



Western Balkans: more resilience for the energy sector

by Zoran Nechev and Aleksandrs Svilans

Although none of the Western Balkan countries has experienced major energy supply disruptions or price shocks in recent years, there are significant risks associated with the ability of the respective governments to address challenges in the energy sector. The lack of fully transparent and open energy markets makes it difficult to adapt to changing market dynamics in the short term, and significant barriers remain to securing investment for future energy infrastructure in the long term. Additionally, the Western Balkans face a daunting task in developing their national energy portfolios under existing commitments to transpose EU energy law and adhere to EU standards – especially when taking into consideration the involvement of numerous external actors in the region.

The EU can play a leading role in enhancing state resilience in the energy sector across the Western Balkans through the continued political support for expedient regulatory and legislative reform and the establishment of a financially attractive environment to secure long-term investment. There are also opportunities for cooperation in the Western Balkans with external actors such as Russia, China, or the Gulf states, thereby demonstrating the EU's commitment to the stability and security of the region, and to the establishment of an integrated European energy market.

Transparent markets and secure investment

The transition to transparent and open energy markets through regulatory and legislative reform in the region is generally slow: progress varies in rate and extent from country to country, and is often obstructed by political uncertainty and government interference in judicial affairs. The establishment of a financially attractive environment in order to secure investment for future energy infrastructure is also a difficult process; enterprises consistently mention political instability, corruption, and access to finance as the main obstacles to business in the region.

The EU has been heavily involved in the development of Western Balkan energy sectors, and remains the largest source of financing in the region by a considerable margin. In addressing the key challenges of transitioning to transparent and open energy markets and securing investment for energy infrastructure in neighbouring countries, the EU has implemented the Treaty on establishing the Energy Community (EnC), to which all of the Western Balkan countries are party, and has established numerous financing instruments such as the Instrument for Pre-accession Assistance (IPA) and Western Balkan Investment Framework (WBIF).



Figure 1: Implementation of the energy *acquis* in the Western Balkans

	Electricity	Natural gas	Regulatory authority	Renewable energy
Albania	<ul style="list-style-type: none"> Unbundling law partially implemented TPA law implemented Market structure law partially implemented 	<ul style="list-style-type: none"> Unbundling law partially implemented TPA law partially implemented Market structure law implemented 	Structure largely compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted No implementation of support schemes
Bosnia and Herzegovina	<ul style="list-style-type: none"> Unbundling law not implemented TPA law not implemented Market structure law not implemented 	<ul style="list-style-type: none"> Unbundling law not implemented TPA law partially implemented Market structure law partially implemented 	Structure not compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted Partial implementation of support schemes
Kosovo	<ul style="list-style-type: none"> Unbundling law implemented TPA law implemented Market structure law partially implemented 	<ul style="list-style-type: none"> Unbundling law implemented TPA law partially implemented Market structure law implemented 	Structure partially compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted Implementation of support schemes
Former Yugoslav Republic of Macedonia	<ul style="list-style-type: none"> Unbundling law partially implemented TPA law partially implemented Market structure law not implemented 	<ul style="list-style-type: none"> Unbundling law not implemented TPA law partially implemented Market structure law partially implemented 	Structure partially compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted Implementation of support schemes
Montenegro	<ul style="list-style-type: none"> Unbundling law implemented TPA law implemented Market structure law partially implemented 	<ul style="list-style-type: none"> Unbundling law implemented TPA law partially implemented Market structure law partially implemented 	Structure largely compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted Implementation of support schemes
Serbia	<ul style="list-style-type: none"> Unbundling law partially implemented TPA law partially implemented Market structure law implemented 	<ul style="list-style-type: none"> Unbundling law partially implemented TPA law partially implemented Market structure law implemented 	Structure largely compliant with EU law	<ul style="list-style-type: none"> National Action Plan adopted Implementation of support schemes

* This table illustrates the extent of implementation of the energy *acquis* across the Western Balkans (based on the monitoring of the EnC). The darker the shade of the colour, the greater the extent of implementation.

The EnC was established in order to extend the EU internal energy market to neighbouring countries through a legally binding framework. It has been pivotal in developing Western Balkan energy sectors through the identification of Projects of Energy Community Interest that would contribute to energy market integration, and the export of the *acquis communautaire* on energy – core EU energy legislation intended to achieve an integrated, transparent and open energy market across the EnC.

In late 2016, the Ministerial Council of the EnC adopted a decision to implement ten Projects of Energy Community Interest, nine of which involve the Western Balkans (although the majority of these projects are to be commissioned

post-2020). These include five electricity projects establishing a trans-Balkan corridor involving Bosnia and Herzegovina, Serbia, Montenegro, and Romania, an Albania-former Yugoslav Republic of Macedonia electricity interconnector, as well as Serbia-Bulgaria, Serbia-former Yugoslav Republic of Macedonia, and Albania-Kosovo gas interconnectors. Transposing and implementing the *acquis communautaire* on energy, or simply the energy *acquis*, has also proven to be a challenging endeavour – the extent of implementation of the energy *acquis* is varied and the EnC Secretariat regularly informs Western Balkan governments about non-compliance issues.

Through its latest IPA, the European Commission has provided €144 million in grants to numerous

infrastructure projects. Additionally, the WBIF (a joint initiative between the EU, international financial institutions, bilateral donors, and Western Balkan governments) has allocated €1.3 billion to infrastructure projects in the Western Balkans, supporting approximately €13.5 billion in total investment.

Nevertheless, due to the relatively limited involvement of the private sector, a number of barriers remain in securing investment for infrastructure projects in the long term. According to the European Bank for Reconstruction and Development and the World Bank, transition indicators are demonstrating an improving investment climate, but private investment continues to be restricted primarily by political uncertainty.

Developing national energy portfolios

The development of national energy portfolios will be largely shaped by the progressive implementation of the energy *acquis* and by the availability of financing. This is an area where the EU can complement its efforts to enhance state resilience in the Western Balkans by supporting national governments, while taking into account recent trends in foreign investment.

There is a marked difference in the approaches of major external actors that finance projects in the Western Balkans – for example, the EU has predominantly financed energy infrastructure projects in hydropower and other renewable energy sources, as well as natural gas and electricity networks, whereas China has predominantly financed lignite mining and power generation. Notably, these developments are taking place in the context of decreasing foreign direct investment (FDI) from the EU, while FDI from Russia, China and the Gulf states is increasing (although the EU remains the clear leader in FDI stock held in the region).

National energy portfolios in the Western Balkans rely almost exclusively on lignite and hydro to generate electricity, and national energy strategies do not envisage a significant decrease in lignite use. These national strategies take into account the future implementation of the EU emissions trading scheme (ETS), but justify continued investment in lignite power generation with the fact that carbon emissions would effectively be offset by extensive hydro deployment. This does carry risks, however, as new lignite power generation assets may become stranded considering future emissions targets, and hydropower is seasonally variable.

Lignite is an attractive choice for many countries in the region because it is economically viable, ensures security of supply, and supports domestic lignite mining industries which significantly contribute to the national economy, particularly in Bosnia and Herzegovina, Serbia, and Kosovo. Although more than 2,600 megawatts (MW) of new lignite power generation capacity is planned in the region, 7662 MW of current lignite capacity will either need to be modified in order to comply with the EU directive on air quality, or be closed in the near future.

Investment in lignite power generation may be viewed as incompatible with the EU's policy of reducing coal use in the long term, and is also controversial because it is largely backed by new foreign investors. The \$715 million expansion of a Serbian lignite mine and construction of new lignite power generation is majority financed by China's Export Import Bank, and new lignite power generation in Bosnia and Herzegovina was recently financed by the China Development Bank.

The focus on lignite and hydro notwithstanding, several countries in the region intend to increase electricity generation from non-hydro renewable sources, as well from natural gas. These initiatives are largely driven by the policy measures outlined in National Renewable Energy Action Plans, the adoption of which is mandatory under EU energy law.

Natural gas is currently not extensively used in the region, and its role in the near future is uncertain, with future demand limited by uncertainty in transmission infrastructure development and in ETS pricing. These factors are crucial to the creation of a competitive gas market, which may be viewed as a prerequisite for investment in gas power generation, particularly from the perspective of the private sector. Taking into consideration the anticipated increase in carbon emissions pricing through the ETS, and the EU's long-term goal of establishing a transparent and competitive gas market across the EU and EnC countries, it would appear likely that these conditions will be met in the future. A transparent and open gas market could be established even sooner if government support for domestic lignite industries and power generation is reduced (weakening the case for lignite power generation from an economic perspective).

Despite modest advances in gas transmission infrastructure development, several projects intended to supply gas to the region are in various

stages of planning, including the Trans-Adriatic Pipeline (TAP), Ionian Adriatic Pipeline (IAP), and Trans-Anatolian Natural Gas Pipeline (TANAP), Tesla, and White Stream projects. All of these projects are currently scheduled to be commissioned by 2020, with the exception of White Stream in 2022.

The establishment of a competitive European gas market is principally pursued through the continuous development and export of EU energy legislation, and through the construction of infrastructure (notably interconnectors and reverse-flow capacity). This has already resulted in an increasingly liquid gas market in central and eastern Europe, which has, in turn, contributed to lower gas prices and increased flexibility (through the transition from long-term supply contracts towards hub prices and spot trading). The EU also supports the TAP, IAP, and TANAP pipeline projects, which could increase the liquidity of the south-east European gas market.

Although modest in volume, gas imports in the Western Balkans are almost entirely Russian in origin. Nevertheless, this reliance has limited potential to be used as leverage due to the markedly low demand (in the Western Balkans gas accounts for around 2% of total primary energy supply compared to an average of 23% for OECD countries). In the event of an increase in Western Balkan gas demand due to the establishment of a competitive gas market, it is unlikely that this dependence on Russia would decrease.

However, increased imports of Russian gas need not represent a security of supply risk in an increasingly liquid European gas market. Gazprom's ongoing transition from long-term supply contracts to hub prices and spot trading, and its commitment to comply with EU competition rules following the Commission's anti-trust investigation against Gazprom's practices in EU countries, are signs of flexible and liquid European gas market, and of the Commission's effectiveness in enforcing competition rules. The prospects of TANAP and White Stream bringing Azeri gas to the region after 2020 would also alleviate concerns about the reliance on Russian gas.

Moving forward

The EU could play a leading role in enhancing resilience in energy sectors across the Western Balkans through continued political support for expedient regulatory and legislative reform, and by supporting advances in governance and enterprise restructuring, as well as improvements in

the trade and forex system, and in competition policy, establishing a financially attractive environment. Avenues for the pursuit of these objectives through diplomatic efforts could also be explored, although the EU, as the primary investor and source of funding in the Western Balkans, also has considerable commercial influence and could consider limiting or withholding investment if reforms are not undertaken.

These reforms could also have other benefits – FDI inflows would positively contribute to the overall economy and create jobs in various sectors, such as financial services or manufacturing, potentially reducing the importance of the lignite industry in the Western Balkans and encouraging a transition away from its widespread use. The EU may also offer to further increase investment in the region, subject to progress in implementing the energy *acquis*. This financing could also be more targeted, accelerating the development of cleaner electricity generation and more integrated energy markets.

There is also room for cooperation with other external actors in the Western Balkans whilst developing national energy portfolios across the region. For example, the EU could cooperate with China and other foreign investors in order to develop alternative sectors of Western Balkan economies and reduce Western Balkan reliance on a lignite industry which carries increasing levels of financial risk.

Enhancing resilience in the Western Balkan energy sectors would not only help ensure secure and economically viable energy supply, it would advance the EU's longstanding policy of creating an integrated European gas market. Though ultimately the interrelation between the energy sector and national economy shows how policies in both areas should ideally be mutually-reinforcing in order to maximise the benefits to the region.

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