



**CREATION OF
THE ENERGY COMMUNITY**

**PROGRESS REPORT
JANUARY TO MAY 2005**

6 May 2005

1. BACKGROUND

The Stability Pact is involved in the Energy Sector in South Eastern Europe (SEE) through its sponsorship of the Athens process of regional energy co-operation. This process launched by the European Commission in 2002, aimed at creating an Energy Community of South Eastern Europe and at integrating it into the EU internal energy market. The creation of this Energy Community is part of Working Table II core objectives.

A first Memorandum of Understanding (MoU), dealing with the electricity sector, was signed in Athens on 15 November 2002. A second MoU, signed in Athens on 8 December 2003, extended the process to gas. Negotiations on the transformation of the two MoUs into a legally binding multilateral treaty started in October 2004 and were preceded by three meetings of Senior Advisors to the Prime Ministers of the region, organised by the Stability Pact, to secure consensus on this ambitious endeavour.

2. MOST SIGNIFICANT RECENT DEVELOPMENTS

In the course of the negotiation, the objective of the Treaty has become more and more the creation of an overall European Energy Community rather than primarily an SEE Energy Community. Starting from a looser concept of co-operation, we are moving towards the establishment of a single European Regulatory Framework for Electricity and Gas.

The draft treaty was initialled on 22 March by country delegates in Brussels. . Formal signing of the Treaty by all the parties is expected to take place in July or September.

The European Commission issued in February a discussion and consultation note on "the Gas Transition Strategy". This note is to be finalised by the Gas Forum, expected to take place in the autumn of 2005, so that a Gas Transition Strategy can be adopted by the Athens Process Ministerial Meeting before the end of the year.

3. KEY FEATURES OF THE ENERGY COMMUNITY TREATY

The European Energy Community would have as members:

- the European Community; and
- the SEE Regional members, namely Albania, Bosnia & Herzegovina, Bulgaria, Croatia, FYR of Macedonia, Romania, Serbia & Montenegro, Turkey , as well as UNMIK, representing Kosovo further to its mandate under UN SC Resolution 1244;
- Moldova will have observer status.

The objectives of the Treaty are:

- to create a single stable regulatory and market framework throughout Europe; this should enhance the attractiveness of SEE for investments in the energy sector;
- to enhance security of supply;
- to improve the environment situation; and
- to develop competition on a broader geographic scale and to exploit economies of scale.

More practically the activities of the Energy Community will include:

- Implementation of the EU “acquis communautaire”;
- Creation of a single mechanism for the cross-border transmission and/or operation of energy markets; and
- Creation of an energy market without internal frontiers.

The extension to SEE of the *acquis communautaire* will cover important areas:

- First of all, the *acquis* on energy proper, i.e. the EC Directives 2003/54 and /55 on internal market in electricity and natural gas and EC Regulation 1228/2003 on conditions for access to the network for cross-border exchanges of electricity. It is under these texts that the SEE countries will be legally obliged to unbundle the generation, transmission and distribution activities, to set up independent national energy regulators and to open access for cross-border trades in electricity and gas. The timetable envisaged for liberalisation is 1 January 2008 for all non-household customers and 1 January 2015 for the other customers.
- Second, the *acquis* on environment, including the directives on assessment of the effects of projects on the environment (by the date of effectiveness of the Treaty), on the reduction in the sulphur content of certain liquid fuels (by the end of 2011) and the limitations of emissions of certain pollutants into the air from large combustion plants (by the end of 2017); the construction and operation of new generating plants will have to comply with the *acquis* as soon as the Treaty will be effective and each contracting party shall endeavour to accede to the Kyoto Protocol and to implement the EC Directive on integrated pollution prevention and control.
- Third, the *acquis* on competition including the prohibition of agreement and concerted practices having as their object or effect the prevention, restriction or distortion of competition, the prohibition of abuse of dominant position and the prohibition of public aids distorting or threatening to distort competition: the basis for assessment will be the relevant articles of the Treaty establishing the EC (Articles 81, 82,86 and 87);

- Fourth, the acquis on renewables, with each contracting party bound to provide a plan to implement Directives 2001/77 and 2003/30;
- Last but not least, compliance with generally applicable EC standards (e.g. technical standards for transmission, cross-border connections, system security, etc.)

The Energy Community is expected to take measures establishing a single mechanism for the cross-border transmission and/or transportation of network energy. Each country will have to adopt security of supply statements, describing in particular diversity of supply, technological security and geographic origin of imported fuels. High levels of provision of network energy to all citizens will be promoted within the limits of public service obligations (e.g. universal provision). Measures can be taken to ensure compatibility of market designs and mutual recognition of licences. Safeguard measures will be allowed under strict conditions.

The creation of a single energy market will be underpinned by the prohibition of customs duties and quantitative restrictions on imports or exports of network energy (except on grounds of public policy or public security). An important feature will be the possibility of a common external energy trade policy, e.g. with respect to environmental standard or safe operation of the internal energy market. There will be co-ordination of mutual assistance in the event of serious disturbance or external disruption.

The governance of the Energy Community will involve common institutions: a Ministerial Council, a Permanent High Level Group (PHLG), the already existing Electricity Forum based in Athens and the future Gas Forum to be based in Istanbul, composed of representatives of all interested stakeholders, including industry regulators, industry representative groups and consumers. An important new institution will be the Regional Regulatory Board, which will advise the Ministerial Council and the PHLG on the details of statutory, technical and regulatory rules and issue recommendations on cross-border disputes involving two or more regulators. A Secretariat, to be based in Vienna, will provide administrative support and review the proper implementation by the Parties of their obligations under the Treaty.

4. THE STABILITY PACT ADDED VALUE

Since the beginning of the Athens Process, the Stability Pact's contribution has been mostly in the three following areas:

- Fostering regional ownership and political consensus: as indicated, the Stability Pact organised three meetings of Prime Ministers' Advisors, respectively in Vienna in June 2003, Sofia in October 2003 and again Vienna in July 2004, to secure consensus at the highest level. A conference for SEE Parliamentarians was co-organised by the Stability Pact and the European Commission in Bucharest in October 2004 under the auspices of the Romanian Chairmanship-in-Office of the SEECP.

- Stimulating private sector interest: the Stability Pact organised with the European Commission two-industry roundtables, one in Prague in February 2003 and one in Sofia in October 2003. The Special Co-ordinator, the Deputy Special Co-ordinator, the Director of Working Table II and the WTII Energy expert have taken part in numerous conferences briefing private investors about the trade and investment opportunities created in SEE by the Athens process and the forthcoming Treaty. Recent events in which the WTII Director spoke include the Energy Seminar organised by the EBRD in Tirana on 10-11 February, the Congress on “Restructuring the Energy Sector in Transition Countries”, co-organised in Leipzig on 8-9 March by the Stadtwerke Leipzig, Verbundnetz Gas and the World Bank, the Investment Forum organised in Oslo on 17 March by the Norwegian Ministry of Foreign Affairs together with the OECD-led Investment Compact, and the Investors Meeting organised by the Swiss Government (SECO) in Bern on 21 March.
- Donors Co-ordination in support of the EC Chairmanship: one of the key features of the Athens process is that all the multilateral and bilateral donors have agreed on a common strategy for the region as a whole, which is exceptional. Donors meet at least twice a year under the chairmanship of the European Commission and more frequently if needed to co-ordinate their assistance to specific countries, e.g. Bosnia & Herzegovina. The most recent donors co-ordination meeting was hosted by the EBRD in London on 4 February 2005. At that meeting, the donors invited the Stability Pact “to help organise social, environmental and parliamentary dialogues”. The donors welcomed the USAID commitment to carry on with the Regulatory Benchmarking exercise and asked USAID to take the lead in drafting a paper on the Regional Regulatory Board functions.

Being a political initiative, the Stability Pact always draws attention to the political significance of the Energy Community: it constitutes a unique political chance for the SEE region and is, in many ways, similar to the European Coal and Steel Community set up in Western Europe by the Treaty of Paris in 1951, in terms of consolidation of reconciliation and prelude to fuller economic integration; it is also a key step on the way to EU integration particularly for the countries that do not have yet the candidate status. For the EU, the Energy Community holds great geopolitical importance as it opens the way for a much-needed diversification in the routes of energy (mostly gas) supply.

When talking about the economic impact of the Energy Community, the Stability Pact always stressed the following points:

- Larger market and predictable regulatory environment will attract investment and financing;
- Level playing field with fair conditions for all groups of market participants;
- Increased reliability and security of systems;

- Beneficial diversification and environmental impact through the development of the market for gas;
- Reduction in operation costs and more competitive prices;
- Enhanced transparency, accountability and market discipline and lower corruption
- Regional framework for determining critical investments;
- Reduction in overall investment needs thanks to enhanced national and regional strategies; and
- Better integration of economic, energy and social policies.

However, the Stability Pact always also draws the attention of all the parties concerned on the magnitude of the challenges facing the countries of SEE, in particular in terms of the socio-economic impact of the Athens process and of the forthcoming Treaty, more specifically:

- the cost of the institution building requirements;
- the importance of designing well thought through energy policies and strategies;
- the importance of a sound regulatory framework and of a competitive environment before privatisation;
- the impact of tariff reform on affordability and the ways to initiate the impact on the most vulnerable social groups; and
- the impact of restructuring in the energy sector (including mining) on employment and the need to work out well in advance measures to mitigate that impact.

5. BENCHMARKING TO ASSESS HOW MUCH PROGRESS HAS BEEN ACHIEVED

Pending the formal establishment of the Secretariat in Vienna, the European Commission, with the help of consultants has been regularly assessing through a benchmarking process how much progress has been achieved towards meeting the commitments undertaken under the two Athens MoUs. An interim secretariat, funded by the Commission, is in the process of recruiting its Director and key staff.

Benchmarking measures reform tasks achieved by target deadlines. Separate benchmarking exercises are undertaken, in each country, for the Ministry of Energy (or equivalent), the Regulatory Authority and the Transmission System Operator (TSO). Benchmarks cover: legislation (existence and appropriateness), institutions (number of staff, qualifications, budget, scope of activities) and performance (what has the organisation done since it was set up).

The picture that emerges is that nearly all countries have adopted legislation to implement Directive 92/96/EC and that by July 2005 they will have implemented Directive 2003/54/EC. Regulators are in place almost everywhere although some are not as independent as they should be. TSOs are making slow progress and there is still some interference in vertically

integrated companies. However, it can be said that most institutions foreseen under the MoUs are anticipated to be operational by the summer of 2005 in all countries.

6. THE GENERATION INVESTMENT STUDY AND THE ENVIRONMENTAL STUDY

The European Commission financed Generation Investment Study (GIS) carried out under the supervision of the World Bank is moving forward and close to completion.

Following the Athens Forum in October 2004, at which, preliminary draft results were presented, a new round of comments from stakeholders countries was invited. Many useful comments were received, particularly as regards demand forecasts. In addition, much work was done in assessing in which cases rehabilitation of existing utilities could be considered economically justified on the basis of cost analysis. Using revised assumptions, the study team has run again its model for an integrated regional electricity system.

Under the base case, the region will need to invest about US\$ 15 billion over the next 15 years in the rehabilitation of 11,574 MW of existing power plants and the construction of about 11,000 MW in new power plants. This does not include the associated investments in transmission and distribution, which are probably no less than US\$10 billion. New capacity is needed relatively soon: for instance, the model suggests that a 500 MW lignite fired plant should be added in Kosovo before 2010; between 2010 and 2015, the model suggests that a further 800 MW should be added in Kosovo, together with 800 MW of gas fired plant at an unspecified location, while after 2015 one notable result is that Belene Nuclear Power Plant unit in Bulgaria would be least cost.

The first results of the hydropower simulations are also very important because they show that introducing about 2,000 MW of best-ranked hydropower plants in the region, instead of building some coal and gas fired plants in the region, increases the total system cost (investments plus operational and maintenance costs) by only 1 per cent assuming the base price of gas. With a higher price of gas, this difference might evaporate altogether leaving significant room for hydropower expansion in the region.

The GIS study is expected to be finalised soon, including the modelling of the transmission network, and will be presented at the Skopje energy week in early June 2005.

In parallel to the main GIS, a World Bank financed Environmental Study is being carried out. The preparation work for this project has now been completed, with construction of a database for plant level environmental performance, together with estimates of compliance costs for various environmental standards. The TORs for the environmental study require that the consultants consider three scenarios: (i) compliance with the EC Directive concerning sulphur dioxide emissions; (ii) introduction of the Kyoto Protocol in the SEE context and (iii) a combination of these two. There is a possibility that the economic rehabilitation programme may change if there is a

requirement to add flue gas desulphurisation, while the economics of rehabilitation and of new plant creation may also change if carbon credits are factored into project cash flows. The results of the environmental study will also be presented at the Skopje Energy Week in early June.

7. Orientations for the future

With the signing of the Energy Community Treaty, the role of the Stability Pact will evolve. It will try more than ever to ensure genuine regional ownership and progressive transfer of responsibility for regional energy co-operation to the region.

The establishment of the institutions of the Energy Community, including the Regional Regulatory Board and the Secretariat will be important steps in that direction. Bulgaria has formally offered to transform the existing Black Sea Energy Centre, based in Sofia, into a Regional Energy Information and Technical Centre. The need for such a regional centre focusing on the collection of relevant statistics and on a number of technical issues has been recognised by the PHLG.

Further to the request of the European Commission and of the other donors, the Stability Pact will help organise dialogue with Parliamentarians, social partners and NGOs, particularly NGOs promoting environmental protection.

The Stability Pact will facilitate the organisation of a new SEE Parliamentary Conference on the Energy Community. This will take place, with TAIEX funding, in Skopje on 6-7 June 2005. This conference is co-organised with the Committee of European Affairs of the Parliament of the FYR of Macedonia. In the view of the ratification process that must take place in the national parliaments, the Stability Pact is prepared to also help organise a number of national parliamentary briefings on the Energy Community and the Treaty.

The Stability Pact will also provide assistance towards organising the necessary dialogue on the Energy Community with the social partners, particularly on the social implications of tariff reform and restructuring in energy utilities. An MoU on the social implications of the Energy Community is being considered. The Stability Pact could provide the expertise and contacts it has gained through its sponsorship of social dialogue in SEE in the framework of its Initiative of Social Cohesion (ISC)

The Stability Pact will also continue to sensitise potential investors about the trade and investment opportunities created by the Energy Community.

With attention shifting from electricity to gas, the Stability Pact is prepared to help organise an Industry Round Table on gas. If the proposed Gas Forum holds its first meeting in Istanbul in the coming months, an Industry Round Table on gas could also be organised on the same occasion.

The Gas Forum and the Industry Round Table on gas would provide an important opportunity to discuss the various gas pipelines under consideration

and to foster regional cooperation towards implementing those projects with the best economic prospects. A next stage might also be the inclusion of oil (seen as another form of network energy) into the evolving regional energy cooperation process.