitivity to suppliers' security of demand concerns and using the EU's soft powers to strengthen and broaden economic relations. Energy trade should be embedded into a mutual, wider trade portfolio in order to increase the shared economic costs of a dispute. Smart prevention also includes engaging the traditional supplier countries in making their economies more energy efficient and sustainable in order to conserve finite resources over a longer period of time. It also involves innovating the non-energy economy, resulting in energy savings.

## **Deterrence**

Above it was argued that the growing geopolitical dilemmas and the willingness and ability to engage with hard power rather than soft were addressed at the member state and EU level. In this context, the question was raised if the EU design should be adapted to include geostrategic policy options. Notice that the answer to this question depends on the future of the NATO alliance. The purpose of NATO has been debated since the demise of the Soviet Union. The current NATO operation in Afghanistan is the first operation outside its traditional 'theatre' of operations, i.e., Europe. The new member states feel comfortable in the alliance with the US, and other countries from the former 'Eastern bloc' would also like to join in order to increase the security threshold between themselves and Russia, and to distance themselves from the past and their dependence on Moscow.

If the NATO member states can find and agree on a new mandate and purpose for the alliance, the development of EU instruments in this area will be difficult, if not impossible to achieve. Much effort will go into making the alliance work, both with an extended membership and with a new mandate.

The formulation of this new mandate might be a conundrum. Finding the proper organizing principle or vision for the alliance should be precise enough to give focus, but broad enough to give purpose. Moreover, vital interests of the member countries should be

represented in the mission statement. Defending democracy or democratic rights could be too vague. NATO will also not be allowed to emulate the UN agenda, and the war on terror as a central goal could too easily be seen as a clash of civilizations and sour sound relations with some Islamic countries. Broad NATO involvement in energy security also runs the risk of straining relations, rather than stabilising or relaxing them.<sup>18</sup> Yet, it is not unthinkable that a newfound rationale for the alliance is be found in the security of energy flows, since this represents the vital interests of all member countries. This security could be defined narrowly, as in securing transportation routes (a narrow definition would only include the naval routes; in a wider definition, vital pipeline routes would be included) and perhaps certain vital production facilities. Or, it could be viewed in a wider sense, to secure energy flows to make certain that sufficient energy will reach international markets. The level of deterrence to divert flows away from the alliance for political and strategic reasons could be fairly high. In combination with the instruments of the UN Security Council, and with the economic instruments of the IEA, a powerful deterrent or credible threat could be envisaged. But such a mandate would also create strategic competition for energy flows with other geopolitical powers and could potentially hamper the operation of the world energy markets when strategic behaviour is provoked. Energy as an organizing principle is therefore also fraught with many difficulties.

The level of deterrence that the EU can muster is mostly of an economic nature, and the structural dependency on imports will limit the general deterrence potential. Yet singling out certain countries for sanctions is conceivable, particularly when it concerns a smaller supplier. In the end, the EU is best served with slightly oversupplied markets in order to maximize the instruments available to the EU. The EU's powers outside the economic domain are mainly to obstruct and neglect, not to create or enforce.

#### *Smart deterrence*

Smart deterrence is based on coalitions that have a full-fledged energy security toolbox and a foreign and security mandate to discipline those that hamper the free flow of energy and to prevent being confronted by other consuming countries. Smart deterrence also involves the redistribution of the cost of maintaining the free flow of energy to potential free riders in the system. Some sort of energy coalition with China, for instance by including China and India in the IEA crisis mechanism, could be a powerful deterrent to producing countries to interfere with oil or gas flows.

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<sup>18</sup> Pierre Noel, "Challenging the myths of energy security," FT, 10 January 2008.

## Containment

The transition to a more sustainable energy economy in Europe can be seen as a long term containment policy, and therefore smart, because it has all the elements of containment in it: diversification of source and origin, demand management, and promoting domestic production. Also, new energies require more system flexibility to integrate them into the energy infrastructure. However, this is a very long-term solution. Before this new energy economy materializes, the dependency on fossil fuel remains substantial. The transition itself could be costly and limit the ability of countries to at the same time invest in security of supply policies. Smart is when the member states realize that the cost of transition is a structural investment in improving their energy security, while traditional security of supply measures are not.

## *Smart external energy diplomacy*

The challenges to the EU are large and immediate. At the same time, the process of developing a full-fledged external energy policy, in conjunction with the transition to a more sustainable energy system, is a very tall order indeed. Only a severe crisis would be able to create the sense of urgency needed to speed up the process of getting a full-fledged policy in place with expedience. Short of a crisis, European policy-making processes are slow. As long as the national energy diplomacy initiatives are there to prevent such a crisis from occurring, and there is no immediate danger, member states will promote their own interests in this area and focus on the transition agenda, while relying on their own policy toolset, experience and abilities to secure fossil energy flows. The Commission has not yet made a convincing case to member states to relinquish their national oriented policies, while their oil policies are secured in the International Energy Agency. The absence of a crisis management policy is particularly important for smaller or follower member states, while large member states are better positioned to secure their energy interests, despite the decline of the national instruments' effectiveness due to the internal market.

The diversity of the energy mixes in Europe also creates possibilities because, except where oil and gas are concerned, the impact of a disruption or extended scarcity could be fairly localized. The improved connectivity also allows for flows to be redistributed, although this function could be technically restricted. Clearly, the biggest problems are for countries at the 'end of a pipeline' or on the edges of the infrastructural system, who have few alternative routes and infrastructure to switch to, countries with concentrated supplies or with a lack of economic ability to purchase energy at premium prices. The internal market will not solve the problems of countries at the outer edges of the European market because the economies might not always be there to develop the proper infrastructure. These

countries should be assisted by the regional fund, an energy security fund or soft European Investment Bank lending window to improve their energy security.

The most pressing issue for external energy policy is the dependency of the European economy on oil and gas imports. European energy diplomacy will most likely be focused on oil and gas producing countries. The limits of independent initiatives towards oil producing countries in the Middle East (although the tripartite discussions with Iran are an important exception) are clear. The 'battle for Africa' is on, but Europe will meet stiff competition from the US, China and India for African resources. Which leaves the most important relationship, Russia. The importance of Russian energy supplies is clear. Moreover, Russia could develop into an energy linchpin on the European-Asian continent. European external energy policy is first and foremost about the energy relationship with Russia and North Africa. Therefore, there is after all nothing new under the European sun. Smart actions would involve returning to the negotiation table and hammering out a new strategic partnership that is respectful of both European and Russian interests.

## **Conclusion**

The EU should recognise that the current incomplete powers in the field of energy and the strategic foreign policy dimensions will take a long time to develop into what can be considered 'one voice'. If immediate accomplishments in this area are desired, a different approach to the development of an external energy policy is required. Instead of trying to convince the member states to transfer their competences in energy, foreign and security policy as soon as possible to the EU level, the Commission should promote a bottom-up approach. This should allow for the smarter use of diversity, asymmetry and subsidiarity among the member states, and turning these perceived stumbling blocks into assets or instruments of external energy policy. Such an approach uses, for example, the discipline of the internal energy market, climate change policies and the expert ministries of individual member states with producer and competing consumer countries.

The Commission can start by enhancing transparency and beginning to prepare the ground for a crisis mechanism. They should focus on stimulating the member states and the companies in a race to the top, and reward best practises, bottom up rather than top down. It is also important that the development towards a low carbon economy, as the EU's long-term containment policy, is made an integral part of security of supply approaches. A smart crisis mechanism is the basis for external energy policy to be developed on, not the other way around.

Furthermore, member states' should substantiate why their external energy policy contributes not only to the national but also to the EU-regional or EU wide security of supply. National interests should not run counter to the interests in continuous energy flows of other member states, but instead should help increase the energy flows available to the European market. By using diversity and asymmetry as an asset of EU policy-making, those policies that truly are most effective at the European level will be 'produced' or demanded by that market.