

ANNUAL REPORT

ON THE ACTIVITIES OF THE ENERGY COMMUNITY TO THE PARLIAMENTS

The current report has been prepared following the requirements of Article 52¹ of the Energy Community Treaty ("the Treaty"), according to which the Ministerial Council of the Energy Community is requested to present an annual report on the activities of the Energy Community to the European Parliament and the Parliaments of the Adhering Parties and of the Participants.

The report summarizes the Energy Community's activities for 2011, making also concrete links to planned and undertaken steps in 2012. It focuses on the following major issues:

- Enlargement of the Energy Community;
- Implementation and Development of the Energy Community Acquis;
- Regional Approach and Regional Market Developments.

More detailed information, related to the Energy Community developments in all aspects is available on the website www.energy-community.org.

1. ENLARGEMENT OF THE ENERGY COMMUNITY

In 2011 the Energy Community underwent its second enlargement.

Following the agreement of the Ministerial Council of the Energy Community in December 2009 and September 2010 as well as internal ratification, on 1st February 2011 Ukraine became a Contracting Party of the Energy Community.

In October 2011, Armenia acquired Observer status and Poland became a Participant.

2. IMPLEMENTATION AND DEVELOPMENT OF THE ENERGY COMMUNITY ACQUIS

In the reporting period, all Contracting Parties continued implementing the legal framework as outlined by the Treaty (energy, environment, renewables, competition, security of supply and energy efficiency). The development of a single energy market and improving security of supply remained key principle objectives.

¹ Article 52 – The Ministerial Council shall submit an annual report on the activities of the Energy Community to the European Parliament and to the Parliaments of the Adhering Parties and of the Participants.

In 2011, the Secretariat published its Annual Implementation Report; such a report shall be publicly available also for 2012. A key conclusion of the 2011 report was that implementing the acquis for real constitutes a great challenge for the Contracting Parties. It requires constant and deep reforms, first and foremost domestically. The Secretariat has assisted the Contracting Parties in this task, and will continue to do so. During 2011, some Contracting Parties, most notably the former Yugoslav Republic of Macedonia and Serbia made significant progress in transposing energy acquis. However, the lack of implementation and application of these elements continues to be problematic for the emergence of open domestic and regional markets. Secondary legislation needs to be improved in basically all Contracting Parties as a precondition for progressing in establishing real markets. In the reporting period, the Secretariat has focused, and will continue to do so, particularly on regulated prices and non-cost-reflective tariffs, as well as the removal of barriers for domestic and regional electricity wholesale markets.

In the period 2011 – 2012 positive developments were reported relevant to the process of implementation of the Acquis in the electricity and gas sectors in several Contracting Parties.

Recently updated legal acts in electricity in the Former Yugoslav Republic of Macedonia, Montenegro, Serbia and Kosovo² pushed forward the completion of missing secondary legislation and regulatory rules. In the same context Moldova and Ukraine were active in revisiting their primary laws – the new Law on the electricity market of Ukraine which is currently in preparation could be a long-expected leap forward from its fragmented and incomplete framework and a breakthrough in this part of the Energy Community. Under EU (IPA 2008) technical assistance Bosnia and Herzegovina went through a comprehensive review of its electricity primary legislation on all administrative levels and stepped into coordinated efforts to draft proposals for the required amendments in the course of 2012 – parallel activities this direction continue in both Entities. In this period Albania started a long-expected effort to develop its new power sector law enforcing a compatible market model. Croatia, having completed its formal obligation on energy legislation in its process of EU accession, pushed ahead with full implementation of the Third Legislative Package in its jurisdiction. Altogether, the level of legal compliance has advanced and matured, and the treatment of infringement cases has become relevant and important instrument for enforcement of the Treaty.

In the area of natural gas, the period 2011 – 2012 brought comparable progress with the Energy Laws in the Former Yugoslav Republic of Macedonia and Serbia. Notwithstanding continuous activities on the secondary legislation, most of the Contracting Parties, including Moldova and Ukraine who joined the Energy Community only recently, have relatively developed primary legal acts – despite the fact that Albania, Montenegro and Kosovo* are still without any gas supply infrastructure. Ukraine recently introduced amendments aimed to support structural reforms of its gas market. The gas market framework of Bosnia and Herzegovina remains fragmented and incomplete, as one of the main challenges for future progress of the Energy Community in this domain. Despite the progress in transposition of the acquis and regular improvement of the secondary legislation and regulatory rules, the process of opening of the energy markets in practical terms has delivered less than expected. The calendar for opening of the markets includes transitional periods rendering eligibility as optional. On the account of supporting the public interest regulated supply prices are kept available to all classes of customers in most Contracting Parties – with the exception of Croatia and to some extent the

² This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo declaration of independence.

Former Yugoslav Republic of Macedonia. The energy is still dominantly provided by the incumbent supplier (generator) – not necessarily under competitive and transparent conditions. Such prices are notably below the level to allow new suppliers to enter the market. Balance responsibility and settlement procedures do not apply market-based criteria. Customer's switching procedures are not sufficiently supported as well. Some progress is made through secondary legislation developed either on own initiative or through Implementation Partnerships of the Secretariat established with some Contracting Parties.

All in all, the bulk of the secondary legislation is either in amendment or still requires one. Transmission Grid Codes shall need review in order to comply with market-based balancing frameworks - as soon they are enforced, and with the development of more sophisticated trading platforms - to be established in the process of regional market integration. In this context, Market Rules are the most missing pieces of secondary legislation. In electricity, Distribution Codes shall need to address the needs of the legally unbundled distribution operators – as soon as they are unbundled. Problems with the partnership with ENTSO-e exist in Albania, Moldova, Ukraine and Kosovo*) – extensive efforts are under way to overcome this long-term task. In some cases (such as the Former Yugoslav Republic of Macedonia, Bosnia and Herzegovina, Ukraine and Kosovo*) the operation of a transmission system (either gas or electricity) is still burdened by administrative, structural or political disputes.

Network tariffs have been set and approved by the regulators in all Contracting Parties, at largely diverse levels. Regulated end-user prices are set for a broad scope of customers, in many Contracting Parties indicating existence of extensive cross-subsidies. The methodologies behind such tariffs are confirmed as compliant however their application is less transparent than optimal, resulting in disputable effects on new investments and security of network operation. The problem of extraordinary high level of losses in distribution is notified in Albania, Ukraine and Kosovo*. In some cases (in electricity – Albania, Kosovo*) this is seconded by significantly low collection rate undermining the security of operation and commercial viability of the utilities.

The acquis on security of energy supply is transposed in a more fragmented way and usually relies on diverse set of legal acts primarily related to such matter as concessions, confidentiality, spatial planning, public procurement etc. – hardly in favor to the core subject matter of the energy acquis. In general, enforcement of transparent and effective frameworks for infrastructure planning, transparency and authorization is imminent for all Contracting parties.

In all, the progress in the Period 2011 – 2012 is significant yet formal – the political focus is insufficiently present in the case of energy reforms and practical support to the liberalization of the energy markets. In all Contracting Parties currently main interest and driving initiatives come from industry, traders and the investment community rather than from the policy makers, regulators or system operators.

Building on the identified vast renewable energy resources and the benefits for the sustainable development of the communities, the policy makers from almost all the Contracting Parties recognised the promotion of energy produced from renewable sources as a strategic goal for the development of the energy sectors across the Energy Community. However, the legal and regulatory frameworks to support renewable energy projects still remain to be finalised to ensure access to finance for investments in renewable energy projects.

In the area of environment, the deadline for transposing the Sulphur in Fuels Directive into national legislation expired by 31 December 2011. Certain progress has been made by the Contracting Parties, although some challenges remain.

Moreover, regarding the preparation for the implementation of the Large Combustion Plants Directive was also in focus of attention. In 2010, an Environmental Task Force was established to provide a platform for consultation and to facilitate the implementation of these two directives in the Contracting Parties. The Task Force started its work in 2011 by holding two meetings that year, focussing on the above challenges.

In the area of energy efficiency, the deadline for transposition the Energy Services Directive and the Energy labelling Directive expired 31 December 2011; most Contracting Parties have made significant progress in transposition, and have adopted their 1st National Energy Efficiency Action Plans. The Energy Performance in Buildings Directive needs to be implemented by 30 September 2012 - the Energy Efficiency Task Force is preparing the path for its transposition in all Contracting Parties.

Dispute settlement under Article 90 of the Treaty continued to play an important role in the Secretariat's activities linked to enforcement. The Secretariat opened cases related to, inter alia, the lack of State aid legislation, non-compliant gas market designs, capacity reserves on electricity interconnectors, non-coordinated capacity allocation, non-cost-reflective network tariffs and others. Coupled with concrete assistance by the Secretariat, most of these cases lead to concrete improvements in national legislation and decision-making.

In terms of developing the acquis further, a key achievement was the decision on implementation of the European Community's "third package" of internal market legislation, incorporated by the Energy Community Ministerial Council in October 2011. This step is of great importance for maintaining homogeneity of energy law in wider Europe. At the same time, the Ministerial Council updated also the acquis on energy efficiency. The adoption of binding acquis Communautaire on renewable energy, on oil and statistics continued to be in the focus of the Community's work. Concrete decisions are expected in 2012.

3. REGIONAL APPROACH AND REGIONAL MARKET DEVELOPMENTS

In 2011, the regional approach in the Energy Community became more prominent.

Following the proposal for a regional energy strategy made by Serbia, a special Task Force was established in October 2011. The Task Force is on the way of completing its work to propose concrete strategy document. It is expected that in October 2012 the Ministerial Council will adopt an Energy Community Regional Energy Strategy. On this ground, energy projects of regional value will be proposed and assessed after the approval of the Strategy document..

2011 brought more intense relations with the newly established regional institutions ACER, ENTSO-E and ENTSO-G. With the support of the Secretariat, gradual concrete involvement of the Contracting Parties' regulatory authorities and TSOs in the work of these institutions is gradually happening.

Substantial work was done in 2011 in relation to the more regional approach in relation to energy security. This concerns both electricity and gas.

In the field of electricity, the preparatory work for the establishment of the Coordinated Auction Office (CAO) brought concrete results in 2011. Within the first half of 2012, after most of the TSOs in the region as well as the Donors committed financially and organizationally, the establishment of a Project Team Company is imminent

In the field of gas, the Energy Community Secretariat in August 2011 officially became a full member of the European Union Gas Coordination Group, which provides now the possibility of presenting and defending the interests of the Contracting Parties in this format. Thus, gas security became an issue concerning the whole of Europe.

In addition to these developments in the area of gas, at the end of 2011, the so-called Gas-to-Power initiative was launched. This provides a frame for concrete considerations both at regional and national level for the usage of gas for electricity production. On this ground, the Secretariat launched a set of missions on national level as to find out the best possible approaches.

The work for establishing a regional electricity wholesale market was boosted by the adoption of a *Regional Action Plan for Wholesale Market Opening in South East Europe*, endorsed by the Regulatory Board, the Permanent High Level Group and network operators (ENTSO-E Regional Group SEE). The goal is to establish a full-fledged regional electricity market in SEE and integrate it with the neighbouring EU market by 2015. Full alignment of the Regional Action Plan with related European activities ensures compatibility. The realisation of the *Regional Action Plan* depends on closing gaps on Contracting Party level as outlined, in particular focussing on balancing rules, cost reflectivity of tariffs, regulated energy prices, single buyer models and unbundling. The Secretariat tackles all of these in parallel through enforcement action or proposal of regional schemes.

5. CONCLUSIONS

2011 represents another very intensive year in terms of the Energy Community developments. Further to the adoption of a new Work Programme and Budget (2012-2013), the year also saw concrete substantial activities and achievements related to the implementation of the Treaty and providing framework for a set of concrete steps in 2012. The process of enlargement within 2011 – both on members' and observers' level – is a clear indication that the Energy Community is a “success story” and “model for regional cooperation” as noted by the European Commission in its report to the European Parliament in March 2011³. As, there is still room for further improvements in all aspects of the Energy Community areas of work, the scheduled activities will be continued. The devotion of the Parties to the Treaty, supported by concrete Work Programme and well planned budget certainly constitute solid background for further achievements.

³ http://www.energy-community.org/portal/page/portal/ENC_HOME/NEWS/News_Details?p_new_id=4381

ANNEX: ABOUT THE ENERGY COMMUNITY

- The Energy Community Treaty entered into force on 1st July 2006. Albania, Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Montenegro, Serbia, Ukraine, the United Nations Interim Administration Mission in Kosovo and the European Union are Parties to the Treaty.
- Armenia, Georgia, Norway and Turkey have status of Observers.
- The general objective of the Energy Community is to create a stable regulatory and market framework in the energy sector in order to:
 - Attract investment in power generation and networks as to ensure stable and continuous energy supply that is essential for economic development and social stability;
 - Create an integrated energy market allowing for cross-border energy trade and linked to the EU market ;
 - Enhance the security of supply;
 - Improve the environmental situation in the region.
- In order to pursue these objectives, the main instrument of the Energy Community Treaty is the implementation of parts of the EU acquis:
 - Key electricity and gas directives and regulations;
 - Key environment directives;
 - Key directives on renewables and biofuels;
 - The main principles of the EU competition policy;
 - Key directives, related to energy efficiency;
 - Major acquis in relation to security of supply.
 - Concrete list of acquis in relation to oil stocks and the new EU RES directive, as well as the legislation under the Third Internal Energy Market Package, are at different stages of current consideration for being implemented.
- The Contracting Parties have the obligation to implement these instruments within specific timeframes.
- Compliance may be enforced through a specific dispute settlement system.
- The Institutions of the Energy Community are the Ministerial Council, the Permanent High Level Group, the Regulatory Board, the Fora (Electricity, Gas, Social, Oil), and the Energy Community Secretariat in Vienna. The donors are organized in a Donors' Community, chaired by EC.
- All documents related to the activities of the Energy Community are available on www.energy-community.org.