Energy Sector Assessment 2010

Foreword

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The energy sector is a crucial driver of economic growth for all modern economies and, therefore, a key component of the development and transition processes. Unfortunately energy infrastructure in developing and transition economies is often old and may have deteriorated significantly beyond intended lifespans. Private investment is essential to the refurbishment, renewal, upgrade and expansion of energy infrastructure and the attraction of such investment needs to be a priority objective of governments – a task made more difficult in the current economic climate.

For its part, the European Bank for Reconstruction and Development (EBRD) invests substantially in the energy sector, making the Bank one of the most active investors in the sector in the countries where the Bank operates, that is, the countries of eastern Europe and central Asia. In accordance with its mandate, the EBRD also seeks to have a catalytic effect by leveraging Bank investments to encourage other (private) investors to invest alongside. To attract such investors, however, it is clear that the legal and regulatory background must be adequate. Other considerations are the existence of social safety nets and affordability. Observable trends include greater regional integration and the emergence of renewable energy.

Experience suggests that an adequate legal and regulatory framework is a precondition for investment. Potential investors seek certainty and legal reforms should provide them with the confidence that laws will facilitate payment discipline and reduce theft of service. Similarly, investors need to be assured that the right institutional balance is struck, including: provision for independence of the regulator; sufficient financial resources; appropriately skilled staff; and transparent due process and accountability. With respect to tariff reform, there must be: a clear movement to cost recovery; avoidance of cross subsidies; and a commitment to energy efficiency. Affordability must be achieved as part of the reform effort, and the difficult task of balancing cost recovery with tariffs and social safety nets that protect genuinely vulnerable areas of society is an integral part of well designed reforms.

Regional integration has become a key facilitator of sector reform and is a trend that the EBRD believes to be very important for opening national energy markets and creating regional energy markets; enabling common energy strategies, regulation, trading and commercial codes; and, helping international financial institutions (IFIs), such as the EBRD, World Bank, the European Investment Bank (EIB), and others act in a coordinated manner. The benefits from such integration are potentially huge as decisions are made on a regional basis, enabling benefits of scale; reducing the need for additional capacity investment, particularly generation; increasing reliability in electricity supply; and lowering operating costs.

As non-renewable sources of energy become more costly and as the true impact of the continued use of those sources is better recognised, renewable energy sources are becoming increasingly important. This is particularly so in the context of European Union (EU) promotion of renewables; rising demands for increased action on emissions and climate change; and the desire to diversify fuels and increase security of supply. In addition to the legal and regulatory barriers to investment that exist for more "traditional" renewable sources, such as large scale hydro generation, there are additional barriers for renewables, such as high capital cost/capacity; the relative small size of most projects; high transaction costs (legal/financial/due diligence) as a proportion of project cost; and difficulties sourcing equity funds. Again an appropriate regulatory environment is important to foster the move to renewables, but regulators face a difficult task in striking the right balance in encouraging the development of renewables while keeping tariffs affordable.

The foregoing are among the numerous and varied challenges that many of the transition economies face both to implement and sustain regulatory reform programmes. However, help is at hand, with a considerable amount of knowledge and experience in the reform of energy markets having been amassed, most notably through the work of the IFIs, the European Union and international and regional energy organisations. In accordance with its mandate, the EBRD has been fully committed to playing its part in promoting energy market development; enhancing energy sustainability; supporting energy efficiency and renewable energy initiatives through its investment activities and technical cooperation programmes.

It is against this background that the EBRD Legal Transition Programme has expanded its activities to include a renewed focus on the legal, regulatory and institutional environment of the energy sector. As part of this commitment and as an anchor for this newly developed focus, the EBRD has conducted its first in-depth assessment of the energy sector in its countries of operations: the Energy Sector Assessment 2010. The Assessment, set out here in full, compares the performance of the energy market in each of the Bank's countries of operations with internationally agreed models of regulation based on best practices adjusted to the regional context. Through this process, the Assessment measures the extensiveness and effectiveness of existing national regulatory frameworks, identifying inefficiencies and barriers to investment, while endeavouring to measure regulatory risks inherent in given investment opportunities.

The Assessment, however, does not undertake such comparisons in the abstract, but instead takes into account a broad array of particularities, including, among other things, the specific characteristics of national regulatory regimes. The Assessment has achieved this, for example, by working directly with each country's Ministry and/or regulator of the energy sector on the data presented in the country profiles.

Overall, the results show that the majority of the EBRD countries of operations have made decent progress in reforming their energy sectors. However, further ongoing reform is required to introduce or strengthen independent regulation, ensure balanced energy tariffs, increase private sector participation and focus more on renewables.

The experience shared by some of the EBRD countries of operations suggests that regional agreements and treaties which establish clear benchmarks of sound regulatory practice, while taking due account of the regional specifics, aid the relevant reform processes and can effectively address energy security concerns. Indeed, national action, driven in isolation of a regional framework, is unlikely to bring about satisfactory reform progress. Accordingly, a core aspect of the Assessment is to highlight the benefits of regional integration in the energy sector through harmonised and transparent frameworks that would promote regional trade, increase energy security and, thus, achieve sustainable development of national economies. The EBRD remains committed to supporting policy dialogue among stakeholders; dialogue which the Bank hopes can deepen multilateral regional cooperation and agreement on effective energy sector reform. We offer this Assessment as a step in that direction.