Goldthau, Andreas; Sitter, Nick

Article

Whither the liberal European Union energy model? The public policy consequences of Russia's weaponization of Energy

EconPol Forum

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Goldthau, Andreas; Sitter, Nick (2022) : Whither the liberal European Union energy model? The public policy consequences of Russia's weaponization of Energy, EconPol Forum, ISSN 2752-1184, CESifo GmbH, Munich, Vol. 23, Iss. 6, pp. 4-7

This Version is available at:
https://hdl.handle.net/10419/272138

Andreas Goldthau and *Nick Sitter*

Whither the Liberal European Union Energy Model? The Public Policy Consequences of Russia's Weaponization of Energy

KEY MESSAGES

- **Energy is primarily a private good but also has public goods characteristics. The EU's traditional strategy to cater to the strategic goods element – energy security – was the liberal market model**
- **The Ukraine crisis has fundamentally put the liberal model in question. The present EU measures are deeply interventionist**
- **Renewables are elevated to matters of national interest. Combined with massive public funds, this accelerates the clean transition and is likely to put structural breaks into the incumbent energy system**
- **Going forward, the EU has three options: a return to the status quo ante (the liberal model); a more robust "public interest" model accounting for the risk of high political costs; and a Colbertist model putting the state in charge of managing markets and the clean transition**
- **The Ukraine crisis highlights each model's political and economic trade-offs. Policy priorities and strategies need to be revisited in light of these trade-offs. This is a watershed moment in European energy policy**

Russia's invasion of Ukraine on February 24, 2022 brought energy security to the top of the European Union energy policy agenda. Since the liberalization of gas and electricity markets in the 1990s, EU energy policy has been built on three pillars: a competitive Single European Market, environmental sustainability, and energy security. Security took a backseat; competition came first. In the first half of 2022 the EU reversed this, with considerable effect. National and EU-level measures focused on enhancing gas storage, adding more pipeline gas from Norway and North Africa and more import of Liquefied Natural Gas, facilitating new import infrastructure, swapping gas for other fuels, including coal and renewables, reducing consumption, and supporting firms and consumers hit by high prices. By September Russian gas was down to less than 10 percent of EU imports, from more than 40 percent at the beginning of the year (Gasworld 2022). Yet, since most of these initiatives involve significant state intervention, the EU's ad hoc measures for surviving an upcoming winter raise important and more fundamental questions about the future of EU energy markets.

We argue that the Ukraine crisis is a watershed moment in European energy policy because two major shifts are unfolding in the shadow of short-term crisis management. The first is a paradigm change, from a liberal to a more interventionist approach to the EU energy market and international energy trade.[1] Because of the national security implication of energy trade, EU governments are unlikely to relinquish their newfound role in energy markets in the way that they wound down state intervention after the financial crisis. The second shift involves the securitization of the transition to a low-carbon economy. Because renewable energy has acquired a role in national security, it is now subject to a much broader range of policy tools than merely those of climate policy. This throws up questions about the EU's strategic options for dealing with energy security.

THE LIBERAL EU MODEL: ENSURING ENERGY SECURITY THROUGH FREE TRADE

The policy measures that the EU and its member states are working on signal a potential break with the EU's established energy strategy. In public policy terms, energy is primarily a private good. Oil, gas, coal, or electrons are rival and excludable in consumption. In Europe, the production, trade, and pricing of such goods is therefore largely left to the market. Yet, energy also has public goods characteristics, in the sense that it includes elements that are non-rival and non-excludable. Inelastic supply, wide price swings, bottlenecks in shipping, and other cases of market failure may put in question the reliable supply of energy at affordable prices. Because the latter is important both for industry and society, it warrants careful policy design, notably in regions that rely on imports for most of their energy needs, such as the EU. The fact that energy security also has national security consequences makes energy a strategic good. Disputes over energy cause conflict and energy revenues sustain conflict, but more importantly, a reduction in energy supply can be used as a tool for political influence or as a means of inflicting harm on an opponent's economy.

The EU dealt with this strategic goods element with a liberal approach to energy markets. This was a deliberate choice. The principal idea was to create

[1] Paradigms are understood as the dominant economic, social, or technological model. For a discussion of policy paradigms in energy, see Goldthau (2012).

a vast and integrated market that was attractive for international suppliers to ensure competitive pricing. Beginning in the 1990s, the EU adopted a series of "energy packages" that liberalized the gas and power sectors, broke up national monopolies, and integrated formerly balkanized European markets. A determined pro-market push in EU energy regulation – the software, as former EU Energy Commissioner Maroš Šefčovič put it – ensured price competition between different sources of gas supply, including from Russia, Norway, Algeria, and global LNG. Inside the EU, third-party access to pipelines and unbundling of operation and ownership in infrastructure fundamentally changed the energy industry. The European Commission even forced amendments to existing gas contracts that included territorial restrictions in resale to further promote intra-European gas-on-gas competition.

The hardware component included infrastructure measures to ensure the free flow of gas (and electricity) across borders. The Commission supported interconnectors and other strategic pipeline projects to a limited extent by funding, but more importantly by facilitating the planning process and through strategic signaling by labeling them 'Projects of Common Interests'. The hardware component of the Single European Energy Market became even more important after the 2009 gas crisis and the 2014 annexation of Crimea, with a focus on improving reverse-flow gas pipeline capacity so that Eastern member states could be supplied from the West.

The liberal approach did not always adhere to textbook principles of pro-market regulation. As some observers argued, the Commission sometimes used the regulatory toolbox in a strategic way, notably by stopping the Russia-sponsored South Stream pipeline and when it extended the Security of Supply Directive to import pipelines (Goldthau and Sitter 2020 and 2015). Moreover, some EU countries showed little appetite to let go of their prerogatives in the domestic energy industry. This delayed or prevented strategically important cross-border infrastructure projects, such as the Bulgaria-Greece-Hungary interconnector or the MidCap pipeline linking Spain and France. In addition, gas storage remained a weak spot.

Overall, however, the liberal model delivered what was intended: gas prices came down. Even long-term contract prices converged across the bloc. This in turn shifted the economic rent from producers to consumers (Stern and Rogers 2017). What is more, Russia lost the ability to charge different prices to various European consumers. In terms of the public goods element of energy, the model catered to the aim of having choice in terms of sources, and affordability in terms of prices. In security terms, it was based on the idea that Russia could not afford to put its oil and gas sales to Europe at risk by interrupting supplies, since fossil fuel pre-crisis sales made up some 45 percent of the Russian state budget (IEA 2022). Moreover, increased energy trade with Russia fit a long-term strategy of drawing Moscow towards the liberal West through globalization and interdependence.

Andreas Goldthau

is Director of the Willy Brandt School and Franz Haniel Professor for Public Policy at the Faculty of Economics, Law and Social Sciences, University of Erfurt and Research Group Leader at the Institute for Advanced Sustainability Studies.

Nick Sitter

is Professor of Public Policy at the CEU, Professor of Political Economy at the BI Norwegian Business School, and a Research Associate at the LSE Centre for Analysis of Risk and Regulation.

THE SHIFT IN ENERGY REGULATION: FROM MARKET TO PLAN

The Ukraine war caused a fundamental change in European perspectives on energy security. Against the backdrop of supply shortages, the specter of gas rationing and skyrocketing wholesale prices –with TTF futures hovering around EUR 200 per MWh for a good part of 2023 – the crucial question is whether the liberal gas market model is a fair-weather phenomenon. Does it deliver only under the condition of a buyers' market, unfit to cope with structural shortage?

Addressing pressing pricing and supply challenges, European governments opted for bold interventions in gas and electricity markets. The most important examples include Germany nationalizing UNIPER, France EDF, and the Netherlands and the UK pondering similar measures. EU leaders started facilitating gas deals around the world, including in Norway, Algeria, Qatar, and the US. In the German case, the government ended up paying some EUR 3 billion out of tax money for LNG cargos. The Commission suggested joint gas purchases, which, after the Council agreed, yielded the EU Gas Platform, which is now suggested to become the legally required vehicle to procure at least 15 percent of the 2023 storage needs. In addition, discussions on price caps on gas are gaining speed. Most member states have taken measures to shield households and industry from the impact of unprecedented price levels.

These steps may turn out to be temporary public policy responses to a severe crisis. However, they could also signal a fundamental shift in the energy policy paradigm, from market (back) to plan. The specter of a EU monopsony in gas purchase, a limited role of trading hubs in delivering price signals, and a flurry of gas diplomacy challenge fundamental building blocks of the liberal model. On September 21, in her State of the European Union Speech, European Commission President Ursula von der Leyen emphasized the need to "keep working to lower gas prices," called for "a more representative benchmark" than TTF, and declared that "The current electricity market design – based on merit order– is not doing justice to consumers anymore" (Von der Leyen 2022). With this, the President of the European Commission

effectively questioned the very principles that had driven three decades of energy liberalization.

THE SHIFT IN ENERGY TRANSITION: FROM MARKET TO SECURITY

The second fundamental shift brought about by the Ukraine war relates to decarbonization. EU climate policy is primarily driven by regulation (such as the Renewable Energy Directive), by mandated targets (e.g. related to CO_2 emissions or renewable energy), and by subsidies (such as feed-in tariffs). These are here to stay, but targets have become much more ambitious since the Russian invasion.

For example, Germany now set the goal of 80 percent renewables in power generation by 2030 (Cleanergywire 2022), whereas the UK aims for "home-grown power" to achieve net zero by 2035 (HM Department for Business 2022). The Netherlands is to double offshore wind capacity by 2030 (Reuters 2022c), while Italy is eying "several tens of gigawatts of offshore wind power" (RFI 2022). Belgium, Denmark, Sweden, and Germany have unveiled plans to effectively turn the North Sea into a green power plant, aiming for 150 gigawatts in wind capacity by 2050 (Reuters 2022a). In addition to supply-side measures, structural demand destruction is hitting both oil and gas markets, as the EU agreed to phase out internal combustion engine vehicles by 2035, as governments aim to retrofit residential housing and heating systems to move them away from gas and energy-intensive industry is relocating.

Moreover, the EU and its member states have mobilized massive public funds in support. The EU's REPowerEU plan is set to unlock EUR 210 billion in funds towards clean energy investment (S&P Global 2022). Germany alone pledged more than EUR 200 billion for industrial decarbonization (Reuters 2022b), with similar measures being taken in other EU countries, including France (Euractiv 2022a). To be sure, supply chain bottlenecks, shortages in skilled personnel, and notoriously protracted planning processes still pose challenges, and not all of the pledged funds are in fact "new" money.

The new dynamics of the green transition is that decarbonization has been securitized. In German finance minister Christian Lindner's words, in the context of Russia's war against Ukraine renewables represent "freedom energy" (Euractiv 2022b). This has been widely echoed in European political circles and lies at the heart of the REPowerEU plan. This changes the way in which renewables are perceived, and how they are treated. It elevates them from the climate domain to the security domain. Renewable energy is no longer merely a long-term matter of saving the planet or achieving cost competitiveness with fossil fuels. Now, it is imperative for the national interest. In international relations terms, European energy has become – or more correctly, it is once again – a matter of "high politics" (Hoffmann 1966). Securitizing renewables enables extraordinary measures: additional public funding, flexibility on state-aid rules, as well as clear decisions on trade-offs between, for example, environmental protection and a fast ramp-up of offshore wind farms.

The effects of elevating the clean energy transition to a matter of national security will unfold in the longer term. Short-term measures could become the structural breaks in the energy industry that are necessary to decarbonize on a large scale. This is likely to shift European energy trade, both in terms of share of imports in the energy balance and in terms of the type of energy resources imported. Natural gas will be sourced in the shape of LNG, rather than from pipelines. This might require long-term contracts. Clean liquids from newly emerging energy partners such as Canada and North Africa could replace some of fossil imports. In short, the Ukraine war may well put the EU green energy transition on steroids.

POLICY CONCLUSIONS: FUTURE PERSPECTIVES AND STRATEGIC OPTIONS

The measures that the EU and its member states are putting into place to meet the challenges raised by Russia's invasion of Ukraine and weaponization of energy have been developed at break-neck speed. The core short-term challenges are to ensure sufficient supply of energy for the coming winter, manage the social and economic consequences of high prices, and maintain political unity in the face of Moscow's aggression. But whatever the outcome of Russia's war in Ukraine – be it victory, loss, a frozen conflict, or even escalation – these policy choices will have significant long-term consequences. How this plays out will depend on which goals are prioritized: price, resilience, or security. The EU faces three scenarios, each of which is also a strategic option for EU energy policy.

The first scenario is a return to the pre-crisis liberal EU energy regime. This means prioritizing price and accepting the risks of high-cost energy crises in the future. A change of regime in Russia is arguably a precondition for such a strategy. This could reverse the structural changes in demand away from gas to other fuels and restore the idea of gas as bridge fuel for the green transition. The main advantage of this scenario is tough gas-on-gas competition benefiting the EU again, if low-cost pipeline gas from Russia comes back. However, as the present crisis drives home, it has important drawbacks both in terms of security and political economy. It does not price in the political risk and leaves the EU vulnerable to Russian weaponization of energy in the future. Moreover, it leaves many EU firms stuck with the long-term, high priced energy deals they are striking with LNG suppliers this year, raising doubts over the economic validity of such a scenario for a key sector in the European economy. Finally, the return to the status quo ante

becomes more unlikely the longer the crisis continues, as governments, firms, and households are taking measures with lasting effect.

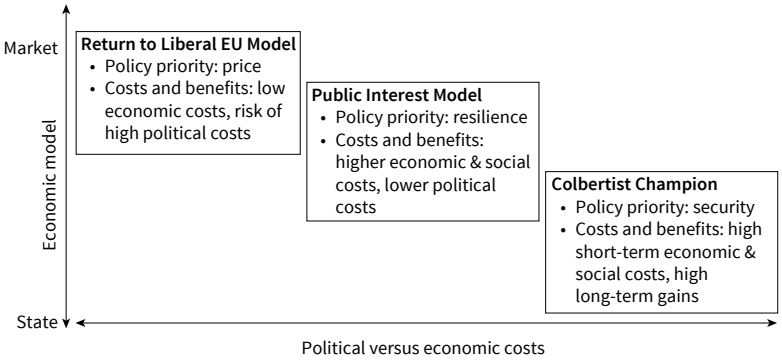
The second scenario centers on building a more robust regime, which prices in the negative externalities (political and environmental) associated with a liberal market model. This scenario puts the public interest first, defined as prioritizing resilience. The economic costs are significantly higher than in the liberal scenario, but they are known and involve less exposure to risk. Costs stem from improving storage, enhancing LNG import facilities, and interconnecting national markets in the short term, and accelerating the structural demand-shift away from gas to renewables in the medium term. It features long-term contracts with non-Russian external gas suppliers, which in turn may require protecting high-cost importers from competition from cheap Russian gas. The advantage of this scenario lies in combining market competition with risk management, both in terms of security and the energy transition. But it involves social and economic costs, as energy prices affect industry, the labor market, and the cost of living.

The third scenario, and strategic option, assigns the state a bigger role in the energy economy. Here, energy security is the priority. It goes hand in hand with a fast green transition that is not just managed, but actively steered, by governments. It requires the EU to abandon its somewhat unique liberal approach to energy and makes it join much of the other importing blocs in treating oil and gas first and foremost as strategic goods. Competition is no longer the principal instrument for ensuring supply security. In this scenario, EU member states promote national champions or European champions: firms that are big enough to play a dominant role on world markets, and robust enough to make long-term deals and hedge risks though their sheer size and ability to trade in volumes that shape international prices. At home this means a more Colbertist approach to trade, distribution, infrastructure, and storage: state ownership and more comprehensive EU regulation across the board. As a corollary, market competition may play a reduced role in setting prices and promoting renewable energy. The costs and benefits associated with this scenario go in the same direction as in the second scenario but are bigger in magnitude: both the short-term costs and long-term benefits are higher.

The EU is at a crossroads. The policy choices that are made in the coming months to meet urgent challenges have long-term implications. Both short-term policy options and long-term strategies are contested at the time of writing (October 2022). Yet one thing is almost certain: The EU's era of low gas prices is over. A model that has served the EUs economy for some 20 years has most likely come to an end. And so has the liberal paradigm that served as its blueprint.

Figure 1

The EU's Strategic Options in Energy Policy



Source: Authors' compilation.

REFERENCES

Cleanergywire (2022), "Parliament Amends Energy Transition Laws, Weakens 2035 Renewables Target", 7 July.

Euractiv (2022a), "France to Invest €5.6bn to Decarbonise Industry", 7 February.

Euractiv (2022b), "Solar is 'Freedom Energy' – unless we Depend on Autocracies for the Technology", 15 July.

Gasworld (2022), "European Gas Imports from Russia Fall to 9 percent", 1 September.

Goldthau, A. (2012), "From the State to the Market and Back. Policy Implications of Changing Energy Paradigms", *Global Policy* 2, 198-210.

Goldthau, A. and N. Sitter (2022), "Oil and Gas", in J. C. W. Pevehouse and L. Seabrooke, eds., *The Oxford Handbook of Political Economy*, Oxford University Press, Oxford, C32S1-C32N1.

Goldthau, A. and N. Sitter (2015), "Soft Power with a Hard Edge: EU Policy Tools and Energy Security", *Review of International Political Economy* 22, 941-965.

Goldthau, A. and N. Sitter (2020), "Power, Authority and Security: the EU's Russian Gas Dilemma", *Journal of European Integration* 42, 111-127.

HM Department for Business, Energy & Industrial Strategy and Prime Minister's Office (2022), *British Energy Security Strategy*, London.

Hoffmann, S. (1966), "Obstinate or Obsolete? The Fate of the Nation-State and the Case of Western Europe", *Daedalus* 95, 862-915.

IEA (2022), "Energy Fact Sheet: Why does Russian Oil and Gas Matter?", 12 March.

IISD (2022), "Navigating Energy Transitions. Mapping the Road to 1.5°C." Winnipeg, Manitoba: International Institute for Sustainable Development, 43.

Reuters (2022a)"Four Countries Pledge Tenfold Rise in EU Offshore Wind Power Capacity", May 18.

Reuters (2022b), "Germany to Spend $220 Billion for Industrial Transformation by 2026", 6 March.

Reuters (2022c), "Netherlands Ramps up Plan for Doubling Offshore Wind Capacity by 2030", 18 March.

RFI (2022), "The Med Gets First Offshore Wind Farm as Italy Vows Energy Revolution", 16 March.

S&P Global (2022), "How the EU Aims to Transform its Energy Mix and Boost Investment in Renewables", 26 August.

Stern, J. and H. Rogers (2017), "The Evolution of European Gas Price Mechanisms", in M. Hafner and S. Tagliapietra, eds., *The European Gas Markets: Challenges and Opportunities*, Palgrave, Basingstoke, .

Von der Leyen, U. (2022), "2022 State of the Union Address by President von der Leyen", 14 September.