The Energy Community of South East Europe: Challenges of, and Obstacles to, Europeanisation

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Abstract: The Energy Community Treaty, signed in Athens in 2005, creates a legal framework for an integrated energy market between the European Union and nine South East European partners – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Montenegro, the Former Yugoslav Republic of Macedonia, Romania, Serbia and the United Nations Mission on behalf of Kosovo. This paper examines the challenges posed by the application of the EU model of energy regulation and the *acquis communautaire*, and the ability of States to meet those challenges.

Given the recent historical context of the 1990s Balkans conflict and subsequent reconstruction efforts, a number of external countries and bodies have intervened in the region with aid and technical assistance programmes. However, the incentive of eventual EU membership affords the EU in particular a certain bargaining power through pre-accession instruments, and the Energy Community framework allows it to act as gatekeeper. This regulatory alignment, encouraging co-operation on technical issues, is expected to create spill-over effects in other sectors of reform.

The paper considers whether the EU energy model is appropriate in South East Europe at this stage. It suggests that regulatory reform alone may not be sufficient – the domestic institutional framework is a significant factor. Analysis using the World Bank's quality of governance indicators suggests that different groups of countries should approach reform differently according to institutional capacity, and a 'one size fits all' solution may not be appropriate.

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This may have implications for targeting technical assistance and capacity building measures.
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1. Introduction

The Treaty establishing the Energy Community was signed in Athens on 25 October 2005 building on the Memorandum of Understanding on the Regional Electricity Market in South East Europe and its integration into the European Union Internal Electricity Market ("the Athens Memorandum"), 15 November 2002, which was sponsored by the European Commission and Stability Pact partners. The Treaty provides for the creation of a legal framework for an integrated energy market, and with it a single regulatory space for trade in energy, between the EU and 9 South East European partners – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Serbia, Montenegro, the Former Yugoslav Republic of Macedonia, Romania and UNMIK on behalf of Kosovo. Although it has not yet signed the Treaty, Turkey is a participant in the regional market as a signatory of the Athens Memorandum. It was granted observer status, along with Moldova, Norway and Ukraine, at the first Ministerial Council on 17 November 2006. Austria, Greece, Hungary, Italy and Slovenia are participants as existing members of the European Union adjacent to the region.

The development of the Energy Community has often been compared to the establishment of the Coal and Steel Community and the subsequent genesis of the European Union. By encouraging cooperation in a highly technical subject area, both initiatives were based on the assumption that this approach encourages communication and integration between countries that might otherwise be hesitant to cooperate. This neofunctionalist framework also assumes that the positive benefits from coordination on technical issues create 'spill-over' effects into other sectors of reform.[1]

The countries of South East Europe all share common aspirations towards membership of the European Union. By participating in the regional energy market, the countries will essentially become *de facto* members of the European Union in the energy sector with the goal of eventual integration into wider European networks and EU membership. Accession negotiations have been opened with Turkey, Croatia and the Former Yugoslav Republic of Macedonia, while Bulgaria and Romania were admitted into the EU on 1 January 2007. Many of these countries, with the exceptions of Greece and Turkey, also share a background of decades of communist rule. The Balkans conflict of the 1990s, and the post-conflict reconstruction efforts, form part of the context of electricity reform for many countries in the region.

1.1 Background to market reform

A number of international agencies, such as the European Commission, the World Bank, the European Investment Bank and the European Bank for Reconstruction and Development, and donor countries, such as the USA, Canada, Germany, Italy, Switzerland, and France, have been actively involved in the economic development and political integration of the region for over a decade. These agencies were the primary drivers of market reform

[1] Moravcsik, Andrew. *The European Constitutional Compromise and the Neofunctionalist Legacy.* Journal of European Public Policy 12:2. April 2005. pp 349-386.

and regional economic stabilisation following the collapse of the communist regimes in the region after 1990 and continue to play a central role in its development, specifically through the energy sector. Supply security and improving the balance between energy supply and demand is crucial to the economic development of the region.

The legacy of a centrally planned economy creates special circumstances for transition countries, as distinct from market economies. This concept is particularly relevant in Central and Eastern Europe (CEE) and in South East Europe (SEE) as economies in transition require reallocation of resources across a sector, closing inefficient firms and creating new ones, in addition to restructuring existing firms to improve performance as in established market economies (Fingleton, Fox, Neven and Seabright 1996).

Following the fall of the Communist regimes, many economists recommended a 'big bang' approach to economic recovery in CEE, encouraging quick mass privatisation, not least to reduce state power and to establish property rights with an emphasis on quick privatisation and liberalisation before the creation of a stable legal-institutional framework.[2] This subsequently left the new owners of privatised firms to carry out restructuring and governments to organise the structure of the market and legal institutions. Policy-makers at the time largely underestimated the role and significance of the institutional framework needed for a well functioning market economy. Even where this was acknowledged, misjudgements in early transition influenced the direction of institutional development. There may also have been a tendency to assume uniformity of goals and reform sequencing across transition countries.

During this time, donor programmes shifted significant financial resources to programmes and policy initiatives in both CEE and in SEE. In CEE, the establishment of transparent, democratic institutions and governance took a prominent role in assistance strategy. As the development process evolved and the economies responded favourably to economic reform and recovered the majority of the economic decline they initially experienced following the dissolution of the Soviet Union, the idea of pursuing integration into wider European political and economic networks was naturally proposed. The process of accession into the European Union provided long-term, sustainable economic prospects for the countries of the region and attracted the support of both EU policy-makers and their American counterparts.

Unfortunately, economic recovery and the establishment of democratic governance in South East Europe, particularly in the Balkans, has not been smooth. The Balkan Wars in the 1990s created a politically and economically unstable climate in South East Europe, as well as inflicting significant infrastructural damage in the energy sector (as highlighted for the case of Bosnia-Herzegovina, by Scholl, 2008). Policy-makers and donor institutions faced the added complication of simultaneously developing humanitarian intervention and conflict mitigation strategies. Initially, a phase of post-conflict

[2] Grusevaja (2006) 'Do institutions matter? An analysis of the Russian competition policy in the period of transformation', Universität Potsdam working paper no. 88, 11th AISPE Conference, Padua, 15-17 June 2006.

reconstruction that focused on the redevelopment of physical infrastructure (electricity lines, housing, water systems, etc.) was pursued as much was destroyed during the period of conflict. Donor lending programmes invested heavily in infrastructure development while also encouraging the re-integration of the population into their communities by assisting displaced persons.

In spite of these obstacles to stability, integration, and growth, a multi-tiered approach was developed to address these issues. As a threshold of stability was achieved in the region, policy-makers and donor programmes naturally shifted increased efforts towards technical assistance programmes, particularly focused on market reforms, transparent governance, and privatisation.

In 1995, the United States proposed the South East European Cooperative Initiative (SECI)[3] to serve as an instrument for peace keeping in the region. It was realised that the measures in the Dayton Agreement needed additional support to encourage cooperation and integration among the countries. While not being an assistance programme in itself and having no control over the use of donor funding, the SECI serves as a coordination mechanism among donor efforts by bringing focus and coordination among the key players.

In the following year (1996), the countries themselves proposed a regional cooperative agreement referred to as the South East European Cooperative Process (SEECP) at the conclusion of a meeting in Sofia. The focus of SEECP is to promote regional peace, democracy, and economic activity while ensuring integration of SEE into wider European and Euro-Atlantic structures. Both the SECI and the SEECP served as precursors to the Stability Pact and were instrumental in directing the focus of donor projects and assistance in the region.

At the EU's initiative in 1999, the creation of the Stability Pact represented a comprehensive coordination mechanism among donors, policy-makers, and other related agents. The Stability Pact is an effort to coordinate and streamline donor assistance in the region by identifying key areas of priority assistance in democracy, economic growth, and long-term conflict prevention.

The partners of the Stability Pact include over 40 countries and a multitude of international organisations, international financial institutions, and regional programmes, all sharing the common goal of promoting regional security and development while drawing the countries of SEE towards fuller European integration.

While the initial focus in Central and Eastern Europe in the early 1990s was on market reform and democratic governance, the strategy in SEE had to primarily focus on conflict prevention and restructuring. Thus, the overall process of Europeanisation and integration into wider European networks has not been as easy for the countries of South East Europe. Political tensions remain both within and between countries in the region. It has been argued

[3] The European Union also played a supportive role in the development of the SECI.

that the impetus for economic cooperation in the Balkans region should come from the business sector rather than from politicians or international agencies, in a bottom-up approach.[4] However, it is clear that policy-makers play a key role in creating the right business environment through better regulation to lighten the burdens on business.

While having made commendable progress over the past decade, the countries of SEE still have many challenges to address. Currently, average energy intensity in SEE is 60% higher than in other European OECD regions (Bergasse 2003). Energy consumption patterns that developed during the control economies are no longer viable as the markets progress towards the adoption of free market principles.

The development of concrete energy policies in transition states may be delayed given the competing priorities for urgent reforms in other spheres. Pre-conditions of donor aid programmemes will further have a bearing on how institutional reform is prioritised and carried out.

2. Europeanisation

The EU, in particular the European Commission as accession negotiator, clearly enjoys a certain leverage in the neighbouring region of South East Europe. The term 'Europeanisation' most commonly refers to the domestic impact of the European Union driven by the requirements of EU membership.[5] However, the term can more broadly refer to the process of adoption of a Western European model of governance. This is appropriate for our purposes, as for many countries in Central and Eastern Europe, the accession process to the European Union has been a catalyst for industry change towards a Western European model of economic governance. Furthermore, it has been characterised as a process of 'regulatory alignment'.[6]

Such Europeanisation is being exported to countries on the periphery of the EU, in particular to those whose applications for EU membership are pending, such as the Western Balkans. While Turkey, Croatia and Macedonia are candidate states, other countries in the region bear the status of applicant states, at an earlier stage along the path to accession. Haughton suggests that the European Commission's transformative power (Grabbe 2006) in a country's domestic context is at its greatest when the EU is making a decision whether to open accession negotiations; that is, between the pre-accession period and the accession negotiations themselves.[7] Vachudova denotes the EU's 'passive leverage' as the strength of attraction of EU membership.[8]

[4] Barrett, L (2002) 'Business in the Balkans: the case for cross-border cooperation', Centre for European Reform, London.

[5] Some have advocated the alternative of 'EU-isation', arguing that a conflation of the European Union and the rest of geographical Europe is inappropriate. See for example Haughton, T (2007) 'When Does the EU Make a Difference? Conditionality and the Accession Process in Central and Eastern Europe' 5 *Political Studies Review*, 233-246 at 234.

[6] McGowan, F & Wallace, H (1996) 'Towards a European Regulatory State,' 3(4) *Journal of European Public Policy*, 560-576.

[7] Haughton, p. 237.

[8] Vachudova, M (2005) Europe Undivided: Democracy, Leverage and Integration After Communism, Oxford University Press.

However, given the current internal debate about the future shape and institutional make-up of the EU, there are constraints on further enlargement. This has implications for the EU's ability to make a credible offer of candidate country status, and for the path-dependent nature of the accession process. In some cases the message appears to be "reform with a view to membership, but don't reform yet".[9]

In the case of the Central and Eastern European countries that eventually joined the EU in 2004, new instruments were created to manage demand for enlargement, representing intermediate steps along the road to accession: Association Agreements, also known as Europe Agreements; and the Copenhagen criteria for EU membership, incorporating both political and economic elements.[10] Assistance and aid was managed through financial instruments such as Phare, ISPA and Sapard (focusing on infrastructure, agriculture and rural development), CARDS specifically for the Western Balkans, and the specific instrument for Turkey.

Bringing together candidate and 'potential candidate' countries at various stages along the road to EU membership, all of these instruments have been integrated since 1 January 2007 under one single Instrument for Pre-Accession Assistance (IPA). This incorporates a three-year financial perspective based on the beneficiaries' needs; absorption capacity, management capacity and respect for the Copenhagen criteria. The IPA comprises five components, the first two of which – transition assistance and institution building, and regional and cross-border cooperation – are available to potential candidate countries as well as to candidates.[11]

A state may therefore be involved in an institutional relationship with the EU short of an accession agreement, as is the case in the Stabilisation and Association Process of the Western Balkans. The Energy Community framework could be characterised as an issue-specific extension of this pre-accession status.

One aspect of the EU's credibility is how closely the European Commission is able to monitor a non-Member State's implementation of the *acquis* and compliance with agreements. Compliance monitoring may be greater than the control exerted over the existing Member States, and applicant states do not have an opportunity to 'upload' their preferences to the EU level to the degree that Member States do. The emergent literature on the Europeanisation of applicant states discusses to what extent that relationship is built on conditionality, socialisation, or a hybrid of the two approaches (Sedelmeier). An applicant state may judge the 'reward' of EU membership and intermediate incentives relative to other agencies or countries with which it has a relationship.

[9] Panel on 'The EU and the Balkans' at the Political Studies Association annual conference, University of Bath, Friday 13 April 2007.

[10] Four political criteria – democratic governance, rule of law, human rights, protection of minorities – and the economic criteria of a functioning market economy and ability to cope with the competitiveness pressures of the common market.

[11] The other three IPA components are regional development, human resources, and rural development, designed to prepare the candidate countries for Structural Fund management.

In light of the delays and deadlines for the EU Member States in completing the internal market in energy, it has been suggested that associated countries in the Athens process may not be permitted to slip as far from their obligations and deadlines as the EU member states themselves. In recent months the European Commission has taken a tough stance, sending warning letters and instigating infringement proceedings against a number of existing Member States for failure to fulfil their obligations under the electricity and gas directives. The Directorate-General for Competition's energy sector inquiry has also led to the Commission issuing proceedings for breaches of competition law.

Tying these willing states into a pre-accession process therefore lends considerable persuasive force to the European Union. The implementation of the EU *acquis communautaire* has expanded beyond the member and accession states and is specifically incorporated into the legal obligations of the Energy Community Treaty (detailed below). In the case of the countries of Central and Eastern Europe (CEECs) who joined the EU in 2004, they may have been motivated by the advantages of full EU membership as distinct from the particular benefits of the EU model in a certain policy area.[12] The Energy Community experiment allows us to observe the process of Europeanisation in recently-joined EU member states, candidate countries, and applicant states through the prism of technocratic cooperation in the field of electricity.

In that context, the European Commission acts as gatekeeper between the member countries of the Energy Community and other external agencies. In effect this blocks additional conditions on aid from the donor organisations, and in the other direction allows the Commission to control the member countries' relations with other external agencies. The 'top down' theory of Europeanisation, dependent on intergovernmental channels in which the EU can directly influence policy-makers and elites, would exclude influence from other external organisations and the interplay between the EU and its external partners. It also fails to explain the voluntary adjustments of applicant states in their interaction with the EU.[13]

Meanwhile, the 'bottom-up' theory of Europeanisation corresponds with the operation of the institutional framework of the Athens stakeholder forum, which obviates the state level and instead conducts business through sub-national technical working groups. Energy project agreements tend to be concluded directly between the Commission and local governments. This can be characterised as the 'societal channel', in which the EU achieves indirect influence through domestic groups applying pressure on their own governments.

In some instances, reform required by the EU may take the national emphasis away from privatisation, particularly given that the European Commission is

[12] Sedelmeier, U (2006) 'Europeanisation in New and Candidate States', 1 *Living Reviews in European Governance,* 3 at p. 5 http://www.livingreviews.org/lreg-2006-3.
[13] Sedelmeier, p. 6.

officially neutral on privatisation. For example, in Macedonia, there had been a drive towards privatisation until the elections of 2002(?), after which the newly elected government reprioritised, deciding that sector reform to comply with EU legislation should take precedence, with privatisation the second priority (Taleski, 2008).

3. Obligations under the Energy Community Treaty

The Treaty establishing the Energy Community obliges the signatories to adopt the EU *acquis communautaire* in energy, competition and environment. This section discusses each of these separately before we turn, in the next section, to discussion of the attractions, disincentives and challenges surrounding the acceptance and implementation of these obligations.

3.1 Energy

The creation of a regional energy market in South East Europe aims for a smooth integration into the EU internal electricity market by 2010. Under the Athens Memorandum of November 2002,[14] the countries of the region made commitments towards a common energy policy, including gradually liberalising power markets, restructuring energy companies, maintaining cost-recovery tariffs, adopting tariff methodologies and technical codes for network access, enforcing payments, introducing social safety nets, and setting up independent regulators to scrutinise third party network access.[15]

The subsequent Treaty establishing Energy Community in South East Europe comprises a number of market design elements in electricity. The European Commission notes that this European market design is "not based on one single concept, but has rather evolved from different regional designs" harmonised through the Florence process.[16]

On the technical side, the signatories agreed to open electricity markets in line with EU commitments,[17] subject to a suitable transition period, and at least to begin opening their electricity markets by 2005. Non-EU member countries are expected to fully open their energy markets for industrial and commercial customers by January 2008, and for household customers by January 2015, compared with July 2004 and July 2007 respectively for the EU Member States. Bilateral agreements between the European Union and the non-EU Member State countries of the region, such as the Europe Agreements (with Bulgaria and Romania) and Stabilisation and Association Agreements (with

[14] The 2002 Athens Memorandum relates to electricity whereas the 2003 Memorandum relates to gas.
[15] Kennedy, World Bank Framework for Development of a Power Market in South East Europe, Energy and Mining Sector Board Discussion Paper No. 15, World Bank, March 2006, p. 4.
[16] European Commission South East Europe Electricity options paper, 5 December 2005, p. 1.
[17] EC Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity; EC Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas; EC Regulation 1228/2003/EC of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity.

Croatia and FYR Macedonia), also contain a chapter on energy reinforcing these commitments.[18]

Vertically integrated utilities must be unbundled to create distribution system operators (DSOs) by July 2007 for those with more than 100,000 customers, and by January 2010 for the remainder, and to create separate transmission system operators (TSOs) by January 2007.

In terms of regulatory and institutional reform, the signatory countries committed to establish State-level national energy authorities; to create national regulatory agencies by June 2003; and to introduce anti-corruption programmemes. At the Energy Community level, a South East Europe regulatory board was put in place in December 2006, with an Energy Community secretariat based in Vienna responsible for implementing the Treaty. There is a business plan for a TSO auction office to be established to manage allocation of cross-border trade capacity.[19] In addition, a Regional Energy Information Centre in Sofia is foreseen to collect energy statistics from the region, mirroring Eurostat data collection functions among the EU Member States. However, the plan is currently on hold and there is no harmonisation on what data should be published.[20]

3.2 Environment

Under the Energy Community Treaty, the SEE signatories are required to adopt EU environmental legislation. They were obliged to implement the environmental impact assessment directive,[21] and the wild birds directive[22] as soon as the Energy Treaty came into force. The Treaty requires full compliance with the EU Large Combustion Plant Directive[23] by the end of 2017, which limits sulphur dioxide emissions, and the directive on sulphur content of liquid fuels[24] by the end of 2011. Environmental legislation will

[18] For example, the energy chapter in the Agreement with Croatia states:

> "1. Cooperation will reflect the principles of the market economy and the European Energy Charter Treaty, and will develop with a view to the gradual integration of Europe's energy markets.
>
> 2. Cooperation shall include the following in particular:
>
> – the formulation and planning of energy policy, including modernisation of infrastructure, improvement and diversification of supply and improvement of access to the energy market, including facilitation of transit, transmission and distribution and the restoration of electricity interconnections of regional importance with neighbouring countries;
>
> – the management and training for the energy sector and transfer of technology and know-how;
>
> – the promotion of energy saving, energy efficiency, renewable energy and studying of the environmental impact of energy production and consumption;
>
> – the formulation of framework conditions for restructuring of energy companies and cooperation between undertakings in this sector;
>
> – the development of a regulatory framework in the field of energy in line with the EC *acquis*."

[19] 10th Athens forum. The target for the establishment of the TSO auction office is January 2008.

[20] Commission options paper, p. 3.

[21] Council Directive 85/337/EEC of 27 June 1985 on the assessment of the effects of certain public and private projects on the environment, as amended by Council Directives 97/11/EC of 3 March 1997 and Directive 2003/35/EC of the European Parliament and of the Council of 26 May 2003.

[22] Article 4(2) only (regarding migratory birds) of Directive 79/409/EEC of the Council of 2 April 1979 on the conservation of wild birds.

[23] Directive 2001/80/EC of the European Parliament and of the Council of 23 October 2001 on the limitation of emissions of certain pollutants into the air from large combustion plants.

[24] Council Directive 1999/32/EC of 26 April 1999 relating to a reduction in the sulphur content of certain

clearly have an impact on investment decisions in generation, for example whether existing lignite-fired plants should be rehabilitated or new gas-fired or hydro plants constructed. The Electricity Generation Investment Study for South East Europe[25] notes that such choices are sensitive to the gas price: hydro projects may be chosen before gas-fired ones, but if carbon credits (under the Kyoto Protocol – see below) are available for both, rehabilitation of existing plants may not be cost-effective (Kennedy).

An addition to the GIS, 'Development of Power Generation in South East Europe: implications for investments in environmental protection', EC/WB, 29 April 2005, outlines the environmental regulations and requirements, compliance and costs.

However, according to Kennedy, environmental legislation to prevail in the regional power market context is yet to be elaborated in full. As he indicates, it is possible that under the terms of their bilateral agreements with the EU, individual countries may have to implement the Directive more quickly.[26] In the case of candidate countries a timetable for adopting the environmental *acquis* is incorporated in the accession negotiations. However, countries covered by Stabilisation and Association Agreements are not bound by strict environmental commitments – rather environment policy is an area of cooperation and to harmonise with the EU *acquis* is a longer-term objective. Macedonia and Croatia have already signed their respective agreements but they have yet to be ratified. Albania, Bosnia and Herzegovina and Serbia and Montenegro are in negotiations. In addition to EU requirements, the countries are subject to requirements set bilaterally by donors, and by their international obligations. In an attempt to simplify this, the European Commission will co-ordinate the donors.[27] While existing generation plants will not be subject to EU environmental norms immediately, newly built infrastructure must meet EU standards.[28]

As far as greenhouse gas emission legislation is concerned, the parties to the Treaty are only obliged to "endeavour to accede" to the Kyoto Protocol by the end of 2006. Bulgaria, Macedonia and Romania have already ratified. Likewise, the parties commit to try to implement the EU pollution prevention directive,[29] but its implementation is not a strict requirement. They are obliged to provide plans to the Commission on how they will implement renewable energy sources.[30]

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liquid fuels and amending Directive 93/12/EEC.

[25] Prepared by PriceWaterhouseCoopers and Atkins International, co-managed by the European Commission and the World Bank, and published on the World Bank's Europe and Central Asia – Power webpages 8 June 2005: http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/EXTECAREGTOPPOWER/0,,contentMDK:20551083~pagePK:34004173~piPK:34003707~theSitePK:733229,00.html

[26] Kennedy, p. 11.

[27] Transition strategy, p. 4.

[28] Energy Community Treaty, art 15.

[29] Council Directive 96/61/EC of 24 September 1996 concerning integrated pollution prevention and control.

[30] With a view to complying with the EU's renewable energy sources and biofuels directives (Directive 2001/77/EC of the European Parliament and of the Council of 27 September 2001 on the promotion of electricity produced from renewable energy sources in the internal market and Directive 2003/30/EC of the European Parliament and of the Council of 8 May 2003 on the promotion and the use of biofuels or

In some cases, hydro generator behaviour may cause power to be produced at times when rising wholesale prices would otherwise call high cost gas- and oil-fired generation capacity into operation (Pittman 2007), which is both welfare-enhancing and environmentally sounder.

3.3 Competition

The members of the Energy Community must apply the EU competition rules relating to restrictive practices (Art 81 EC), abuse of a dominant position (Art 82 EC), public services (Art 86) and State aids (Art 87 EC).

Energy privatisation contracts, and in particular procurement processes, may raise competition concerns at the EU level, which may in turn have implications for accession. For example, if an industry is privatised with a negative net value it may be construed as a State aid. State aid rules interpreted in this way could preclude a government from choosing the welfare-maximising option.

The transition strategy encourages harmonisation in State aid legislation and practices among the SEE countries, including sovereign guarantees, where the State acts as guarantor concerning debts, potentially reducing capital in privatisation. One Commission view is that the member countries may provide State aid as much as they wish, since to date there is no functioning market: there are no loss-making energy companies if they are still state owned. However, the Directorate-General for Competition may take a different view on this, particularly when a functioning market does come into being in the future.

The World Bank and European Commission envisage the market design as one based on bilateral contracts between generators and consumers, coupled either with tendering by transmission companies or with capacity obligations on load entities, with gradual liberalisation. Under the transition strategy, “long-term contracts and power purchase agreements within the parameters of the European Union’s competition rules are not excluded as long as they facilitate investment and do not obstruct the functioning of the market”. The report of DG COMP’s EU energy sector inquiry of January 2007 suggested it would focus attention on vertical foreclosure downstream by such long-term contracts, as well as hoarding of capacity downstream on pipelines, gas storage and interconnectors.

Long-term contracts’ compatibility with EC competition rules will have to be decided on a case-by-case basis (options paper, p. 6). Enforcement of such contracts could be undermined by a weak legal system. The intention is to leave agreements to the national regulators and competition authorities to assure generation adequacy. Bilateral contracts are favoured largely because both political commitment and technical capacity for a centralised implementation are limited.

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other renewable fuels for transport).

Where generation capacity is tight, incentives for good performance are reduced, limiting the benefits of competition to customers. As evidence from Romania suggests, there are incentives to restrict output of non-baseload (flexible) plants when baseload coal plants are in the same enterprises as higher cost gas- and oil-fired plants (Pittman 2007). In a regional energy market attempts to restrict output would be thwarted by imports, but only if non-discriminatory grid access were assured, to be achieved either through the presence of a strong regulator or by complete vertical separation.

The European Commission has identified the importance of transparent network tariffs to identify and eliminate price distortions and cross-subsidies. Improvements in the accounting systems of the electricity companies should contribute to this transparency.

One of the stated objectives of the Energy Community Treaty is to develop network competition on a broader geographic scale. The regional energy market in wholesale electricity could be defined as a single geographical market for the purposes of EC competition policy enforcement. However, this will depend on national as well as cross-border transmission capacity, and potential congestion at periods of peak demand. It is possible that there may be markets within markets and overlapping regional markets with EU member states. For example, Slovenia and Croatia may be in a different geographic market with Italy, Austria and Hungary.

3.4 The social dimension

The SEE countries' intention to introduce social safety nets to protect affordability for consumers in the event of tariff increases was first expressed in the Athens memorandum. Public service obligations must be ensured to encourage public support for the process.

A Memorandum of understanding enshrining a social dimension to the Energy Community was adopted at the initiative of the European Federation of Public Service Unions (EPSU) and the European Parliament. Although not legally binding, this mirrors the social dimension of the EU energy directives insisted upon (by, among others, France) as an essential *quid pro quo* for market liberalisation. More broadly it reflects the social aspects of the internal market, including the fundamental social rights laid down in the EU Charter on Fundamental Freedoms and in the European Convention on Human Rights, and the core labour standards defined by the International Labour Organisation. The provisions of the Memorandum seem to target electricity sector workers on the one hand, and electricity consumers on the other. The Memorandum recognises that economic and social progress is to be achieved by adhering to principles of equal treatment between men and women, and by improving living standards and working conditions, including health and safety provisions. It recognises the need to support firms and workers in anticipating and adapting to change brought about by implementation of the Treaty and to provide high quality, accessible and affordable services. In this respect security of supply is a key goal of the Energy Community. It also stresses the need for horizontal alignment with other relevant policy areas. It acknowledges that consumers, trade unions, employers and civil society

should all be involved in implementation and monitoring, aiming at a broad acceptance of the Energy Community through transparent processes.

The intention is that there should be a Social Action Plan for each country, focusing on improving energy efficiency, encouraging consumers to take advantage of competition in the market, assistance for the elderly and disabled, tackling fuel poverty and debt prevention management and providing services for prepayment meter customers. Distribution companies should have Codes of Practice to implement these objectives at the domestic consumer level. However, tariffs are not the only social impact to be taken into account: employment and skills, and democratic control are also important. It is possible that the reforms will have a divisive rather than unifying effect, for which there is some evidence in Bosnia and Ukraine.

3.5 Regulatory agencies

Monitoring of the market is intended to take place on two levels, by national agencies and through benchmarking at the EU level. The EU, advocating the liberalisation of energy markets, publishes an annual report on the implementation of the gas and electricity internal market, using benchmarking techniques.[31]An enhanced European regulatory function was proposed in the Commission's communication 'An Energy Policy for Europe' of 6 February 2007, with a response by the European Regulators Group for Electricity and Gas (ERGEG), 'Is a supranational regulatory agency possible or desirable?'.

Effective design of regulatory agencies is crucial to the success of market reform. Attention must be paid to funding, organisational design, and procedural safeguards. [32] Regulatory bodies should be independent, adequately staffed, have technical expertise such as in financial accounting, economic policy analysis, or law, and perhaps most importantly have access to information on costs, prices and service quality.

Attention should be paid to the consequences of the 'big bang' radical change approach where establishment of a legal-institutional framework is a secondary concern after privatisation – immediate destruction of former institutions, replaced with free market arrangements – contrasted with institutional economic approach focusing on implementation and quality of institutions measured by effectiveness and efficiency. In Russia, Grusejava finds that the success of the competition enforcement agency was impeded not only by a lack of clear regulation for natural monopolies, such as in the energy sector, and an obligation to support all State authorities in legal matters hence a lack of independence and too-widely defined tasks, but more broadly by an absence of legal culture and inconsistency between formal and informal institutions.

[31] Most recent report: COM (2004) 863 final, Brussels 5.1.2005 (together with the Commission Staff Working Document, Technical Annexes to the Report from the Commission on the Implementation of the Gas and Electricity Internal Market).
[32] Kessides, I (2005) 'Infrastructure Privatisation – Gone Too Far? Or Too Early to Tell?', Privatization Barometer newsletter no. 3.

4. Attractions, disincentives and challenges of energy market integration

4.1 Attractions

It is often assumed that the greatest incentive for regional cooperation in SEE is the future prospect of EU candidacy and ultimately admission into the European Union. There is generally high receptivity and interest by the general population to pursue EU membership. Regionalization, by creating larger markets, creates attractive investing opportunities while providing the lowest economic prices possible. Restructuring in the energy sector also offers greater transparency and less corruption in governance.

The experience of many development aid projects displays that regional cooperation can serve as an impetus to private investment. Cooperation on the Energy Community has signalled international donor programmes and private sector investors that the region is pursuing coordination on a variety of key economic and political issues and is a suitable destination for foreign investment. The subsequent presence of donor funded projects that address economic reconstruction, political transparency, and encourage business market reforms further increases the overall attractiveness of the investing climate in the region. As the countries pursue economic and business reforms, the region will continue to reap the benefits of regional economic activity and integration. Economies of scale from regionalisation allow for further economic investments.

The Energy Community also creates the mechanism for geopolitical opportunities for countries to diversify and/or to create new supply routes connecting the region to external markets. It also cultivates the opportunity to participate in the wider EU internal energy market and to realise advantageous trading opportunities with regional partners (Maksijan 2004).

The challenges and opportunities facing the countries of SEE are not unique to the region. A majority of the topics highlighted are systematic and exist in every Europe & Eurasia country (and in the rest of the world for that matter). While the Energy Community certainly creates the environment for increased harmonisation and streamlining of cooperation on projects, a significant presence of domestic pressure and from the lending requirements of international donors encourages reforms to inefficient tariff structures.

4.2 Disincentives

The primary disincentive or challenge facing the countries of the region is introducing competitiveness and efficiency to the energy sector. The domestic political cost associated with rising energy prices has also been identified as a challenge for energy market reform overall (and not specific to integration in a regional market). Consumers in a country with low production costs may lose from integration even if total welfare in that country increases, for example they may experience higher prices if it is cheaper for producers to transport to consumers at more distant locations in the market.

Energy tariffs in all areas of the energy sector – generation, transmission, and distribution – have risen to reflect cost and ensure efficient cost-recovery. Indeed, prices were beginning to rise prior to the privatisation process and have continued their natural evolution to competitive levels. The goal of a regional energy market is to deliver the lowest economically sustainable and competitive prices. So while prices have invariably risen in the past ten years, in the context of a regional market, they are certainly not as high as they would have been in a scenario of cost-reflective prices in closed, national markets.

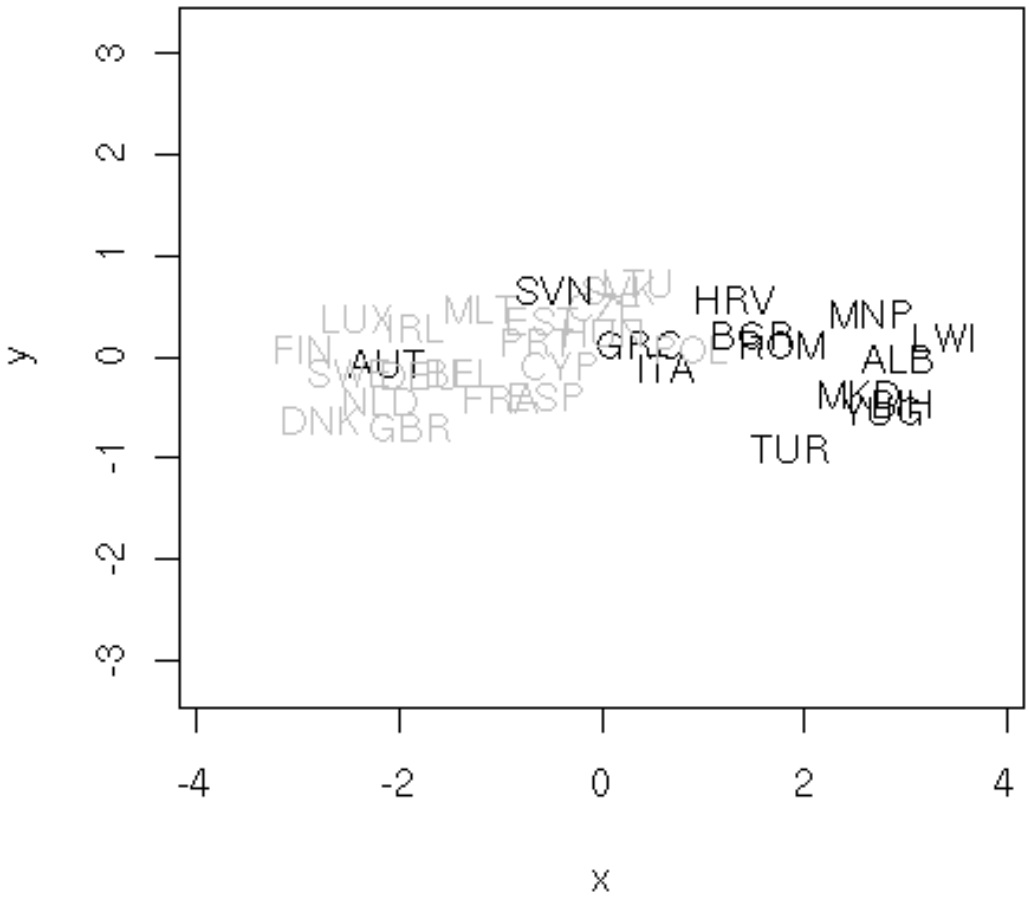
Rising energy costs represent a significant social disincentive in that higher tariffs primarily affect vulnerable households. While the MOU regarding social issues addresses affordability, universal access to energy systems, and job loss, many countries are still struggling to cope with corruption in governance and self-interested behaviour that decreases the effectiveness of legislation and donor programmes. There are many political disincentives associated with regionalising the energy sector, specifically when there are strong ties between political entities and state owned assets.

4.3 Challenges

The technical challenges of meeting the *Acquis* obligations (discussed in the previous section) raise a separate set of issues. In general, the quality of governance in South East European countries falls short of that in Western European countries, and this raises questions about the ability of these countries to implement reforms in a beneficial manner. Figure 1, below, shows a Sammon mapping of the World Bank's 2006 *Worldwide Governance Indicators* (Kaufmann, Kraay and Mastruzzi, 2007) for the European Union countries, members of the Energy Community and countries with observer status.[33] The x-axis can be an interpreted as a composite measure of quality of governance, increasing from right to left. As Figure 1 seems to suggest, Kauffman, Kraay and Mastruzzi's estimates of the quality of governance in the South East European countries trails those of other European countries. To the extent that state effectiveness matters to reform outcomes (as suggested for example by Evans 1997, World Bank 1997), this raises questions about the ability to meet the challenges of applying *Acquis* obligations designed for the needs of states with a higher overall quality of governance. The success of the regional market experiment might therefore be thought to depend not only on sector-specific reforms, but on improvements in the quality of government more generally.

[33] Sammon mapping is a form of non-linear multi-dimensional scaling, (for an implementation in the R statistical environment see Venables and Ripley 2002, pp. 307-309). It is used here to reduce the six dimensions of the *Worldwide Governance Indicators* to two dimensions, allowing overall differences in the quality of governance to be interpreted visually. The six dimensions of the *Worldwide Governance Indicators* are: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Figure 1: Sammon mapping of the World Bank's 2006 *Worldwide Governance Indicators*



In spite of these challenges, the countries in SEE have continued to perform well overall in terms of legislative reform progress. The Regulatory Benchmarking Reports, developed primarily in cooperation with the Council of European Energy Regulators, the South East Europe Regulators, and the European Commission with the overall support of the US Agency for International Development, have developed performance indices and screens that identify anticompetitive market conduct, market flaws and market power. In the most recent report, it was discovered that the majority of countries already have enacted laws delineating energy authority and establishing the regulatory agencies as separate legal entities.

Based on their cooperation, individual countries are being encouraged to identify their own areas of priority assistance (with the inclusion of environmental objectives and targets for climate change commitments) and to develop a strategy, contingent on the support of donors, to meet those objectives.

The Zagreb summit of the Stability Pact partners and the SEECP in May 2007 recognises this transfer of ownership of regional cooperation from international institutions to the countries of SEE. In 2006, the European Commission, as part of the treaty, worked with the countries to develop a roadmap detailing the gradual transfer of full responsibility of regional cooperation and of key functions of the Stability Pact to local agencies. According to the European Commission, social cohesion and gender mainstreaming will also be a focus, in addition to economic and social development, infrastructure, justice and home affairs, security cooperation, building human capital, and parliamentary cooperation. (EC website)

5. Conclusions

The Energy Community for South East Europe is a bold experiment in Europeanisation, drawing inspiration from the very first such experiment, the ECSC. At the same time, ECSEE faces a number of challenges alongside the attractions. Here we have drawn attention to the challenge of compliance with the complex obligations on which the European model of energy market liberalisation is based. Given the technocratic challenges of compliance, a concern is whether the countries of ECSEE – which, as we have seen, differ substantially in terms of performance in the World Bank's governance indicators – will rise to these challenges. Of course, capacity-building measures might allow countries to meet these challenges, so our analysis is not necessarily a prophecy of doom.

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