Europe's 8th Region: Securing investments in the Energy Community

A EURELECTRIC 10-step Action Plan

November 2014

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EURELECTRIC is the voice of the electricity industry in Europe.

We speak for more than 3,500 companies in power generation, distribution, and supply.

We Stand For:

***Carbon-neutral electricity** by 2050*

We have committed to making Europe's electricity cleaner. To deliver, we need to make use of **all low-carbon technologies**: more renewables, but also clean coal and gas, and nuclear. Efficient electric technologies in **transport and buildings**, combined with the development of smart grids and a major push in **energy efficiency** play a key role in reducing fossil fuel consumption and making our electricity more sustainable.

***Competitive** electricity for our customers*

We support well-functioning, distortion-free **energy and carbon markets as** the best way to produce electricity and reduce emissions cost-efficiently. Integrated EU-wide electricity and gas markets are also crucial to offer our customers the **full benefits of liberalisation**: they ensure the best use of generation resources, improve **security of supply**, allow full EU-wide competition, and increase **customer choice**.

***Continent-wide** electricity through a coherent European approach*

Europe's energy and climate challenges can only be solved by **European – or even global – policies,** not incoherent national measures. Such policies should complement, not contradict each other: coherent and integrated approaches reduce costs. This will encourage **effective investment to** ensure a sustainable and reliable electricity supply for Europe's businesses and consumers.

EURELECTRIC. Electricity for Europe.

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KEY MESSAGES:

Despite the expected growth in energy demand, the Energy Community (EnC) members are not attracting sufficient private capital and investment. Several governments of the region have even signed up to populist measures that have scared present European private investors away. While a tailor-made approach is needed for each country, given their significant heterogeneity, the establishment of a regional electricity market is the only way to prosperity for the full region. EURELECTRIC recommends ten actions for change:

1. **Protect and enforce existing investments:** EURELECTRIC calls upon national policymakers to avoid populist measures which have damaging effects on the most important infrastructure of their countries by scaring investors away.
2. **Reform and strengthen the EnC and include private stakeholders:** The May 2014 recommendations of the EnC High Level Reflection Group should be transposed into concrete actions to be implemented without delay.
3. **Make the regulatory agencies fit for purpose:** National/EU policymakers and regulatory agencies should take action to, for instance, ensure regulators’ financial independence from the government and increase their capacities and competences.
4. **Transparency is key to creating responsibility:** Transparency is needed for market operations like trading. Newcomers must have access to the data necessary for their investment decisions.
5. **Enable cost-reflective energy prices:** Existing price levels in much of the EnC are not cost-reflective and thus cannot support new generation investments or responsible customer behaviour, e.g. on energy efficiency.
6. **Eradicate energy poverty through targeted social policy:** Energy efficiency measures, together with a targeted social policy, are an appropriate response to energy poverty. The EnC should take the lead in developing a strategy for the region.
7. **Incentivise risk sharing facilities and public support for priority infrastructure:** Given the current political instability, parallel action is recommended to improve the regulatory environment while hedging investment risk. Public private partnerships could for example leverage public funding to attract private investment.
8. **Enhance participation in European institutions and industry bodies:** The participation of EnC countries in existing institutions and structures such as ACER, ENTSO-E and ENTSOG, but also EURELECTRIC and business associations, is crucial to bring best practice, regulatory standards and know-how on energy policy to the region.
9. **Bet on energy education:** Dedicated training for key energy decision makers within the EnC can improve competence and knowledge sharing. EURELECTRIC recommends developing a specific EnC school for energy regulation or an alternative programme for executive education.
10. **Include private stakeholders to monitor progress:** The Energy Community already includes in its annual implementation report a section on progress in investments. The inclusion of private stakeholders is recommended to improve this exercise further.

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Europe's eighth region is the 'youngest' of the EU energy regions: the European regulators established seven regions in 2003, all composed of EU members. The last followed in June 2008, on the initiative of the Energy Community. The eighth region is different from the others as it is conceived as an overarching bridge region of EU members and non-members: the latter are all part of the Energy Community. All EU energy regions strive for a regional rather than national approach to regulatory reform and ultimately convergence in order to promote welfare, security of supply, cost efficiency and the low carbon energy agenda. The prominent place of 'regions' as a step towards EU integration has been singled out in the EU's Communication on the Internal Energy Market, published on 14 October 2014[1]. Additionally, the Commission Recommendation of 29 October 2014 has underlined the need for strong regulatory cooperation between ACER and EU national regulators on the one hand, and the regulatory authorities of the Energy Community countries on the other[2].

Members

The 8th Region groups together six countries from the Western Balkans (Albania, Bosnia and Herzegovina, FYR of Macedonia, Kosovo, Montenegro, and Serbia) and seven neighbouring participant countries (EU member states) of the South East European region. Moldova and Ukraine became part of the 8th Region through their accession to the Energy Community in May 2010 and February 2011, respectively. The Energy Community Contracting Parties have committed to transpose, among other EU legislation, the EU *acquis* included in the third energy package. The deadline for this is 1 January 2015.

Figure 1 – The Members of the 8th Region

[1] See for the regional approach the Internal Energy Market Communication of 14 October 2014, stressing the 'implementation and deeper integration based on regional integration' (chapter 4)

[2] Recommendation EU Commission 29.10.2014, published in the Official Journal on 31 October 2014 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_311_R_0020&from=EN

The 8th Region focuses on establishing a regionally coordinated electricity capacity allocation and congestion management model as a stepping stone and a driver for the development of electricity market integration in South East Europe. The level of cross-border electricity trade and convergence of prices remains a benchmark in this respect.

In order to cover the forecasted demand growth of the region – very different from the 'mature' EU member states where demand is stagnating – the Contracting Parties of the Energy Community have indicated in their strategies and investment plans a total amount of 21 GW of new capacity to be added, representing a total investment of €44.6 billion over the period 2012 through 2020[3]. However, these demand projections and estimated capacity needs were presented in June 2012[4] before the global and financial economic crisis had a significant negative impact on the economies of the Western Balkans, Moldova and Ukraine, and hence they are certainly overambitious from today's perspective.

Attracting investments not only in generation, but also in transmission and distribution infrastructure has been and is an essential challenge for the South East European countries. While developed, liquid and integrated energy markets are the well-known key factors to success, an enabling environment for investment will also be crucial to building the infrastructure required to sustain the growth in consumption.

Today, despite the forthcoming growth in energy demand, the Energy Community members are not attracting enough private capital and investments. A list of Projects of Common Energy Community Interest (PECI) has been adopted, but in contrast to the EU PCIs there is no support foreseen for them so far. Several governments of the region have even signed up to populist measures that resulted in scaring present European private investors away. The big question today is thus how to attract further investment in all parts of the energy value chain, in times when national public budgets are facing significant financing constraints, potential investors do not want to bear the risk of political and regulatory uncertainty in the region, which is perceived as increasing, and economic development is still slow as a result of the global financial and economic crises. Facilitating and stimulating sustainable investments is thus a core responsibility of national and EU policymakers, to be supported by a strong Energy Community.

There is a need for action now.

The region is characterised by significant heterogeneity in markets and regulation. Although a tailor-made approach is needed for each country, the only way to prosperity for the full region is the establishment of a regional electricity market.

EURELECTRIC has undertaken a survey of its members to assess the current investment climate in the 8th Region. In the following, we present the **European electricity industry's**

[3] Energy Community Planned new capacity by 2020: http://www.energycommunity.org/portal/page/portal/ENC_HOME/AREAS_OF_WORK/Investments/capacity_2020

[4] Presented to the ECS Permanent High Level Group in June 2012 (four years after economic crisis emerged). See: Ref: 25 PHLG/21/06/2012 - Annex 1/07.06.2012

Ten Recommendations for Europe's Energy Community Neighbourhood, our response to the current investment challenges. These actions should be implemented without delay, and we call upon the new Commissioner for Energy, the Vice President for Energy Union, national policymakers as well as the Energy Community to respond and to jointly develop a roadmap to stimulate investments in South East Europe.

TEN RECOMMENDATIONS

1. Protect and enforce existing investments

Various European electricity generation and distribution companies are already investing in South East Europe, including for instance CEZ, ENEL, E.ON, PPC, EVN Verbund, and Gas Natural Fenosa. But in an alarming trend these companies are either leaving, like Verbund[5], considering leaving or exploring international arbitration. One of the main reasons is the unstable regulatory framework and the populist pressure on 'foreign' companies investing there, resulting in sudden taxes, withdrawal of licenses and other administrative harassment.

EURELECTRIC calls upon national policymakers to act responsibly and avoid populist measures which will have damaging effects on the most important infrastructure of their countries by scaring investors away.

2. Reform and strengthen the Energy Community (EnC) and include private stakeholders

The recommendations of the High Level Reflection Group of the Energy Community (May 2014) need to be transposed, into concrete actions to be implemented without delay: the EnC is already playing a prime role in integrating the region and moving it closer to the EU energy *acquis communautaire*.

EURELECTRIC recommends:

- Further emphasis on increasing an investment friendly area mainly through higher legal certainty is needed, as stated in the proposal: "An investment friendly area must be created by reducing risks and increasing transparency and predictability".
- The regulatory framework, although in progress, is not fully in line with the *acquis*, especially with regards to wholesale market opening, transparency of capacity allocation, and third party access to the network. The gap between the commitments made and implementation in real terms requires a strengthening of enforcement and investors' access to judicial recourse also below the level of arbitration. The members of EURELECTRIC have invited the Energy Community to explore the possibility for setting up a regional court, but such a court should not be seen as a panacea to all problems. A continued emphasis on soft measures such as cooperation with governments and stakeholders in the region is needed in order to build capacities for best practice.

[5] Verbund has almost totally withdrawn from the region (sold windmills in Bulgaria recently and operates just some windmills in Romania)

- The fact that the Ministerial Council of the EnC has rejected the proposal to build a social strategy is seen as a mistake by EURELECTRIC. The EnC has to take leadership in cutting the Gordian knot of energy poverty and energy regulation.
- Finally, EURELECTRIC would like to see a stakeholder group established around the EnC including the energy companies active in the region, to monitor progress and exchange of best (and worst) practice.

3. Make the regulatory agencies fit for purpose

Unstable and unpredictable regulation has been identified by EURELECTRIC's members as the single most important risk, well above the financial risks. And regulatory instability has also been indicated by those companies not present in the region as the single most important factor preventing them from engagement. The European Commission's DG Energy has itself stressed the need to increase cooperation between ACER/EU national regulators on the one hand, and the weak and embryonic regulators of the Energy Community, including Bulgaria and Romania, on the other[6]. This would require increasing staff within ACER.

EURELECTRIC urges national and EU policymakers and regulatory agencies to take actions in order to:

- make the regulatory agencies of the region fit for purpose. This means, for instance, ensuring their financial independence from the government by ensuring their financing through tariffs. The salaries of the Bulgarian regulator, for example, are still outstanding in October 2014, as the government has not yet cleared the payment. This should be seen as worst practice, and any possibilities of the government to take regulators hostage through delayed payments of salaries for example must be ruled out. Standards for the financing of regulatory agencies have to be set and respected.
- Furthermore, capacities and competences have to be built in regulatory agencies, for instance through twinning, participation in ACER monitoring processes and the like. As the Internal Energy Market Communication of October 2014 rightly emphasised, "the Commission is concerned about the cutting of staff and budgets of the regulators of several member states"[7]. The situation in the EnC membership is even more alarming. ACER should be staffed in a way that allows it to support the regulatory development in the EnC countries.
- Competent staff to provide good governance has a price and this should be considered when funding regulatory authorities. Sound qualifying assessments are needed to find experts accepting high responsibility. Not applying liability of officials, as is currently the case in Bulgaria, is unacceptable.

4. Transparency is key: transparency creates responsibility

EURELECTRIC member companies mention the lack of conducive investment policies, the absence of sound permitting processes, as well as the general lack of transparency as important investment barriers. Transparency is of utmost importance for the proper

[6] See footnote2- recommendation EU Commission 29.10.2014, published in the Official Journal on 31 October 2014

[7] European Commission, Progress towards the Internal Energy Market, 13.10.2014, p 15

functioning of the market, to attract new market actors to the region, to serve customers efficiently and to obtain their trust. First, transparency is needed for market operations like trading. Newcomers must have access to the data necessary for their investment decisions. Second, transparency is needed to detect and remove price distortions and cross-subsidies. Finally, transparency in a broader sense is needed on the energy strategy of the country, the choices made in this context, and the rationale for those choices.

5. Enable cost-reflective energy prices

The existing price levels in many of the EnC member countries are not cost-reflective and thus cannot support new generation investments; neither by attracting private investors, nor by providing domestic utilities with the means to invest on their own. Energy prices are not transparent to customers in their cost structure, and thus don’t incentivize responsible customer behaviour, for example with respect to energy efficiency. While we acknowledge that higher tariffs are unpopular, it is a key requirement if the private sector is to invest in much needed generation capacity and grids. The example of Ukraine shows that lack of timely actions to raise tariffs to a cost-reflective level only worsens the situation in times of severe crisis. With electricity production costs in Ukraine standing at 4.8 US cents/kWh (net of taxes) in 2014, the tariff for households remained the lowest in the whole region: 3.5 US cents/kWh[8]. On top of this, under current extraordinary circumstances the total financial deficit of thermal generation in regulated market could exceed €220 million[9] by end 2014.

6. Eradicate energy poverty through a well targeted social policy: a leading role for the EU Commission and the EnC to conceive

A lack of access to energy is unacceptable, but nevertheless occurs – in the EU as well as in the Energy Community, and indeed in developing countries. Energy for free – as a right – cannot be an answer, as in all cases somebody will ultimately need to foot the bill. Targeted and well suited general economic policies have to respond to this challenge. Energy poverty results from low incomes, low energy efficiency and high costs of energy[10]. The Electricity and Gas Directives from 2009 require a guarantee for the protection of vulnerable customers by national energy regulators. EURELECTRIC believes that cross subsidies and artificially low electricity prices as a support means for vulnerable customers are not an adequate response: regulated and artificially low prices are not cost-reflective, they do not stimulate investment, and they incentivise the waste of energy and thus offset energy efficiency incentives. In addition artificially low prices even benefit those who are not in a need. Therefore, social targeting is in any policy measure a conditio sine qua non.

As energy poverty is in most cases related to poor quality heating equipment, energy efficiency measures are an appropriate response. Here the access to suitable credits plus fiscal incentives can lead to change. On the other hand energy prices in a market

[8] exchange rate USD to UA as on January 2014

[9] 3,9 bln UAH, exchange rate: 17,41 UAH per 1 Euro

[10] See EWI Working Papers, Dubois, Ute, Meier, Helena, Households facing constraints. Fuel poverty put into context. EWI Working paper No 14/07, February 2014

environment, resulting from competition on a regional or EU-wide scale, lead to better choice and better deals for customers and should thus be central for policy design.

The Energy Community Social Forum received relevant messages from EURELECTRIC member EVN[11] in its meeting in 2013. EURELECTRIC fully subscribes to those messages, which should guide further policies. They read as follows:

- Tackle fuel poverty and deprivation as fast as possible through social targeting;
- Get electricity prices out of social policy and give way for future price structure;
- Enable urgently needed infrastructure investments in the power sector;
- Improve the system efficiency by improved cost allocation giving the right signals in power usage;
- Enable a regional internal market by harmonising the framework;
- Provide calculable development and achieve stability for future prosperity.

EURELECTRIC regrets that the EnC Ministerial Council has not supported the proposal to elaborate a social strategy on energy poverty for the region. Indeed, we strongly feel that the EnC has a role to play here and urge the EnC to reconsider.

7. Incentivise risk sharing facilities and public support for priority infrastructure

Financial instruments to hedge the regulatory risk have to be put in place, given the current political instability. This is indeed a ‘chicken and egg’ problem, as in principle, regulatory problems should be solved prior to investment. But in real life, a vicious circle would result from missing investments and risks worsening the regulatory situation even further. Therefore, under current circumstances parallel action is recommended on both: regulatory improvement on the one hand as well as hedging investment risk on the other. Public private partnerships (PPPs) could for example be considered as project delivery mechanisms that can leverage public funding to attract private investment. Long-term government payment security, proper PPP procurement law and appropriate risk allocation to the private sector are just a few of the necessary criteria for successful PPP.

The Projects of Energy Community Interest (PECI) definitely deserve more than just symbolic support, as they stand for the regional integration advocated by the EU. Exploring business cases and the use of innovative finance through leverage should be the answer, developed in close cooperation between the EnC, DG ENER, and the EIB. It is important to also include distribution projects like smart meters and smart grids, along with the discussion on PCI criteria inside the EU[12].

8. Enhance participation in European institutions and industry bodies – support ACER

As for improving the regulatory framework, the participation of EnC countries in existing institutions and structures is crucial and should be closely monitored by the European

[11] Bramboeck, Guenter, EVN, Energy Poverty. Suppliers experience and request for social targeting. Energy Community Social Forum, Belgrade, 23 April 2013

[12] DSO associations position November 2014

Commission. Such structures include ACER, ENTSO-E and ENTSOG, but also EURELECTRIC and business associations capable of bringing best practice, regulatory standards and know-how on energy policy to the region. In order to be able to do so, ACER and ENTSO-E need to be staffed in such a way that this ‘connection’ role can be assumed.

9. Bet on energy education

There is a need to shape strategy further by providing dedicated training for key energy decision makers within the Energy Community in order to improve competence and share knowledge and information between EU member states and EnC members. EURELECTRIC recommends developing a specific EnC school for energy regulation or an alternative programme for executive education which could help improve the qualification of senior staff in government bodies, regulatory authorities, TSOs, etc.

An extension of the Florence School for Regulation training programme ‘Annual Training on Regulation for Utilities’ should be developed for the EnC and adapted to the needs of the various stakeholders.

10. Include private stakeholders to monitor progress

The Energy Community already includes in its annual implementation report a section on progress in investments. This assessment is an important starting point for monitoring investments in the region. The inclusion of private stakeholders is recommended to improve this exercise further.

EURELECTRIC Members within the 8th Region

Ukraine
Ukrenergo http://www.ukrenergo.energy.gov.ua/

Bosnia & Herzegovina
Electroprivreda Bosne i Hercegovine http://www.elektroprivreda.ba/

Serbia
Electric Power Industry of Serbia http://www.eps.rs/

Albania
Korporata Elektroenergjitike Shqiptare (KESH) sh.a.

EURELECTRIC pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability

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