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## ARTICLES

### The EU's External Energy Policy Towards Azerbaijan: Success Or Failure?

Bernd Weber

2013 was a crucial year for energy relations between the EU and Azerbaijan, Europe's key partner in the Caspian region. After a decade of ups and downs and a heated pipeline race, a Final Investment Decision (FID) has been reached on the Shah-Deniz phase II development (SD-II). It paves the way for Azerbaijani supplies of 10 billion cubic meters (bcm) per year, which will be shipped to Europe from 2019 on. These deliveries are considered to be the strategic "door opener" for the development of the Southern Gas Corridor, which is supposed to supply up to 20% of the EU needs in the long-term.<sup>1</sup> The corridor contributes to EU supply security by giving European consumers access to Caspian gas resources. Severe political and economic uncertainties with regard to the future of Russo-Ukrainian relations and repeated gas conflicts between Europe's main supplier and the major transit state highlight the importance of the corridor. While EU officials hailed the FID as a breakthrough for EU supply security and a groundbreaking milestone of EU external energy policy towards Azerbaijan, three shortcomings put this appraisal into question. Firstly, contracted gas volumes represent only 2% of the gas consumption of the EU-28.<sup>2</sup> Secondly, the strategic added value in terms of diversification of gas supplies for the most vulnerable consumers in Central and South East Europe remains limited. Thirdly, domestic reforms to integrate Azerbaijan into a common, pan-European gas market, based on liberal EU rules and norms have stalled. The question that arises is twofold: How successful has the EU external policy been towards its resource-rich neighbour and what are the remaining challenges and uncertainties for Euro-Azerbaijani energy relations?

#### The EU's comprehensive approach to gas supply security

The EU's import dependence on gas is supposed to increase to more than 80% by 2035.<sup>3</sup> In order to deal with this structural dependence and the risk of potential cut-offs, Brussels is aiming to reduce the EU's vulnerability towards dominant suppliers and supply routes by diversification. The Southern Gas Corridor has become the EU's major strategic

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initiative in this context and Nabucco has become the flagship pipeline project within it. Indeed, the EU went far beyond the role it played in former infrastructure projects in terms of political, diplomatic, and financial sponsorship and by prescribing the supplies, route and regulation of the corridor. The Commission pursued a multi-supplier approach, which included multiple potential Central Asian and Middle Eastern suppliers, Azerbaijan being but one of them. Furthermore, it prioritised a specific supply route, along the "South Eastern Achilles' heel" of European gas supply security, which runs through the Balkans up to Central Europe. Countries along this route are characterised by a high dependence on Russian gas imports, limited alternatives and have experienced the most severe supply cuts during former gas crises.<sup>4</sup> The Commission went beyond the strategic rationale of physical diversification, as it endowed the corridor with a liberal regulatory framework, based on EU norms, such as Third Party Access (TPA).<sup>5</sup> EU regulations were introduced to limit supplier control and transit risks within the corridor.

The second pillar of EU external energy policy towards Azerbaijan is embedded in the EU's overall energy policy towards its neighbourhood. The EU seeks to integrate its neighbours in a pan-European energy market, based on EU norms, rules and standards. In this context, Brussels has multiplied its bilateral and multilateral instruments to export EU energy regulations, in order to liberalise and modernise the energy sectors of its neighbours. The unbundling of the gas sector, i.e. the separation of network operation from production and supply activities, is the linchpin of the EU-envisioned market restructuring. The EU models of unbundling and transparent market pricing are supposed to stimulate investment and depoliticize energy sectors, thereby contributing to EU supply security.<sup>6</sup>

1 European Commission (2013) Gas from Azerbaijan: Commission welcomes final investment decision to extract gas pledged for Europe, Press Release.

2 Calculation based on the "Policy Scenario" forecast for 2020 in: International Energy Agency (2013) World Energy Outlook 2013.

3 Ibid.

4 Pirani et al. (2009) The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment, Oxford Institute for Energy Studies.

5 Intergovernmental Agreement regarding the Nabucco project, 13/7/2009

6 European Commission (2010) Commission Staff Working Paper on the Unbundling Regime.

## Tacking stock – What has been achieved?

While convergence with some technical norms and security standards has been achieved, convergence with EU key norms and rules is virtually absent. In 2006, Baku and Brussels signed a memorandum, which stipulates that the neighbouring country would reform energy tariffs, as well as establish an independent energy regulation authority and Transmission System Operator (TSO).<sup>7</sup> However, no tangible progress has been made with regard to both market pricing and minimal unbundling. Furthermore, a Twinning programme between European and Azerbaijani experts on legal approximation and structural reforms has been carried out. Experts from both sides have prepared four draft laws in 2010, but there is little hope that they will be adopted.

Compared to other Eastern neighbours, such as Ukraine, Moldova and Georgia, convergence of Azerbaijan's gas sector with EU norms is minimal. While supplier countries have arguably less interest in unbundling and market pricing, since this would affect the dominant role of their state-owned energy companies and loosen their grip on an economically and politically sensitive sector, one wonders why Azerbaijan agreed to pursue reforms that aim for gradual convergence with EU legislation. Indeed, Azerbaijan formally committed to specific regulatory provisions, since it hoped to engage the EU in a wider and deeper strategic partnership, by accepting the EU's convergence approach. Baku's prior interest was to establish an outlet for Azerbaijani gas to Europe and to thereby pave the way for its development as a gas supplier in a geopolitically difficult environment. Western political and financial support was deemed to be crucial to achieve this objective. In the 90s, the US played this role with regard to the Baku-Tbilisi-Ceyhan oil pipeline and the EU appeared to be the actor capable to assume it with regard to a strategic gas pipeline.

For its part, Russia engaged on different levels to prevent Caspian gas from reaching its traditional markets in Central and South East Europe. Moscow tried to use its political and military support for the Armenian side in the Nagorno-Karabakh conflict as leverage, sought to acquire strategic assets in Azerbaijan's energy sector and purchase large volumes of SD-II gas. Furthermore, it signed memoranda with member states and Turkey to facilitate the South Stream project, which aimed at supplying the same destination markets as Nabucco, in order to make the project unnecessary. The Russian-Georgian War shed further doubt on Nabucco's geopolitical fate and increased

Baku's vital interest in a geostrategic partnership with the EU. However, the more it became clear in the late 2000s, that the EU won't be able to implement Nabucco, but continued nonetheless to give priority to the overambitious pipeline and neglected economically more feasible, smaller projects, the more convergence vanished from the Euro-Azerbaijani energy agenda.

While its opening is certainly an important achievement, the Southern Gas Corridor, as it stands today, reflects only partially the shape and features the EU was striving for. Instead of having one pipeline filled with gas from several suppliers, only Azerbaijani gas will reach Europe via Georgia and the Southern Caucasus Pipeline (SCP), Turkey and the Trans Anatolian Pipeline (TANAP), before the Trans Adriatic Pipeline (TAP) brings it to Italy via Greece and Albania.

Indeed, the EU managed to sign non-binding memoranda with Kazakhstan, Turkmenistan, Uzbekistan, and Iraq to source additional gas, but this has not proven to be effective for three reasons. Firstly, private European import commitments were not sufficient in the eyes of producers. While the EU has developed a mechanism to aggregate demand in order to address this issue, flat overall EU gas demand became the major obstacle in the aftermath of the economic crisis. Secondly, all suppliers are landlocked. The missing link is a pipeline that would enable Central Asian supplies to cross the Caspian and connect to Azerbaijani gas. In 2011, the Commission obtained an unprecedented mandate from the European Council to negotiate with Azerbaijan and Turkmenistan on a Trans Caspian Pipeline (TCP). However, the status of the Caspian Sea remains a highly politicized conflict, which involves Russia and Iran, who have an interest in preventing the project. Iraq as an alternative supplier is still struggling with severe security issues, which are a major obstacle for pipeline-based supplies. Thirdly, while Russia has political and economic means to put pressure on Central Asian countries, the EU is still no significant player in the region.

Confronted with the deadlock of the EU-promoted Nabucco project, Baku began to actively reconfigure the Southern Gas Corridor. By the early 2010s, Azerbaijan's strategic and economic ambitions went beyond its initial role as mere crude exporter. With its traditional partner Turkey, Azerbaijan agreed on the construction and terms of TANAP, in which the Azerbaijani state company SOCAR holds a majority stake. This fait accompli made the Eastern part of Nabucco obsolete, put the non-European section of the Southern Gas Corridor under Azerbaijan's control and left only the final decision on the routing on European territory open. The EU reacted by adopting a more neutral approach towards the competition between different

<sup>7</sup> Memorandum of Understanding on a Strategic Partnership between the European Union and the Republic of Azerbaijan in the field of energy, 7/11/2006.

projects, from which TAP and a downscaled “Nabucco-West” version with a capacity of 10 bcm emerged as final options for the EU section. Both projects were scalable and allowed for additional capacity between 10 and 15 bcm. Furthermore, TAP developed plans to supply also some destination markets in South East Europe, which was partially a response to EU demands.

Behind the scenes, particularly the European External Action Service (EEAS) firmly supported the Nabucco-West option, however, the EU was not able to influence the Final Investment Decision in its favour. TAP does not ease Central and South Eastern Europe’s dependency on Russian supplies sufficiently. Azerbaijan’s choice of TAP was certainly influenced by economic considerations and its successful acquisition of additional strategic assets in the distribution and transmission sector along the route. In the context of privatisations during the Euro Crisis, SOCAR secured a majority stake in the Greek gas transmission operator DESFA.

With regard to the regulatory framework of the Southern Gas Corridor as well, not much is left of the EU’s initial ambitions. The Commission drafted an Intergovernmental Agreement (IGA) for Nabucco, which provided for Third Party Access for 50% of the supply volumes.<sup>8</sup> Its signing by all consumer and transit countries was considered to be a political and diplomatic breakthrough and the framework was presented as a model for future projects. The agreed provisions would have reduced the influence of energy producing countries and upstream companies along the whole route. However, the document is now obsolete. While the TANAP IGA is inspired by the Nabucco IGA, it does not provide for Third Party Access.<sup>9</sup> Furthermore, TAP was granted exemptions from the TPA regime for the entire initial capacity of 10 bcm for a period of 25 years.<sup>10</sup>

## Remaining challenges and uncertainties

The last decade has clearly shown the limits of EU external energy policy towards Azerbaijan. The EU’s efforts to promote structural reforms and regulatory convergence with EU legislation have largely failed to produce tangible results in Azerbaijan’s gas sector. With regard to convergence, EU external energy policy should now focus on other fields, such as energy efficiency and renewables. Reforms in both

fields seem more feasible and could help to make more gas available for exports and thereby contribute indirectly to EU energy security. As to the further diversification of corridor supplies, it is highly questionable, whether other Central Asian producers will join Azerbaijan and supply gas to Europe in the mid-term. While the EU should continue to negotiate with Azerbaijan and Turkmenistan on a Trans Caspian Pipeline, Azerbaijan will probably opt to expand TANAP and fill the additional capacity with indigenous gas from fields like Absheron. Thus, the pipeline does not seem to be an infrastructure link available for other regional or Eastern Mediterranean suppliers. Finally, it remains to be seen, how much Azerbaijani gas will be available for the most vulnerable Central and South East European countries, since the bulk of the initial volumes is earmarked for the well-diversified Italian market. After the “death” of its flagship project Nabucco, the EU should now cooperate with Baku and TAP and firmly support interconnections, such as the Ionian Adriatic Pipeline (IAP), which would permit Azerbaijani gas to reach the Central and South East European network.

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<sup>8</sup> Intergovernmental Agreement regarding the Nabucco project, 13/7/2009

<sup>9</sup> Intergovernmental Agreement concerning the Trans Anatolian Natural Gas Pipeline System, 26/6/2012.

<sup>10</sup> European Commission (2013) Commission Decision on the exemption of the Trans Adriatic Pipeline from the requirements on third party access, tariff regulation and ownership unbundling.

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## Carbon Pricing in a Time of Uncertainty

Johanna Grusch

Uncertainty is a recurring theme in today's debates on future energy sources, their prices and their security of supply due to the inherent unpredictability within the energy sector. The beginning of the 21st century was marked by several rapid transformations resulting from unforeseen economic, political as well as technological developments that impacted global energy markets. In order to achieve security of energy supply, this essay argues that political and economic flexibility is crucial for energy providers and consumers in order to adapt to the uncertainties and unpredictable changes in global energy structures. When putting energy security in the context of environmental sustainability, this flexibility imperative supports arguments in favour of carbon pricing mechanisms, such as carbon taxing and trading schemes.

In addition to providing a neutral policy instrument in order to incentivize the reduction of greenhouse gas emissions, such market based instruments also protect the freedom to choose whichever technology economic actors perceive as most cost-effective. They therefore allow energy suppliers and consumers to adapt to unpredictable and unknowable changes quicker and more cost-effectively. However, even though different systems of carbon taxation and trading exist and already provide a higher degree of flexibility, these systems themselves entail inherent instability and have not been able to generate the required reduction in carbon emissions. What is needed is a restructuring, stabilisation and strengthening of carbon pricing mechanisms that equip energy providers and consumers with sufficient flexibility to adapt to a changing energy market and as a consequence, to achieve both security of energy supply and the mitigation of climate change.

### The need for flexibility

Looking back over the last decade, several developments impacting global energy structures have occurred that could not have been predicted by policy makers or market participants in advance. In addition to technological advances allowing for instance for the US shale gas revolution (IHS CERA 2010), various unforeseeable political factors have significantly reshaped energy markets.

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Besides widespread political turmoil in the oil-rich Arab world (Maher 2013), for instance, political uncertainties stemming from Russia and the willingness of its leaders to use energy markets as instruments for political leverage, contribute to the level of uncertainty in Europe's energy supply.

Moreover, the combination of technological and political insecurity has rendered the nuclear power sector subject to major transformations. While the incidents in Fukushima led to a moratorium of nuclear power stations in Germany and a resulting increase in the use of highly carbon-intensive energy sources, the UK is still strongly committed to using nuclear power in order to reach its emission reduction targets, mitigate climate change and increase its energy independence. The costs of nuclear power, however, can no longer be carried by private investors alone, necessitating major government investments, such as a £16 Billion deal with EDF to build two reactors at Hinkley Point in Somerset (Froggatt 2013).

In the UK, and in Europe, these developments have led to a return of centralised energy planning. As Robinson (2013) highlights, the resulting re-politicisation of energy markets adds another layer of uncertainty, resulting in a demand for a 'political uncertainty premium' for investments. However, whether the political efforts to secure energy supplies while mitigating climate change will be successful, is as unforeseeable as the aforementioned developments. In fact, the impact of climate change on our environment itself remains not predictable. While documents like the Stern Review (2007) warn against the dangers of global temperature increases beyond 2°C and call for immediate action to avoid reaching a dangerous threshold of carbon concentrations of more than 450 parts per million, others point to the sheer impossibility of measuring the impact of a plethora of factors changing global temperature levels (Robinson 2013, Helm 2012).

The recent report of the Intergovernmental Panel on Climate Change (2013), which records a slowdown in temperature increases, further adds to the uncertainty. In combination with diverging national interests, capabilities, responsibilities and climate change impacts, this increases the difficulty of establishing an international agreement that would determine who will contribute how much to which level of climate change mitigation. It is therefore not surprising that the World Energy Forum states an international climate agreement as the most uncertain of all