

## The energy security package: significant overhaul or business as usual?

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On 16 February 2016, the European Commission presented its energy security package, the first major delivery of the Energy Union agenda. The package includes legislative texts (the revised Regulation on Security of Supply and the Decision on Inter-Governmental Agreements) and non-legislative texts (the Communications on the LNG and Storage Strategy and the Heating and Cooling Strategy). This commentary takes stock of the political and market conditions surrounding the proposal, highlighting strengths and weaknesses of the EU's approach. It argues that more attention should be devoted to demand to ensure correct investment signals, which are key to the strategy's success.

The **LNG and storage strategy** has the objective of making liquefied natural gas (LNG) and storage contribute to the diversity and flexibility of the EU's gas system. Such a role has been prevented in the past by two factors: first, the lower EU prices in comparison to Asian prices, which made the Union a residual absorber; second, the physical and regulatory bottlenecks in the EU market, which prevented EU regions more exposed to Russia's monopolistic market practices from accessing LNG.

Indeed, it will be up to market conditions to allow (or not) LNG producers to compete with the incumbent rather than undercut each other's shares. Opportunities arise from the declining gas price differentials between the Atlantic and Pacific basins, and from a global LNG glut expected to come on-stream by 2025. However, Gazprom seems to be well placed to confront this competition, thanks to production and export overcapacity. The declared Russian intention to sell more gas via auctions suggests that Moscow is preparing for a price war on the market place, targeting North American LNG especially.

Correctly, the strategy does not deem this as a problem if the EU can rely upon sufficient optionality and flexibility regarding sources and routes, and emphasises the role of infrastructural upgrade and full regulatory implementation. However, it is recognised that this flexibility is not fully rewarded by the market, so that strategic investments will rely on the help of EU funding instruments. Future policy action will have to strike a fine balance between the overcapacity needed to ensure resilience and the risk of stranded assets. As such, more attention will have to be paid to demand dynamics in light of the decarbonisation agenda. Regional cooperation in particular will be essential to avoid the subsidised proliferation of national re-gasification terminals, which risks consolidating the current situation of member states fighting each other to be an entry point. In this regard, the proposal of establishing regional action plans by grouping national regulators should be the driver of efficient decisions.

A more controversial reception is likely to be reserved for the **revision of the Security of Supply Regulation**. Beside a welcome shift towards the regionalisation of security of supply measures, the text includes a mandatory solidarity principle stating that the supply to non-protected consumers in a given member state subject to supply disruption has to be ensured by neighbouring jurisdictions to which its transmission network is connected. This would also imply that if one member state's external supply choice – which remains a national prerogative according to Article 194 TFEU – could put its neighbours' gas security at risk, it will have to take collective security obligations in case of major disruptions. This is especially relevant in light of the Nord Stream 2 dispute.

Such an approach takes into account two major problems: the persistent misalignment in energy security concepts among member states and the EU's weak position given a treaty provision that potentially endangers collective energy security. However, the top-down nature of the Regulation is likely to meet resistance from member states and national regulators. Also, implementation challenges might arise as the text leaves member states some room to define what a protected consumer is when it comes to SMEs and essential social services. In any case, it is acknowledged that a market mechanism – ensuring that zonal price spreads act as a mechanism of collective security - should come before coercive solidarity. This should require the full implementation of the internal market, and a larger role for common oversight.

The EU is also likely to expand its role in monitoring commercial contracts. Automatic *ex post* notifications will apply to contracts relevant to the security of supply. A relevant element is the exemption from this obligation for contracts indexed to hub pricing, which seems to break the Commission's neutrality on the price indexation, highlighting disfavour towards the oil-linked pricing, which for a long time has been dominating the relations with the key EU suppliers

The **Decision on Intergovernmental Agreements** (IGAs) represents a welcome step. The EU will perform a mandatory *ex ante* assessment of the compliance of IGAs with EU legislation. Such a provision will finally ensure that investment is no longer wasted on projects elaborated in disregard of the EU legal framework, like those that occurred in the past as part of the defunct South Stream pipeline.

All in all, the package does not represent a complete overhaul of the EU's role in the security of external supply, as demonstrated by the fact that no common public gas purchasing agency will be established. The EU essentially remains a 'liberal actor' in the field of energy security: rather than adopting mercantilist practices towards third countries, the Commission strengthens its role *vis-à-vis* member states' prerogatives in order to prevent these prerogatives from becoming a factor of collective vulnerability.

On a less positive note, the approach remains focused on the supply side, failing to bring into the picture the transformative dynamics triggered by the climate agenda. Demand continues to play a minor role in the construction of the energy security discourse. A properly strategic view would have to provide a clear response to whether there will be a substantial coal/gas switch in the power generation mix, to what extent energy efficiency will reduce gas consumption and whether this will only accompany declining domestic production or will also impact the projected import needs. Whilst the provisions should align with the 2030/2050 objectives, the assumption of demand based on current policies "projected to remain relatively stable in the coming years" exposes a general leaning towards favouring diversification over demand reduction, somehow in contradiction with an efficiency-focused heating and cooling strategy. Such a lack of clarity raises the possibility of either wrong investments resulting in stranded assets or no investments at all, leading to vulnerability.

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