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POLICY PAPER

VISEGRAD SECURITY COOPERATION INITIATIVE

Visegrad Security Cooperation Initiative (VSCI) is a project organized by the Slovak Atlantic Commission and its partners from the Visegrad group countries: Jagello 2000 (CZ), International Centre for Democratic Transition (HU) and Euro-Atlantic Association (PL).

Its creation would not be possible without the financial support from the International Visegrad Fund.

Through systematic work in the joint expert groups, the project identifies shared security and defence interests of the Visegrad group countries and analyzes the possible means of their common realization. The process results in the elaboration of common policy papers that could represent the intellectual as well as practical impetus to the political and expert discussions on the common foreign policy strategies.

This analysis is elaborated as a result of several months lasting work of the Energy Security Expert Group.

Hereby, we recommend you another analysis from the Visegrad Security Cooperation Initiative series elaborated by the Trans-Atlantic Security Expert Group.

SAC
SLOVAK ATLANTIC COMMISSION
SLOVENSKÁ ATLANTICKÁ KOMISIA
Klariská 14, 811 03 Bratislava,
Slovak Republic
Phone/fax: 00421/2.544.106.09
e-mail: sac@ata-sac.org
www.ata-sac.org

ENERGY SECURITY

ANDREJ NOSKO **ANITA ORBÁN**
WOJCIECH PACZYŃSKI **FILIP ČERNOCH*** **JAKUB JAROŠ***

The objective of this analysis, which is part of the Visegrad Security Cooperation Initiative is to identify shared challenges of Visegrad 4 countries, their common interests, and to propose concrete solutions and paths for the governments to enhance their cooperation in order to promote their interests in the field of energy security. We have made our best efforts to consult and reflect the common denominator in predominant expert opinions in our respective countries. Nonetheless, the synthesis offered in this paper represents a compromise in our own opinions shaped by discussions among ourselves and experts from our respective countries, and it should not be considered a sole or exclusive synthesis of expert opinions of Visegrad countries on the Energy Security policy, which we recognize as politically contestable concept.

In this report we understand energy security as predictable, reliable access to desired forms of energy at transparently determined market prices. We specifically focus on natural gas, and electricity (including transmission and various aspects of generation) as in these areas we see the highest potential risks, and also the possibility for cooperation bearing fruits.

This paper progresses by first briefly outlying the current energy security situation in the Visegrad four countries as a basis for cooperation in this field, and identification of available opportunities. The recommendations based on the assessment of the situation are offered in the second part.

Energy Security Situation of the V4 Countries and Rationale for Cooperation

Former US Ambassador to Lithuania, Keith Smith believes that "the biggest obstacle to collaboration and more effective resistance to Russian pressure is the lack of sufficient reform within the CSEE countries. Their vulnerability to energy coercion and questionable agreements with Russian leaders in large measure stem from the lack of transparency in the governments themselves. In addition, there are regulatory, licensing

* On the elaboration of the analyses on behalf of the partner from the Czech Republic participated consequently Mr. Filip Černoch (initial phase) and Mr. Jakub Jaroš (final phase).

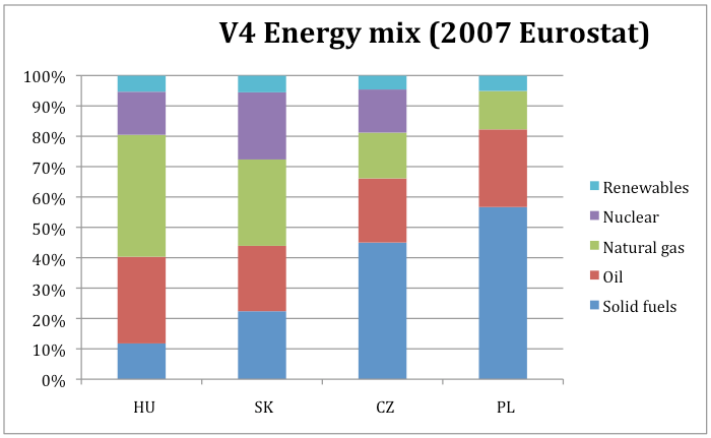
Visegrad Fund 2010 years
JAGELLO 2000 ASSOCIATION FOR EURO-ATLANTIC COOPERATION
ICDT International Centre for Democratic Transition
Euro-Atlantic Association

and taxation issues that have to be tackled by each of the region's government, in order to effectively implement the funding programs approved by the European Commission."

In order to increase the energy security of the Visegrad countries, some countries of the region therefore must decrease the share of natural gas in their energy mix. In addition to improving the domestic situation, cooperation is needed to improve the standing vis-a-vis the current dominant energy supplier. The long-term contracts should include more flexibility including elimination of destination clause and easing of the take-or-pay clause. An integrated infrastructure and contracts favoring market pricing and allocation would decrease Moscow's option to use the energy weapon in bilateral disputes.

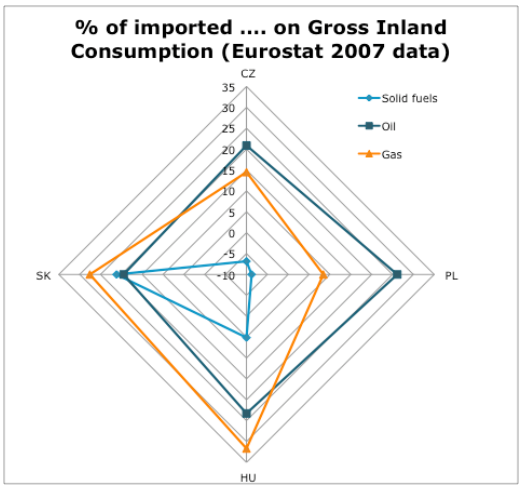
Already a general overview of the energy profiles of the Visegrad countries highlights some important facts. All 4 economies are very energy intensive. They are all among the 8 most energy intensive EU countries. As of 2007, they needed between 2.4 (Poland) and 3.3 times (Czech Republic) more energy per unit of GDP[1]. All V4 countries are in the process of improving their energy intensity (it declined by 20-30% over the decade 1997-2007) nonetheless, there is still a long way to go to achieve competitive levels of energy efficiency.

There is heterogeneity in energy mix of V4 countries (Figure: V4 Energy mix), just as is the case for the EU as a whole. Poland and the Czech Republic stand out with a very large role played by hard coal and lignite. Hungary relies on natural gas to the extent that is typically found only among large EU gas producing countries (the Netherlands, UK). Renewables account for a relatively low share of gross inland consumption – about 5% in all four countries, compared to the EU average of 8%. The burden sharing commitments under the EU climate and energy package imply the need for substantial investment in renewable energy resources in all four countries. More generally, all countries (Poland and the Czech Republic in particular) face the challenge of "greening" their energy sectors. Further improvements in energy efficiency and changes in the energy mix with most polluting energy sources being replaced by more environmentally friendly ones are the key elements of this strategy. Additionally, three Visegrad countries currently use nuclear energy that plays quite an important role in their energy balances while Poland plans to build nuclear power plants in the near future.



Source: Eurostat last available data (2007)

Even though V4 countries as a group are less dependent on overall energy imports than the EU average, from the perspective of security of energy supplies their import structure is actually quite unfavorable. This is because of relatively high reliance on natural gas imports from Russia and typically (especially in the case of Slovakia, Hungary and Poland) via a single route and with very limited options of switching to alternative sources in case of supply disruption. One additional aspect of this is that a potential disruption of natural gas supplies would not only affect industry and electricity generation, but also the residential heating sector which could be very problematic in the winter season given the climatic conditions of the region.



Source: Eurostat last available data (2007)

[1] 2007 Eurostat data: Energy, transport and environmental indicators, Eurostat pocketbook, 2009 edition.

One of the biggest challenges facing all Visegrad countries is related to the outdated electricity and gas infrastructure and limited generation/transmission capacity in view of forecast increases of power demand. Hence, the needs for large investments especially in new generation capacity and interconnections to allow larger imports of electricity from abroad and ease the task of balancing supply and demand in view of rising role of intermittent renewables. As an illustration, the recent IEA analysis for Poland estimates the investment needs of the power sector at around 1.3% of GDP annually[2]. Over two-thirds of this amount would be needed for building new power plants. Mobilization of such level of investments and creating conditions ensuring that emerging patterns of generation and transmission will be favorable from the perspective of environmental impacts and security of supply is a serious challenge.

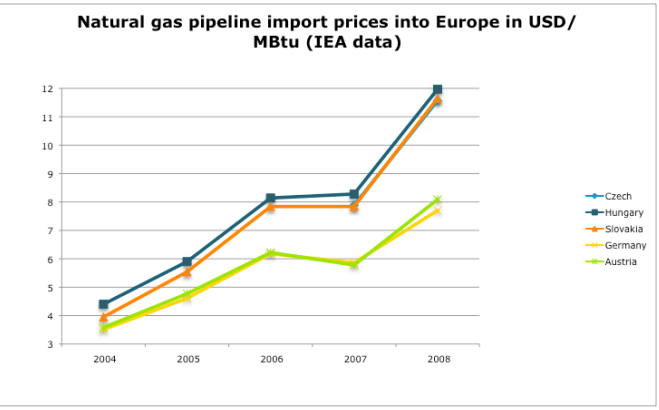
Rationale for V4 cooperation and recommendations

The brief discussion below shows that all Visegrad countries need to invest significant resources in energy generation, transmission and other infrastructure elements. Most of this will need to come from private investors. Countries need to create better policy and especially regulatory climate for this and create incentives for emerging investment patterns to be consistent with long-term energy security objectives. Foreign companies are looking for investment opportunities in larger markets. A more integrated Central European energy market would enhance the chances of investments in R&D, manufacturing and infrastructure. International financial institutes are also more ready to finance joint than individual projects. In light of this, it is not only rational for the Visegrad countries to cooperate; it is a necessity in order to successfully face the challenges of the future.

Coordinating their positions as well as acting together whenever possible, the Visegrad countries can have a larger impact on future EU energy/climate policy and hence limit the uncertainties / risks on its future shape. Also, given that different directions of EU action can have different effects in terms of distribution of the burdens, close cooperation of V4 countries among themselves and with other EU partners could lead to shaping the future EU energy policies in ways that are more favorable to their national interests and domestic conditions.

In particular, creating a functioning EU electricity market and natural gas market is in the long-term interest of all V4 countries. Regional cooperation towards this aim and even creating a regional "forerunner/early-adopter" example is in our opinion a good option. Visegrad four can be a basis for regional cooperation not only limited to the four countries, but a solid basis for cooperating with neighbors. The currently applied approach of not limiting the cooperation to V4 but involving others is therefore worth continuing, examples such as Central East Electricity Regional Initiative (ERI)[3] or other Visegrad+ initiatives should be promoted.

Making steps towards larger cross-border trade in electricity and gas will lead to more competition and hence lower prices as well as stronger resilience to supply disruptions e.g. due to failures of some import gas pipelines or large generation units. The price argument is not an unimportant issue given that the gas import price wedge observed at present (Figure: Natural gas pipeline import prices…) and that gas and electricity prices expressed at purchasing power standards paid by households in V4 countries are among the highest in the EU[4].



Source: IEA/OECD. *Natural gas information 2009: with 2008 data*. OECD/IEA, 2009.

One of the clear examples of benefits from the regional cooperation is improving the bargaining power. The V4 countries are paying higher price for their natural gas imports, which puts them at an

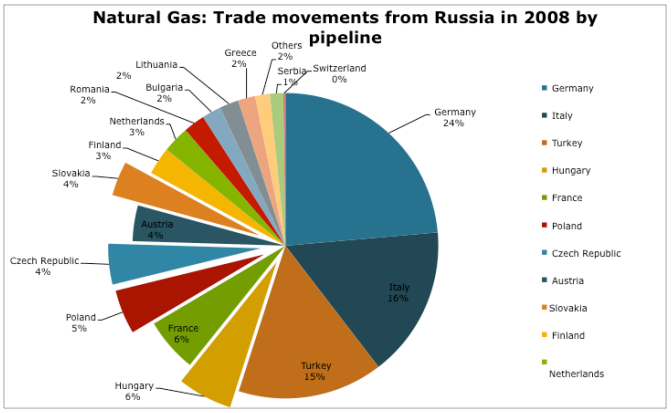
[2] IEA, Energy and CO2 emissions scenarios of Poland, Paris 2010. The figures refer to the baseline scenario.

[3] See http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_INITIATIVES/ERI

[4] The data pertain to the second semester of 2009. See Eurostat, Data in focus 21/2010 and 22/2010.

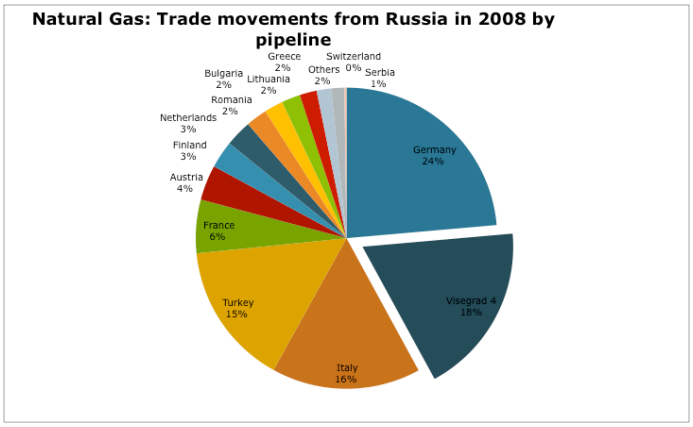
economic disadvantage vis-à-vis their richer western neighbors.

The reason for this price disparity might be either in the market size or already mentioned market structure, which is the result of the contractual base. When taken separately, the share of Visegrad countries on the Russian natural gas export market is not extraordinary, ranging from 4% in case of Slovakia and Czech Republic to 6% in case of Hungary. (As is illustrated in Figure: Natural Gas: Trade movements…)

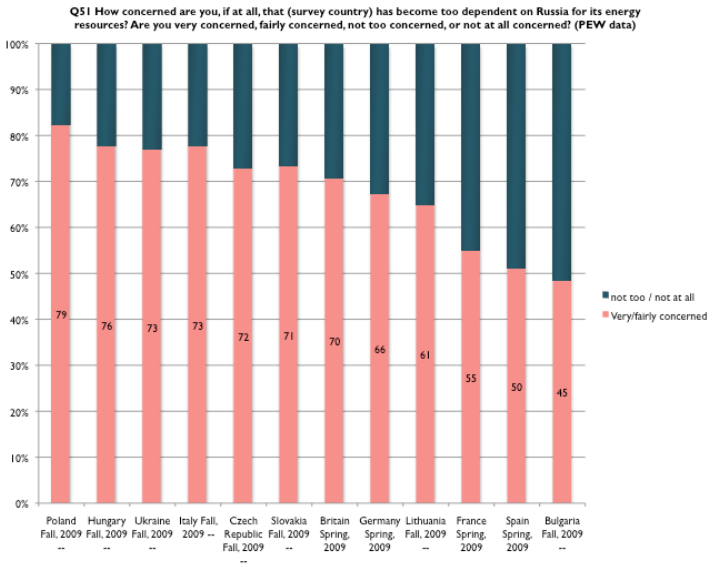


Nonetheless, if taken together, their joint share on the Russian natural gas export market becomes second only to Germany with 18%.

Although the long-term ultimate goal should be to have pan-EU natural gas market and in the medium term ideally there should be more coordination of negotiations at the EU level, possibly achieving EU as a single negotiator with third parties, currently Germany (and Italy) may not be too keen on this (see their respective market positions), since companies in these countries (with the support of their governments) may reasonably believe that they are in better position to negotiate. Nonetheless, if V4 is able to show joint support during framework negotiations and genuine commercial coordination support for their companies, current large market players, who are stalling the creation of genuine EU energy market, might be compelled to join this game. In this case V4 cooperation could be a genuine front-runner of EU energy market creation, mainly because of the high financial and strategic pay-offs for the countries of V4 this should be the preferred option.



One other argument that can support the cooperation drive if used wisely is the fact that the societies across the V4 are generally afraid of dependence on imports from the single supplier – Russia (Figure: Q51 How concerned are you…). While interpretation of such public perceptions requires caution and it would be unwise to build energy strategies on the worry factor, the coincidence of public worries with actual problems creates opportunities for building domestic and international consensus and public support for good energy policies or specific projects improving the energy security.



Source: Times Mirror Center for the People & the Press. *The Pulse of Europe 2009: 20 Years After the Fall of the Berlin Wall*. PewResearchCenter, 2009. http://pewglobal.org/reports/display.php?ReportID=267.

Finally, regional cooperation can improve access to funding. This in particular applies to the public sector money and especially occasionally available EU allocations to energy projects. This suggests an idea of creating a portfolio of viable projects applications for EU funding opportunities where joint actions could be promoted. Beyond this successful regional cooperation in energy sphere and progress in energy markets' integration could also increase the attractiveness of the region for private capital, both domestic and foreign.

Winners and Losers of Cooperation

Regional cooperation has different stages. It can range from building sufficient infrastructure to a common energy market. In-between there are several steps. When identifying winners and losers of cooperation, it is important to keep the different stages in mind, this is of crucial relevance to understand the potential for coalition building as well as to understand the motivations for those having less interest in cooperation for their particular interests.

The merits of regional cooperation are well known, nonetheless, twenty years after the Visegrad cooperation started, we are still facing the mentioned problems. Therefore in order to shape cooperative policies, it is important to understand who the main winners and losers of the cooperation are, and what their role is. This knowledge will not only enable the internal coalition building, but also appropriate compensations to the short-term losers of this cooperation.

Winners of cooperation:

Since the gains from cooperation are thinly distributed it is harder to identify who would gain than who would loose.

When it comes to energy infrastructure, construction companies and financing institutions could all benefit from the large-scale construction projects. The existing interconnectors would make the region less vulnerable to a supply disruption.

The existing infrastructure would be the prerequisite of a regional energy market. Energy companies involved in the wholesale would certainly benefit from that. In this case the price of energy may decrease for all energy users. Big energy user industries with locations all over the region (like chemical plants, glass industries, transportation and delivery companies etc.) may integrate their energy procurement practices all over the region and thus have a lower energy price. The integrated energy market would result in a lower price for the households, as well.

More importantly, enhanced energy transportation infrastructure and eventually an integrated energy market would make it possible for CEE governments not to be constrained in their room of maneuver vis-à-vis their monopoly supplier that is Russia.

Rewards of cooperation:

As politically all the governments of the region announced regional cooperation as a priority project, steps in this direction can be presented as a success for all. The Commission is interested and encourages the cooperation and aims at making Central European cooperation the European success story. An integrated infrastructure and an integrated market would attract more investment in the region both in the energy sector and other industries. Additionally, cooperation in the field of energy could become a good platform for cooperation between the V4 countries in other areas, as well.

Losers of cooperation:

The losers of the cooperation are easier to identify. Players who are enjoying preferential status by the individual states and those who are beneficiaries of the bilateral trade with Russia may loose from the cooperation (at least in the short term). State-owned companies may have to give up some of their privileges in case regional cooperation reaches a certain stage. Everybody who is in monopoly position in its own market may end up loosing from an integrated infrastructure and market. Non-transparent, inefficient and uncompetitive companies and entities interested in non-transparent deals are also subject to loosing from collaboration.

A successful V4 cooperation will be perceived and interpreted by Russia as an action against Moscow. Gazprom, as the monopoly supplier of natural gas to the region, may certainly loose if such a collaboration starts.

Some Visegrad capitals perceive that attempts to collaborate in energy policy in the Visegrad area are looked upon with suspicion from the capitals of Berlin and Paris. Even though French, German and other

Western European companies would benefit from a larger and better interconnected regional market, and better energy security, as a result of Visegrad cooperation.

Recommendations

In light of the above analysis we suggest the following specific recommendations for regional cooperation in Visegrad countries:

1. **Build and improve the regional infrastructure in order to enhance regional energy market**

   This means building the physical infrastructure (interconnecting pipelines and electricity grid, ports). Specifically, the north-south gas interconnectors (both for supply security, as well as price as it provides for access to spot markets and new competing sources of supplies) are necessary to achieve functioning single market. In electricity market, the coordination of electrical generation capacity and electricity interconnectors within ENTSO-E, including regional feasibility studies.

2. **Regulate better and improve the market fitness and transparency**

   In order to facilitate building of the regional market as step towards EU-wide energy market, it is important to create favorable conditions for investments in regional infrastructure, including transparent and coordinated tariff system and investment conditions, which would prevent situation when interconnector which is feasible on the one side of border is not feasible, or price competitive on the other side of the same border. This measure has to include also the removal of any remaining barriers to energy trade in the region and improvement of energy regulation.

3. **Utilize cross-sectoral regional opportunities**

   Border regions between the Visegrad countries belong among the most disadvantageous, poorest and least developed regions in the EU. Opportunities for regional cooperation between the intra and Visegrad+ Euroregions especially in the field of local generation as means of interconnecting the common agricultural policy, regional development policy and energy policy should be closely studied.

4. **Enhance the regional Research and Development in all sort of energy-related practically oriented research**

   The common problems of the V4 countries may enhance cooperation in Research and Development. For example the abundant coal reserves should be a good incentive to start region-wide research into clean coal and CCS technologies. In terms of renewables, common research in biomass and biofuels would benefit all the countries.

5. **Coordinate energy diplomacy and support coordinated negotiations**

   There are numerous opportunities to create value through coordinated diplomacy and negotiations. Be it the intra-EU at the Council on legislation and funding in the area of energy policy, or extra-EU especially vis-à-vis Russia including the price negotiations, removal of destination restrictions and softening and/or removal of take-or-pay contractual conditions. Coordination and common negotiations at other forums also offers opportunities and value. Common presence and using diplomacy for promoting trade and energy security in the region including using the development aid, like supporting Ukraine with "energy security" aid, and stronger cooperation of our Trade Promoting Agencies, would provide benefits not only in the energy policy but would have positive spill-over effects on wider economic policy as well.

6. **Create Visegrad energy policy secretariat**

   The listed opportunities for regional cooperation provide clear value for all Visegrad countries. It is acknowledged fact, that the largest problem of Visegrad cooperation is *not* lack of shared interest, or value of the cooperation itself, but the intermittency of Visegrad agenda and lack of persistent follow-up.

   This *technical* problem can be easily solved by intensifying the cooperation and by proceeding towards intensification of information exchange and coordination. This can be done, without significant financial costs in following steps:

1. Commit to regular meetings of dedicated high-level experts
2. Establish a dedicated (rotating) desk at a ministry or permanent Representation at EU with the task of coordinating virtual Visegrad energy secretariat.
3. Create permanent structure with liaised dedicated high level experts and permanent staff to follow-up and coordinate common Visegrad energy interests at all forums.

The creation of the permanent and dedicated Visegrad energy policy secretariat is needed to promote the Visegrad regional agenda. This includes promoting the common V4 energy security interests at various forums, putting it on the agenda at all relevant forums and following up with it. Coordinating interests and negotiations issues of common Visegrad relevance at various forums. Identifying opportunities for interest promotion and matchmaking between opportunities and stakeholders within V4. Sharing of experiences and best practice in energy efficiency gains, good regulation and market promotion.

ANDREJ NOSKO
nominated by
Slovak Atlantic Commission
Slovakia

ANITA ORBÁN
nominated by
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