South East Europe's electricity sector: Attractions, Obstacles and Challenges of Europeanisation

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South East Europe’s electricity sector: Attractions, obstacles and challenges of Europeanisation

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Abstract

The Energy Community is a bold experiment in integration, creating a regional energy market between the European Union and nine South East European partners – Albania, Bosnia-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.

An investigation of governance in the countries of South East Europe (SEE), including analysis based on the World Bank’s Worldwide Governance Indicators, suggests a lower overall performance of governing institutions in SEE, compared with countries of the EU 25. The paper, therefore, considers whether the EU energy model is appropriate in South East Europe at this stage. The EU model confers certain institutional resources, but at the same time imposes significant costs of compliance with the energy chapter of the acquis. It remains to be seen which of these two opposing factors will dominate, but the analysis suggests that for some countries in the region, regulatory reform alone may not be sufficient.

1. Introduction

The establishment of the Energy Community for South East Europe is a bold experiment in Europeanisation, inviting comparison with the creation of the European Coal and Steel Community (ECSC), arguably the first successful European experiment in sectoral integration. By encouraging co-operation 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 co-operate. As scholars have argued of the earlier experience of the ECSC, because it makes demands on other sectors, integration in one sector may very quickly “run up against its own logical boundaries” (Haas, 1958, p. 105). At the same time, co-operation in a single sector may produce a “spill-over effect”, leading to further integration. Such spill-over effects may arise as the result of a “demonstration effect” of successful co-operation in a narrow, technical subject area.¹

Alternatively, such spill-over effects might arise because, following an initial agreement to co-operate in a single sector, further harmonisation measures are seen as necessary to the proper functioning of the integrated sector (Haas, 1958, Ch. 8). While such a neo-functionalist perspective is not without its sceptics,² in the case of the Energy Community, long run positive expectations of further integration – including the aspiration of eventual EU membership – have been a principal motivation for participation in a regional South East European energy market. Indeed, Bulgaria and Romania were admitted to the EU on 1 January 2007, while accession negotiations have been opened with Turkey, Croatia and the Former Yugoslav Republic of Macedonia.

Since membership of the Energy Community grants de facto membership of the European Union in the field of energy, this path to Europeanisation affords certain institutional resources. These include the opportunity to take policy choices out of the hands of majoritarian decision-makers and into the realm of expert technocratic decision-making, more credibly than purely domestic or intergovernmental approaches; as well as enabling the European Commission, but also other international and domestic advocates

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¹ At first sight, the energy sector (and electricity, in particular) seems well-suited to provide such a demonstration effect, given the potential benefits from market integration in terms of efficiency, security of supply and sustainability (as discussed by Hooper and Medvedev, 2009).

² For a critique of the neo-functionalist perspective, see Moravcsik (2005).
of reform, to use the incentive of full EU membership to shape policy. But while domestic policy-makers may appreciate this advantage of Europeanisation, it comes at the price of loss of their own control over certain policy areas. Furthermore, sectoral integration makes substantial demands on the institutional capacity of the participant countries to comply with the complex obligations that membership of the regional energy market entails. Such attractions, obstacles and challenges of Europeanisation are in practice inseparable.

A number of issues are still to be addressed if the experiment of regional energy market integration is to lead to further regional integration. Political questions remain following the disintegration of Yugoslavia in the 1990s, most notably the future status of the territory which to date has been administered by the UN Mission, in light of Kosov’s recent declaration of independence. Furthermore, with the exception of Greece and Turkey, the participant countries share a background of decades of communist rule, and face the challenges of transition economies, while political, economic and cultural differences remain.

The following section investigates the background to electricity market reform in South East Europe. We then consider the notion of Europeanisation, before looking at the specific legal obligations of members of the regional energy market under the Energy Community Treaty. The concluding section examines the incentives, barriers and challenges to sectoral integration. We point to the implications of our analysis both for successful integration in the energy sector, and for further integration as part of a process of Europeanisation.

2. Background to market reform

For over a decade, international agencies including the European Commission, the World Bank, the European Investment Bank and the European Bank for Reconstruction and Development, together with individual donor countries, have been actively involved in the economic development and political integration of the region. These agencies were the primary drivers of market reform and 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. Security of supply and an improvement in the balance between energy supply and demand is seen by donors to be 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. Economies in transition require reallocation of resources across a sector, closing inefficient firms and creating new ones, in addition to the need to restructure existing firms to improve performance as in established market economies (Fingleton et al., 1996). Following the fall of the communist regimes, many economic policy advisers recommended a ‘big bang’ approach to economic recovery in Central and Eastern Europe, encouraging quick mass privatisation in an attempt to reduce State power and to establish property rights, in some cases before the creation of a stable legal-institutional framework (Grusevaja, 2006). This subsequently left the new owners of privatised firms to carry out internal restructuring and governments to organise the structure of the market and legal institutions. Even where the role and significance of the institutional framework needed for a well-functioning market economy was acknowledged at the time, misjudgements in early transition may have influenced the direction of institutional development.

While the European Union certainly played a guiding role during this time, shaping donor policy, other external donors exercised flexibility in determining their own priority areas for assistance. Significant levels of financial resources were subsequently invested in the region, focusing on democracy, transparency, and good governance in the promotion of free market economic reforms. The pursuit of peace and stability in the region, by means of economic integration into wider European markets, was a priority both for the European Union and for other global powers. As the development process evolved and the economies responded favourably to reform and recovered from 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 has provided long-term, sustainable economic prospects for the countries of the region while ensuring the promotion of democracy across Europe’s geographical boundaries.

Unfortunately, economic recovery and the establishment of democratic governance in South East Europe, particularly in the Balkans, have 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. Policy-makers and donor institutions faced the added complication of simultaneously developing humanitarian intervention and conflict mitigation strategies. Initially, a phase of post-conflict reconstruction that focused on the re-development of physical infrastructure (electricity lines, housing, water systems, etc.) was pursued, as much of it 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 the face 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.

At the EU’s initiative in 1999, the creation of the Stability Pact represented a comprehensive co-ordination mechanism among donors, policy-makers, and other related agents in an effort to 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 the additional challenge of ensuring conflict prevention and restructuring. Thus, from a historical perspective, the overall process of Europeanisation and integration into wider European networks has not been as easy for the countries of South

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3 The view of the European Commission as an expert decision-maker to which national governments delegate responsibility to enhance policy credibility is principally put forward by Majone (1994).

4 As discussed by Scholl (2009), the Balkans conflict also had a significant detrimental effect on the energy infrastructure in parts of the region, from which countries such as Bosnia-Herzegovina are only now emerging.

5 It is true that even countries such as Turkey and Greece must also contend with a legacy of public ownership in their electricity sector. The challenges arising from (planned as well as completed) ‘tactical’ privatisations are, however, somewhat different from the ‘strategic’ or ‘economic-system-altering’ privatisations elsewhere in the region. On the importance of this distinction, see Feigenbaum and Henig (1994).
East Europe. Moreover, current obstacles to integration still remain; both competing regional interests and the need for reform across a broad range of technical sectors are significant obstacles to integration and energy sector restructuring. Pre-conditions of donor aid programmes will further have a bearing on how institutional reform is prioritised and carried out. This places a significant demand on the institutional capacity of national governments while implying the Commission and international agencies perceive a level of sufficient, credible governance necessary to make the Energy Community of South East Europe (ECSEE) a success.

While the quality of national governance is integral to the success of this project, a lack of political harmonisation both within and between the countries in the region might impair the implementation of a regional strategy. Hence, it has been argued that the impetus for economic co-operation in the Balkans region should come from the business sector rather than from politicians or international agencies (Barrett, 2002). However, it is clear that in spite of political tensions, policy-makers play a key role in creating the right environment through better regulation to lighten the burdens on business. From this perspective, the quality of governance is viewed as a cornerstone of Europeanisation.

To illustrate differences in the quality of governance between the countries of South East Europe and the EU 25, Fig. 1 (above) plots principal components of the World Bank’s Worldwide Governance Indicators for selected countries. These indicators measure the quality of governance along six dimensions: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Fig. 1 shows a clear separation between EU 25 countries and South East European countries, predominantly along the first principal component, suggesting a lower overall standard of governance in South East European countries (a plot of the second and third principal components, not shown, reveals no clear separation). Pollitt (2009) rightly questions whether the ‘EU model’ of energy regulation is, therefore, appropriate to the countries of South East Europe. At the same time, as well as imposing a burden of compliance on participant countries, integration with the EU model provides certain institutional resources, and so the ability of the countries of South East Europe to benefit from sectoral integration and reform may well rest on which of these two oppositional forces comes to dominate. Further, this may depend on the particular circumstances of domestic politics in individual countries, and the success of capacity-building initiatives in the region. In the next section we examine the issue of Europeanisation, and its application in the context of South East Europe, in more detail.

3. Europeanisation

Europeanisation provides a useful insight into the transformation of both internal and external policy priority areas of the European Union over the past 15 years. 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. However, it 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’ (McGowan and Wallace, 1996). In this context, in particular, the contrast between ‘top-down’ and ‘bottom-up’ approaches to Europeanisation may not be discrete, and it is possible to see aspects of both approaches in the process of energy market integration, as discussed below.

Europeanisation in this sense is in the process of 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

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6 See further Kaufmann et al. (2007).

7 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 (2007, p. 234).

8 For a critique of this contrast see Lodge (2005).
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. Vachudova (2005) denotes the EU’s ‘passive leverage’ as the strength of attraction of EU membership. 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” (PSA, 2007).

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. 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. Norms such as democracy, peace, and human rights, have become a high priority in EU negotiations culminating in the Copenhagen criteria. While economic co-operation remains a primary vein of EU policy, the introduction of ‘soft’ policy priorities not only represents the EU’s expanding external geographic and political space, but also the strengthening of the EU’s ability to comprehensively influence policy in prospective Member States. Although the rates of reform and levels of integration of individual countries varied, activity in Central and Eastern European countries and the eventual EU accession in 2004 was seen as a relatively successful pilot for Europeanisation, setting the framework for future attempts – South East Europe in this instance – at integration.

Bringing together candidate and ‘potential candidate’ countries at various stages along the road to EU membership, all of these instruments have been integrated since the beginning of 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 co-operation, are available to potential candidate countries as well as to candidates.

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, 2006). 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.

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. Since 2004 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. Given that existing EU Member States are apparently unable to meet their legal obligations, this raises the question of how non-Member States will be able to meet those same requirements with lesser State capacity, as suggested in Fig. 1.

Tying these willing States into a pre-accession process 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 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 (Sedelmeier, 2006, p. 5). 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 co-operation 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 (Sedelmeier, 2006, p. 6).

Meanwhile, a ‘bottom-up’ model of Europeanisation would correspond with the operation of the institutional framework of the Athens stakeholder forum of the Energy Community, 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. A combination of these approaches may emerge as relationships within the Energy Community become more established.

Europeanisation represents a reward and incentive for EU policy-makers and external stakeholders. On one hand, further integration provides the opportunity for the EU to access additional markets, expand trade partnership, and strengthen relations with neighbouring nation States. On the other hand, as countries are further

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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 competitive 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.
integrated into the European Union, external donors and States are able to gradually phase out their technical assistance programmes as regional development is perceived to fall primarily if not solely under the jurisdiction of the EU. Thus, from the prospective of both the EU and external States, Europeanisation is often a highly desirable outcome.

4. 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. As noted in Section 1, this delegation of national policy-making authority to supranational institutions may be attractive to national governments, because it allows them to distance themselves from potentially contentious policies, while enhancing the credibility – and hence effectiveness – of sectoral policies. At the same time, we noted that such delegation has its costs, both in terms of the loss of national policy-making authority, as well as the demands of compliance with European energy policy. This section discusses ECSEE members’ obligations relating to energy, competition and the environment separately before we turn, in the next section, to discussion of the attractions, disincentives and challenges surrounding the acceptance and implementation of these obligations.

4.1. 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 2002,12 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 (Kennedy, 2006).

The subsequent Treaty establishing the 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 involving existing EU Member States.13

On the technical side, the signatories agreed to open electricity markets in line with EU commitments,14 subject to a suitable transition period, and at least to begin opening their electricity markets by 2005. Non-EU member countries were 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 Croatia and FYR Macedonia), also contain a chapter on energy reinforcing these commitments.15

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 programmes. 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.16 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.17

Monitoring of the market is, therefore, 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.18 An enhanced supranational regulatory function was also 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 (EREGEC).

4.2. 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,19 as well as the wild birds directive20 when the Energy Treaty came into

15 For example, the energy chapter in the Agreement with Croatia states:

1. “Co-operation 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. Co-operation 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 co-operation between undertakings in this sector;

- the development of a regulatory framework in the field of energy in line with the EC acquis.”

16 The 2002 Athens Memorandum relates to electricity whereas the 2003 Memorandum relates to gas.


force. The Treaty requires full compliance with the EU Large Combustion Plant Directive, which limits sulphur dioxide emissions, by the end of 2017, and the directive on sulphur content of liquid fuels by the end of 2011. Environmental legislation will 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 (GIS) for South East Europe 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, 2006). An addition to the GIS on implications for investments in environmental protection outlines the environmental regulations and requirements, compliance and costs.

However, according to Kennedy, the 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. 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 co-operation and to harmonise with the EU acquis is a longer term objective. While existing generation plants will not be subject to EU environmental norms immediately, newly built infrastructure must meet EU standards. 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.

Macedonia and Croatia have ratified their respective agreements, whereas Albania, Bosnia-Herzegovina, Montenegro and Serbia 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. 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, 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.

4.3. 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 European 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. Bilateral contracts are favoured largely because both political commitment and technical capacity for a centralised implementation are limited. 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”. In fact, the economics literature is ambiguous with respect to the compatibility of long-term contracts with effective spot-market competition. On one hand, where a firm derives the greater proportion of its revenues to forward contracts, it will have little incentive to abuse its market power in spot markets; on the other, extensive bilateral contracting may impede the development of an effective spot market.

Long-term contracts’ compatibility with EC competition rules will, therefore, have to be decided on a case-by-case basis (European Commission Annual Report on the Implementation of the Gas and Electricity Internal Market options paper, 2005, p. 6). The report of the Directorate-General for Competition’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. This leaves to one side the question as to whether the 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, with a view to assuring generation adequacy.

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 in the absence of barriers to trade, which could potentially take the form of constrained interconnector capacity, or else arise as the result of strategic behaviour by firms in the absence of non-discriminatory grid access. While the former may be dealt with by investment in appropriate infrastructure, the latter might be avoided through effective regulatory action 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.

4.4. 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 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 appear to target electricity sector workers on 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 in account: employment and skills, and democratic control are also important, especially given the possibility that the reforms will have a divisive rather than unifying effect, for which there is already some anecdotal evidence in Bosnia and Ukraine.

5. Attractions, obstacles and challenges of European energy market integration

As noted by Bagadioglu and Odyakmaz (2009), the large size of the Turkish market means that many of the benefits of energy market reform may be achievable by a purely domestic reform programme; for many other countries in the region, a regional approach may be the only practical reform route. Even in such cases, a successful embrace of Europeanisation is not inevitable, in the sense that reforms may be forestalled, delayed and sidelined. Here, we can only outline the various political attractions and obstacles to Europeanisation, that may determine the outcome and further development of the current reform initiatives, and the challenges that may tip the balance for or against further integration, depending on how well those reform initiatives are managed.

5.1. Attractions

While others in this special issue have noted the economic benefits of regional electricity market integration, it may well be that the greatest incentive for regional co-operation 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. Such receptivity may in turn be influenced by the economic benefits and vice versa. The experience of many development aid projects displays that regional co-operation can serve as an impetus to private investment. Co-operation on the Energy Community has signalled to international donor programmes and private sector investors that the region is pursuing co-ordination 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 investment 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, thus reinforcing enthusiasm for the reform process.

Similarly, the delegation of responsibility for policy-making to European institutions offers a number of attractions to national policy-makers. As well as providing the ability to access the technical policy-making competence provided at the European level, a significant attraction may also be the opportunity to off-load responsibility for contentions policy areas, for example, tariff re-balancing. This opportunity to ‘blame-shift’ may be particularly attractive in the presence of domestic pressure from producers and from the lending requirements of international donors encouraging reforms to inefficient tariff structures. Europeanisation in this sector also provides national policy-makers the opportunity to participate in the wider EU internal energy market and to realise advantageous trading opportunities with regional partners (Maksijan, 2004). Restructuring in the energy sector should also offer greater transparency and lessen corruption.

A possible third set of incentives, that we have not dwelt on in this article, arise from geopolitical factors surrounding security of supply. For many countries, security of supply means lack of reliance on another State’s resources, which may be an issue particularly in this region given its relatively recent turbulent history. This wariness must be weighed against the potential strengths of an Energy Community, including the central co-ordinating role of non-majoritarian decision-makers, which may help to provide necessary reassurance to participant countries. Externally, a unified position may help to give European energy markets greater buyer power in terms of their reliance on exports of natural gas from Russia.29 In

29 For example, alarm was raised in December 2007, when Russia’s State-owned Gazprom opened negotiations with the Serbian Government for a controlling interest in Petroleum Industry of Serbia (NIS). The Russian firm had reputedly managed to sweeten an otherwise low offer by the promise of routing a branch of the South Stream gas pipeline through Serbia. See Financial Times, “Alarm at Gazprom’s Serbia Move”, December 31 2007.
addition, trade with neighbours in the Energy Community should afford opportunities to diversify energy sources and to develop alternative supply routes. In particular, Turkey’s expected participation in the Energy Market also has the potential to facilitate access to new supply routes from Asian sources. These benefits are more likely to be realised as trust within the region gradually grows.

5.2. Obstacles

As we have noted, while the ability to off-load responsibility for aspects of energy policy to the supranational level has certain advantages both in terms of enhancing credibility and technical competence, and in shifting the responsibility for contentious decisions, such a strategy comes at certain political costs.

Attempts by domestic policy-makers to shift responsibility for unpopular outcomes such as price rises may not always prove successful. By the same token, if domestic policy-makers take the blame for such outcomes regardless, they may find it difficult not to ‘interfere’ in regional policies, perhaps by attempts to frustrate the implementation of regional liberalising policies, or by placing their own country’s energy interests ahead of a regional approach to security of supply.

A primary goal of a regional energy market is to deliver the lowest economically sustainable and competitive prices, but given the unsustainably low prices in many countries, 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 liberalisation process and have continued their natural evolution to competitive levels. Furthermore, as Waddams Price and Pham (2009) show, consumers in a country with low production costs may lose from integration even if total welfare in that country increases.

Rising energy costs represent a significant social disincentive in that higher tariffs primarily affect vulnerable households. While the Memorandum of Understanding on 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 accordingly many political disincentives associated with regionalizing the energy sector, specifically when there are strong ties between political entities and State-owned assets.

5.3. Challenges

While Europeanisation in the energy sector may hold significant attractions and disincentives, for the reasons given above, reforms also pose a number of governance challenges, even to willing national authorities, in terms of meeting the acquis obligations which we outlined in the previous section. Such challenges may frustrate the achievement of the technical benefits of European energy market integration, tipping the balance against Europeanisation. We noted above that the quality of governance in South East Europe falls short of that in Western European countries, for example, and that this may place limits on the abilities of participant countries to take advantage of market integration and liberalisation. This may in turn frustrate any hoped-for “demonstration effect” if it is not offset by the institutional advantages of delegation to regional and EU institutions or by capacity-building measures at the country level.

Whilst, as noted above, there is likely to be a synergy between technical and political benefits of regional energy market integration, failure to meet the technical demands of integration may conversely undermine the political attractions of a regional approach.

In spite of these challenges, the countries of South East Europe have continued to perform well overall in terms of legislative reform progress. The Regulatory Benchmarking Reports, developed primarily in co-operation of 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 anti-competitive 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. These benchmarks may be useful from a policy perspective for targeting technical assistance programmes and further capacity-building measures.

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