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*Energy Community: Rationale Behind and Establishment of  
the Regional Electricity Market in South East Europe*

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## 1. Introduction

The countries from South East Europe (SEE) have a clear perspective for membership in the European Union (EU) and a process of reforms is going on in them, including reforms in their energy sectors. Accepting the political obligation to adjust their legislation to the EC law in the energy sphere has been made explicit with signing the Athens Memoranda 2002<sup>1</sup> and 2003,<sup>2</sup> which were later implemented in the Treaty establishing the Energy Community for South East Europe (Energy Community Treaty - EnCT),<sup>3</sup> signed between the EU and the nine countries from SEE.<sup>4</sup> The EnCT has the objective of creating a regional energy market (REM) in SEE which should later be integrated in the internal energy market. Through its implementation, the SEE countries are set to become part of the EU internal market in a key economic sector – energy, even before their accession to the EU.

Due to the fact that there is no comprehensive overview of the development of the Energy Community in the existing academic literature, this paper would try to fill in that gap. The paper will provide an overview of the Athens Process and the establishment of the Energy Community as well as an explanation of the rationale that led the EU to launch the idea and the countries of SEE to establish a REM.

The paper will argue that, unlike the reforms undertaken in Central and Easter Europe (CEE) which were focused on economic reforms, the countries from SEE had to go through a process of recovery from the political conflicts and wars that took place in the 1990s. Therefore, not the market reforms including the energy liberalisation and democratic governance, but conflict prevention and reforms for establishing the stability and restructuring of the physical infrastructure took place in the last decade in the SEE. Another point that will be stressed is the fact that the SEE countries are developing countries, which have needs that are in many aspects different from the needs of the developed countries such as the Member States of the EU. Nevertheless, exactly the model of liberalisation of the energy markets in the EU is the model that SEE countries are given to follow.

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<sup>1</sup> Memorandum of Understanding on the Regional Electricity Market in South East Europe and its Integration into the European Union Internal Electricity Market, signed in Athens on 15/11/02. *bis* D(2002) C2/BD/CA.

<sup>2</sup> Memorandum of Understanding on the Regional Electricity Market in South East Europe and its integration into the European Union Internal Electricity Market – Athens, on 8<sup>th</sup> December 2003, 15548/03/*bis*.

<sup>3</sup> Treaty establishing the Energy Community for South East Europe, signed on 25<sup>th</sup> October 2005, OJ 2006 L 198/18 (the text of the Treaty is attached to the Council Decision of 29 May 2006 on the conclusion by the European Community of the Energy Community Treaty, OJ 2006 L 198/15). It entered into force on 01.07.2006.

<sup>4</sup> The countries of the SEE are: the Republic of Albania, the Republic of Bulgaria, Bosnia and Herzegovina, the Republic of Croatia, the Republic of Macedonia, the Republic of Montenegro, Romania and the Republic of Serbia, as adhering parties, and, Kosovo through the United Nations Interim Administration Mission in Kosovo (UNMIK), pursuant to the United Nations Security Council 1244. Since 01.01.2007 Romania and Bulgaria have been full members of the EU.

## 2. Overview of the development of the Energy Market in Europe

### 2.1. Legislative framework of the European Union

Historically, national monopolies existed in the electricity markets in Europe and a state owned vertically integrated company operated in each country, meaning that the same company was dealing with production of electricity, its transport (transmission and distribution), as well as supply of electricity to the final consumers. Until the 1960's – '70's large interconnected networks were already built and energy was an essential part of the integration process of the European Community (EC) since the very beginning. That could be seen from the fact that two of the three founding treaties of the EC signed in the 1950s<sup>5</sup> were specifically related to the energy sector.<sup>6</sup> The Treaty of Rome on the other hand, did not include any provision for a common energy policy<sup>7</sup> and due to the Member States' unwillingness to grant new competencies to the EC, specific energy chapter was not included in the EC Treaty neither with its later changes. Nevertheless, the EC Treaty provides for establishment of a common market<sup>8</sup> and it is clear that the common market covers the energy sector as well.

For a long period of the European integration, there was lack of clear competence of the Community to take measures on energy matters so it was relying on the legal basis of other EU competences, such as the internal market, environmental or external policy, as well as competition policy. Besides the competition law rules, the provisions for free movement of goods and services are also applicable to the energy sector. However, due to the fact that the competition law relies on *ex-post* action, it was not an effective way of creating a pro-competitive regulatory framework in the energy sector and to introduce competition in markets where vertically integrated monopolies existed.<sup>9</sup> Therefore, the competition policy is complemented by sectoral legislation and there are now two sets of rules applicable to the energy sector: general competition and sector specific rules.

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<sup>5</sup> Treaty of Paris establishing the European Coal and Steel Community, Paris, signed on 18.04.1951, entered into force 25.07.1952 and expired 50 years later; Euroatom Treaty creating the European Atomic Energy Community, Rome, signed on 25.03.1957, entered into force on 01.01.1958.

<sup>6</sup> CROSS, E. D., *Electric utility regulation in the European Union: a country by country guide*, Chichester: Wiley, 1996.

<sup>7</sup> Two views are presented in CAMERON, P. *Competition in Energy Markets: Law and regulation in the European Union*, 2<sup>nd</sup> edition, Oxford University Press, 2007 at 42, *supra* to explain why energy rules were not included in the EEC Treaty: 1. the intention was to treat energy in the same manner as any other economic sector and therefore it did not deserve any special status in the primary EC law and 2. it was a mistake that needed to be corrected with the Constitution for Europe.

<sup>8</sup> As defined in article 8(a) of the Single European Act [1987] OJ L169/1: "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".

<sup>9</sup> KIACKENBERG D. at al, *Rethinking the EU Regulatory Strategy for the Internal energy Market*, No.52, December, CEPS Task Force Report, 2004.

The first more ambitious phase towards the liberalisation of the European energy market, involved fixing of a specific timetable for liberalization in 1996 with the adoption of Directive 96/92/EC<sup>10</sup> and Directive 98/30/EC,<sup>11</sup> concerning electricity and gas markets respectively. The objective of that first generation of liberalisation directives was to open the energy markets through gradual introduction of competition, thereby increasing the efficiency of the energy sector and the competitiveness of the European economy as a whole. After some years, the Commission has tabled a formal proposal for amendment of the first liberalisation directives and at the same time has proposed a Regulation setting out principles and procedures for cross-border exchanges of electricity. The result was the adoption of the second generation of liberalisation legislation: Directive 2003/54/EC<sup>12</sup> (Electricity Directive) and Directive 2003/55/EC<sup>13</sup> (Gas Directive), as well as Regulation 1228/2003/EC on cross-border exchanges in electricity.<sup>14</sup>

After couple of years of experience with the second legislative package for liberalization of energy markets, the single energy market was not established yet. This led the Commission to open an inquiry into the functioning of the European electricity and gas markets in June 2005.<sup>15</sup> It identified the remaining obstacles for creating a single energy market and on 19.09.2007 presented its third package for liberalization of the energy markets in the EU in which it proposed competition, regulatory and structural measures to be taken. The competition law remedies were needed to address the problems of market concentration, vertical integration and lack of market integration, which should be supplemented by regulatory and structural measures. The Commission tabled amendments of the Electricity and Gas directives strengthening their provisions.<sup>16</sup>

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<sup>10</sup> Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity, OJ 1996/L 27, 30.01.1997.

<sup>11</sup> Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas, OJ 1998/L 204, 21.07.1998.

<sup>12</sup> 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 and Repealing Directive 96/92/EC, OJ 2003/L 176/37, 15.07.2003.

<sup>13</sup> 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 and repealing Directive 98/30/EC, OJ L 176 of 15.7.2003.

<sup>14</sup> Regulation (EC) No 1228/2003 of the European Parliament and of the Council of 26 June 2003 on the Conditions of the Access to the Network for Cross-Border Exchanges in Electricity, OJ 2003/L 176/1, 15.07.2003.

<sup>15</sup> Commission decision (EC) No (2005) 1682 of 13 June 2005 initiating an inquiry into the gas and electricity sectors pursuant to Article 17 of Council Regulation (EC) No 1/2003.

<sup>16</sup> European Commission, Explanatory Memorandum to the Third package for liberalization of the energy markets, Brussels, 19.09.2007, COM (2007) Draft.

## 2.2. Cross-border Trade and Regional Integration of Energy Markets in the EU

Besides the many important issues concerning the liberalisation of the electricity markets that are out of the scope of this paper, the Electricity Directive did not include provisions on cross-border trade of electricity. It was decided that this issue should be dealt with directly applicable instrument, i.e. a regulation was seen as more suitable than a directive. Therefore, together with the second Electricity Directive, Regulation 1228/2003/EC<sup>17</sup> was adopted which sets the basic rule for cross-border exchanges in electricity and was supplemented by Guidelines on congestion management (CMG)<sup>18</sup> and by Trans-European Energy (TEN-E) Guidelines.<sup>19</sup>

It is widely accepted that the objective for establishing an internal energy market in the EU would be more easily achieved through establishment of several regional markets. Not only more harmonised rules, but also the physical, institutional and political links are stronger at regional level.<sup>20</sup> In spring 2006, European Regulators Group for Electricity and Gas (ERGEG) with support of the European Commission, launched two Regional Initiatives: Electricity Regional Initiative (ERI) and Gas Regional Initiative (GRI). They are seen as an interim step and consequence to the idea of moving from national electricity and gas markets to an internal market.<sup>21</sup>

### 2.2.1. Definition of a Regional Market

As explained in the preceding paragraph, establishing a regional energy markets became a “natural” way of establishing the internal electricity market.<sup>22</sup> Therefore, the idea for establishing a regional energy market in SEE, which is the focus of this paper, is not unique. As stated above, in the EU there are already seven regional energy markets defined, and the idea for their establishment was discussed by the European Regulators even before the official launch of the Regional Initiative (ERI and GRI mentioned above) in spring 2006.

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<sup>17</sup> Regulation No 1228/2003, *supra*.

<sup>18</sup> Commission Decision (EC) No (2006) 770 of 9 November 2006 amending the Annex to Regulation (EC) No 1228/2003 on conditions for access to the network for cross-border exchanges in electricity OJ L312/59.

<sup>19</sup> Guidelines for Trans-European energy networks, Decision No 1364/2006/EC of the European Parliament and the Council of 6 September 2006 laying down guidelines for trans-European energy networks and repealing Decision 96/391/EC and Decision No 1229/2003/EC OJ L 262, 22.09.2006, p.1-23 (hereinafter, TEN-E Guidelines).

<sup>20</sup> CAMERON, P. (2007) *supra*, at 110.

<sup>21</sup> Some authors see the Regional Initiatives as “a single market initiative in disguise”. See: ZIMMERMANN, F. and TALUS, K., *Regulation of Electricity Markets at the EU level*, European Energy and Environmental Law Review, February 2008 at 16.

<sup>22</sup> ERGEG, Regional Initiative Annual Report 2008: The Regional Initiatives – Europe’s key to energy market integration, 26.02.2008.

As the factors such as, geography and physical proximity, the common historical heritage, culture, partly language and social and economic cohesiveness, are conducive to regional economic integration,<sup>23</sup> according to the Council of European Energy Regulators (CEER), there are some preconditions which might be a signal that REM may exist in a certain area. If there is sufficient transmission capacity between the markets within the region, and if that capacity is made available to market participants could be the technical signal. If furthermore, there are no distortions within the local markets which significantly could affect the functioning of the regional market could be another point of relevance. And if also an appropriate legal and regulatory framework is in place and if the national institutions from the countries co-ordinate and co-operate closely with each other within that appropriate framework, could strengthen the possibility for existence of a regional market.<sup>24</sup>

It should be stressed that defining the geographic scope of the REM is a very important issue. On the other hand, defining the borders of a regional market is not an easy task. It depends on the national and cross-border transmission capacity, congestions in the interconnections and experienced peak demand.<sup>25</sup> Furthermore, there might be overlap between the markets and one national electricity market may tend to fall in different regional structures.

### 2.2.2. Definition of the Regional Energy Market in South East Europe

The Congestion Management Guidelines define the seven REMs in Europe without mentioning the SEE region. The definition and the geographical scope of this potential 8<sup>th</sup> region in Europe are still not clear and it shows the possibility for some of the countries to belong to more than one regional market. For example, Romania have expressed willingness to join the Central-East (CEE) REM<sup>26</sup> instead of remaining in SEE, and Bulgaria have stated its own limited terms and conditions for participation.<sup>27</sup> Furthermore, Croatia have stated that it would give two borders to the CEE (with Slovenia and Hungary) and two to the SEE (with

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<sup>23</sup> Grupe, C. and Kušić, S., *Intra-regional cooperation in the Western Balkans: Under which conditions does it foster economic progress?*, Discussion Paper 37, Centre for the Study of Global Governance, London School of Economics and Political Science, 2005.

<sup>24</sup> ERGEG, *A Creation of Regional Electricity Markets*, 08.06.2005, at pp.5-6

<sup>25</sup> DEITZ, L., et al. *The Energy Community of South East Europe: Challenges of, and Obstacles to Europeanisation*, CCP Working Paper 08-4.

<sup>26</sup> The CEE REM covers: Austria, Czech Republic, Germany, Hungary, Poland, Slovakia and Slovenia.

<sup>27</sup> Information from a presentation by Goran Majstrovic, Energy Institute Hrvoje Pozar Croatia, *Network Issues in Electricity Markets-South East Europe Study Case*, presented at the Advanced Training Course in Electricity Markets, Florence School of Regulation, 31.03-04.04.2008.

Bosnia and Herzegovina and Serbia), whereas Serbia retains full control over all interconnections, negating the existence of UNMIK interconnections.<sup>28</sup>

The Energy Community Regulatory Board (ECRB) recognizes the importance of defining the borders of this region and consequently the perimeter countries to it. Therefore, it has asked the ERGEG Electricity Working Group to make a recommendation to ERGEG with regards to establishing an 8<sup>th</sup> region in Europe, and the Commission to start the common Commitology procedure between the EU and the contracting parties of the Energy Community Treaty with that regard.<sup>29</sup> However, until the present moment, this has not been done even though activities have been taken having in mind the abovementioned difficulties. In particular, in its decision of 27.06.2007,<sup>30</sup> implementing the Commission Decision of 9.11.2006 amending the Annex to Regulation 1228/2003/EC on conditions for access to the network for cross-border exchanges in electricity,<sup>31</sup> the Ministerial Council of the Energy Community stated that common coordinated congestion management method and procedure for allocation of the capacity to the market shall be implemented by the end of 2008 and will be applicable to the so called 8<sup>th</sup> region. This region according to the Ministerial Council Decision is formed by the territories of the Parties adhering to the EnCT, as well as the Republic of Bulgaria, Hungary, Romania, Slovenia, the Hellenic Republic and the territory of the Republic of Italy with regards to the interconnections with the territories of the Parties of the EnCT.

Finally, it should be borne in mind that the definition of the geographical scope is a very important issue because it is the first step towards the creation of the market itself.

### 2.2.3. The Athens Process as an example of regional integration in the energy sector

As it was announced in the paragraphs above, in a liberalized electricity market cross-border trade of energy becomes more attractive and it should therefore be stimulated. A fundamental precondition to such liberalization is the existence of a comparable regulatory

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<sup>28</sup> *Ibid*

<sup>29</sup> Energy Community Secretariat, Report on the Implementation of Regulation 1228/2003/EC on Conditions for Access to the Network for Cross-Border Exchanges in Electricity in the Contracting Parties to the Treaty Establishing The Energy Community, Ref: 4thECRB/R1228/rev-final/12-10-2007(ECS), ECRB Ref: R07-GA-04-05\_final, October, 2007 at 7 (hereinafter, Energy Community Secretariat, Report on Implementation of Regulation 1228/2003).

<sup>30</sup> Ministerial Council of the Energy Community, Decision 2008/02/MC-EnC: on the implementation of Commission Decision of 9.11.2006 amending the Annex to Regulation 1228/2003/EC on conditions for access to the network for cross-border exchanges in electricity.

<sup>31</sup> Commission Decision (EC) No (2006) 770 of 9 November 2006, *supra*

framework in all countries concerned.<sup>32</sup> Additionally, it is desirable to establish similar market structures in the neighbouring regions, which would both anticipate further integration and recognize the situation of the existing grid interconnections.<sup>33</sup> A common framework may be established notably through the conclusion of bilateral or regional agreements not only between the regions in the EU, but also between the EU and third countries. In this later case the third countries concerned have to have an electricity market organized in compliance with the basic principles of the energy *acquis*.

Good example of such regional arrangement is the conclusion of the Energy Community Treaty<sup>34</sup> in 2005 between the EC and the countries of the SEE in the framework of the Athens Process. In addition to the Contracting Parties of the EnCT (the EC and the countries from SEE), any Member State of the EU may obtain the status of a Participant, which has the right to take part in all the institutional meetings of the Energy Community. For instance, Bulgaria and Romania were parties of the EnCT, but after their accession to the EU in 2007 their legal status has changed from Contracting Parties to Participants. As of April 2008, there are fourteen Participants to the Energy Community.<sup>35</sup> In addition, there are five countries with a status of Observers to the Energy Community.<sup>36</sup>

In the following paragraphs, the rationale behind the Athens Process will be presented in more details, explaining the reasons why the EU have launched and supported the process and what was the motivation for the SEE countries to accept the requirements stemming from it.

### **3. Rationale behind the Athens Process**

After briefly discussing the development of an internal energy market in the EU, the Athens Process with the EnCT as its result, have been introduced in the previous paragraphs. As stated above, the idea behind the establishment of the Energy Community is to create a regional energy market in SEE which would be integrated into the EU internal energy market. This imposes obligation on the countries of SEE to establish their regional market which would be compatible and in accordance with the rules that govern the EU internal energy

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<sup>32</sup> Communication from the Commission to the Council and the European Parliament: Completing the Internal Energy Market, Brussels, 13 March 2001, COM (2001) 125 final.

<sup>33</sup> European Commission, DG TREN, Strategy Paper: Medium - Term Vision for the Internal Electricity Market, Brussels 01.03.2004.

<sup>34</sup> Treaty establishing the Energy Community for South East Europe, *supra*

<sup>35</sup> See: [http://www.energy-community.org/portal/page/portal/ENC\\_HOME/ENERGY\\_COMMUNITY/Stakeholders/Participants](http://www.energy-community.org/portal/page/portal/ENC_HOME/ENERGY_COMMUNITY/Stakeholders/Participants) (last visited: 28.01.2009).

<sup>36</sup> Georgia, Moldova, Norway, Turkey and Ukraine are granted with status of Observers.

market. Nevertheless, it should be borne in mind that even though energy has been considered as one of the most important issues since the beginning of the European integration in the 1950s, the legislative and the real creation of the EU internal energy market itself begun only in the 1990s. This is forty years after the creation of the Community, when the rest of the common market has been almost completed and when strong economic integration between the Member States was in place. This is not the case with the SEE, because there is no such a strong regional integrated community between the countries from the region. Moreover, it should not be forgotten that the countries in SEE are developing countries, which are still in transition trying to reform their systems and to implement market economy after the central planned economy that existed in the socialist period. Furthermore, countries in SEE are trying to stabilise their political and security situation at national and also at regional level by trying to re-build friendly relations with their neighbours after the wars that took place in the region in the 1990s.

Having stated these diametrically different situations present in the EU and SEE, the question of whether the existence of the Energy Community is sustainable and whether is worth doing research on it comes to one's mind. Therefore, the purpose of the following part of this paper is to try to identify the driving forces behind the Energy Community.

### **3.1. Rationale of the EC**

#### **3.1.1. The interest of the EC for the SEE region**

Before turning to the discussion of the rationale of the EC behind the idea for the Athens Process and the creation of the Energy Community, the question about the interest and the concern of the EU in the SEE region in broader terms needs to be addressed. The political science literature has tried to give an explanation to this question, which as will be shown later in this paper, seems to be justified. Bringing peace and stability to the SEE region, after the conflicts and wars that took place in the '90, would contribute to the overall stability and friendly relationships in Europe. It is not questionable that overcoming the instability and insecurity might open the door to foreign investment in the region, as well as to encourage its economic development and prosperity.<sup>37</sup> All these opportunities for economic growth along with the signs for political stability in SEE are relevant for the EU and its role at the

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<sup>37</sup> Gavranović, A. *The Stability Pact – the prospects and perils of regional economic co-operation*, South East Europe Review for Labour and Social Affairs, issue: 01/2001, pp: 161-171, at 162 and Qerimi, Q., Sergi, B., *The European Union and its prospective enlargement to the southeast*, South East Europe Review for Labour and Social Affairs, issue: 04 / 2005, pages: 15-32.

international scene. In order to help the countries from SEE to pave the path of economic growth, the EU has established programs for financial assistance for the region.<sup>38</sup>

In addition to this economic rationale and the prospects of the SEE, other cross-border issues that are affecting the still fragile stability<sup>39</sup> of the region are foreign direct investment, trade and transport facilitation, people mobility and migration, environmental protection as well as energy supply. Taking into consideration the strategic geo-political position of the whole region, those issues need to be addressed as part of a broader regional vision. Some authors have underlined that seeing SEE as a bridge between Europe and Asia, CEE and the western Asia and Russia, brings one to the conclusion that national and bilateral solutions would not be enough to address the issues of economic development, energy policy and other strategic issues.<sup>40</sup> In fact only a pan-European framework and regional organisations could be expected to be effective.<sup>41</sup> Those pan-European visions “set the bilateral as well as regional dimensions in a coherent and significant framework for an efficient development of economic, political and cultural co-operation” as well as “ensure a bold and new vision for SEE and also for Europe as a whole.”<sup>42</sup>

Many regional initiatives that were launched in this region, the Stability Pact for SEE (which together with the EU stands behind the idea of the Energy Community) being one of them, could be seen against that general background.<sup>43</sup> Most of these regional forms of cooperation were not initiatives launched by the SEE countries themselves, which made the very notion of regional co-operation part of the post-conflict stabilisation efforts of the international community. Therefore, the SEE countries mostly perceived them as going back to the Yugoslavian model and they were often reluctant to engage and to accept those regional

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<sup>38</sup> EU has designed a Community Assistance for Reconstruction, Development and Stabilisation (CARDS) Programme, which together with PHARE (Poland and Hungary: Assistance for Restructuring their Economies), ISPA (Instrument for Structural Policies for Pre-Accession), SAPARD (Special Accession Programme for Agriculture and Rural Development), has later been replaced by an instrument for Pre-Accession Assistance (IPA) for the period of 2007-2013. For IPA see: Council Regulation (EC) No 1085/2006 of 17 July 2006 establishing an Instrument for Pre-Accession Assistance (IPA) OJ 2006 L 210/82, 31.7.2006. For detailed rules implementing IPA see: Commission Regulation (EC) No 718/2007 of 12 June 2007 implementing Council Regulation (EC) No 1085/2006 establishing an instrument for pre-accession assistance (IPA) OJ 2007 L 170/1, 29.6.2007. The total pre-accession funding for the current financial framework (2007-2013) is € 11.5 billion.

<sup>39</sup> For the view that the EU “aims at exporting the EU’s zone of peace into the South-Eastern corner of Europe by engaging regional governments in its initiatives” see: Kavalski, E., *The Western Balkans and the EU: the probable dream of membership*, South East Europe Review for Labour and Social Affairs, issue: 01+02 / 2003, pp: 197-212.

<sup>40</sup> Solioz, C., *Rethinking south-eastern Europe through a pan-European perspective*, South East Europe Review for Labour and Social Affairs, issue: 02 / 2007, pp: 67-80 at 73.

<sup>41</sup> *Ibid*

<sup>42</sup> *Ibid* at 74.

<sup>43</sup> For non-exhaustive list see: Solioz, C., *Rethinking south-eastern Europe through a pan-European perspective*, *supra* at 77.

initiatives. Now, the transformation of the Stability Pact into Regional Co-operation Council (RCC) based in Bosnia and Herzegovina, shows that the SEE countries have started to be more open for cooperation and integration, not only bilaterally each of them with the EU, but also among themselves, and have changed their attitude accepting cooperation at regional level as well.<sup>44</sup>

### 3.1.2. The rationale of the EC to launch the Athens Process

The completion of the EU's internal energy market strengthened the need for an explicit European Energy Policy. In its Green Paper of March 2006,<sup>45</sup> the Commission set the basis for such a policy, which is expected to meet three core objectives: sustainable development, competitiveness and security of supply. For that purpose it underlined six priority areas, one of which is the common external energy policy.<sup>46</sup> It should be noted that the idea for common external energy policy develops in a period in which Europe is facing great challenges in the energy field.<sup>47</sup> For example, there is a need for investment for changing the old infrastructure and for building new interconnections between the Member States. Furthermore, it should not be forgotten that the EU is dependent on import of primary fuels, such as oil and gas in around 50% of its total consumption. On the other hand, about half of the known natural gas reserves are located in Russia and Iran, while most of the oil reserves are placed in Russia, Saudi Arabia, Iraq and Iran. Another important issue that has an impact on the European energy policy is that not only the EU's demand, but also the world's energy demand is expected to rise due to the growth in the global economy driven in particular by China and India. For instance, during 2008 the oil and gas prices on a world wide level were rising which, certainly had an impact on the prices of electricity in the Member States of the EU, due to the fact that oil and gas are the main fuels used for production of electricity. In addition to all this, the growth in energy consumption is expected to increase the emission of greenhouse gases and to cause climate changes, issues addressed at European level as well.

Having in mind this global context, the EU has set the following priorities in the energy field: the creation of competitive internal energy markets; the diversification of the energy

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<sup>44</sup> *Ibid* at 78.

<sup>45</sup> European Commission, Green Paper: A European Strategy for Sustainable, Competitive and Secure Energy, Brussels, 8 March 2006, COM (2006) 105 final.

<sup>46</sup> The other priority areas were: completion of the internal energy market, solidarity among Member States, sustainable, efficient and diverse energy mix, measures addressing the climate change, strategic energy technology plan.

<sup>47</sup> On the views about the challenges that EU is facing in the energy sphere see: BUSEK, E., *The Energy Community Treaty: Securing the Energy Supply in Southeast Europe and in the EU*, SÜDOSTEUROPA Mitteilungen Vol. 05-06/2006, p.16-21.

mix, suppliers and supply routes; energy efficiency; solidarity and an external energy policy. According to Erhard Busek, the Coordinator of the Stability Pact, the Energy Community which creates the largest internal energy market in the world bringing together all the Member States and the countries from SEE,<sup>48</sup> have a certain role in achieving all of the abovementioned priorities.<sup>49</sup> Therefore, the rationale behind the idea of the European Commission to launch the idea for establishing the Energy Community is going to be analysed in the light of those priorities:

a) *Firstly*, having in mind that the EU imports high percentage of its energy consumption one of the priorities would be a *diversification of the energy mix, suppliers and supply routes*. The countries from SEE, even though as the Member States of the EU, are free in making choice of their national fuel mix the obligations stemming from the EnCT would make them rethink and improve that mix. Renewable energy is already playing an important role in the region, namely thanks to the potential of the small hydropower plants (HPPs). At this point it is worth recalling that the SEE countries with the EnCT have undertaken the obligation to implement the Renewables and Biofuels Directives. Due to the fact that, except in Romania and Bulgaria, the gasification of the SEE region is very weak, most of the countries are making studies for the possibilities for increasing or building new gas pipelines. From the perspective of the EU's dependence on imported fuels used for production of electricity, SEE is considered to be able to provide for a substantial gas storage capacity and to serve as a transit area for new pipelines supplying the Member States. The diversification of suppliers and supply routes could be made possible by the construction of liquid natural gas (LNG) facilities, which would make it possible to import gas from the East.<sup>50</sup> In addition, pipelines to connect the region with Turkey could be built. There are two main projects that deserve to be mentioned at this point. The first one is the Nabucco pipeline, which connects the Caspian region, Middle East and Egypt via Turkey, Bulgaria, Romania and Hungary to Austria and further on with the Central and Western European gas markets. The pipeline's length would be approximately 3,300km and could supply between 5 to 10% of the EU's energy demand.<sup>51</sup>

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<sup>48</sup> European Commission, Ministers hail largest energy internal market in the world – Energy Community Treaty, Brussels, 08.06.2006, IP/06/757.

<sup>49</sup> BUSEK, E., *The Energy Community Treaty: Securing the Energy Supply in Southeast Europe and in the EU*, *supra*

<sup>50</sup> In its Discussion and Consultation Note of 2004, *supra* at 9, the Commission sees the possibilities for supply of gas from the East as key to energy security of supply for the region.

<sup>51</sup> For further details, see: <http://www.nabucco-pipeline.com/> (last visited: 28.01.2009). Nevertheless, since the EU have announced that it will not fund Nabucco project, its future is jeopardised. For more details, see: <http://www.euractiv.com/en/energy/eu-rules-funding-nabucco-gas-pipeline/article-178913> (last visited: 28.01.2009).

Another example would be the Trans-Adriatic Pipeline (TAP) which is a 520km long pipeline and will transport gas via Greece and Albania and across the Adriatic Sea to the Italian southern region of Puglia and further into Western Europe. It will interconnect Western Europe with Greece's existing pipeline system that is linked to the East with Turkey. This would furthermore, end the network isolation of one of the Member States, Greece. The TAP project is in its development phase supported by the EU as a "Priority Project" under the TEN-E Guidelines because it contributes to the EU's objectives and policies aimed at diversification and security of gas supply.<sup>52</sup> These projects, in which SEE region plays great role, are designed to reduce the EU's dependence on Russian gas of the SEE region (which is more around 90%).

b) With regard to the objective for increasing *energy efficiency*, the aim of the European Commission is to reduce the consumption of energy by 20% by 2020. The Energy Community pays attention to achieving this goal as well, by enabling the Energy Community to take measures to foster effective demand management policies and to adopt measures to enhance development in the area of energy efficiency.<sup>53</sup> Due to the highly subsidized cost of energy, people and companies in the SEE had no incentive to save energy and the present levels of energy demand are significantly higher in this region than in the EU. Taking into consideration the perspective of the EU membership of the countries from SEE, if efficiency programmes are not implemented on time in the region, EU's objective for achieving its 20% by 2020 could be easily jeopardised.

c) In the EU, there are no mechanisms for *solidarity* among Member States to prevent energy supply crises and for the way in which they should be managed if they occur.<sup>54</sup> On the other hand, in the EnCT there is an obligation of mutual assistance in the event of disruption in the energy supply.<sup>55</sup>

d) Last but not less important, the aim of the European Commission is that the Member States should speak with a common voice in their *external energy policy*. Even though the EnCT restricts the scope of this external policy to trading issues, it seems that by enlarging the European internal energy market to SEE countries, the Commission tries also to increase the potential bargaining power of the EU *vis-à-vis* its external energy partners. According to Mr. Busek, Europe could use this power in the negotiations with Gazprom to allow access to

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<sup>52</sup> For further details see: <http://www.trans-adriatic-pipeline.com/index.php?lang=> (last visited: 28.01.2009).

<sup>53</sup> Articles 32 and 35 Energy Community Treaty, *supra*, respectively

<sup>54</sup> The importance of the solidarity issues is highly relevant nowadays during the crisis of gas supply due to the Russia-Ukrainian dispute.

<sup>55</sup> Articles 44-46 Energy Community Treaty *supra*.

its pipelines in exchange for access to the European retail gas markets, due to the higher profits. In support of this argument is the intention of Gazprom to enter the EU's energy market through taking the control of Toscana Energia<sup>56</sup> that makes the issue more relevant.<sup>57</sup> What is more, it would also not be easy for the EU to convince some Member States to abandon their benefits from the privileged relationships with Russia (ex. German E.ON). It should be noted, moreover, that Russia has increased its engagement in the Balkans, and during the last period, Moscow has also played the energy card in relation to the Kosovo status issue, with important investments in Serbia and in Republika Srpska. It is also trying to use the indecisive position of Serbia towards the EU and to position it against EU projects to diversify supply routes.<sup>58</sup>

Another place where the EU needs to strengthen its position and bargaining power is the Caspian Basin where Russia and China are very active. Shanghai Co-operation Organisation<sup>59</sup> has been used as a forum for China, India, Russia and Iran to sign energy deals with one another and have begun creating a central Asian "energy club" having its own energy market. This economic game goes against Europe's efforts to make use of the oil and natural gas reserves from the Caspian Basin.<sup>60</sup> This is another reason why the European Commission very much favours cross-border consolidation inside the European internal energy market covering the whole SEE region as well.

European Neighbourhood Policy (ENP) also has a certain role in increasing the bargaining power of the EU through the Energy Community itself. The countries from SEE which are signatories of the EnCT are not part of the ENP, but are part of the enlargement Stabilisation and Association Process (SAP) of the EU, and all of them have a clear perspective for potential membership in the EU. However, the EnCT allows for the possibility

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<sup>56</sup> Toscana Energia is the local distribution company in which ENI (the former state-owned monopoly in the gas sector) and the region of Tuscany, are the main shareholders.

<sup>57</sup> Regione Toscana, Consiglio Regionale: Gazprom nell'azionariato di Toscana Energia? Danti e Remaschi sollevano dubbi ed interrogano la giunta regionale, 27.02.2008, available at: [http://www.consiglio.regione.toscana.it/politica/comunicati-stampa-dei-gruppi-politici/comunicato/testo\\_comunicato.asp?id=3453&filtro=02](http://www.consiglio.regione.toscana.it/politica/comunicati-stampa-dei-gruppi-politici/comunicato/testo_comunicato.asp?id=3453&filtro=02) (last visited: 28.01.2009).

<sup>58</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, Working Paper No.31, June 2008 at 24

<sup>59</sup> The Shanghai Cooperation Organisation (SCO) is permanent intergovernmental international organisation, created on 15.06.2001 in Shanghai (China). One of its main goals is strengthening mutual confidence and good-neighbourly relations, promoting their effective cooperation in ...energy... to move towards the establishment of a new rational political and economic international order. For further information, see: <http://www.sectsc.org/EN/index.asp> (last visited: 28.01.2009).

<sup>60</sup> In this context see: the Transport Corridor Europe – Caucasus – Asia or the "New Silk Road" (TRACECA) <http://www.traceca.org/default.php?l=en> (last visited: 28.01.2009), the initiative for Baku-Tbilisi-Ceyhan pipeline, as well as Interstate Oil and Gas Transport to Europe <http://www.inogate.org/en/> (last visited: 28.01.2009), funded through the EU's Technical Assistance to the Commonwealth of Independent States (TACIS) program.

to be further extended to the states which are now Observers of the Energy Community (Norway, Moldova, Turkey, Ukraine and Georgia), covered by the ENP at the same time. Article 96 of the EnCT states that “upon a reasoned request of a neighbouring third country, the Ministerial Council may, by unanimity, accept that country as an Observer.” Moreover, in the same article it is stated that Moldova shall become an Observer within 6 months after the Treaty enters into force. At the first Ministerial Council on 17.11.2006 Moldova, Norway and Ukraine were granted an observer status. Turkey was granted an observer status as well, even though it is a signatory of the Athens Memoranda and therefore, it is a participant to the regional market. Ukraine, Moldova and Turkey have already applied to join the Energy Community and the Commission states that their inclusion “should be considered at the earliest possible moment.”<sup>61</sup> Following a decision taken by the Ministerial Council of the Energy Community, the Council of the EU mandated the European Commission to carry out negotiations with these three countries and the negotiations for accession of Ukraine and Moldova to the Energy Community have been opened on 25.11.2008.<sup>62</sup> Having in mind the broader perspective of the ENP, the Commission's consideration to carry out a “reflection concerning other possible membership applications” as well, becomes very relevant in this context.<sup>63</sup>

After explaining some of the motives behind the idea of the EC to launch and to support the creation of the Energy Community, next section will be devoted to the motives that led the countries from SEE to stand behind the idea for establishment of the Energy Community.

### **3.2. Rationale of the SEE countries**

#### **3.2.1. Common problems of the SEE countries**

Except Albania, which has never been regionally integrated and even during the socialist period turned away from both economic blocks in East and West and followed a policy that was exclusively oriented on autarky, the other countries that were part of Yugoslavia share the common history that economically and politically was quite unique.<sup>64</sup>

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<sup>61</sup> European Commission, Communication from the Commission to the European Council, External Energy relations – from Principles to Action, Brussels, 12.10.2006, COM(2006) 590 final at 5.

<sup>62</sup> For further details see:

[http://www.energy-community.org/portal/page/portal/ENC\\_HOME/NEWS/News\\_Details?p\\_new\\_id=1501](http://www.energy-community.org/portal/page/portal/ENC_HOME/NEWS/News_Details?p_new_id=1501) (last visited: 28.01.2009).

<sup>63</sup> European Commission, Communication from the Commission to the European Council, 2006, *supra*.

<sup>64</sup> “The cornerstones of this uniqueness were: 1. the relative independence of the Soviet Union since 1948, when Tito broke with Stalin, 2. the slow approach to the West since then and 3. the special economic system of workers’ self-management” in: Grupe, C. and Kušić, S., *Intra-regional cooperation in the Western Balkans: Under which conditions does it foster economic progress?*, *supra* at 8.

However, after the war conflicts that the countries from ex-Yugoslavia went through in the '90, regional cooperation and integration was unthinkable. The region has been economically and politically disintegrated so, the conditionality for regional integration imposed by the EU on the region would appear as a force to re-merge formerly integrated countries.<sup>65</sup>

In 2001, the Commission put special attention to the regional dimension of the European transport and energy strategy in SEE, in the context of the European integration of countries from the region.<sup>66</sup> The common problems, as earlier identified in the World Bank's study, such as limited primary sources and dependence on import, low level of energy efficiency and lack of reforms were outlined in the Commission's Strategy, but it was also underlined that the differences that exist between the countries in the region shall be taken into account.

The need for regional cooperation of the SEE countries in the energy field derives from the common problems that these countries are facing discussed in a study from the World Bank dating from the year 2000.<sup>67</sup> The energy prices were below economic levels and pricing/tariff structures were inappropriate. Moreover, energy trade was prevented by poor infrastructure, as well as by the political and social legacy of the conflicts in the SEE region. On the other hand, state-owned vertically integrated companies existed in the region and the institutional capacity in all the countries was limited whereas energy policies, legislation and standards were very much different from those in the EU. The policy and institutional framework necessary for encouraging private sector investment needed for restoring the infrastructure and for constructing new power plants in the region, was not in place. After three years, the same problems have been identified by the International Energy Agency<sup>68</sup> in a paper drawing on the experience from the Central European countries, which after 10-12 years of reforms started to gradually open their energy markets. Grid reconnections, rehabilitation of existing infrastructure and the creation of a market economy after the socialism are seen as major challenges by other authors as well.<sup>69</sup>

Another common problem of the SEE countries is the lack of transparency. Due to the fact that only Bulgaria and Bosnia and Herzegovina from the Contracting Parties are net

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<sup>65</sup> Despite the commonalities between the countries, when economic model of gravity is applied to the SEE region shows that it is very difficult to speak of the countries as a region since the state of their economy differs from country to country. For application of this economic model, see: Christie, E., *Potential trade in South East Europe: a gravity model approach*, South East Europe Review for Labour and Social Affairs, issue: 04 / 2002, pp.: 81-101.

<sup>66</sup> European Commission, Transport and Energy Infrastructure in South East Europe, Brussels, 15.10.2001

<sup>67</sup> World Bank, The Road To Stability And Prosperity In South Eastern Europe: A Regional Strategy Paper, March 1, 2000.

<sup>68</sup> BERGASSE, E., International Energy Agency: Public service review, *What energy policy for South East Europe?* Spring, 2003.

<sup>69</sup> RYDING, H., IPA Energy Consulting, Energy in East Europe, 07.01.2005, Southeast Europe, No.55, at 12.

exporters of electricity, there has always been some cross-border trade. But it was generally trade between utilities, governments or companies connected to them. Moreover, in the past the legal frameworks in all these countries have been unclear and investment and supply contracts often awarded without openness and transparency, which is not unusual even today in some parts of the region. Even where governments had been willing to privatize, foreign investors were lacking the incentive to invest in those separate markets which were not promising stable and investment-friendly climate.

### 3.2.2. Benefits from regional integration and establishing a regional energy market

Regional cooperation was seen, not only as an answer to the common problems identified above but also as a “crucial ingredient of stability” and a “key test” for these countries to show that will be able to cope with the requirements in order to live in the European family after the accession.<sup>70</sup> In order to tackle these problems in its Strategy Paper, the World Bank identified some benefits of a regional cooperation.<sup>71</sup> Firstly, reliable, low-cost and environment-friendly sources of energy would be available and would allow for sustainable economic development of the region. With regard to the supply of electricity, the regional approach would be beneficial for better utilization of the existing capacities, but would also attract foreign investments. Cross-border trade would be facilitated, which would in turn influence lowering the transaction costs. A regional approach would help strengthening the institutional arrangements and would assist SEE countries in adopting the EU standards for infrastructure development and regulation, having in mind the expected integration in the internal electricity market.

In addition, there are technical and economic reasons for unification of national electricity systems in a regional one. For example, the fuel diversification is impossible in a small system. Moreover, an electricity system requires reserve power,<sup>72</sup> the need for which declines with the size of the system<sup>73</sup> and lower investment for reserve power is needed in larger systems. Finally, as the networks were destroyed during the regional wars in the ‘90s,

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<sup>70</sup> For the role of the Stability Pact and its complementarity with the SAP, see: PRIEBE, R., *The European Perspective of the Western Balkans, its Regional Dimension and the Contribution of the stability Pact*, SÜDOSTEUROPA Mitteilungen 04/2004, p.40-47.

<sup>71</sup> World Bank (2000), *supra*.

<sup>72</sup> Reserve power refers to generating plants which stay inactive most of the time.

<sup>73</sup> For ex. a system with only one generator should keep another generator as a reserve plant, i.e. double its investment, while reserve capacity in a large system may range between 10-20% of the overall generation capacity.

it was more efficient to invest from the beginning in the construction of a connected regional grid instead of rebuilding the national grids and later trying to interconnect them.<sup>74</sup>

*a) Generation: Installed Capacity, Import and Export in SEE*

Bulgaria and Bosnia and Herzegovina as well as Slovenia, even though not as a signatory of the EnCT, are three countries exporting electricity in SEE. In 2004, volume traded between the SEE countries was 9%.<sup>75</sup> Bulgaria has been supplying from 50 to 90% of the electricity shortfall in the region, with its total exports amounting to 7600GWh in 2005.<sup>76</sup> However, the whole region as such, is a net importer. There was an increase in import volumes in the period between 1995 and 2002 (from 1837GWh to 5549GWh), and then it decreased in 2003 (2657GWh).<sup>77</sup> Romania, Bulgaria and Serbia experienced decline in the production of electricity, whereas Albania, Macedonia and Slovenia remained with almost unchanged production. The electricity production in the region according to a recent article by Hooper and Medvedev about the electricity production, (excluding Greece and Turkey, and including Slovenia) was 190TWh in 2004.<sup>78</sup> In the same article there is an analysis of the fuel type used for production of electricity where it was found that in SEE there is 40% coal, 23% hydro, 23% gas, 7% oil and 7% nuclear.<sup>79</sup> With regard to the specific countries, gas is used in Turkey, Croatia, Romania and Greece, whereas nuclear power stations exist in Bulgaria, Romania and Slovenia. Most of the countries rely on coal (Macedonia produces 78% of its total electricity production from coal, and then is Serbia with 66% and Greece with 61%). Albania with 98% of its electricity production relies on hydro power, which is the biggest

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<sup>74</sup> “Among the tasks of the Stability Pact’s was to develop projects which are to be financed mainly through donor conferences, and a sufficiently developed infrastructure (especially in transport, energy and telecommunications) which is an important complementary production factor in economic exchange, was one of the important precondition for contributing to the economic growth” in Becker, J., and Jurkeit, J. *The Balkans Stability Pact and the interests of the West*, South East Europe Review for Labour and Social Affairs, issue: 01 / 2001, pp: 145-160. Among the tasks of the Stability Pact’s was to develop projects which are to be financed mainly through donor conferences, and a sufficiently developed infrastructure (especially in transport, energy and telecommunications) which is an important complementary production factor in economic exchange, was one of the important precondition for contributing to the economic growth.

<sup>75</sup> KENNEDY, D. and BESANT-JONES, J. *World Bank Framework for Development of Regional Energy Trade in South East Europe* World Bank, Energy and Mining Sector Board Discussion Paper, Paper No. 12, 2004 (hereinafter, World Bank 2004).

<sup>76</sup> SEETEC Balkans: “*Study of the Obstacles to Trade and Compatibility of Market Rules*”, Southeastern Europe Electrical System Technical Support Project, Regional Activity REM-1202: Final Draft Report 014551-REM-1202-47RA-I-0001-01, June 2006, presented at the 9<sup>th</sup> Athens Forum, 23-25 October 2006, Athens at 20.

<sup>77</sup> HOOPER, E. and MEDVEDEV, A. *Electrifying Integration: Electricity Production and the South East Europe Regional Energy Market* CCP Working Paper 08-6, January 2008 at 11

<sup>78</sup> Data available in: HOOPER, E. and MEDVEDEV, A. (2008), *supra* at 6.

<sup>79</sup> HOOPER, E. and MEDVEDEV, A. (2008), *supra* at 18.

percentage in the region, after which Croatia follows with 53% and Bosnia and Herzegovina with 47%.<sup>80</sup>

In line with the discussion on the benefits from regional integration, this data shows that there is a possibility for substitution between thermal and hydro power in peak and off-peak periods in SEE. In addition, advantage could be taken from the differences in the fuels' price, and electricity should be produced in countries with lower fuel price that could be consumed in another country of the region. In this line is the observation that due to the fact that coal is mostly domestically supplied, price of the coal and nuclear power might be controlled at national level and could be considered predictable that is, there would not be a higher risk of sudden price fluctuations.<sup>81</sup> On the other hand, oil and gas, which together amount to 30% of the total fuels used in the SEE region, are extremely dependent on the prices world wide and there are risks from variations of the final price of electricity produced from them. Hydro power with its 23% depends on weather conditions, and therefore countries such as Albania and Bosnia and Herzegovina are those exposed to this kind of risks mostly. With regard to the periods of peak demand, the whole region except Greece is experiencing winter peak and that should be taken into account when planning the trading relations. In addition to all this, operating costs might be reduced of 11-15% if regionally integrated power system operates in SEE.<sup>82</sup>

#### *b) Need for Investment in Generation Capacity*

When considering the regional energy strategy for SEE region in 2001, the European Commission started with a premise that there is no need for new power generation because the installed capacity is enough to meet the regional demand and that the shortages and the import of electricity which this region faces is not due to lack of capacity, but due to the fact that the capacity is not used effectively because of physical, technical, administrative and political reasons.<sup>83</sup> Therefore, rehabilitation of the existing generators was the initial priority of the Commission. It was furthermore decided that the identified projects in the generation should be financed on commercial basis and from private investors, and only the transmission lines and cross-border interconnection projects which usually do not attract investments, could be financed from state-owned or donors funds. Promotion of energy efficiency and rehabilitation of lignite mines, HPPs and increase of the electricity production taking into

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<sup>80</sup> HOOPER, E. and MEDVEDEV, A. (2008).

<sup>81</sup> HOOPER, E. and MEDVEDEV, A. (2008), *supra* at 19.

<sup>82</sup> World Bank (2004), *supra*.

<sup>83</sup> European Commission, Transport and Energy Infrastructure in South East Europe, Brussels, (2001) at 18.

account the environmental standards, was another priority. Development of cogeneration of heat and power (CHP) plants in SEE was also part of the energy strategy developed by the European Commission. The countries from SEE were supposed to identify the infrastructure needs and to prepare a plan with priorities that starts from a regional perspective but has regard to state needs.<sup>84</sup>

Shortly after, the World Bank in its framework document for development of the regional energy trade in SEE considered that the installed capacity in SEE is low and in the simulations predicting demand growth it will not be enough to cover the needs of the region.<sup>85</sup> Later on, a Generation Investment Study (GIS) was financed by the EC and project-managed by the World Bank in which it was concluded that 11.6GW installed capacity needs to be rehabilitated and 13.5GW new capacity needs to be installed, which would require EUR16 billion of investment.<sup>86</sup> Those investments would be necessary for the energy demand of the region to be met in the period between 2005 and 2020, and the potential deficit of energy not to occur as a problem for the regional market development. Furthermore, competition which is supposed to be introduced in the energy markets in the region could be limited by the power outages, because power generators in situations when there is deficit of power do not have incentives for good performance, but instead could have more opportunity depending on their market power, to withhold capacity and raise prices.<sup>87</sup>

Due to the phased approach of liberalisation in the region, the Commission advised that regionalisation of the investment should be done only in the second phase after the priority short-term reforms are in place.<sup>88</sup> In that case, it has to be ensured that criteria for determining the investment priorities are applied transparently and correctly.

### *c) Transmission Connections and Need for Investment*

From technical point of view, establishing REM requires physical interconnection of the transmission systems of the countries in question. Functional transition lines at national level and sufficient interconnections are very important precondition for development of cross-border trade and for allowing flow of electricity among the countries preventing bottlenecks

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<sup>84</sup> European Commission: Strategy Paper on the Regional Electricity Market in South East Europe and its Integration into the European Union Internal Electricity Market, Brussels, 11.11.2002 D(2002), at 7.

<sup>85</sup> World Bank (2004), *supra*.

<sup>86</sup> European Union CARDS programme for the Balkan Region, Contract No. 52276: Regional Balkans Infrastructure Study – Electricity: Generation Investment Study (GIS), Final report, 31.12.2004.

<sup>87</sup> KENNEDY, D. *World Bank Framework for Development of Regional Energy Trade in South East Europe* World Bank, Energy and Mining Sector Board Discussion Paper, Paper No. 15, 2006 (hereinafter, World Bank, 2006).

<sup>88</sup> European Commission, DG TREN: Discussion and Consultation Note, *supra*.

of the system. During the existence of the Socialist Federal Republic of Yugoslavia (SFRY) the electricity systems of its republics were part of Yugoslavia's electric utility association, which in turn was part of the Union for Co-operation of Transmission of Electricity (UCTE).<sup>89</sup> Therefore, at that time the national electricity systems were not designed to be self sufficient, but rather part of a regional and through it, of the international system.<sup>90</sup> After the break-up of SFRY with the damages of the system of Bosnia and Herzegovina in a war in the '90s, the UCTE system was broken in two zones. Nevertheless, the re-connection of the system with the first synchronous zone was successfully performed in 2004 and now the UCTE norms and standards are again fully applicable in the region. It is only Albania's electricity system which has been underdeveloped for decades and whose transmission system was never connected to UCTE. Bulgaria and Romania on the other hand, are in a more advanced phase with their approximation to the EU because of their earlier implementation of the EU Directives as part of their accession negotiations.

Nevertheless, the borders of the electricity market in the region are congested and bottlenecks exist. The case of Macedonia may serve as an example. The capacity for exchange of Macedonia at the moment is close to the peak load of the internal system, and therefore investment in new inter-connections is necessary to increase the diversity and security of Macedonia's electricity exchange and for overcoming the congestions in the electricity market in the region.<sup>91</sup> This is of great importance for a small country as Macedonia, which is in the middle of the SEE region and which is dependant on import of electricity (characteristics shared by most of the SEE countries). The existing high voltage network of Macedonia is connected on 400kV level with the systems of Greece and Serbia, but the existing capacities are small and not enough to prevent congestions and better flow of electricity. With regard to the East–West interconnections, since 30.10.2005 there are two 110kV connections operating between Macedonia and Bulgaria and another 400kV transmission line is under construction. Macedonian transmission system for the moment is not connected only with one neighbouring country, Albania. There are projects for strengthening the interconnections by upgrading the existing line North–South and

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<sup>89</sup> The "Union for the Co-ordination of Transmission of Electricity" (UCTE) is an association of transmission system operators in continental Europe. For further details, see: <http://www.ucte.org/> (last visited: 28.01.2009).

<sup>90</sup> Due to the close economic collaboration between the SEE countries in the past, "common exit towards economic integration in the world" is preferable. See: Qerimi, Q. *Southeast Europe's EU integration: Dreams and realities*, South East Europe Review for Labour and Social Affairs, issue: 04 / 2002, pages: 43-56.

<sup>91</sup> Energy Community Secretariat, Statement on security of supply – Republic of Macedonia, Skopje, 2007.

establishing new one East–West.<sup>92</sup> By finishing all the planned projects the system of Macedonia not only will be connected with the systems of all the neighbouring countries, but will also enlarge the possibilities for exchange of electricity in the region.

This is just one example of the necessity for investment in transmission lines and interconnections, which total amount for the SEE region is estimated on EUR340 millions in GIS.<sup>93</sup> The criteria for transmission investment in SEE are covered by the TEN-E Guidelines,<sup>94</sup> GIS (cost-reflectivity and consideration of the region as an interconnected power system) and South Eastern Cooperative Initiative - SECI (technical and economic criteria for transmission network investment).<sup>95</sup> The priority plans made by the countries from the region should ensure the complementarity of state and regional projects, but the projects shall clearly have regional focus.<sup>96</sup>

### 3.2.3. Challenges on the road to establishing a regional energy market

The coins always have two sides; likewise, the benefits deriving from the regional cooperation in the establishment of a REM are not free from certain challenges and obstacles. After explaining the common problems and the potential for regional integration, as well as the benefits that could be achieved by that integration, the motivation for reforms in the energy markets for the countries in SEE and the commitment to create regional energy market could not be fully understood without brief explanation of the broader context and the challenges that these countries are facing and which have an impact on the achievement of their final goal.

#### *3.2.3.1. CEE v. SEE*

Unlike the reforms undertaken in Central and Eastern Europe, which were focused on establishment of transparent, democratic institutions to economic reform and recovery of the economic decline resulting from the dissolution of the Soviet Union, the countries from the SEE had to go through a process of recovery from the political conflicts and wars that took

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<sup>92</sup> For the main transmission projects, see: Energy Community Secretariat, Statement on security of supply – Republic of Macedonia, Skopje, 2007, *supra* at 31.

<sup>93</sup> Generation Investment Study (GIS), Final report, 31.12.2004, *supra*. at 21.

<sup>94</sup> TEN-E Guidelines, *supra*.

<sup>95</sup> In addition, an Infrastructure Steering Group operates as an instrument to support the development of infrastructure within a regional approach. The second most represented sector is energy, after transport being the first, with a cost of € 1.7bn, or 33.15%, and spread between twelve projects (eleven electricity projects and a gas, oil and heating district project). For more details, see: Qerimi, Q., Sergi, B., *The European Union and its prospective enlargement to the southeast*, *supra* at 24.

<sup>96</sup> European Commission: Strategy Paper on the Regional Electricity Market in South East Europe and its Integration into the European Union Internal Electricity Market, *supra* at 7.

place in the 1990s in the region. Therefore, not the market reforms and democratic governance, but conflict prevention and reforms for establishing the stability and restructuring of the physical infrastructure took place in the last decade.<sup>97</sup> Several of the countries in SEE are still undergoing the process of defining borders and establishing sovereignty.<sup>98</sup>

Beside this major difference, in a recent paper from the European Policy Centre,<sup>99</sup> other issues these two regions different have been identified. The political and social consensus that backed up the process of EU accession in the CEE made also the costs of reform more acceptable. In these countries, there was a shared and strong commitment to the idea of the “return to Europe”, and the drive towards EU integration meant an irreversible escape from Soviet/Russian domination.<sup>100</sup> On the other hand, as the countries of SEE did not “suffer” under the Yugoslavian communism do not have the united need to converge towards the idea of the European family.<sup>101</sup> Moreover, some of the SEE countries, such as Serbia and Bosnia and Herzegovina, still could be seen as not decisive neither about their future and therefore the reforms that shall be undertaken in those countries could not be accepted easily.<sup>102</sup> In addition, the economy of the CEE countries made it easier for a political consensus to be achieved, whereas the low Gross Domestic Product (GDP) growth rate of the SEE countries makes that objective more difficult.<sup>103</sup> During the last decade, a different level of foreign direct investment is noticeable in the two regions. According to some authors, the explanation should be found in the isolated geographical position of the SEE countries, whereas according to others the reasons were related to the slow establishment of the market oriented economy.<sup>104</sup> Moreover, the trade imbalance and the high level of import make the

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<sup>97</sup> ERLER, G., *The Stability Pact: The Stability Pact, the Stabilisation and Association Process and the New EU Strategy: An Attempt to Set out the Political Context*, SÜDOSTEUROPA Mitteilungen 04/2004, p.10-29: “*The Stability Pact was seen as an engine to pull the entire crisis-torn region out of the vicious circle of chronic conflicts between neighbours and outbreaks of ethnically motivated violence after the ordeal of four wars, worldwide attention was focused on this first-ever plan to use the promotion of regional cooperation as a strategy for consolidating peace as well as for crisis prevention*”.

<sup>98</sup> Van Meurs, W. *The Stability Pact and economic strategies for the Balkans*, *supra* at p. 11.

<sup>99</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra*

<sup>100</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra* at 32

<sup>101</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra* at 32

<sup>102</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra* at 18

<sup>103</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra* at 33

<sup>104</sup> Qerimi, Q., Sergi, B., *The European Union and its prospective enlargement to the southeast*, *supra* at 22 and Sergi, B., *FDI and the Balkans: A regional investment agency and regional centred economic choices to shape this decade*, South East Review, issue: 01-02/2003, pp. 7-16 at 8. With regard to the FDI in Macedonia, see:

economic integration within the SEE region and with the rest of Europe less strong than in CEE, which have managed to redirect its trade from East to West in a relatively short period of time.<sup>105</sup>

Finally, according to Grupe and Kušić, “unlike in central Europe, where regional integration was a consequence rather than a precondition for EU integration, for the *Balkans*, for political and economic reasons, i.e. their tendency to national insularity and political instability, *regional integration is a must*.”<sup>106</sup>

### 3.2.3.2. *The needs and the expectations of the developing v. developed countries*

It should be noted that by accepting the binding obligations stemming from the EnCT, the countries from SEE are facing challenges and disincentives as well. Due to the fact that these countries are developing countries, they have specific needs which are in many aspects different from the needs of the developed countries such as the Member States of the EU.<sup>107</sup> Nevertheless, exactly the model of liberalisation of the energy markets in the EU is the model that SEE countries are given to follow. With regard to some economic policies, it has been acknowledged that some of the EU harmonisation policies have been highly effective and successful for the emerging market economies of the CEE, but it was held that they may distort reform processes in the less developed weak states of SEE.<sup>108</sup> That should be born in mind as an issue which makes energy liberalisation in SEE different from that one taking place in other developing countries. Therefore, the energy market reforms in the region are said to be “bold experiment in Europeanisation”<sup>109</sup> or even an “experiment for the whole world”, closely watched by the many donors such as the World Bank, the European Bank for Reconstruction and Development (EBRD) and the EU.<sup>110</sup>

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Petkovski, M., *External economic relations of the Republic of Macedonia*, South East Europe Review for Labour and Social Affairs, issue: 03 / 2001, pages: 113-123.

<sup>105</sup> European Policy Centre, Task Force on the Balkans in the EU: The Balkans in Europe: containment or transformation? Twelve ideas for action, *supra* at 34.

<sup>106</sup> Emphasis added, see: Grupe, C. and Kušić, S., Intra-regional cooperation in the Western Balkans: Under which conditions does it foster economic progress? *supra* at 7.

<sup>107</sup> For assessment of the application of energy models from developed to the developing countries, taking into consideration the specific characteristics of the later, see: URBAN, F. et al., *Modelling energy systems for developing countries*, Energy Policy 35, 2007, 3473–3482. For the specificities of the developing countries see further: JAMSB, T., *Reform and Regulation of the Electricity Sectors in Developing Countries*, Working paper CMI EP 08/DAE 0226, 2002.

<sup>108</sup> Van Meurs, W., *The next Europe: South-eastern Europe after Thessaloniki*, South East Europe Review, issue: 03 / 2003, pp: 9-16, at 15.

<sup>109</sup> WRIGHT, K. *The Energy Community of South East Europe: Challenges of, and Obstacles to Europeanisation*, CCP Working Paper 08-4 at 18.

<sup>110</sup> POLLITT, M. *Evaluating the Evidence on Electricity Reform: Lessons for the South East Europe (SEE) Market* CCP Working Paper 08-5, at 3. With regard to the technical assistance provided by the donors, see the example of GTZ assistance to Albania and Macedonia: *Albania and Macedonia from a perspective of a technical*

With regard to the challenges that SEE countries are facing, one of the most important issues is the necessity to minimise the price distortions and to introduce cost-reflective tariffs if investments are to be attracted. Due to the fact that highly subsidised tariffs well below the economic level are in place in almost all SEE countries, as in many other developing countries, the experience has shown that the reforms will bring raising the prices.<sup>111</sup> This might lead to the expectation that the consumers in a country with low production costs may loose from integration even if total welfare in that country increases; for example they may experience higher prices if it is cheaper for producers to sell to consumers at more distant locations in the market.<sup>112</sup> Furthermore, the privatisation which is supported by the World Bank and other donors is usually undertaken as part of the reforms in many developing countries. However, even though it is expected that privatisation will have positive impact on the economic growth and will lead to better production processes, some developing countries which have implemented this policy as a condition for getting grant or a debt relief from the financial institutions, experienced negative effects on the prices, employment rates and on the welfare of the great deal of their population.<sup>113</sup>

Moreover, the differences between the developed and developing countries, briefly addressed above, are very relevant when regional integration of electricity systems is discussed.<sup>114</sup> Lowering the prices and improving the efficiency of the electricity system are the benefits which could be expected from the liberalization in the developed countries, but same could not be done for the developing countries. In the later, even though the prices will increase substantially in order to be raised to economic level, the benefit that deserves appreciation may be the fact that transparent and effective process of regulation, which is independent from the electricity industry and the government's influence, is going to be introduced for the first time. Furthermore, privatization which, even though is not required during the reforms, and as explained above may bring a price increase, allows solving many problems which are characteristic for the developing countries only (such as overstuffed, non-

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*assistance organisation – Some remarks from GTZ experts, South East Europe Review for Labour and Social Affairs, issue: 01 / 2004, pages: 35-44.*

<sup>111</sup> For an analysis of the impact on prices of certain liberalisation measures (unbundling, independent regulator, wholesale spot market) in 83 developing countries from Latin America, Asia, former Soviet Union and Eastern Europe, see: NAGAYAMA, H. *Effects of Regulatory reforms in the Electricity Supply Industry on Electricity Prices in Developing Countries*, Energy Policy, 35, 2007, pp.3440-3462.

<sup>112</sup> DEITZ, et al., (2008), *supra*.

<sup>113</sup> BAYLISS, K. *Privatisation and Poverty: the Distributional Impact of Utility Privatisation*, Annals of Public and Cooperative Economics, 73:4, 2002, pp.603-625

<sup>114</sup> POLLITT, M., (2008), *supra*

payment and theft of electricity), which could not be solved by any government of a developing country without dissatisfaction and opposition from the population.

Therefore, privatization, establishment of a wholesale market and independent regulation are considered to be key elements of reforms in a developing country. Moreover, addressing the problems such as necessity for investment, decreasing the level of power shortages, system losses and non-payment are important indicators to be taken into account when reforms are undertaken in developing countries, as opposed to lowering prices, rate of switching and costs of regulation which are indicators for reforms in the developed countries.<sup>115</sup>

#### 3.2.4. The EU membership perspective

When explaining the motivation of the SEE countries, it is very important to be held in mind that all countries signatories of the EnCT have a real perspective for membership in the EU. Besides Romania and Bulgaria, which are Member States since 01.01.2007, Croatia is engaged in accession negotiations and Macedonia obtained a candidate status,<sup>116</sup> whereas the other countries are potential candidates. The European Council in Feira in June 2000<sup>117</sup> for the first time expressed the view that all countries from the Western Balkans are potential candidates for EU membership, which was later confirmed with the Thessaloniki Agenda in June 2003.<sup>118</sup> The rapprochement of the Western Balkans towards the EU is developed under the SAP initiated in 1999, which is a policy framework of the EU accompanying the countries all the way to their final accession after fulfilling all the Copenhagen criteria from 1993.<sup>119</sup> The EU's regional approach towards the Western Balkans clearly expressed in the Declaration of the Zagreb Summit in November 2000<sup>120</sup> is the main characteristic of the SAP. After the 2006 Communication<sup>121</sup> in which the Commission assessed the progress made after the Thessaloniki Summit, and the countries' Progress Reports published on annual basis, in

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<sup>115</sup> POLLITT, M., *ibid.*

<sup>116</sup> EU Presidency Conclusions – European Council, 15-16.12.2005, 15914/1/05 REV 1

<sup>117</sup> European Council, Presidency Conclusions, Santa Maria da Feira European Council, 19-20.06.2000, available at: [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/00200-r1.en0.htm](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/00200-r1.en0.htm) (last visited: 28.01.2009).

<sup>118</sup> Thessaloniki Agenda: Moving towards European Integration. See: [http://ec.europa.eu/enlargement/enlargement\\_process/accession\\_process/how\\_does\\_a\\_country\\_join\\_the\\_eu/sap/thessaloniki\\_agenda\\_en.htm](http://ec.europa.eu/enlargement/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/thessaloniki_agenda_en.htm) (last visited: 28.01.2009).

<sup>119</sup> European Council, Presidency Conclusions, European Council in Copenhagen, 21-22.06.1993

<sup>120</sup> See: [http://ec.europa.eu/enlargement/enlargement\\_process/accession\\_process/how\\_does\\_a\\_country\\_join\\_the\\_eu/sap/zagreb\\_summit\\_en.htm](http://ec.europa.eu/enlargement/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/zagreb_summit_en.htm) (last visited: 28.01.2009).

<sup>121</sup> European Commission, Communication from the Commission - The Western Balkans on the road to the EU: consolidating stability and raising prosperity, Brussels, 27.01.2006, COM (2006) 27final.

March 2008 the Commission adopted new Communication<sup>122</sup> enhancing the existing initiatives and adopting new ones in order to accelerate the progress of these countries towards EU membership. One of the enhanced priorities in the last Communication was the regional cooperation, covering the Energy Community,<sup>123</sup> which has been said that is an “issue specific extension of the pre-accession status”.<sup>124</sup> This was another expression of the strong commitment to the European perspective of these countries,<sup>125</sup> including the establishment of regional energy market.

Measuring the benefits and challenges, it has been held that all the difficult but necessary reforms would not be possible without the clear membership perspective of all the countries from the SEE region.<sup>126</sup> The perspective of accession to the EU explained above, and not the European financial funding as well as the funding by other donors, has been the key driving force for undertaking these difficult reforms. The Stability Pact Coordinator argues that even though the donor support is necessary, it has proven not to be sufficient in moving the reform process along.<sup>127</sup>

Finally, the economic impact of the creation of the Energy Community would be to create a larger and predictable market which should be attractive for investors, but its political significance should not be underestimated, neither.<sup>128</sup> Establishment of the Energy Community represents a very important political step in a key-economic sector before accession of the SEE countries to the EU. It is moreover, a part of the emerging regional economic strategy, giving it a “true credibility.”<sup>129</sup> That is why the Energy Community was compared to the European Coal and Steel Community which paved the way for the European Community more than fifty years ago.<sup>130</sup> In the paragraphs that follow, the establishment of the Energy Community will be discussed in more detail through an overview of the Athens Memoranda and on the Energy Community Treaty.

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<sup>122</sup> European Commission, Communication from the Commission to the European Parliament and the Council, Western Balkans: Enhancing the European Perspective, Brussels, 05.03.2008, COM (2008) 127final.

<sup>123</sup> European Commission, Press Release: Regional cooperation: an overview of main activities, Brussels, 05.03.2008, MEMO/08/143.

<sup>124</sup> DEITZ, L., et al. *The Energy Community of South East Europe: Challenges of, and Obstacles to Europeanisation*, *supra* at 7.

<sup>125</sup> European Commission, Press Release: Western Balkans: Enhancing the European Perspective, Brussels, 05.03.2008, IP/08/378.

<sup>126</sup> BUSEK, E., *The Stability Pact: Adapting to a Changing Environment in South Eastern Europe – Successes and Remaining Challenges*, SÜDOSTEUROPA Mitteilungen 04/2004, at 23, and HOMBACH, B., *The Stability Pact – Lessons for the Future*, SÜDOSTEUROPA Mitteilungen 04/2004, at 27.

<sup>127</sup> BUSEK, E., *ibid*

<sup>128</sup> Stability Pact for South Eastern Europe, Fact Sheet: EU / South Eastern Europe Energy Community.

<sup>129</sup> BUSEK, E., *The Energy Community Treaty: Securing the Energy Supply in Southeast Europe and in the EU*, *supra*

<sup>130</sup> BUSEK, E., *The Stability Pact: Adapting to a Changing Environment in South Eastern Europe – Successes and Remaining Challenges*, *supra*

## **4. The Athens Process: Establishment of the Energy Community**

### **4.1. Athens Memoranda**

In March 2002, the European Commission with the support of the Stability Pact<sup>131</sup> started the so-called Athens Process by proposing the creation of a regional SEE energy market to be eventually integrated into the EU energy market. In November 2002, a Memorandum of Understanding<sup>132</sup> (Athens Memorandum 2002) was signed by nine countries from the region, with the Commission and the Stability Pact acting as sponsors. The Athens Memorandum 2002 set up a number of institutions: Ministerial Council, the Permanent High Level Group (PHLG) and the South East Europe Electricity Regulation Forum (Athens Forum).<sup>133</sup> Two years later in 2004, after a proposal by the PHLG, the South East European Regulators Board for Electricity and Gas (Energy Community Regulatory Board - ECRB) was established by the Ministerial Council with the Tirana Declaration.<sup>134</sup>

This cooperation was further expanded to the gas sector through a second Memorandum of Understanding<sup>135</sup> (Athens Memorandum 2003) in December 2003. Under these Memoranda the SEE countries committed themselves to adopt EU-inspired norms in their energy sectors. These documents did not constitute an agreement and were not binding for the parties. Moreover, these Memoranda representing the political intent did not provide for any legal commitment with regard to the parties, sponsors and the donors.

### **4.2. Treaty Establishing the Energy Community for South East Europe (EnCT)**

In the Athens Memorandum 2003, it was stated that the participants will seek to replace it with a legally binding agreement. This was done on 25.10.2005, by signing the Treaty establishing the Energy Community<sup>136</sup> between the European Community on the one hand, and its nine partners in SEE on the other. The EnCT, which has been negotiated by the European Commission in accordance with the Council Decision of 17.05.2004, has been

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<sup>131</sup> The Stability Pact is a political declaration of commitment and a framework agreement on international co-operation to develop a shared strategy for stability and growth in SEE. It is not a new international organisation nor does it have any independent financial resources. In February 2008, handed over responsibility for co-ordinating and monitoring regional co-operation processes in SEE to the newly created Regional Co-operation Council (RCC) which is based in Sarajevo. For further information, see: <http://www.stabilitypact.org/> (last visited: 28.01.2009).

<sup>132</sup> Memorandum of Understanding 2002, *supra*

<sup>133</sup> For detailed information on the institutions, see: <http://www.energy-community.org/> (last visited: 28.01.2009).

<sup>134</sup> Ministerial Council Decision on Establishing the South East European Board for Electricity and Gas, Tirana Declaration, 01.06.2004

<sup>135</sup> Memorandum of Understanding, 2003, *supra*

<sup>136</sup> Energy Community Treaty, *supra*

signed<sup>137</sup> under the EC Treaty provisions with regard to the functioning of the internal market (article 95), making a reference to the provisions for freedom of establishment, services, competition and state aids, as well as environment. This Treaty entered into force on 01.07.2006 after being ratified by all the signatories.<sup>138</sup> It was the first time in the history that all of these states and territories have signed a legally binding treaty. It has been held that the EnCT was consciously modelled on the European Steel and Coal Community that in the 1950s was the genesis for the EC.<sup>139</sup>

The EnCT aims at regulating the relations between the countries signing it, in a manner that would create a common legal and regulatory framework for the energy markets and would allow trading energy across their borders. Its objective was the creation of a single energy market, including the coordination of mutual assistance in case of serious disturbance to the energy networks or external disruptions, and which may include the achievement of a common external energy trade policy.<sup>140</sup> The EnCT would encompass the principles and policies of the EC, taking into considerations the specificities of all parties. This objective would be achieved through ensuring that the SEE countries adopt the *acquis communautaire* in areas such as energy, environment, competition and renewables.

The *acquis* on environment covers: the Environmental Impact Assessment Directive 85/337/EEC,<sup>141</sup> the Directive 1999/80/EC for reduction of sulphur content of fuels<sup>142</sup> and the Large Combustion Plants Directive 2001/80/EC,<sup>143</sup> while the *acquis* on renewables is related to adoption of the Directives for promotion of renewables<sup>144</sup> and promotion of the use of

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<sup>137</sup> Council Decision of 17 October 2005 on the signing by the European Community of the Energy Community Treaty, 2005/905/EC, OJ L 329, 16.12.2005, p. 30

<sup>138</sup> Council Decision of 29 May 2006 on the conclusion by the European Community of the Energy Community Treaty, (EC) No (2006) 500, OJ L 198, 20.7.2006, p. 15 The Treaty was ratified by the Republic of Macedonia on 03.05.2006 by the Law for Ratification of the Treaty for Establishing the Energy Community, published in the Official Gazette No. 59/2006 on 12.05.2006.

<sup>139</sup> European Commission, Press Release: The EU and South East Europe sign a historic treaty to boost energy integration, Brussels, 25.10.2005, IP/05/1346 and European Commission, Press Release: An Integrated Market for Electricity and Gas across 34 European Countries”, 25.10.2005, MEMO/05/397.

<sup>140</sup> Article 2 Energy Community Treaty, *supra*.

<sup>141</sup> 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 Directive 97/11/EC of 3 March 1997 and Directive 2003/35/EC of the European Parliament and of the Council of 26 May 2003.

<sup>142</sup> Council Directive 93/12/EEC of 23 March 1993 relating to the sulphur content of certain liquid fuels, OJ 74/L, 27.3.1993, p. 81–83

<sup>143</sup> 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, OJ 309/L, 27.11.2001, p. 1–21.

<sup>144</sup> 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 electricity market, OJ L 283, 27.10.2001, p. 33–40.

biofuels.<sup>145</sup> The energy *acquis* covers the Directives from the second package for liberalization of the energy markets, the Electricity and the Gas Directives, as well as the Regulation for cross-border trade in electricity.<sup>146</sup> In addition, adoption of the EC competition rules, in particular articles 81, 82 and 87 EC are applicable<sup>147</sup> in order to prevent trade between the Contracting Parties to be affected.<sup>148</sup>

Additionally to the adoption of the EC *acquis* on energy, the other obligations taken by the SEE countries in the sphere of electricity particularly may be summarized as follows:

- establishing common rules for the functioning of the national electricity markets and establishing mechanisms for crisis situations – safeguard measures,<sup>149</sup>
- establishing the REM itself – prohibition of taxes and quantitative restrictions for import and export of electricity,<sup>150</sup> common rules for trade with third countries<sup>151</sup> and
- opening the markets: all non-household by 2008 and all household markets by 2015).<sup>152</sup>

The EnCT formalises the institutions established by the Athens Memorandum 2002 and the Tirana Declaration. *Firstly*, the Ministerial Council which is composed of Ministers of Energy of the Contracting Parties and the European Commissioner for Energy takes place every six months and it takes strategic decisions and gives directions to the Treaty or formally adopts or endorses secondary legislation. The Presidency of this Council rotates on a six monthly basis. *Secondly*, the PHLG is composed of representatives of the Ministers of Energy of the Contracting Parties and the European Commission. The group prepares the Ministerial Council and ensures the follow up of its decisions. The Commission co-chairs this group along with the President in office. There is *thirdly*, the Treaty Secretariat which has its seat in Vienna and is the central co-ordinating body for the EnCT. It is also responsible for co-ordinating international donors, validating work and proposing technical, legal and regulatory developments. The Regulatory Board - ECRB is the *fourth* institution, which is based in Athens and comprises representatives of the Energy Regulatory Authorities of each Contracting Party and the European Community. It considers issues of regulatory co-operation and develops as a regulatory decision making body and/or a dispute settlement

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<sup>145</sup> Directive 2003/30/EC of the European Parliament and of the Council of 8 May 2003 on the promotion of the use of biofuels or other renewable fuels for transport, OJ L 123, 17.5.2003, p. 42–46.

<sup>146</sup> Article 11 Energy Community Treaty, *supra*.

<sup>147</sup> Article 18 Energy Community Treaty, *supra*.

<sup>148</sup> According to article 25 Energy Community Treaty, the Energy Community may take measures to implement amendments of the *acquis communautaire*.

<sup>149</sup> Article 36-39 Energy Community Treaty, *supra*.

<sup>150</sup> Article 41 Energy Community Treaty, *supra*.

<sup>151</sup> Article 43 Energy Community Treaty, *supra*.

<sup>152</sup> Annex I Energy Community Treaty, *supra*: Timetable for the Implementation of the EC Directives 2003/54 and 2003/55, and the EC Regulation 1228/2003, of 26.06.2003.

mechanism. The European Commission considers its role as central to the operation of the enlarged market. *Fifthly*, similarly to the Florence and Madrid Fora in the EU,<sup>153</sup> there is a Forum set up by the Energy Community Treaty, which provides a possibility for discussion including all stakeholders and is called the Athens Forum. According to the Commission, the institutions established by the Energy Community are analogues to those in the EU such as the Energy Council, Energy Working Group of the Council and the Madrid and Florence Fora.<sup>154</sup>

The EnCT is concluded for a period of 10 years from the date of entry into force. The Ministerial Council acting by unanimity, may decide to extend its duration. If no such decision is taken, the Treaty may continue to apply between those Parties who voted in favour of extension, provided that their number amounted to at least two thirds of the Parties to the Energy Community.<sup>155</sup>

## 5. Conclusion

After explaining the motivation for participating in the SEE REM of the EC on the one hand and the countries from SEE on the other, and providing an overview of the establishment of the Energy Community it could be concluded that there are strong driving forces on both sides, which led to development of the idea and now keep forcing the implementation of the EnCT in practice.

The EU's energy policy has three main objectives: competitiveness, security of supply and sustainability. In that line, an article by Hooper and Medvedev it was stated that the motivations for regional trade in SEE have to be such as to meet these three energy policy objectives.<sup>156</sup> With regard to the *competitiveness*, it is relevant that due to the fact that in small electricity markets such as the national electricity markets in SEE, competition could not be easily introduced or could not be introduced at all, the regional integration provides a possibility for achieving that objective. Furthermore, the regional integration lowers the dependence on external factors and brings diversification of sources, which is in line with the second objective, *security of supply*. The fact that power supply reliability is higher in

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<sup>153</sup> For detailed information see: [http://ec.europa.eu/energy/gas\\_electricity/forum\\_electricity\\_florence\\_en.htm](http://ec.europa.eu/energy/gas_electricity/forum_electricity_florence_en.htm) and [http://ec.europa.eu/energy/gas\\_electricity/forum\\_gas\\_madrid\\_en.htm](http://ec.europa.eu/energy/gas_electricity/forum_gas_madrid_en.htm) for electricity and gas, respectively (last visited: 28.01.2009).

<sup>154</sup> European Commission, DG TREN: Discussion and Consultation Note, The Regional Energy Market in South East Europe and its Integration into the European Community's Internal Energy Market, The Athens Forum, 3-4.06.2004.

<sup>155</sup> Article 97 Energy Community Treaty, *supra*.

<sup>156</sup> HOOPER, E. and MEDVEDEV, A. (2008).

interconnected systems as well as the better optimization of the national fuel mix, contribute to the *sustainability* objective. Therefore, it could be concluded that the regional integration of the SEE energy markets and the establishment of a REM is very important for the EU and for its energy policy objectives.

As for the SEE countries, due to the common problems that they share and the many regional cooperation programmes already launched in other fields, it could be concluded that there is great potential for regional integration in the energy field as well. The Energy Community, introduced in this paper is a very good example. Nevertheless, when undertaking steps in that regard, the specificities of the region need to be taken into account. The specific needs of the SEE countries as developing countries, which as it was shown differ from the developed countries, such as the Member States of the EU, should be paid due attention. This is especially relevant when taking into consideration that, unlike the other developing countries which are relatively free in choosing the model of reforming their electricity markets, the SEE countries are given a specific model to follow – the model of the EU energy market liberalization. Undertaking the reforms, which in many aspects happened to be difficult also for the EU Member States, could not be accepted without the clear membership perspective of the SEE countries.

In addition, other specificities such as the common history, mutual relations, economy and past integration are to be borne in mind when making any prospects of regional integration in the SEE. As explained in the preceding paragraphs, unlike the CEE countries which united towards the clear objective of joining the EU undertook market reforms in the last decade, the SEE countries “lost” a decade in ethnic conflicts and wars. Now, despite the different pace of acceding to the EU and the different pace of reforms in each of the countries from the region, the membership perspective is the greatest motivation for the SEE countries to accept the reforms in their systems, including the difficult energy liberalisation reforms.

The membership motivation argument of this paper has been supported strongly by the political science literature, where “the ‘carrot’ of accession” is seen to provide “the incentives for following the ‘sticks’ of appropriate policy-behaviour, one of which is that the SEE countries ‘establish *normal* relationships between themselves”.<sup>157</sup> Having in mind that these *normal* relationships could be established through bilateral and regional mechanisms supported by the EU, this paper has introduced the Energy Community as an example of the latter.

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<sup>157</sup> Kavalski, E., “*The western Balkans and the EU: the probable dream of membership*”, *supra* at 204.