

THE TIME HAS COME FOR A EUROPEAN ENERGY UNION

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20 November 2014

A comment on the EU Council's "Conclusions on 2030 Climate and Energy Policy Framework" European Council, 23 and 24 October 2014

Introduction

After the appointment of the new European Commission, the long-awaited European Council in October ended in a set of Policy Conclusions¹. These focus on the 2030 European Climate and Energy Policy, thus reaffirming the centrality of a sustainable energy sector to foster an industrial growth urgently needed after half a decade of economic crisis.

The October Council meeting raised high expectations, including the definition of the main strategic lines for a common European energy policy. They specifically concerned gas security challenges, an assessment of the electricity sector in light of the revolutionary changes brought about by decentralized generation, and guidelines giving energy a key role in EU Investment Plans for the re-launching of the economy.

However, despite the Council's great ambitions, none of these issues² were actually directly addressed. The Council's conclusions tackle a different set of priorities, as they seem to respond to the EU's main objective of reaffirming its leadership in the forthcoming United Nations 2015 Paris

¹ "Conclusions on 2030 Climate and Energy Policy Framework" European Council 23 and 24 October 2014

² Anticipations called for, among others, a vision able to offer objectives and consistent tools to address the extraordinary changes that, in such a short period, have dramatically impacted the energy sector and affected the competitiveness of European industry. Indeed, for fossil fuels, unconventional gas and oil exploitation has boosted profit margins for American industry, while the increase of GNL has modified gas routes and decoupled gas from oil prices. These changes have driven increasingly national and divergent interests to prevail over the Commission's struggles to unify national energy markets. A similar effect is caused by the drastic increase in new renewable energy sources (RES) that triggers national solutions for electricity to both integrate ICT devices for smart grids and gradually decrease electricity supply from oil and gas CCGT (combined cycle plants). As RES push electricity wholesale market prices to unsustainable levels (less than 30 Euro/MWh), national measures to provide back reserves for intermittent energy sources become more and more necessary.³ These measures of compensation include: a Reserve Fund of emission allowances (2%) for low income countries with GDP per capita inferior to 60% of EU than EU average, and, for countries with a slightly lower GDP per capita than EU average (90%) a 10% share of the yields from Member State allowances auctions.

meeting on Climate Change. The meeting is expected to pave the way for a stronger EU role in international negotiations, in order to foster burden sharing and globally binding Third Country targets and commitments. The set of objectives, tools and implementation procedures proposed shows that, once again, EU governance constitutes an obstacle to achieving an effective and cohesive industrial and energy policy, thus posing the question as to whether the time has come for Member States to invest in a European Energy Union. In this perspective, three of the four goals for 2030 are highly symbolic. The primary target, around which the entire framework is built, is the reduction by 40% of EU greenhouse gas emissions (GHG) compared to 1990 levels. It is a binding target, though at a European level only. The second, also binding at a European level, entails a share of 27% of RES in final consumption. The third target, which is merely indicative, is an increase in energy efficiency by 27% compared with the 2005 values. Finally, a fourth objective was included among the environmental goals: it confidently predicts the completion of the Internal Energy Market. For the first time, it prescribes a 10% increase by 2025 and a 15% by 2030 of national infrastructures with the objective of strengthening electrical interconnections amongst Member States (MS) - Spain, Portugal and the Balkans in particular - and connecting Finland and Baltic countries to sustain Europe's ability to diversify its energy sources. Finally, in order to bolster energy security, the Council recommends the Commission to coordinate investments for Projects of Common Interest (PCI) and electric infrastructures, to complete the North-South and South gas corridors, to push for the diversification of supply routes, and to guarantee a better usage of storage and regasification plants.

In short, these objectives reaffirm the Commission's 2030 Framework proposal, though the energy efficiency target is downgraded from 30 to 27%. But it is also worth mentioning that two substantial elements of discontinuity were introduced: a flexibility principle for which no binding targets are defined on a national level and a reinforced principle of solidarity for which some forms of compensation are recognized to support the de-carbonization of lower income Member States³.

The difficulty in achieving a balance between environmental objectives on the one hand, but also the competitiveness of Europe's industry on the other hand are particularly evident throughout the text. It also explains why the Council looks for compromises and compensations in order to reach the convergence of 28 Member States. Indeed, Europe runs a great risk of penalizing its economy to pursue its de-carbonization strategy. The Oxford Institute for Energy Studies (2014)⁴ estimates that EU industries have recorded a yearly 3,5% increase in energy prices since 2008, a result mainly due to the EU's climate change policies. The institute also forecasts that the EU's share of global export market for energy-intensive goods over the period to 2035 will decrease by 10% (from today's 36%). This deeply contrasts with the January 2014 Commission's

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⁴ Oxford Institute for energy studies, Costs competitiveness and climate policy: distortions across Europe, April 2014.

Communication for a “EU Industrial Renaissance”⁵. Until now, however, the Council, has not shown the political willingness to take this qualitative leap.

Objectives, tools and governance.

That said, three questions need to be asked: 1) Are the objectives challenging from an environmental perspective? 2) Are the objectives realistic? 3) Are the tools in place consistent and effective enough to achieve these objectives?

1. Symbolically speaking, the European objectives may seem rather challenging. However, if we consider the EU’s objective of 40% GHG emission reduction, the main target of the package, it rather appears a *business as usual* scenario. Indeed, the “Progress towards 2008 – 2012 Kyoto targets in Europe”⁶, shows that as of 2013, Europe achieved a 19% reduction of GHG, meaning that the 2020 target has already been met six years in advance, though this result is rather the result of the member states’ very slow economic growth in recent years. Much to the same extent, the indicator of energy efficiency should be sterilized from the macro economic effects on energy demand in order to adequately reflect the impact of low-carbon technologies and rationalization of consumption (an energy intensive indicator - i.e. kg of oil equivalent per 1000 Euros of GDP - would prove more efficient than the energy saving equivalent).
2. The feasibility of the objectives is strictly tied to the EU governance. The two themes are closely related as the model of governance contributes to determining progress, associated costs, and the choice of instruments (coercive, market or otherwise) to employ. Nevertheless the debate on the European strategy has always focused on the objectives to be achieved, without identifying the tools to pursue such objectives. Their identification, instead, has usually been the task of sectoral initiatives, while the EU has shown little or no interest on the underpinning model of governance. The Conclusions do not investigate this issue either and rather limit themselves to underling the flexibility granted to Member States, re-proposing National Plans for environmental objectives. The EU is only given a restricted role that solely consists in “facilitating the coordination of national energy policies and foster regional cooperation between Member States” (p.10).

A step towards Europeanization, following the Commission’s emphasis in its 2030 Energy Framework, was initially expected. Regretfully, however, the Council, in its Conclusions, showed more restraint and less perseverance. In more detail, the process entails the definition of 28 national plans and national tools to implement them, and while the Commission is only given the assessment

⁵ European Commission - MEMO/14/37 22/01/2014

⁶ Report published on the 28th of October, 2014 by the Commission and the European Environment Agency <http://www.eea.europa.eu/publications/progress-towards-2008-2012-kyoto>

task, the enforcement of such plans falls entirely within the responsibility of the Member States. Accordingly, the assessment phase is allocated to the Commission and should be achieved through the analysis, in an iterative procedure, of National Plans and their consistency with the EU targets. Member States should be able, and willing, to build National strategies that are somehow consistent with both each other and are coherent with the single, common EU objective. In other words, some high levels of optimism are required to envisage that the autonomous convergence of 28 National Plans towards a single EU binding target is likely to succeed. The past experience of National Plans for emission trading schemes (ETS) indeed constitutes a warning signal that cannot be disregarded at this point.

The Commission itself suggests that “in a second stage, should the cooperative approach prove ineffective, it may be necessary to adjust the normative model for the management of these policies, foreseeing greater powers to EC organs”. This statement adds further uncertainty to a regulatory framework that should instead provide more certainty and stable rules to promote long-term investments.

The subsidiarity principle is thus respected by this new process, but what are the chances of the process working efficiently?

Two crucial questions remain unanswered. Do the Treaties allow a more effective governance enabling the EU to achieve its targets efficiently? And second, even more challenging, are Member States prepared and willing to empower the Commission to carry out a truly common energy policy, embracing a forward-looking vision which is able to comprehend the great benefits of an Energy Union?

3. As for the tools, no assessment of cost effectiveness, technical feasibility, or economic inconsistencies among tools and targets are specifically foreseen. The Conclusions state that “the main European instrument to achieve the GHG emissions target is a well-functioning, reformed Emissions Trading System ETS”. The Council however does not propose a reform, but rather a series of corrective measures for the System in order to mitigate the past criticalities that eventually led to its failure in the initial experimental phases. The EU ETS established a cap of total emissions for the region; the emission allowances are tradable and the price of carbon is fixed on the market⁷.

This system presents at least two critical issues: the price and the initial allocation of allowances. Indeed, the market carbon price must be sufficiently high to successfully induce energy efficiency and innovative investments. In Europe this price was initially estimated to be around 26/28 euros, today the market carbon price in Europe is only around 6 euros. Between 2005 and 2007, the price, which remained lower than anticipated within a range of about 5-15 euros, fell to zero at the end of the first EU ETS period. In the second period, between 2008 and 2012, it precipitated. At the beginning of the recession, it remained at around 15 euros as a result of

⁷ In particular, the market price of carbon has the purpose of internalizing the social cost of pollution in firms' cost functions, maintaining the advantage of gas and less polluting sources over coal and promoting investment for low carbon technologies.

oversupply until the end of the second term. For the entire period, the price of carbon remained at levels that proved insufficient to promote investments in low carbon technologies. However, the Council lacked the courage to reduce ETS allowances to handle this criticality. This would also have increased the credibility of EU policy in Paris 2015.

Following the Commission's proposal, the Council states that the total supply of allowances (cap) will be reduced by a yearly rate of 1.74% until 2020 and by 2.2% from 2021 compared to today's cap of 2.039 Million toe-. The aggregate supply of allowances is further reduced, as 2% of allowances are devolved to the Reserve Fund (Solidarity Fund for investment projects in Member States with GDP pro capita lower than 60% of EU average).

The second critical issue is that the initial allocation of tradable permits, as greatly debated by academics, must be as effective as possible. In fact, grandfathering, i.e. the initial free allocation of allowances, risks being translated into extra profit for businesses in the involved sectors, especially for those operating in oligopolistic markets. On the other hand, the allocation through auctions, by increasing production costs, pose certain risks of aggravating competitiveness for internal industries, while globally creating a carbon leakage. In other words, besides penalizing the European industry, this pattern actually worsens global pollution and shifts the production to countries with less environmentally-sophisticated technologies.

To obviate this critical point, the Council established a set of countermeasures: a share of allowances is distributed free of charge until 2020 to firms in sectors that face the risk of "losing international competitiveness" in order to safeguard efficient power plants from EU environmental measures. However, as the "benchmark for free allocation will be periodically reviewed, in line with technological progress" a degree of uncertainty is further introduced.

For the sectors not part of ETS, i.e. transport, buildings, agriculture and waste, the national objectives of emission reductions to 2030 are re-affirmed in line with the principle of subsidiarity.

Concluding remarks: can Europe dare more?

Having made the above considerations concerning the objectives, procedures, tools and feasibility of the environmental targets, the fundamental point remains the creation of an Energy Union. This calls for a different political and economic approach at a European level and is not by any means fully achieved with the completion of an internal energy market (IEM) by 2014. It requires the empowerment of European organs and a clearly coherent and common EU industrial policy.

In this direction some steps may be put into consideration to bring about gradual change. Examples of policy recommendations are the following.

1. An important step would be the promotion and financing of large-scale, mission-oriented investments in low carbon projects on a European level, replacing current national,

uncoordinated incentives for specific, small-scale projects (e.g. PV solar plants), currently under the scrutiny of the Commission⁸

2. At the same time financial instruments to promote specific R&D projects for the energy sector, under EU coordination and support, should be examined. A positive example in this very direction has been US President Obama's strategy for energy and growth with the launch of ARPA-E in 2009, the Federal Advanced Research Project Agency for Energy, in which the Federal Government identified a strategic role for the energy sector. Not generic subsidies but mission-oriented large research programs are the core of US public intervention. ARPA-E is financed by the Federal program (ARRA) and is already producing spill-over effects on industrial innovative technologies⁹. Needless to say, this process would have to be carried out gradually over time if it were to happen in Europe, and that a series of important amendments would have to be assessed within the framework of the EU Treaties.
3. From an environmental perspective, a further example is the gradual phasing out of the usage of coal (e.g. in Germany). Given the national independence on fuel mix, the Member States' governments are each individually required to follow their commitments. However, following the Court's decision against the Polish Government which confirmed the legitimacy of the 20-20-20 Package to impose a share of renewable sources to Member States, it has been discussed whether there is ground for imposing fuel targets on Member States based on environmental needs¹⁰. This Court's decision opens new margins towards a European Energy Union.
4. Finally, policy recommendations refer to strengthening both the Government and the Governance in the EU energy field. On the Government side, there is an urgent need for a EU industrial policy, or at least a EU-level coordination of Member States' industrial

⁸ It is under discussion whether they may be considered forms of "state aid".

⁹ This much in the same way as the Federal Agency on the Defence Sector (ARDA) worked, producing extraordinary industrial innovative technologies from military research after WWII (eg GPS, ICT technologies, etc), thus enabling American firms to gain a global leadership in these frontier sectors.

¹⁰ The European Commission, on March 2013, has referred Poland and Cyprus to the Court of Justice of the European Union for failing to transpose the Renewable Energy Directive. The Directive had to be transposed by the Member States by 5 December 2010 and aims at ensuring a 20% share of renewable energy in the EU by 2020. The Renewable Energy Directive includes key provisions for achieving these objectives, particularly setting individual targets for the overall share of renewable energy in each Member State's energy consumption and rules on grid access for electricity from renewable energy sources. Furthermore, it may be interesting to recall that in the recent past Poland appealed to the EU General Court asking for the annulment of the Commission's Decision 2011/278/EU, determining transitional Union-wide rules for harmonised free allocation of emission allowances. The Sentence of March 7th 2013, in case T-370/11, of the EU Tribunal rejected Poland's appeal, confirming that national legislative acts related to renewable energy and emission trading shares were not deemed substantial enough to implement the Directive and the ETS instituted with Dir. 2003/87/CE. The Court sustained that the decision is an implementation of the Directive that was adopted on the basis of the dispositions of the Treaty on the Functioning of the European Union (TFEU) pertaining to environmental policy and not on the basis of the dispositions on energy policy.

policies. The urgent need for a EU strategy towards third countries, particularly energy producers, seems also fundamental.

Although the importance of governance cannot be overlooked, the risk of Europe falling into a trap of excessive bureaucracy is becoming more apparent than ever before. EU and National Regulators have almost fulfilled their tasks for the harmonization of rules (i.e. network codes) and the integration of national markets (for the creation of an Internal Energy Market). It is now time for Governments to invest in a new European Energy Union, showing the same political generosity and forward-looking vision they had once demonstrated in the 1950's for the launch of the CECA and the Common Market. Along the same lines as what occurred two decades ago regarding the monetary policy, the creation and implementation of an effective European industrial policy requires the same willingness of national governments to devolve a degree of national sovereignty.

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