THE ATHENS FORUM OCTOBER 2004

DISCUSSION AND CONSULTATION NOTE

ELECTRICITY TRANSITION STRATEGY

This paper is intended to be adopted by the Forum or the PHLG or both. It is not a European Commission paper.

This paper envisages eventual adoption of state specific papers as annexes establishing the individualised responsibilities of the states.

This paper envisages that local actors and states should take the lead in developing the actions mentioned. Only when there is a clear need should donors or the European Commission take a lead.

WRITTEN COMMENTS ON THIS PAPER ARE WELCOMED: THEY SHOULD BE FAXED TO:

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1. SUMMARY

This is a Discussion and Consultation Note to be finalised by Athens Forum, in order that an Electricity Transition Strategy can be adopted by the Athens Process Ministerial in the course of 2005. The aim is not to bind any party but to provide a consensus on the challenges and offer some tentative suggestions as to how on a common basis they can be overcome.

A Gas Transition Strategy may follow.

The common objective of the parties adhering to the Athens 2003 Memorandum of Understanding[1] is to underpin the secure supply of energy, especially electricity, to their citizens, and to secure economic growth and investment in South East Europe by improving the availability, efficiency and reliability of network energy sources at reasonable cost. The parties seek to achieve the objective through promoting greater regional integration, the creation of a European Union compatible regional energy market, competition and increased trade within the SEE region and between it and the European Union internal energy market. The ultimate aim is to have single regulatory space for electricity and gas trade that stretches from Ankara to Oslo, from Sophia to Lisbon.

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[1] "Memorandum of Understanding on the Regional Energy Market in South East Europe and its Integration into the European Community Internal Energy Market" – Athens December 8, 2003.

Following the European Union's decision[2] to open negotiations with the countries[3] of South East Europe in order to conclude a legal agreement covering energy market restructuring and consequently the inclusion of the region into the European Union's Internal Energy Market, this Electricity Transition Strategy could accompany the legal agreement. This Electricity Transition Strategy does not spell out any terms of the legal agreement but indicates the complementary issues that need to be resolved and that are necessary for transition. **Nothing in this paper is to be considered as prejudging the outcome of Treaty negotiations.**

The main issues to be addressed are:

- The status and reform of distribution companies;
- Payments reform and transparent pricing policies;
- Compatibility of national market designs; and
- Phasing and reform sequence.

Special emphasis needs to be put on the social aspects of reform.

2. BACKGROUND

The improvement of the performance of the energy sector is crucial to improve and sustain economic development in South East Europe.

In 2002, the European Commission put forward a strategy outlining the principles and the institutional necessities on which the development of the regional electricity market should be based[4]. All South East European countries agreed to adopt European Union legislation and to set up a structure to monitor the operation of the market. These commitments were included in the Memorandum of Understanding on the Regional Electricity Market in South East Europe, signed in Athens in November 2002.

In March 2003, it was decided to extend the approach to gas. The European Commission then prepared the Athens 2003 Memorandum of Understanding which takes into account both the extension to gas and the new electricity and gas directives that were adopted within the European Union in June 2003. The European Union signed this document.

The 2003 Memorandum is politically binding. The states of the region stressed the need to move towards a legally binding framework, strong institutions and an oversight body

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2 Council Document No. 9531/2004 – Competitiveness Council 14 May 2004, A-points, recording Adoption 7554/04 ENER 93 COWEB 67 + COR. 1 (pt)

3 The countries are Albania, Croatia, Bosnia & Herzegovina, Bulgaria, Republic of Serbia, Republic of Montenegro, FYROM, Romania, Turkey.

4 The Strategy Paper published at http://www.seerecon.org/infrastructure/sectors/energy/documents/see_electricity_market_strategy_paper.pdf

to monitor the operation of the market. The Commission – in conformity with the legal constraints of Article 300 of the EC Treaty (Treaty of Nice) - obtained a negotiating directive from the Council on 14 May 2004 to conclude a legally binding agreement having essentially the same content to the two Memoranda.

The regional level donors[5], co-ordinated by the European Commission following the Istanbul Conference of the Stability Pact in 2001, have endeavoured to co-ordinate state and regional initiatives in order to achieve the common objective. The present active partners are Canada [CIDA], USA [USAID], Germany [KfW] the World Bank, the EBRD, the EIB, Italy [MPA], Switzerland [SECO], and France [DREE].

The parties and the donor community work with responsible organisations such as the Council of European Energy Regulators (CEER), the European Transmission System Operators (ETSO), the Union for the Co-ordination of Transmission for Electricity (UCTE), Gas Transmission for Europe (GTE), the European Federation of Energy Traders (EFET) and the Energy Regulators Regional Association (ERRA).

3. THE OVERALL APPROACH

The preferred approach is of full, state level control over energy policy but with a regional dimension. A strong regulator for both electricity and gas sectors is needed in each state[6]. To develop regional trade aiming at the optimal utilisation of regionally available natural resources and of existing as well as planned facilities, there has to be a consistent level of co-operation and co-ordination of investment policies[7] taking into account the security of supply in the region. This might allow cost minimisation and bring the regional electricity and gas infrastructure up to a standard comparable with that of the European Union in a relatively short period and for a comparatively low cost. The countries of the region should be able to adopt state policies within the scope of applicable European Union legislation and this regional perspective. However, nothing should nor does prevent them from adopting a purely national strategy.

In particular, the Commission and the donors place great emphasis on payments and tariff reform, meaning better collection rates and cost-recovery pricing, to create the market conditions for foreign and domestic direct investment in the energy sector. Without this, investment is unlikely.

In principle, foreign direct investment is encouraged. Investment security guarantees (excluding market segmentation or exclusive infrastructure rights) may be needed. Long-term contracts and power purchase agreements within the parameters of the European Union's competition rules[8] are not excluded as long as they facilitate

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5 There are a number of additional national level donors.

6 As in the European Union, states may decide to have a common regulator or to devolve some regulatory functions to a joint body.

7 However, there could be no restriction on investments.

8 Within the legal agreement, the Commission could endeavour to secure a means to give greater legal security to such contracts.

investment and do not obstruct the functioning of the market. Aside from the competition aspects of such instruments, the impact on the functioning of the market should be assessed by a regional regulatory body which would have an advisory role, as in the European Union.

The utmost care must be taken in achieving public support for the process. In a transition period and thereafter, full regard to public service obligations, appropriate to the situation in each of the states concerned, must be ensured.

Environmental issues are a priority and should be addressed in a manner consistent with the international obligations of the countries of the region and the stipulations made bilaterally by donors.[9] Operating standards should be compatible with European Union levels, or there could be a timetable for their achievement, and for new-build[10] infrastructure, should never be set at a level inferior to European Union standards.

4. SOCIAL DIMENSION

The social effects of the Electricity Transition Strategy should be further investigated by enhancing the social dialogue with trade and employers unions and NGOs and finding the most appropriate mechanisms to deal with the social consequences.

The experience of the European Coal and Steel Community could be a useful precedent in this respect.

The social consequences might concern direct and indirect employment, effect on skills and qualifications, tariffs for householders (and especially the effect on vulnerable ones), and democratic control over the future direction of the energy system. It is prudent to establish measures to deal with these effects such as training programs and employment generation measures. The Governments should consider accompanying and mitigating measures to deal with the social effects of restructuring. A Steering Group composed by representatives of SEE governments and social partners might be established. Interested Partners from the region are invited to propose actions.

Public support is essential for the success of reform, and this could be obtained by promoting balanced regulation, by taking into account the interests of the industry participants and in particular of retail customers.

Energy reform on should be accompanied by measures to compensate households for the loss of income this would normally entail. At present, there is no standard approach to dealing with this issue in the SEE region. Income support mechanisms must be developed taking into account local characteristics, including income levels and the extent of the household-price increase brought about by reform. Key issues that the participants must address include establishing criteria for determining eligibility for support and the mechanism for providing support.

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[9] The Commission, as co-ordinator of the donors, will seek to streamline and simplify donor conditionality. A good first example if the World Bank APL Facility.

[10] Excluding retrofitting when justified and agreed with the relevant governance body.

The Commission envisages the implementation by each participant of a Social Action Plan which will be targeted at helping those who have most difficulties. The participants, working with relevant groups, would be able to fulfil their duties to protect the interest of customers, wherever appropriate by promoting competition.

The South East European Regulators Board for Electricity and Gas could issue, in concert with the above mentioned Steering Group, guidelines for the respective Social Action Plans, with special focus on improving energy efficiency, encouraging older people to take up the benefits of competition, helping prepayment meter customers, encouraging best practice debt prevention and management, tackling fuel poverty in rural areas and promoting competition.

The social dimension should be reflected also by distribution companies or domestic suppliers which should publish Codes of Practice on key areas of their service. The Codes of Practice could cover payment of bills, dealing with customers in difficulty, provisions on energy efficiency advice, services for prepayment meter customers and special help for the elderly, disabled or chronically sick, debt prevention strategies. The competent regulatory body could approve the codes, and monitor them to ensure they are operated effectively.

The Commission intends to look at further work on these aspects.

5. INSTITUTIONAL STEPS TOWARD THE COMMON OBJECTIVE

The Memoranda have underpinned a Ministerial Council, a Permanent High Level Group and a Forum for the discussion of issues.

The Forum could be put on a legally sound basis and given and advisory role, consistent with its analogues in the European Union (the Madrid and Florence Fora).

As the energy market develops, the need for bodies to oversee and monitor the operation of the market is a necessity. The parties to the 2003 Memoranda envisage the creation of a South East European Regulators Board for Electricity and Gas[11] (the Regulatory Board) which could ensure a level playing field in the regional market. This Regulatory Board is based on the European Union's Regulators Group for Electricity and Gas. It could play an important advisory role in setting the detailed statutory, technical and regulatory rules in the region, and monitor implementation. It might also have limited adjudicatory powers for certain types of market disputes that in the European Union are settled bilaterally by regulators, but in the context of South East Europe might be better handled by a wider group.

A Secretariat could be put in place. It could monitor implementation of the commitments and prepare meetings.

To ensure the reliable operation of the market, the establishment of Technical Committees, under the umbrella of the Regional Energy Information and Technical Centre (REITC) may be required. Energy information and statistics are neglected and yet

[11] See the draft Tirana Declaration

needed. The REITC could systematically collect data from across the region and make it accessible to all.

6. THE GAS TO POWER GENERATION MARKETS[12]

The gas market in South East Europe is relatively underdeveloped considered as a whole, but this masks wide difference between the Eastern Balkans through into Turkey, and the Western Balkans through into Greece. In the Eastern Balkans and Turkey, gas use is either mature (Bulgaria or Romania) or rapidly developing (Turkey)[13]. In the Western Balkans, gas supply to Albania, Bosnia and Herzegovina, (FYRO) Macedonia, and Serbia and Montenegro is either underdeveloped or non-existent or has fallen into disuse[14]. In Greece, gas market development is underway where the development of the distribution network system has only been achieved by creating a power market and then adding long-duration distribution concessions.

Investments in the gas sector are envisaged to come primarily from the private sector.

Gas consumption in the region may be *declining*, with a reported 5% drop in use in the period 1995-2000, with nuclear and hydro-power being the major beneficiaries: this may be the result of an overall decline in energy use. In addition, the long-term energy market may not have much potential for gas: if energy use relative to GDP is significantly higher than in the European Union, efficiency gains will decrease demand. Market reforms could result in convergence in this ratio with Western Europe suggesting that new energy sources may not be needed (though old ones will need replacing or upgrading), if all other things remain the same. In addition, the present fuel mix shows that on a regional level, gas does not make a significant impact (ranging as examples from 1.7% in Albania to 20% in Romania), let alone equal the figure for the European Union (24%)[15].

(The Commission invites the IEA, CEER and GTE to comment on these statistics.)

The Commission would like to see the gas market develop across the region in a sustainable manner and as economics permit. Moreover, the Commission feels that energy security of supply for the region could be enhanced by increased use of gas coupled with increased supply portfolio diversity, or at least the possibility of diversity. With that perspective, the possibilities of supply into the region include Russian gas from the North and from the South, Caspian basin gas, again from the North or the South, traded gas from the North West Europe market, gas from North Africa through the foot of Italy, gas from the Middle East/Gulf and Liquefied Natural Gas (LNG) through existing facilities or new-build.

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[12] The Commission notes the need to coordinate its activities with regard to gas, notably with the INOGATE, Euro-Med and PHARE programmes.

[13] See EMRA Gas Study, ANRG Reports, Bulgaria National Energy Reports / IEA.

[14] World Bank Study "Cost of Gas Supply to Albania, Bosnia and Herzegovina, Macedonia and Serbia"[sic], ECA Consultants July 2003.

[15] EU-15: considered to be around 24% of primary energy fuel use, but incorporating several large economies in which gas is not used for power generation, such as Germany.

As a first step, the Commission considers that each state should investigate the possibility of expanding gas consumption to a nominal target of total primary energy supply by 2015. Using an indicative target, the states should be encouraged to see how this can be achieved and whether the increased security of supply offsets any additional costs. The keys to the penetration of gas into the region are the degree to which the generation market develops and the extent to which residential gas consumption increases.

On the generation side, the Commission has commissioned a Generation and Investment Study[16]. Having established credible, and perhaps more importantly, shared, assumptions about the link between economic development and generation expansion, the study aims to report in December 2004 on the need for new generation investments across the region. These investments could then be fast-tracked for development. How many of these investments, if any, would favour gas powered generation is unclear now.

Residential gas use could increase in the Western Balkans only through the creation of distribution networks. Given the small size of the potential market (the Western Balkans is sparsely populated and its urban population is relatively small), we envisage the use of long duration concession contracts to serve urban areas. The PHLG could actively support the use of auction systems for the award of contracts. These could either vary the terms of the regulatory framework under which a fixed term concession could be awarded (the fixed rate of return for example) or the duration of the concession (or both). However, the very highest levels of public procurement rules should be applied at the state level.

In the Eastern Balkans, gas expansion could be envisaged in the district heating system and for the residential sector. However, given the relative maturity of these markets, the general rules applicable in the European Union should be sufficient to incentivise investment if the correct regulatory framework is in place (favouring stability above all) and legal systems are capable of ensuring payments.

What the PHLG can do now is to determine the outline structure of a regulatory framework favouring gas. As part of the European Union's engagement for South East Europe, the states could envisage to establish a long distance transmission tariff mechanism that could assist in making tariff systems transparent and predictable. The EU might want to extend the Kyoto carbon trading principles to South East Europe in a way that the overall effect is to control and/or reduce emissions to the benefit of new entrants into the primary fuels market. The Commission strongly favours a separate Gas Forum to discuss these issues.

In any case, the states have to apply the terms of the gas directive following the Athens Memorandum 2003. For the developed gas markets, this could be relatively straightforward and for the new and emerging markets, the exceptions from the general rules in Article 28 of the Gas Directive should be applied in such a way as to enhance investment.

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[16] The intellectual management of the study has been devolved to the World Bank which is leading the study on behalf of the Commission. The European Bank for Reconstruction and Development and the European Investment Bank provide comment.

7. INDIGENOUS FUEL SOURCES AND RENEWABLES[17],

Indigenous resources have to be considered. Coal must be considered, as is expected to be the dominant fuel for electricity generation worldwide but this will depend on its supply security and environmental viability. Concerns over energy availability and security of energy supplies are re-emerging. The opportunities for coal remain positive, conditioned by the policy settings of contemporary markets in an environmentally balanced framework, reflecting the interest in a secure energy future. The right balance between domestic security, employment concerns and fuel diversification must be found and the Commission intends to further undertake outreach programmes to discuss these issues with interested stakeholders.

Further work needs to be done to make full use of hydro-power resources.

Renewable energy sources have considerable potential and they could make an increasingly substantive contribution to supply diversification, emission reductions, security of supplies and sustainability of the energy sector as a whole, over a long-term perspective. Many participants view renewables as a way of promoting the development of small local businesses in selected areas and diversifying supply patterns, at the regional level. There are some national programmes on renewable energies, and also indicative targets. However, financial constraints, energy pricing policies and the lack of supportive schemes continue to hamper the development of renewable energy sources. The potential for renewable energies is large, but still remains a complement to rather than a replacement for fossil fuels.

A Working Plan on Renewable Energy might be considered, under the coordination of a regional leader[18]. The Plan's goal will be the increase of the market share of renewables in the current energy mix by promoting policy instruments, regulatory incentives and market mechanisms. The Working Plan could be focused on: major renewable energy sources in the SEE region, e.g. small-scale hydro, biomass, geothermal, wind and solar, or all renewables, including municipal and industrial wastes. The promotion of hydrogen and of hybrid fuels options, such as coal/biomass might be investigated.

8. PHASING AND TRANSITIONAL MEASURES FOR ELECTRICITY

This part of the Discussion Note considers the steps to be achieved in order that a national and then regional wholesale electricity market from December 2007 is possible. A first stage will introduce state-level wholesale markets and then regional integrated wholesale markets will be investigated.

Two necessary preconditions are:

– that all parties stamp out trading abuses, corruption and non-commercial arrangements, as the parties have committed to do under the Athens 2003 Memorandum; and

[17] The Commission thanks UNECE for input into this section.

[18] Suggestions as to who this might be are invited.

– Develop energy statistics on a state basis and *within states* that allow for effective policy development[19].

8.1. Priorities in Transition Phase 1 (Present to December 31, 2005)

Payments reform is the first priority and is primarily a state level issue. The region needs a comprehensive payments reform process for network delivered electricity and gas. This might have three elements at each state level:

(1) A plan to bring payments up to 90% of billings before the end of the transition phase, elimination of abuse and corruption, reduction of non-technical losses, and complete account transparency;

(2) A plan to make retail tariffs at least cost reflective over the medium term; and

(3) A plan to make transmission and distribution tariffs cost reflective and transparent (covering actual costs now) over the course of the transition phase and then to raise them to the marginal level of investment by June 1, 2010[20] (that is the level necessary to facilitate new investments). There may be a need for timetables and intermediate steps. **The Commission believes that a co-ordinator of this work is necessary and should be appointed from the region.**

Governments need to actively support investment by ensuring that collection discipline is enforced. If private participation in the electricity business is to succeed, the Government, the customers, the investors, and other stakeholders all need to reach some consensus about the tariff regime that will be introduced and about the enforcement of collections, including the conditions under which disconnection of customers takes place. Disconnection should be of those who have the ability to pay but do not.

The Regulatory Board could draw up model/framework contracts with minimum and mandatory clauses detailing public service obligations and the framework for determining disconnection.

On the other hand, utilities must be given financial incentives commensurate with their service obligations. If, by more efficient operation, or by investment in additional equipment or by expansion in capacity, they provide enhanced services, they must be allowed to recover their costs of doing this over an appropriate period.

If a distribution company or a supplier becomes operationally solvent as a result of a reform programme, the possibility of state debt forgiveness for these could be explored so that there are genuine incentives for reform.

In the transition phase, for the majority, direct subsidy paid to the default supplier by central or local government should replace implicit or covert subsidy presently hidden in

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[19] According to the Commission information, Albania and Croatia do not the requisite Statistics Agencies.

[20] Cost reflectivity is to be defined by means of minimum criteria established by the Regulatory Board and implemented on an appropriate local basis by state level regulators. Tariffs may have to reflect average incremental cost at an early date.

the fuel price or retail tariff[21]. After the transition phase, subsidy should progressively become targeted on particular groups and paid directly to them or assistance for their payments should be provided on an individualised basis to suppliers. Under the directives, this public service obligation (PSO) is an issue for subsidiarity, but it is clear that the way the problem is dealt with should not impede the creation of the competitive wholesale market. However, the states themselves could make social safety net issues more of a priority in this phase. Issues of how to determine affordability can be discussed at a more elevated level, but ultimately these are issues that have to be decided at the level closest to the citizens affected by the decisions made.

The second priority for this period to December 31, 2005 is to begin the process of distribution company consolidation[22]. This might again be phased. Where consolidation has not happened, consolidation into companies of a reasonable size for the (national) market and the privatisation or marketization[23] of these companies could be desirable.

After December 31, 2005, distribution should operate in a regional context and therefore distribution companies might conceivably be restructured to take account of the larger market. Regulators can take account of the need to incentivise distribution reform.

The third priority is investment. Investments need fast-tracking. The power generation facilities considered as necessary as a result of the Generation Investment Study through the relevant financial institutions could be a first priority, but only if there is general and shared consensus on how these investments are identified. Additional investment in electricity interconnection between states is also necessary and the way forward could be defined using the Generation Investment Study combined with interconnection studies that have already been done[24]. The European Union does not take action with regard to choosing between the various bulk gas transmission projects in the region but to actively support all of them with regard to surmounting regulatory hurdles. Which are built is to be left to the market.

The fourth priority is to put in place incentives to develop reasonable levels of reserve generation capacity. The Commission invites the CEER to advise the Forum on this.

Fifthly, we should consider putting in place mechanisms, principally through the appointment of a lead co-ordinator and a willing donor, to:

(1) bring about compatible national and regional market designs and make this work transparent and coherent, and to make regular reports on this to the Forum; and

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[21] Derogation from this might be possible but only upon detailed analysis of why such action would be warranted.

[22] In this period, the Commission could also give guidance on what should be considered as an optimal size of a distribution company based on experiences in other transition economies and also practice in the European Union.

[23] Marketization is the process of making companies follow private sector principles and incentives.

[24] Most importantly, the USAID SECI Study.

(2) to work on the coherence and development of statistics and energy information within the REITC.

Lastly, the regulators must be made more independent, better capable of dealing with concrete problems, sufficiently resourced, having operational autonomy but also democratic accountability. The Commission will advise on a bilateral basis on this, though donors and regulators are encouraged to continue discussions on technical assistance.

8.2. Other Actions in Transition Phase 1 (Present to December 31, 2005)

The Commission will insist that all the regulatory and legal rules necessary for the operation of the gas and electricity markets are in place. This should mean abiding by the terms of the two Athens Memoranda.

Within this broad perspective, active promotion of transmission and distribution system[25] unbundling is needed, within the scope of the Directives and the interpretative notes. In many cases, only legal divestment can achieve the right incentives for the market model in the gas and electricity directives to work, especially in smaller jurisdictions, although European law does not demand it. Where there is no legal divestment, it is required that the holding company demonstrate that all necessary safeguards are in place to ensure diverging incentives between the management unbundled divisions. The state Regulator should ensure this, and the Regulatory Board should monitor application. Full access to audited accounts[26] would be a necessity.

The monopoly parts of distribution and transmission could be subject to regulation relating to cost and incentives, but the fuel price and retail tariff might not. The Regulatory Board is invited to consider what additional measures may be needed to assist in transition, but we could suggest that the Regulatory Board consider issuing guidelines on the linking (or not) of fuel commodity and retail prices for an interim period until sufficient transparency and liquidity are present. It should not be necessary to regulate the actual level of the retail tariff. However, there should be no decoupling of input costs and retail tariffs.

At this stage, the normal implementation work that the Commission undertakes in member States of the European Union could be extended to the region as a whole.

Technical approximation and rule making for the operation of the market could be devolved to technical organisations and committees. We have seen in electricity that UCTE, CEER and ETSO have played a prominent and active role. More generally, EFET has assisted with horizontal issues relating to trading rules. For gas, GTE and EazeeGas might play a role. These organisations, once they become involved, could be invited to organise their own work, though, as in the European Union, the Commission would take an interest in the work. Their work should cover grid codes and technical protocols for system security. We could assist by providing the REITC as a permanent base for their work.

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[25] Especially important is the requirement that eligible customers be given access to the distribution grid.

[26] The 2002 Memorandum insists upon IAS Standards for accounts.

– A primary goal for these organisations is to agree and implement accurate measurement for off-takes at the bulk gas and electricity transmission level so that the wholesale market can work and losses in the system can be correctly attributed.

– A secondary goal for them is to put in place all the information and interface protocols to allow customer switching and billing.

Where appropriate, technical proposals and protocols could be considered within the institutional hierarchy (Permanent High Level Group and Ministerial) for approval, but in the normal course of events, we suggest that this work be considered publicly in the Forum.

Lastly, all remaining customs and other duties on energy products should be abolished in this period.

8.3. Priorities in Transition Phase 2 (December 31, 2005 to December 31, 2007)

8.3.1. Regionalisation of investment

In transition phase 2, the institutions of the regional energy market should have a legal basis and some operating experience. It is important that they become involved in deciding the priorities for investment across the region. As long as the means of awarding contracts is compliant with best practice and EU norms for public procurement, the PHLG or the Commission do not have a large role to play in this process. The PHLG might ensure that the criteria for the determination of investment priorities are fair and transparent and are correctly applied, as the Commission does within the European Union. The actual substance of the criteria is to be determined by the states.

8.3.2. Pre- and post- investment guarantees

With the exception of Serbia & Montenegro, all of the countries in the region are signatories of the Energy Charter Treaty. This requires post-investment national treatment investment guarantees as derived from the World Trade Organisation rules. National treatment should be extended to the pre-investment stage on a multilateral basis. At this point, investment leadership might start to shift from international financial institution led investment to private investment, with a gradually diminishing role for development bank credits. As a potential investment area competing at a global level, South East Europe needs to increase its attractiveness and also to get investment from a variety of international investors. Pre-investment national treatment could be very helpful.

8.3.3. Single market design

A market design for the region is an option. The market design could be either a unique system across the region or a series of compatible national markets with regional trading. Given the size and the development of the markets, moving to a single market design over transition phase 2[27] is an option, but in this scenario the market design could operate

[27] See Commission Discussion Paper on the Standard Market Design for South East Europe, submitted to the Athens Forum, 2/3 June 2004 at Annex 1.

post-transition. This is a point for discussion. Above all, Governments and regulators should underpin the legitimacy of the market design through broad based consultation and development. The Council of European Energy Regulators papers on market design have set a good base for further work and the principles and operating mechanisms could be endorsed by the Forum and the Ministerial. Timing could be key and it is in this phase that the necessary implementation should take place once adoption at ministerial level has taken place.

8.3.4. Contracts exchange

Based on standardised trading contracts, a functioning contract exchange, acting as a clearing mechanism as well, should be set up. This might create liquidity in the power, gas and carbon markets and also provide bench-mark regional prices. Donor could make a proposal on this idea and could endeavour to ensure that non-market risks are assumed by the clearing mechanism.

8.3.5. License harmonisation and mutual recognition

Mutual recognition of licenses might apply at this stage. If a shipper is licensed in one state, his license might also be recognised in the other participating states on a national basis. The Regulatory Board might establish minimum criteria for license awards such as creditworthiness.

8.3.6. Day-ahead markets and regional markets

The market design proposals as presented by the Council of European Energy Regulators, as amended through broad-based consultation and if adopted at Ministerial level, should go live in this phase.

9. ENVIRONMENTAL ASPECTS

These aspects are an immediate priority. They are predicated on capacity building in Ministries and Regulators.

9.1. Legislative Framework

For Bulgaria and Romania, clear timetables for compliance with the *acquis communautaire* have been developed in the framework of accession negotiations. Transition periods can be negotiated on a case by case basis to allow for a prolongation of the timetable for harmonisation. These transition periods would normally only be given for investment heavy directives. The same could be true for Turkey from the point should negotiations be opened, although already under the Customs Union Agreement Turkey undertakes to comply with certain single market directives.

For candidate countries, environmental issues could be broadly addressed through their alignment with the *acquis* in accordance with the negotiated timetables. No further specific actions are required on alignment under this process.

Other parties are in a different situation and are covered by the Stabilisation and Association Process (SAP). The Stabilisation and Association Agreements (SAA) that form the legal basis for relations between each country and the European Union do not

contain strict environmental commitments but identify the environment as a key sector for cooperation. The SAP goal is eventual integration of these countries into the structures of the European Union; therefore harmonisation with the *acquis communautaire* becomes a long-term objective. So far agreements of this kind have been signed (but not yet ratified) with (FYRO) Macedonia and Croatia and negotiations have opened with Albania. The poor economic state of all of the SAP countries means that the prospect of compliance with the European Union environmental *acquis* is some way off.

The Commission agrees that the SAP countries should not be expected to immediately apply the environmental norms and standards of the European Union to their existing generating plants. However, the same cannot be argued for construction of new plant, particularly if financed by the international community.

The key Directives are listed in the Athens 2003 Memorandum. This Memorandum requires that the SAP states put in place indicative timetables for compliance. Some countries are already preparing timetables for approximation with the *acquis* and any timetables need to be discussed and examined in the particular context of the state. It is also clear that the environmental legislation needs to be clearly linked into the timetables for other legislation to enable a phased implementation. As the proposed market begins to fall into place, there could be a raised capacity to finance any environmental investment.

The Commission intends to keep this subject under review but to include commitments with binding legal force in the legal agreement to be drawn up. All timetables for environmental commitments might be finalised in Phase 1 as a condition for passage to Phase 2 (on a state by state basis).

9.2. Energy Efficiency[28]

Improvements in energy efficiency depend not only on technical innovations, but more on a change in consumer attitudes and in a strong institutional framework for the gains to be sustainable. In order to achieve such changes, convincing and solid national policies are required, which could bring structure to government actions as well as provide the right signals and motivations to encourage market transformation.

The energy efficiency is an essential issue for the market reform process and subsequent market opening.

Customers can be motivated to use energy efficiently. In non-energy intensive sectors, where energy costs do not exceed 2-5% of total operating costs, it is nonetheless important for companies to exploit opportunities to use energy more efficiently when the rate of return of investments in energy-efficient technologies is acceptable. Generally, such investments require payback of no more than five years. Rational energy use is even more important in energy intensive sectors iron and steel, glass, non-metallic minerals and heavy chemicals, where energy costs can account for as much as 40% of total operating costs.

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[28] The Commission thanks the Canadian supported SEETEC Programme for input into this section.

The importance of efficient residential energy use is increased by the fact that this sector accounts for a large proportion of final consumption. Under-pricing has discouraged energy-efficiency improvements up to now. Raising prices in the residential sector would boost interest in using energy more efficiently. In addition, it is important that technical solutions be made available to help people save energy if they wish to, including: installation of meters and heating controls in individual housing units, individual billing, subsidies such cheap loans and tax concessions.[29]

Under the pressure of numerous urgent reforms, the transition economies of the South East Europe region have unfortunately delayed the development of strong policies. There have been a multitude of isolated efforts that either fall short of their full potential or are short-lived due to the lack of fundamental framework elements.

A national energy efficiency policy might typically consist of a comprehensive multi-year plan that describes in broad yet flexible terms what realistic objectives, strategy, action plan, legal framework and organization are needed. These policies might cover specifically energy efficiency, energy conservation and renewable energies. Under such circumstances, technical solutions could become instruments of change, rather than an ends in themselves.

The development of national policies on energy efficiency could require a profound shift in priorities in most states and the development of specific skills. Indeed, while the local technical capabilities are often highly commendable, the ability to develop long-term plans and to define strategies is less so. Taking into consideration the poor energy performance of most South East Europe countries, we think that such skills should be quickly developed and regrouped within national energy efficiency agencies, perhaps with a regional focus centre. This expertise should need to be deeply involved in the policy development process and be trained in managing and delivering strong and sustainable results. The Commission could seek to marshal foreign aid and best practice expertise from international donors to add value in this process. The Commission will appoint a lead co-ordinator and a lead donor to this work.

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[29] UNECE Guidelines on reforming energy pricing and subsidies