The EU's external energy policy and the neighbouring suppliers Azerbaijan and Algeria: Is the pipeline half full or half empty?

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"Safety and Security lie in variety and variety alone.1" After 80 years, Churchill's principle that energy security requires diversification is still applicable and holds particularly true with regard to Europe's gas supply security.

Overall, the EU's import dependence on gas is supposed to increase to more than 80% by 2035, in the light of dwindling conventional production and absence of substantial shale gas extraction in Europe2. At the same time, 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 alternatives. The EU is aiming to limit its vulnerability towards Russia and the "Eastern Corridor" by diversification. In this context, supplies from Azerbaijan and Algeria are crucial for three reasons. Firstly, the share of Liquefied Natural Gas (LNG) from remote suppliers in the EU's import portfolio is growing, but will remain limited3. Secondly, recent gas discoveries in the East Mediterranean have the potential to fill a new European gas corridor, but it is too early to tell what volumes will be available. Thirdly, in the neighbourhood area, Azerbaijan and Algeria are the strategically most relevant gas suppliers. The Eastern neighbour is Europe's key energy partner in the Caspian region and holds the potential to multiply export volumes and become a gateway for additional regional supplies. Algeria is the EU's third biggest supplier, has large untapped unconventional sources and has proofed to be the most reliable producer in the aftermath of the "Arab Spring".

After a decade of ups and downs, EU officials hailed the final investment decision on Azerbaijani supplies and the signing of a memorandum with Algeria last year as milestones of EU external energy policy. However two shortcomings put this appraisal into question. The two major regional pipeline projects, Nabucco and GALSI, have not been implemented. Furthermore, reforms to integrate both suppliers into a common, pan-European gas market, based on liberal EU norms have stalled. The question that arises is twofold: How successful has the EU external policy been towards its resource-rich neighbours and what are the major challenges ahead?

The EU's comprehensive approach to gas supply security in the neighbourhood

The EU's comprehensive approach to gas supply security in the neighbourhood goes beyond the rationale of physical diversification.
With regard to Nabucco, the EU's flagship pipeline project in the Southern Gas Corridor, Brussels assumed a very active role in prescribing the supplies, route and regulation of the corridor. The Commission pursued a multi-supplier approach, which included several potential regional 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 Europe4. What is more, Brussels endowed the corridor with a liberal regulatory framework, based on EU norms, such as Third Party Access (TPA) and transparent tariffs5.

With Medgaz and GALSI, the EU considered two Algerian gas pipelines to be of “common European interest”[6]. While the Algerian state company SONATRACH and European importers determined supplies and routes themselves, the Commission assumed a more active role in reconfiguring long-term contracts and limiting Algeria’s control over pipelines.

The second pillar of EU external energy policy towards Azerbaijan and Algeria 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. Unbundling and transparent market pricing are supposed to stimulate investment and depoliticize energy sectors, thereby contributing to EU supply security[7]. Compared to transit countries, suppliers 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. At the same time, the EU does not hold a strong bargaining position towards its resource-rich neighbours. Major EU incentives at offer, such as Deep and Comprehensive Free Trade Agreements (DCFTA), are insufficient to counterbalance costs.

Tacking stock – What has been achieved?

While convergence with some technical norms and security standards has been achieved in the early 2000s, Azerbaijan’s convergence with EU key norms and rules remains ambivalent. 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)[8]. However, little tangible progress has been made on this. 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. In the mid-2000s, Azerbaijan was exposed to Russian pressure on different levels. Moscow tried to use its political and military support in the Nagorno-Karabakh conflict as leverage and sought to gain control over Azerbaijani resources. 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.

Confronted with the deadlock of Nabucco, Baku began to actively reconfigure the Southern Gas Corridor. With its traditional partner Turkey, Azerbaijan agreed on the Trans Anatolian Pipeline (TANAP). This fait accompli limited supply to Azerbaijani sources, 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 projects and engaged in a more “horizontal cooperation” with Azerbaijan and energy companies. Indeed, the Commission managed to prevent a mere upgrade of the Turkish network to transport Azerbaijani gas to Greece, which would have exposed the corridor to an increased transit risk. Furthermore, Brussels persuaded Azerbaijan to develop plans to supply markets in South East Europe through the Trans Adriatic Pipeline (TAP) and additional interconnectors, in the light of Nabucco’s failure.

With regard to the regulatory framework of the corridor as well, the EU had to adapt its approach. The Commission drafted an ambitious Intergovernmental Agreement (IGA) for Nabucco, which incorporated EU key provisions, but eventually became obsolete. Nonetheless, the TANAP IGA is inspired by the Nabucco IGA, but does not provide for Third Party Access (TPA). Furthermore, TAP was granted exemptions from the EU’s TPA[9] regime for the entire initial capacity of 10 billion cubic meter (bcm) per annum for a period of 25 years10.

As to Algeria, convergence with EU key rules and norms is virtually absent. In the early 2000s, the government undertook remarkable reforms in the context of an ambitious liberalisation strategy. However, they did not proof to be sustainable, but failed due to broad domestic resistance, which concerned particularly the envisioned unbundling of the energy sector. The EU's unchanged insistence on an agenda towards comprehensive regulatory convergence led to a deadlock situation. While Algiers was seeking a strategic energy partnership with Europe in the aftermath of the Russo-Ukrainian gas crisis in 2006 in order to increase gas export capacities, the EU's demands for regulatory reforms were completely delegitimised in the eyes of Algerian actors. The liberalisation of the EU's internal energy market complicated Euro-Algerian energy relations further, since it jeopardised oil-linked long-term contract prices and resulted in Algerian revenue and market share losses.

It was not before prices slumped and the Arab Spring destabilised the Southern neighbourhood that Algiers opened up to a more pragmatic EU external energy policy. In the context of the Arab Spring, public spending increased by 50%11. Confronted with decreasing production and a booming domestic gas demand, the country needs foreign investment to guarantee sufficient energy revenues. In 2013, the EU and Algeria signed a memorandum after five years of negotiations. Not much is left from the initial text proposed by the Commission12. Convergence with EU rules has vanished from the agenda and the focus has shifted to more pragmatic issues, such as improving investment conditions in order to increase conventional production and pave the way for the development of unconventional gas.

Compared to Nabucco, Medgaz and GALSI received little support from the European level in form of limited financial sponsorship. Both pipelines are essentially bilateral, exporter and importer promoted projects and were introduced by Algeria to secure market shares and bypass Morocco and Tunisia as transit countries. Since Medgaz came on line in 2011, it does run on its full capacity of 8 bcm, but remained temporally half empty, since Spain had trouble absorbing contracted gas volumes. Demand insecurity also sheds doubt on the GALSI project, which is supposed to supply additional 10 bcm to Italy. Algerian deliveries would have to compete with the bulk of TAP's initial supplies, which are also earmarked for the already oversupplied Italian market. Furthermore, Azerbaijan is likely to increase these volumes in the mid-term.

Limited achievements and challenges ahead

The last decade has clearly shown the limits of EU external energy policy towards both suppliers. The EU's efforts to promote structural reforms and regulatory convergence with EU legislation have barely been effective in the East and have largely failed to produce any tangible results in the South. With regard to convergence, EU external energy policy should now focus on other fields, such as energy efficiency and renewables, where reforms are more feasible. Indirectly, this would also help to make more gas available for exports to Europe.
EU efforts to prescribe gas corridors have not only proofed to be quite ineffective but resulted in the non-implementation of prioritised pipelines. However, the example of TAP demonstrates that the EU can shape corridors in its favour, if it adopts a more pragmatic approach, which takes supplier interests into consideration.

After the “death” of Nabucco, the EU should now cooperate with Baku and TAP and firmly support capacity expansion and interconnections, which would permit Azerbaijani gas to reach Central and South East European networks. With regard to Algeria, the major challenge ahead is to ensure that exports do not drop further, since this could seriously jeopardise the domestic security situation. The development of unconventional gas sources is the key to achieve this objective and can help to fill up Algerian pipelines to recovering EU markets in the mid-term.

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