Energy Community

"AN ENERGY COMMUNITY FOR THE FUTURE"

REPORT BY

THE HIGH LEVEL REFLECTION GROUP OF THE ENERGY COMMUNITY

MAY 2014

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"Secure, competitive and sustainable energy supply is a prerequisite for prosperity and stability in entire Europe. The rules of a well-connected energy market ought to stretch beyond the current external borders of the EU and ought to be actively co-shaped by the neighbouring countries. The Energy Community Treaty has been providing the appropriate framework for achieving this goal. Although the Community has been a success story in many areas, its potential has not been fully exploited. We are presenting our proposed responses to the most pressing challenges facing the organisation on the threshold of the second decade of its existence. They include low level of implementation of the acquis communautaire, lack of investment and partial effectiveness of the institutional setup. We hope that these proposals will be helpful in rendering the Energy Community an even more powerful win-win instrument of international energy policy."

Prof. Jerzy Buzek
Chairman of the High Level Reflection Group

"Today, more than ever, the Contracting Parties should realise how important it is to fully exploit the potential of the Energy Community framework for reforming the energy sector and creating a common energy market regulatory area in the region."

Günther H. Oettinger
European Commissioner for Energy

"The Energy Community needs profound upgrading, despite being labelled as a success story of European external energy policy up till now. If its key deficiencies are overcome, then a new Energy Community that is on course to achieve its objectives could well become a new Union or a fourth European Community, after the European Coal and Steal Community, the European Economic Community, and the European Atomic Energy Community. If not, we will miss a unique opportunity to reinvent cooperation partnerships with the EU's neighbouring countries in energy and potentially other sectors."

Janez Kopač
Director of the Energy Community Secretariat

The Energy Community is an international organisation dealing with energy policy founded by the Energy Community Treaty, which entered into force in July 2006. The Parties to the Treaty are the European Union and eight Contracting Parties from South East Europe and the Black Sea region: Albania, Bosnia and Herzegovina, Kosovo*, former Yugoslav Republic of Macedonia, Moldova, Montenegro, Serbia and Ukraine. Georgia, Armenia, Norway and Turkey participate as Observers. Georgia is presently in the process of joining the Energy Community as a full-fledged member.

The Energy Community's mission is to extend the EU internal energy market to South East Europe and beyond on the basis of a legally binding framework. The overall objective of the Energy Community Treaty is to create a stable regulatory and market framework in order to:

- Attract investment in power generation and networks 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 integration with the EU market;
- Enhance the security of supply;
- Improve the environmental situation in relation with energy supply in the region; and
- Enhance competition at regional level and exploit economies of scale.

For further information about the Energy Community, please visit our website: www.energy-community.org.

** 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.*

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BACKGROUND

The Energy Community High Level Reflection Group was established by a decision[1] of the Energy Community Ministerial Council on 24 October 2013. The Group was mandated to make an independent assessment of the adequacy of the institutional set up and working methods of the Energy Community for the achievement of the objectives of the Energy Community Treaty, taking into consideration the evolution of this organisation over the past years and its extended membership, and to make proposals for improvements to the Ministerial Council in autumn 2014. To this end, it was tasked to prepare a written report to the Ministerial Council by 1 June 2014, outlining possible reform proposals and the necessary steps for the implementation of these proposals.

The Ministerial Council appointed Prof. Jerzy Buzek as Chair of the High Level Reflection Group, who subsequently designated five members of the Group: Mr. Walter Boltz, Ms. Vesna Borozan, Mr. Fabrizio Donini Ferretti, Mr. Volodymyr Makukha and Mr. Goran Svilanović.

The work of the Group was actively supported by representatives of the Energy Community Secretariat (Dirk Buschle, Barbora Jaksova, Janez Kopač), European Commission (Fabrizio Barbaso, Malgorzata Peksa Blanchard, Brendan Devlin, Blanca Andres Ordax), Ukrainian Presidency in Office of the Energy Community 2014 (Vsevolod Chentsov, Oleg Shevchenko), Gerhard Langeder (adviser to Walter Boltz) and Lesya Nedelcu and Tomasz Rusek (advisers to Prof. Jerzy Buzek).

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J. BUZEK

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PREFACE: CREATING A PAN-EUROPEAN ENERGY MARKET

The objective of securing energy in "wider Europe" in a stable, sustainable and competitive manner lies at the heart of the Treaty establishing the Energy Community, signed in October 2005. By extending the internal energy market beyond the boundaries of the European Union, the Energy Community carries forward the success story of European integration in the crucial sector of energy.

The Energy Community is a win-win instrument. On the one hand, for the EU, cooperation and interconnection with its neighbours – via the Energy Community – greatly contributes to ensuring energy security and affordable energy prices. On the other hand, for the non-EU states, increasing efficiency and transparency through reforms is a precondition for attracting investment and, in turn, for reaching economic and social stability, for securing the necessary energy supply and for raising citizens' welfare in an environmentally sustainable way.

Despite progress made by many Contracting Parties, implementation of the *acquis* remains a significant challenge. Difficulties existing on the energy markets stem from the fact that many of the countries still have not resolved the basic problem of energy market reform, i.e. opening of markets and launch of cross-border cooperation. Private companies are still not confident to invest in the Contracting Parties to the extent needed.

Rendering Energy Community's rules and institutions more effective will bring concrete benefits to all its members, within and outside the EU. It is fundamental for investors within the Energy Community to have a system enabling vigorous and independent enforcement in countries which may not provide for credible recourse paths for private and non-incumbent investors to pursue in case of breach of contract. The relatively low credibility of the judicial system and its compensation by stronger supranational enforcement procedures is also addressed in this report. So is the need of enhanced communication of the benefits for citizens and investors.

Achieving a pan-European energy market should not result in the narrowing of the number of countries that wish to join the Energy Community. The Energy Community should be made even more attractive - for its prospective as well as present members. What the EU can offer to the Energy Community is a functioning legal framework and transparent rules. The major added value for the Contracting Parties is the provision of a toolbox for energy market reform coherent with EU-wide market designs and practices. Today, more than ever, the Contracting Parties should realise the importance of exploiting the full potential of the Energy Community framework for reforming the energy sector and creating a common energy market regulatory area together with the European Union.

GENERAL REMARKS

The High Level Reflection Group,

having been mandated by the Ministerial Council of the Energy Community to make an independent assessment of the adequacy of the institutional set up and working methods of the Energy Community to the achievement of the objectives of the Treaty establishing the Energy Community taking into consideration the hitherto evolution of this organisation and its extended membership, and to make proposals for improvements to the Ministerial Council in 2014,

taking into account that:

- The Energy Community, as a unique organisation built upon the EU institutional and market model, has proven its added value in its areas of operation,
- The **main objective** of the Energy Community remains unchanged: **to reform energy markets and to integrate them into the European Union's Internal Energy Market** as a precondition for economic and social stability, which will translate into attracting investment, securing the necessary energy supply and raising citizens' welfare,
- The Energy Community strives to set up secure, open, transparent and competitive national energy markets, based on the rule of law, a stable regulatory framework and investment-friendly principles, and to integrate these markets both regionally and within a pan-European energy market,
- The Energy Community is a **rule-based organisation** with legal obligations for Contracting Parties to be developed, monitored and enforced by the institutions **in accordance with the highest European legal standards**,
- While all hitherto achievements - that sum up to a success story of the Energy Community - should be preserved, in certain key areas there is need for improvements, for enhanced implementation of law as well as for more adjustment to differing national or regional reality and changing circumstances,

is hereby presenting a report which contains an assessment of the status quo as well as proposals for improvements in the spheres of: legal perspective ("Our Rules"), investments ("Citizens' Benefit"), geographical scope ("Our Family") and institutions ("Our House").

The proposals may be implemented at different levels, depending on whether they require:
a) no modification of the Treaty (Level I),
b) modifications of the Treaty by simple decision of the Ministerial Council (Level II),
c) full Treaty revision (Level III).

Without prejudice to detailed legal analysis, the High Level Reflection Group has assigned its proposals to these three levels. Final attribution shall be based on detailed legal assessment by Energy Community institutions, as foreseen in the conclusions of the Report.

PROPOSALS OF THE HIGH LEVEL REFLECTION GROUP

The Energy Community is a "win-win" instrument for all its members from within and outside the European Union. **For the EU, the fact that its neighbouring countries share its values and apply its common rules increases energy security beyond the Union's borders. The Contracting Parties from outside the EU, likewise, benefit from solidarity within the Energy Community.** At the same time, by committing to transparent and non-biased rules, they create a unique chance to reform and enhance their energy sectors.

The Energy Community has been often referred to as **the most successful policy framework of the European external energy policy.** Such an appraisal must come with the caveat that tangible progress on what was from the start an ambitious agenda – measured as the state of implementation of the *acquis communautaire* – is only partial and very slow. In addition, important elements of the Treaty's potential and tools remain unexploited.

Eight years after the Energy Community Treaty entered into force, several of the key expectations remain unfulfilled, including: complete reforms of the markets' structure, introduction of cost-reflective prices, creation of a favourable and predictable investment climate, regional market integration or elevation of environmental standards. The absence of an enforcement mechanism, and of adequate built-in support to Treaty implementation are among the main explanations.

It is to be recalled that while the Energy Community pursues goals comparable to those of the European Union, the Contracting Parties – in their socio-economic structure and capability of attracting investment – **face different challenges** than most EU Member States. **Thus, it can hardly be expected that "exporting" EU energy rules to the Contracting Parties would yield results comparable to those of the European Union. As an autonomous organisation, the Energy Community should be based on its own set of rules incorporating parts of the EU's *acquis*.**

The High Level Reflection Group also wishes to recall the evolution of the underlying purpose of the Energy Community. The Community was designed to support investment, stability and a balanced and sustainable development in the Balkans, and to prepare the then Contracting Parties for a swift accession to the European Union. While the latter goal still has not been completed, the initial objective of establishing an integrated market in natural gas and electricity among the Parties has been extended into the creation of a pan-European energy market which stretches far beyond the Balkans. Thus, **the Energy Community has evolved into a powerful international energy policy instrument. Developing the Community in this direction is desirable not only for the sake of security of energy supply, but also transparency and adherence to the rule of law.**

Taking all the above into consideration, the High Level Reflection Group comes to the conclusion that the achievement of the ambitious goals will not be possible without a reform of the Community's legal, procedural and institutional set-up.

IMPLEMENTING OUR RULES IN A MORE EFFICIENT MANNER

The *acquis communautaire* of the Energy Community is sectoral in nature; even horizontal rules (on the environment or competition) are **limited to the definition of network energy** which comprises electricity, gas and oil. This limitation should be reconsidered, as it makes it difficult to incorporate rules of a general nature which would support the achievement of the Treaty's objectives, such as rules on public procurement, taxation (VAT), or a cross-industry emissions trading scheme.

Furthermore, unlike the EU, the Energy Community Treaty knows **not four fundamental freedoms but only one**: free movement of goods. Provisions on the freedom of establishment, services and capital are missing. This creates an imbalance vis-a-vis the legal situation in the European Union and hampers the addressing of topical problems such as double taxation, seat requirements for traders, investment restrictions in the shareholding structure etc.

With regard to secondary legislation, the argument is made sometimes that the Contracting Parties are not ready to implement additional legislation, as they should effectively implement the existing *acquis* first.

This argument is incorrect for several reasons. Firstly, it ignores that new and additional *acquis* is often complementary to existing one and may make its application even easier. That is true, for example, for certain implementing rules such as the Network Codes, but also for certain elements of horizontal *acquis* without which a true and thorough sector reform will remain piecemeal.

Secondly, the Energy Community is based on the idea of homogeneous application of laws both within the European Union and in the Contracting Parties. If the latter are decoupled from the evolution of the rules in the former, especially in the case of implementation rules (for example network codes) the basic idea of an Energy Community and its effectiveness are at stake. To react to a perceived lack of progress by lowering the level of ambition would, in any event, not be the appropriate response.

In order to build a **true pan-European Energy Community** going beyond a simple mechanism for the export of law, the **Treaty's elements providing flexibility** need to be reinforced. Two dimensions of flexibility need to be addressed:

Firstly, the **EU *acquis* incorporated under Title II of the Treaty needs to be better and more thoroughly adapted to the socio-economic situation of the Contracting Parties**. This requires strengthening and making better use of current Article 24. At the same time, creativity and homogeneity need to be well-balanced in each individual case. EU Regulations, including Network Codes, should be directly applicable within Contracting Parties once incorporated in the Energy Community.

Secondly, **tapping the Energy Community's full potential for external energy policy**

calls for **more flexibility in the creation of a legal framework governing the relations between the European Union and Contracting Parties, based on the principles of fairness and solidarity, and satisfying also the legitimate interests of the European Union's partners. Designing its governance should not be a one-way street.**

Title IV, the chapter of the current Treaty, allowing for designing a true pan-European energy governance for a Single European Energy Market, has not been used so far. The High Level Reflection Group recommends its strengthening and expansion. In this context, **the HLRG recommends that the European Union's restrictive Decision 500/2006/EC be revised in order to allow for more flexibility.**

Title III, which currently encompasses the Contracting Parties as well as certain EU Member States - neighbours thereof, has proved to be of little relevance. Its provisions on substance should be moved to Titles II and IV, as appropriate.

One concrete example for the unsatisfactory results and problems caused by the lack of flexibility is the definition of "interconnectors" in the incorporation of the 3rd Package into Energy Community law. As it was (only) based on Title II, Member States are not covered, and the connection between Member States and their neighbouring Contracting Parties, as originally intended, is obstructed. This hinders the objective to achieve the true pan-European energy market envisaged in the Energy Community Treaty. Making more and better use of Title IV will allow for these problems to be avoided.

Many stakeholders participating in the public consultations on the future of the Energy Community expressed concerns about the Community's **lack of ambition in the areas of environmental protection and climate change**. In this respect, the High Level Reflection Group recalls that sustainability is a key pillar of European energy policy. This must be properly reflected when the policy is extended outside the European Union. While significant gains can be made by exporting the EU principles and rules related to sustainability to third countries, their specific socio-economic conditions require maintaining a reasonable balance with the absorption capacity for reforms.

At the same time, the Group considers that the **existing institutions and procedures of the Treaty provide enough flexibility** to adapt the relevant EU norms – also those pertaining to the environment – to the situation in the Contracting Parties. The same goes for commitments related to enhanced energy efficiency. In this context, **existing commitments could be reconsidered** in areas in which new approaches are currently being discussed within the EU, such as the promotion of renewable energy sources.

The High Level Reflection Group believes that **implementation of the *acquis***, paramount to achieve the objectives pursued by the Treaty, **may pose the biggest challenge**. In particular, market reforms still need to be achieved, starting with establishing efficient wholesale markets data management, transparency and fostering interconnections.

The proposals below are meant to adapt the tools and mechanisms currently available to the needs of better implementation.

THE HIGH LEVEL REFLECTION GROUP MAKES THE FOLLOWING PROPOSALS:

Level I

Proposal 1.1. More **flexibility should be allowed in the scope and time of the adaptation of the *acquis***, taking into account that the situation of the Contracting Parties may differ in many aspects which are key for implementation (e.g. social conditions, existing or missing links to EU transmission grids, existing or missing gas pipelines, different country sizes, different technical standards etc.)

Proposal 1.2. Interconnectors between EU Member States and Contracting Parties should be considered interconnectors regardless of whether they are interconnectors between Member States or between Contracting Parties.

Proposal 1.3. The **financial support** needs to be improved. Financial assistance should be **conditioned on implementation** of the *acquis*.

Proposal 1.4. The Energy Community should reconsider the **scope of rules related to environmental protection**. See annex with proposed additional regulations.

Level II

Proposal 1.5. Title IV should be expanded and used more systematically in order to design a genuine set of rules and institutions governing fully integrated pan-European energy markets.

Proposal 1.6. The scope of the Energy Community should be broadened, *inter alia*:

a) by symmetrically applying all fundamental freedoms: besides free movement of goods, also free movement of services and capital and freedom of establishment should be introduced in the Treaty,

b) by including procedural rules related to competition and State aid in the energy sector in accordance with the EU model (e.g. including notification of State aid to the Secretariat, following the model of Article 108 TFEU),

c) by including rules on public procurement (Directives 2004/17 and 2004/18/EC) in the energy sector.

Proposal 1.7. To encourage also private enforcement of the Treaty before national courts, it should be amended to the effect that provisions of Energy Community law can be relied upon by individuals even without implementation if these provisions are sufficiently clearly defined and unconditional.

INVESTMENTS FOR ENHANCING CITIZENS' BENEFIT

Attracting investment is the rationale behind many of the measures and actions taken by the Energy Community. **Yet, private investment has remained far below the levels hoped for when establishing the Energy Community.** Besides incorporating EU legislation, the Treaty does not offer any specific instruments which could help promoting investments.

Recently, the Energy Community adopted a list of priority infrastructure projects (PECIs), following the EU example. Unlike in the European Union, however, there is limited specific funding available to support these projects at a cost of financial capital consistent with project feasibility. In the current financial environment, this constitutes a real disadvantage.

Most of the Contracting Parties are characterized by a risk profile that is not compatible with attracting significant streams of private international capital. In addition, recent government/regulators' behaviour in some countries of the region has shown that debt and equity were riskier than previously considered, with very few available options to shelter the equity holders from such political risk.

Public funding (e.g. from IFIs) remains a most meaningful source of capital, mostly through debt instruments, but is constrained - both in total amounts and by the lending rules of the IFIs (no 100% financing of a project by one IFI, "additionality", etc). Under such circumstances, it is questionable if any meaningful private capital amounts will flow to the region, without a credit enhancement or equity insurance mechanism.

Risk can be controlled upfront by selecting projects that are economically sound, technically and financially optimised, and do not violate any "principle of reality" such as affordability by the ultimate payer (rate payer, tax payer, consumer). However, political risk – in its numerous shapes – and governance-related risks are perhaps the most intractable, as they cannot be hedged, or reduced, or correctly measured; they can only be further distributed (e.g. via insurance or guarantees).

The improvement of the public and private governance in the energy sector is one of the expected outcomes of the implementation of the *acquis*, and it will have a positive impact on the investment climate. The timeframe of such an improvement will however be longer than urgent infrastructure commends, which calls for a bridging mechanism.

The **investment environment in the Energy Community must be considered in a broader framework of structural reforms**. Given the capital intensity of reforms of the energy sector, **attracting investment in Contracting Parties' energy infrastructure** is a prerequisite for success.

Moreover, the Energy Community should help Parties to reduce the investment risk also by applying the best available European standards in screening the projects for their compliance with the long-term climate policy of the EU. The blueprint for this could be taken from the European Investment Bank's energy policy.

THE HIGH LEVEL REFLECTION GROUP MAKES THE FOLLOWING PROPOSALS:

Level I

Proposal 2.1. **An "investments-friendly area" must be created** by reducing risks – and increasing transparency and predictability – on the selling of energy within the territories of Contracting Parties, also by sharing advice and experience on the regulatory frameworks, and planning and managing a coherent transition to an integrated market.

Proposal 2.2. **Permitting procedures and criteria should be harmonized**, made as clear and transparent as possible, and a maximum time for the granting of permits or authorizations by any competent authority should be established.

Proposal 2.3. **More funding** should be made available in bilateral and multilateral support, as well as in support from international financial institutions (such as the World Bank etc.) and the EU, for technical assistance as well as for investments (at least for Projects of Energy Community Interest). **Funding should be conditional on compliance** with Energy Community obligations.

Proposal 2.4. An **entity allowing for demand aggregation for imported energy**, most notably gas, would enhance the ability of relatively small players to improve their negotiation position, obtain better terms, better manage security of supply challenges, and – with the possible support of an **Energy Community Risk Enhancement Facility** (see below) – constitute a credit-worthy shipper able to support the implementation of critical infrastructure. Art. 43 of the present Treaty already provides the basis for such a measure.

Proposal 2.5. A mandatory (non-binding) opinion of the Energy Community Secretariat should be introduced by donors in their procedures.

Proposal 2.6. Benefits for citizens and investors should be better communicated.

Level II

Proposal 2.7. The Secretariat, or a separate entity overseen by the Energy Community, should mobilize, on a contractual basis and without the need to hire a permanent team, the **project development and the financial expertise required to enhance the quality and preparedness of priority projects**, so that they may stand a better chance to obtain financing.

The aim of such joint teams is, inter alia, to define what is required to reach the financing stage, act on behalf of the Energy Community to commission the necessary studies, assess the least-cost options, identify the obstacles to implementation, interface with potential financiers, and identify the required financing gaps and credit enhancements required, so as to allow the Energy Community to help overcome concrete obstacles and coordinate efforts in complex projects.

Proposal 2.8. The establishment of an **Energy Community Risk Enhancement Facility (ECREF)** is suggested, to address risks such as breach of contract by public bodies, retroactive measures, discriminatory taxation, payment default by public entities, and similar risks which are a strong deterrent to both lenders and investors, and are difficult to mitigate effectively.

An ad-hoc vehicle should be established to provide the relevant guarantee or insurance products and manage the facilities. The role of ECREF will be to mobilize stand-by financial commitments or ad hoc guarantees provided by a group of guarantors, and to tailor the guarantees to the requirements of eligible projects. The ECREF vehicle will contract adequate expertise on a competitive basis, and the Secretariat could both fund and supervise this work. ECREF will only be available for priority projects of the Energy Community which enhance either market integration or security of supply.

Furthermore, the Energy Community may negotiate framework implementation or host government agreements with the governments, as need be, in order to provide further comfort to the guarantors. ECREF will act as a complement to other IFI initiatives such as the Joint IFI Action Plan for Growth in Central and South Eastern Europe, and one of its roles will be to provide a "one-stop-shop" for the mobilization of finance directed at priority projects.

Proposal 2.9. The Energy Community could establish **"platforms" of complementary or similar projects** which reinforce each other (e.g., an "energy security project" or a "networks enhancement project" involving several pieces of infrastructure in several Contracting Parties or neighbouring states), perhaps structured according to a build-operate-transfer model, which could be credit-enhanced as a whole through the ECREF.

ENLARGING OUR FAMILY

One of the areas discussed widely in public is the future geographical scope of the Energy Community as well as its role for an EU external energy policy. The European Parliament, for instance, in autumn 2013, called "*for further expansion of the Energy Community via the Eastern Neighbourhood Policy in line with the objectives of the Energy Community on the basis of mutual interest*". The Council of the European Union held that "*the Energy Community should be promoted as a framework for energy relationships with countries in the Western Balkans, Eastern Europe and other neighbouring countries willing and able to implement the relevant EU acquis.*"

The High Level Reflection Group believes that **no geographical limitations** should be imposed with regard to the Community's territorial range. Regions such as the Black Sea, the Caspian or the Mediterranean are linked to the Energy Community's internal market in various ways and can both benefit from the reform spirit at the bottom of European legislation and constitute an important complement to the existing geographical scope. **With the Energy Community becoming the main multilateral instrument for organizing the European Union's external energy relations,** a **variable geometry** should be introduced which **would allow Europe to effectively spread its key principles and rules beyond its current sphere of influence.**

Countries acceding to the Energy Community have a continuous and strong interest in applying European rules. This interest may not be as evident on the periphery of Europe as it is for countries with a concrete and imminent EU accession perspective. The same is true for upstream countries, i.e. countries producing oil and gas. To accommodate them, the new Energy Community Treaty should envisage flexibility in the sense that countries may opt for applying only a certain core set of EU rules and retain more sovereignty in certain areas. The introduction of such a system should be followed by adaptations to the current institutional and procedural design.

THE HIGH LEVEL REFLECTION GROUP MAKES THE FOLLOWING PROPOSALS:

Level I

Proposal 3.1. The approach of **binding obligations related to EU acquis implementation** should be maintained in principle.

Level II

Proposal 3.2. The **Energy Community should declare its interest in specific strategically important countries and/or regions**, such as Eastern Partnership countries, Switzerland, Norway and Mediterranean countries.

Level III

Proposal 3.3. The Energy Community should be **open for membership to countries able and willing to apply the rules**. In return, the current "one size fits all" approach should be replaced by a differentiating scheme that would take into account specific conditions existing in various countries. The Energy Community should (a) fix realistic implementation deadlines and (b) allow for flexibility in the adoption of the law – by setting one common minimum extent to be adopted by all Members *(see next proposal)*, with a more ambitious scheme of transposing EU acquis for core members and a possibility for Associated Members to "opt in" to implement rules pertaining to additional policy areas and to improved enforcement procedures and easier access to financing.

Proposal 3.4. This differentiation should be reflected in the terminology: **Members** instead of Contracting Parties for countries ready to commit to implementing the full set of Energy Community *acquis communautaire*, and **Associated Members** for countries agreeing on a basic level of implementation obligations (the latter to be further defined by the Energy Community institutions). The Observer status should be kept. The category of "Participant" in the current Treaty should be eliminated.

Members and Associated Members may differ in terms of budget contributions. With regard to participation in the decision-making process, Associated Members should only be excluded from voting on rules not applicable and enforceable vis-a-vis them.

REFURBISHING OUR HOUSE

Enforceable legal commitments and a well-balanced system of political and expert institutions distinguish the Energy Community from other international organizations and projects active in the same sector. The level of integration achieved under the Community can be compared to that of the European Union itself or the European Economic Area (EEA), and it is notably higher than that of the Energy Charter formed in 1991. This distinctive feature is of great significance for the governance of pan-European energy relations and should be further developed.

The High Level Reflection Group believes that a refurbishment of the institutional architecture is necessary, in particular **to enable the enforcement** of the far-reaching commitments the Parties accepted under the Treaty.

The Group supports **the calls for reforms** in this area, expressed by EU institutions. In 2011, the European Commission demanded that the Energy Community's "*regulatory scope should be progressively extended and combined with more effective implementation and enforcement.*" The European Parliament in 2013 demanded "*adapting [the Energy Community's] decision-making to future challenges, including by setting up legal control mechanisms to deal with deficient acquis implementation*".

The Council of the European Union requested, also in 2013, that "*a thorough discussion and analysis should address any weaknesses in the instruments and working methods used, leading to substantial improvement of the Treaty's substance and procedures to adequately address the manifold challenges, and possible ways of improving the institutional settings and the enforcement mechanism should be considered.*"

The fact that the **Ministerial Council** is a high-level assembly of ministers whose meetings are held once a year makes it best-suited to take long-term political decisions. Yet, the Council currently exercises the role of a lawmaker, enforcement body and political institution at the same time. Members of the Permanent High Level Group, on the other hand, lack an adequate decision-making mandate and political empowerment.

The Regulatory Board, while designed as a prototype for a pan-European coordination body for regulatory authorities, has not delivered on these expectations. Its relevance is being called into question by the establishment of ACER in Ljubljana. The permanent and impartial character of the Secretariat makes it most suitable for taking day-to-day decisions and enforcing binding measures in crucial areas like competition and State aid which, however, the Treaty currently prevents.

Weak enforcement mechanisms constitute one of the major obstacles to implementing the *acquis communautaire* in the Contracting Parties. The current dispute settlement system, tasking the Ministerial Council with taking decisions on highly complex legal questions, does not live up to the expectations. Similarly, the **sanctions foreseen by the Treaty lack any weight and do not provide an incentive for Contracting Parties to fulfil their obligations.**

Dispute cases taken up by the Secretariat are currently resolved in bilateral negotiations with Contracting Parties, an approach which appears to have reached its limits. Furthermore, the Treaty **does not envisage any kind of judicial protection of individuals and companies** against decisions taken by the institutions of the Energy Community. The existing enforcement mechanism falls short of the standards applicable within the European Union related to access to justice. Arbitration possible under the Energy Charter Treaty is an effective tool in particular for large international investors, but it is not particularly well suited for protecting the interests of small and medium-sized companies, domestic undertakings or customers.

Hence, the establishment of a Court is the best solution to allow for more effective public enforcement, and to increase the level of protection for the private and legal persons for whom the internal energy market extended through the Energy Community is created.

The High Level Reflection Group concludes that also the **sanctions mechanism needs to be revisited**. Sanctions are essential for enforcement. Complemented by appropriate incentives, they are key for better implementation of the Treaty and investor protection. The type of sanctions should differ significantly between Members and Associated Members. For Members, they could come in two forms, namely political (in the form of a commitment by the EU to not close or re-open the energy chapter in the accession negotiations in case of a serious and persistent breach) and financial (commitment to cutting EU assistance as well as direct pecuniary sanctions with the amount of penalties being modified by a GDP factor). The current political approach of "suspending certain rights" in reaction to a "serious and persistent breach" does not satisfy the standards of an Energy Community based on the rule of law.

Cooperation between the Energy Community Regulatory Body and the Agency for the Cooperation of Energy Regulators (ACER) is currently limited to personal contacts (such as the nomination of an ACER representative in the ECRB) or to case-by case handling by the Secretariat. In line with the spirit of the pan-European energy market, and given that the key tasks of ACER are of direct relevance for the Contracting Parties, the participation of Energy Community Contracting Parties' regulators in ACER should be developed more explicitly than envisaged in Regulation (EC) No 713/2009 which refers to the participation of regulatory bodies of any third countries applying EU energy law. Moreover, an option for a meaningful participation in ACER will raise the attractiveness of the Energy Community vis-a-vis those countries who are not yet members. Transmission System Operators from Contracting Parties should also have a right to become members of ENTSO-G as they can become members of ENTSO-E.

Finally, the Fora, which helped awareness-raising and increased legitimacy in the early years of the Energy Community, are not of the same relevance any longer. Discussions take place in other bodies and through other channels, including public consultation. They also duplicate to a large extent discussions which take place in the EU Fora.

THE HIGH LEVEL REFLECTION GROUP MAKES THE FOLLOWING PROPOSALS:

Level I

Proposal 4.1. The institutions of the Energy Community and its Contracting Parties should be **better and more efficiently linked with the institutions set up within the EU internal market** under the Third Energy Package. In particular, the national regulatory authorities of the Contracting Parties should be represented in ACER, and the TSOs in ENTSO-E and ENTSO-G. EU Member States in the 8th Region should take leadership in establishing regional energy markets.

Level II

Proposal 4.2. The Energy Community institutions should be strengthened through increased ownership of the Contracting Parties. Ownership means responsibility. Increasing responsibility and awareness will be beneficial in the implementation of the commitments. The high level of independence of enforcement and monitoring institutions should be preserved.

Proposal 4.3. As part of the process of increasing the ownership of the Energy Community by Contracting Parties, the budget contribution system should be reviewed, in view of increasing the share of the budget coming from the Contracting Parties. This increase in contributions of the Contracting Parties could consist in offering secondments at the Secretariat, a possibility to also further develop human resources in the Contracting Parties' authorities.

Proposal 4.4. The **role of the institutions of the Energy Community should be strengthened** in order to better support the achievements of the Energy Community Treaty's objectives. In particular:

(1) As the policymaker who ensures that objectives are attained, the **Ministerial Council should focus on strategic issues** and leave as many decisions as possible to the Permanent High Level Group.

(2) **The Permanent High Level Group should be strengthened** so as to exercise its function of the Energy Community's plenipotentiary, high-level and permanent collective decision-making body.

(3) The **institutional capacity of the Secretariat should be strengthened** in terms of providing assistance related to law implementation, including the monitoring of implementation. The Secretariat should carry out a coordinating role in managing EU technical assistance in energy sectors, including investment promotion.

(4) The Energy Community Fora should be re-examined case by case in terms of their efficiency, role and relevance. They could be replaced by pan-European Fora also open to the stakeholders in the Contracting Parties, and/or by participation of experts from Contracting Parties in the existing EU Fora. The **role of civil society and business in the institutions should be strengthened** by granting them an observer role in the Permanent High Level Group.

(5) The current **decision-making procedure for dispute settlement** (decisions currently taken by the political and non-expert Ministerial Council) **should be reconsidered**.

Level III

Proposal 4.5. The **Secretariat should be strengthened in terms of executive and investigative powers**, e.g. in the area of competition, procurement and State aid in accordance with the model applied in the EU.

Proposal 4.6. The **dispute settlement procedure should be gradually replaced by a Court of Justice**, based on the EU model as applied in the European Economic Area (EFTA Court). Before becoming a permanent institution, the Court could convene on an ad-hoc basis. The Court should also be accessible directly by individuals and companies.

Proposal 4.7. Differentiated enforcement mechanism should be envisaged for Members and Associated Members.

Proposal 4.8. **Financial sanctions** should be foreseen in the future, based on the model applied within the European Union, namely the sanctions introduced by the Lisbon Treaty for the infringement of EU law by Member States.

Proposal 4.9. In the light of progressive integration of markets, the membership of Contracting Parties' (Members') energy regulators in Energy Community Regulatory Board (ECRB) should be gradually phased out and replaced by Contracting Parties' regulators' membership in ACER, while keeping the ECRB for energy regulators from Associated Members.

CONCLUSIONS

Most of the recommendations made by the High Level Reflection Group require further assessment in terms of their legal, financial and political feasibility.

The Group suggests the establishment of a roadmap for the preparation of concrete proposals by the Secretariat and European Commission preferably by **the end of 2014 and no later than by the end of March 2015**, to the Permanent High Level Group and the Ministerial Council, according to the three levels of proposals listed in this Report.

The High Level Reflection Group recommends the Ministerial Council to mandate the Permanent High Level Group to carry out the necessary feasibility assessment and prepare appropriate draft decisions – **for adoption by the Ministerial Council in 2015** in line with its proposals.

ANNEX 1:
ENVIRONMENTAL *ACQUIS COMMUNAUTAIRE*, THE INCORPORATION OF WHICH IS PROPOSED FOR FURTHER CONSIDERATION

1. Chapter II of Directive 2010/75/EU on industrial emissions and Chapter IV also for existing plants,

2. Directive 2008/50/EC on ambient air quality,

3. Directive 2004/35/EC on environmental liability,

4. Directive 2001/42/EC on strategic environmental impact assessment,

5. Directive 98/70/EC relating to the quality of petrol and diesel fuels and amending Council Directive 93/12/EEC as adapted by Directive 2009/30/EC,

6. Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading.

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