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Abstract

Considering the lack of pipelines and infrastructures, natural gas is not widely available in the Balkans and specific policies are required to build new networks in upstream and downstream phase.

In this regard, the South East Europe Energy Community (ECSSE) is promoting the Balkan Gas Ring pipeline as Project of Interest (PECI).

The new South Eastern Energy Corridor (Azerbaijan to Italy) will be likely in operations in 2018 and then, it would be necessary to encourage the private sector to step-in to the building of infrastructures in order to take the opportunity of strengthening the regional energy market or to create a market where it is still marginal and negligible.

The Energy Community is strongly aware about the historical opportunity the Balkans could achieve: In its “Study on Recommendation for funding investments in energy Community Gas Ring” the current infrastructures’ network is deeply analyzed in order to identify possible actions for markets’ development.

Keywords

Energy Community, South East Europe, Gas Ring, Infrastructures, Pipelines, Energy Policies, Risk management policies

Gas Ring project: attracting investments in gas the market improvement process.

The South East Europe Energy Community (ECSEE)¹ is promoting the Balkan Gas Ring pipeline as Project of Interest (PECI).

The project is aimed at to create a natural gas infrastructural network in the Balkans in order to promote the gasification of the area and to open an integrated regional market².

Nowadays because of the lack of pipelines and infrastructures natural gas is not widely available and specific policies are required to build new networks in upstream and downstream phase.

This regional approach is complicated by the area features: first of all, it is necessary to consider how difficult it is to enhance international cooperation in the area.

The Nineties war has left a very difficult situation and the

1 The Energy Community of South East Europe (ECSEE) is an international organization established by the Treaty signed in 2005: the Treaty is the final act of a process started from the Thessaloniki UE-Western Balkans Countries meeting that stated the intention of the parties to cooperate toward a European integration for the Balkan area. The Energy Community of South East Europe (ECSEE) Treaty is an important part of this process since the signatories committed themselves to create a regional integrated energy market by implementing the European *acquis communautaire* and the European market principles. The Treaty has been signed by E.U., Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia and UNMIK (Kosovo): after these Countries the Community has been joined by Moldova and Ukraine. Georgia and Armenia acquired the status of observers: the E.U. members obtained the status of member. Further information http://www.energy-community.org/portal/page/portal/ENC_HOME

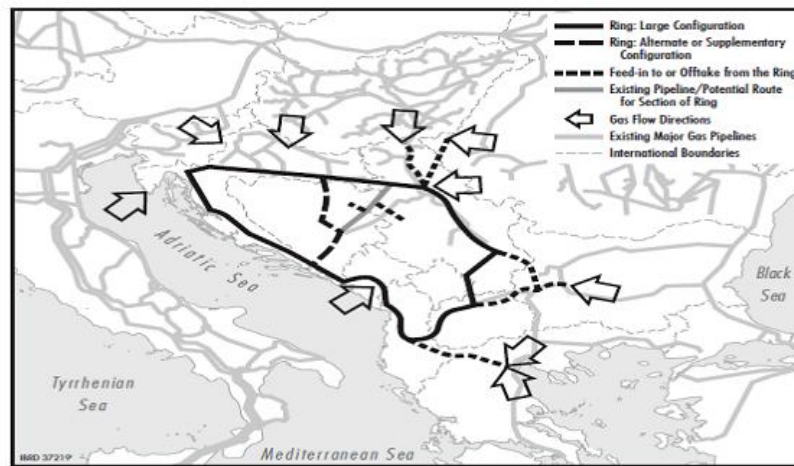
2 The Gas Ring concept is based on three main targets: bringing gas to new power stations in currently ungasified areas on the Adriatic coast. Those power plants would, in turn, anchor the economics and bankability of the transmission investment. As a next step, additional sections of the Ring would be developed, gasifying new areas, connecting new entry points and increasing diversity of supply options and technical and commercial security of supply. Finally, the entire Ring would be completed, delivering from this point onwards, all of the benefits unique to a ring, especially the increase of capacity with each new injection point. Besides the project will link the seven markets of Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia into a regional market configuration and to connect six regional capitals (Belgrade, Sarajevo, Podgorica, Tirana, Skopje and Pristina), three of which are ungasified at present. Further information http://www.energy-community.org/portal/page/portal/ENC_HOME/AREAS_OF_WORK/GAS/Regional_Market/Gas_Ring_Concept

transition of the area from the Yugoslavian collapse seems to be not completed yet. Actually, some positive goals in the Serbia-Kosovo relations have been recently achieved³ and it is well known that the Kosovo status after the Pristina unilateral independence declaration was one of the main hurdles in the regional relations. Nevertheless, the regional cooperation process has never been interrupted over last ten years⁴: probably not all the regional cooperation initiatives have been effective but, surely, several processes at this level have been promoted both by international and local players.

In this framework, the energy policies have been one of the most discussed topics considering that the regional size is the minimum dimension to shape an efficient and attractive energy market.

On the other hand, the Balkans area is currently in the international focus since the new South East Energy Corridor will be definitely open in the area.

Fig.1: Gas Ring Pipeline Route



Source: World Bank.

3 The relations between Serbia and Kosovo have been very tense after the independence declaration: *de facto* the Serbian Government has not recognized the Pristina Government considering still Kosovo as a Serbian region. After several talks under the European Union mediation the parties reached an important agreement in April 2013 toward the normalization of Serbia-Kosovo relations. http://eeas.europa.eu/top_stories/2013/190413_eu-facilitated_dialogue_en.htm

4 Delević, M. "Regional Cooperation in the Western Balkans." Chaillot Paper No. 104. EU Institute for Security Studies, Paris

Actually, in 2013 the Shah Deniz gas fields Consortium decided to improve the off shore natural gas production in Azerbaijan starting from 2018: after this decision the South East Energy Corridor has become a reality.

Considering the current geopolitical risks related to the Russian-Ukrainian crisis, the prolonged instability in North Africa and Iraqi destabilization actually in progress, the South East hydrocarbon route is more and more precious in order to implement the diversification and supply risk management policies.

This topic is particularly sensitive for the European Union and for the Balkans as well, considering the dependence level from a few suppliers.

Several oil/gas pipelines projects have been proposed over the past ten years with the purpose to export the Azerbaijani resources to the rich Western markets: after an arduous selection process the Trans Adriatic Pipeline (TAP)⁵ has been selected by Shah Deniz Consortium as the most reliable and feasible natural gas pipeline to reach the European market.

The planned TAP route will run throughout Greece and Albania: the flow of the Azerbaijani gas in the Balkans, and in general, the setting of a real energy corridor in the area, enhanced the debate on possible implementation of the regional energy markets in order to create a sound investment climate for investors.

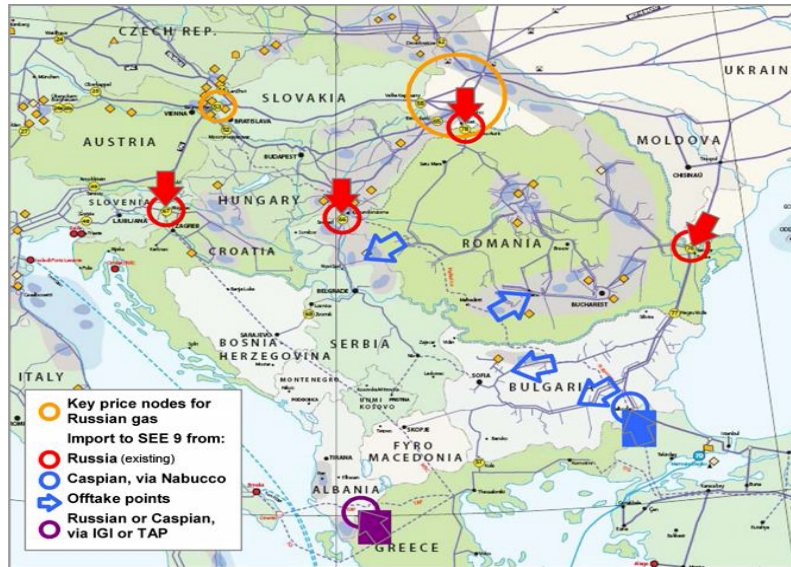
The energy corridor will be in operations in 2018 and then, it would be necessary to encourage the private sector to step-in to the building of infrastructures in order to take the opportunity of strengthening the regional energy market or to create a market where it is still marginal and negligible. Creating new pipelines and infrastructures could really evolve the gasification status of the region and the gas coming through TAP is the most reliable candidate to potentially feed up the Balkan Gas Ring⁶: spreading the

5 TAP's shareholders are BP (20%), SOCAR (20%), Statoil (20%), Fluxys (16%), Total (10%), E.ON (9%) and Axpo (5%). Further information, S.F. Massari "Trans Adriatic Pipeline: l'apertura del Southern Gas Corridor e i possibili scenari per l'Italia e i Balcani. Un'intervista a Giampaolo Russo Country Manager Italia TAP AG" Pecob's Papaer Series, January 2014.

6 TAP pipeline is more and more important considering it is the only feasible project at the moment: actually, on the grounds the ECSEE expectations the Ring project should be fed by the development of the new major pipelines projects bringing gas through or past the region such as Nabucco, Turkey-Greece-Italy gas pipeline (TGI), Trans Adriatic Pipeline (TAP), GUEU-White

pipelines throughout the area would mean to have several benefits from many points of view.

Fig. 2: Feeding pipelines to the Balkans Gas Ring System (existing and potential)



Source: Energy Community

First of all, the building of the infrastructure is a business itself that could bring into the area huge capital and investments: Secondly, a widespread pipeline system would reach a large number of consumers and it could create a new market, a more effective competition and positive effect on energy cost and affordability.

The Energy Community is strongly aware about the historical opportunity⁷ the Balkans could achieve: In its *“Study on Recommendation for funding investments in energy Community*

Stream-PEGP (see Fig. 2). It is a matter of fact that just TAP entered into the commercial agreement for the Azerbaijani gas acquisition and so it remains the only alternative source to the current Russian gas supplies.

⁷ Dirk Buschle, deputy Director of the ECSEE Secretariat, defined the importance of South East gas corridor with the following words: *“For the Contracting Parties, this is not a corridor, it is a living room. We are happy to see that TAP will complement and diversify the options to energize it”* South East Energy Community Secretariat press release http://www.energy-community.org/portal/page/portal/ENC_HOME/NEWS/News_Details?p_new_id=7541

Gas Ring” the current infrastructures’ network is deeply analyzed in order to identify possible actions for markets’ development.

First of all, according to the planned Gas Ring project two pipeline sections will be opened: The first section will run across Serbia, Croatia and Bosnia and Herzegovina.

The Southern route will be placed throughout Albania, Macedonia, Montenegro and Kosovo.

The area presents several different situations from an economic and a regulatory point of view: The gas market development level is quite scattered as well.

Anyway, it is clear that the investors’ interest in a project is based on a reasonable and secure return on investment: On the grounds of this a sound investment climate has to be settled and a strong risk analysis and a clear model of revenues have to be available.

In the above mentioned study, the Energy Community provides possible answers to these matters trying to identify different solutions on risk management.

Potential investors could be driven to the complicated Balkans area by promoting a set of specific actions to be implemented on the grounds of the current markets’ economical and legislative situation.

Actually, the pipeline business finds its revenue mainly on the tariffs paid by the infrastructure’s users.

In order to determine the tariffs’ level two main approaches are usually identified: In a market based perspective the Transport System Operator (TSO that is the pipeline operator) could freely negotiate with the infrastructure’s users at the market level.

In a market regulated approach, on the contrary, the national Authority evaluates the correct cost level for the pipeline capacity use, trying to set up satisfactory cost reflective tariffs and proper tools to regulate the investment.

The effectiveness of these approaches depends on the status of the market where they will be deployed: A better understanding of these models could be useful to identify when they could be applicable in the current situation of the Balkan regional markets.



Market based investment approach.

The market based investment's model founds its mechanism on private equity returns obtained by the selling of the services on the free market.

Considering the infrastructure building, this approach has undoubtedly some positive effects: First of all the financial and construction risks are falling on the investor's shoulders with no consequences on public budget.

Secondly, the private investor involvement usually guarantees higher performing cost allocation and the best financial returns.

Nevertheless, possible disadvantages could rise: First, the tariffs on a free market could have an incremental trend, especially considering that the TSO is commonly managing an essential facility⁸ that is natural monopoly.

In fact, it is clear that a fundamental infrastructure like a pipeline cannot be easily duplicated or, very often, this could be not feasible financially or environmentally.

Besides, since the risks are mostly and directly on the investors' side, the cost of capital involved in the building is usually higher in order to properly remunerate the financial assets involved.

Moreover, in the case of a private investment the possibility that the public policies perspective will not match the investor's priorities

8 An essential facility is an infrastructure that has to be left available for the market's functioning and purposes and not just for its owner's commercial interest. To define an infrastructure as "essential" four conditions should be present: the infrastructure should be owned by a monopolist, a new infrastructure should be not possible or feasible, there should be a "not justified" refuse to the access for third parties and third parties use should be legal or possible. First essential facilities concept implementation come from the United States Supreme Court case *U.S. vs Terminal Railroad Association* U.S. 383 dated 1912: the Court stated that the conduct of the owner of the bridge crossing the Mississippi river was not acceptable when the bridge use was refused to the owner's competitor. The European Commission implemented the essential facilities concept in its decisions since 1993 in the case *Sea Containers vs. Sealink*. One of the European Court of Justice most important decision on this matter is the case *Oscar Bronner GmbH & Co. KG v. Mediaprint Zeitungs-und Zeitschriftenverlag GmbH & Co. in 1998*.

with a predominance of the commercial aspects rather than public needs is likely higher.

Finally, in the free market the investor will prefer to sign long term binding agreements for the infrastructure use in order to be sure about future cash flow.

Potentially this approach could create a market paralysis since the new infrastructure's users could not find capacity available for their transport needs: This could affect the competition dynamics by creating a stable position for a few markets' players.

Considering the possible distortions on the free market, a regulatory scheme is necessary: actually, according to the current legislative European requirements applicable to the ECSEE Members State, each Country has to establish a powerful independent Regulatory Authority appointed to regulate the energy market.

The role of the Authority is really basic for the market effectiveness since it will organize the market's aspect that could not properly work by itself: for instance, the TSO could abuse its role as manager of the infrastructure by discriminating the users for commercial purposes or, for instance, it could impede the competitors step-in or it could impose higher tariffs not based on cost reflective criteria.

To avoid this situation, the European market regulation requires a Third Party Access mechanism to be enacted in the national legal framework in order to restrict the TSO powers: in this way the TSO is obliged to grant the indiscriminate access to infrastructure's potential users.

Secondly, in order to facilitate the gas trading and transport a Capacity Allocation Mechanism⁹ has been set up together with the relevant Network Code¹⁰: according to this regulation the infrastructure's capacity allocation *optimum* will be reached by a "stock exchange mechanism" where the national and international

9 On 15 April 2013, the 'Committee on the implementation of common rules on the transport, distribution, supply and storage of natural gas' delivered a positive vote on the CAM Network Code, which was published as *Commission Regulation (EU) no 984/2013* in the Official Journal of the European Union on 15 October 2013. Most provisions of the CAM Network Code will apply from 1 November 2015, following the implementation period. The Agency ACER will monitor the proper implementation of the CAM Network Code and its effect on the completion of the internal energy market.

10 The Network Code is the contract applicable which defines the terms of service, the obligations and responsibilities that the parties must mutually respect.

transportation demand and offer will match each other without any external influence.

In this way, the shipper will be the bidder that will offer the highest price to acquire the rights to use the infrastructure's capacity on that day and at that time.

It is clear that in a market based approach the market's players can organize the business by themselves obviously remaining in the legal framework; the Authority will monitor the players' conduct and market dynamics.

Regulated market investment

The regulated approach is based on a strong presence of the public sector in the market: in this case, because of the structural deficiencies of the markets it not possible to think about an autonomous investment appeal.

Considering this approach, it is necessary to identify tools and benefits required to move investor's interest to this kind of market: Of course, since the public sector will be involved in this strategy, the economic and financial parameters of the infrastructure's investment will be strongly supervised by the public bodies involved.

Indeed, the public side could gain several benefits from this approach: in fact, the TSO could be requested to take care of public needs in the infrastructure's design in order to promote public policies.

Secondly, the public resources injected in the investment make the cost of capital lower than the cost of financing a total private equity infrastructure.

On the other hand, part of the risk is transferred to the national budget or to the consumers by the transport tariffs payments.

Besides, considering a cross border infrastructure, it could be hard to evaluate how to allocate the infrastructure's cost at different national levels: it could be necessary to coordinate a coherent approach to the cost evaluation and tariffs level as well.

Hybrid Projects

Another possible solution has been investigated by ECSEE.

Actually a hybrid approach, mixing private and public, could fit the diversified regional market situation: it is a matter of fact that the planned infrastructure will play a different role considering the different status of each Country.

It is true that a non-homogeneous market situation in the Balkans obliges who is planning a cross border infrastructure to interact with a various markets' development stage by different tools.

On the ground of these remarks, ECSEE divided the Balkans area into three tiers; in Tier A case, the infrastructure's main role is to satisfy the national gas consumption demand and to improve the supply mechanism. The source of the TSO remuneration will remain the market and the tariffs applicable for the services allocated.

In Tier B case, the infrastructure rationale would be to satisfy large consumers as power plants or factories already present in the market: in this case, in fact, the larger consumers would be the "anchor load" that would attract the investors already comfortable by their consumption level. Once the infrastructure will be operating, then the other market sectors, such as households, could evolve toward gas consumption since there will be the structural conditions.

In Tier C case, the infrastructure will create new capacity where there was not any previous pipeline or where there was a very limited market.

In this case the capacity could be not earlier allocated to some specific or larger consumers since the infrastructure should create the market itself.

The Northern and Southern Gas Ring route: infrastructures and market status and a possible risk management approach.

The regional status in the Balkans varies according to the legislative and regulatory framework of each Country: ECSEE suggested to divide the gas ring project in an Northern and Southern route in order to better examine the current status and to evaluate the best approach to drive the investment.

Thanks to this partition, it will be easier to estimate the infrastructure's role in different Countries, to evaluate their position by the Tiers A-B-C classification and then to understand the best risk management/investment appeal tools.

The Northern Gas Ring route

The Northern Gas Ring route is planned throughout Croatia, Serbia and Bosnia and Herzegovina (BiH).

Considering that an infrastructure business model based on market works just where a clear legal and institutional framework has been set up, Croatia and Serbia seem to be the most advanced Countries in the European regulatory benchmarks convergence process.

The Croatian Energy Regulatory Agency (HERA) is independent from governmental and commercial influence and it is acquiring the competence to fully regulate the market.

Serbia has established a Regulatory Agency in 2005 on the ground of the European experiences.

Nevertheless, the situation is quite different in BiH: the peculiar nature of this Country compounded by Republika Srpska and

Federation of Bosnia and Herzegovina makes the competence partition on these matters not clear.

In fact, Republika Srpska established a Regulatory Commission for Energy (RERS) while the matter is under the governmental control in Federation of Bosnia and Herzegovina: as a consequence, there is not a third and autonomous body able to regulate the market.

This could be one of the main issues for investor that could be involved in a possible project in the area since there will be not a "third party" Authority able, for instance, to intervene in the dispute resolution phase.

In fact there will be not a special arbiter for the disputes related to the network access and use. The recourse to the ordinary Court is really not attractive considering the trials' length and the specific knowledge needed to judge possible disputes in these matters.

On the other hand, a possible market based investment would face another important risk.

Actually, Northern Balkans Countries such as Croatia, Serbia and BiH do not present a large gas consumption market.

Actually, Croatian planned natural gas demand increase is quite moderate since the expected consumption will rise from 3.1 bcm in 2010 to 4.4 bcm in 2020.

Nevertheless, the domestic natural gas production and the planned and in progress energy infrastructures make Croatia an interesting potential market.

The situation in Serbia diverges according to the geographical area considered.

The northern part of the Country is very well gasified; the western and central part presents a non-homogeneous situation whilst the southern part is severely affected by a shortage of infrastructures and, consequently, is not well gasified.

The worst situation is reported in BiH where natural gas consumption is mainly concentrated in Sarajevo and in very few consumption points as steel and cement factories.

In order to mitigate the risks related to the volume of selling, very real in such market conditions, it is possible to evaluate some strategies that could make an investor more comfortable in entering into a developing market.

The main idea is how to create a sound investment climate even

in a situation where there is not a clear market visible: in the lack of certainty and guarantee on the selling there could be not any investor available to bear the cost of the infrastructure without a serious risk management approach.

First of all, it is necessary to verify if a market exists: a market test with an “open season” mechanism could be a useful tool to identify possible users in the markets.

In fact by the open season possible buyers would show their interest in buying and entering in binding preliminary agreements for future capacity.

In this way it is expected to find possible “anchor loads” such as large firms, natural gas power plants or existing power plants to be converted to gas burning.

Anyway, it seems clear that using the ECSEE evaluation on Tier A-B-C each possible case is present in the northern gas ring route: it means that different strategies will be requested to create a sound investment climate.

If to find an “anchor load” or a dynamic market sector available to absorb the new natural gas offer is possible in Croatia and Serbia (in Tier A and B case), the Tier C situation in BiH is quite different.

Since the Tier C status is common in the Southern Balkans it will be analyzed in the sector dedicated to the Southern Gas Ring route.

Southern Gas Ring Route

The Gas Ring Southern Route is planned throughout Albania, Macedonia and Kosovo: the situation in this part of the Balkans is very poor in relation to the existing gas infrastructure and markets.

Actually, Albania was a quite reliable producer in the past but nowadays the domestic extraction is severely decreased.

After this, the natural gas pipeline system has been definitely compromised and it has fallen into disuse.

From an institutional point of view Albania has established an independent market Authority and it has enacted a national law on the natural gas market and transport.

Macedonia has established a national energy Authority as well: the Macedonian infrastructure system is very poor and underutilized: the Country is completely dependent on energy imports.

The Kosovo situation is probably worst: historically this area has been very often under tension because of the conflicting relations with Belgrade till the unilateral independence approved by the Pristina Parliament in 2008.

This situation has been not favorable for the energy sector development and in fact the current production in Kosovo is still based on lignite and fuel oil with heavy impact on the pollution level.

Household consumption is based on liquefied petroleum gas (LPG) especially in the rural areas. From institutional point of view the Pristina Parliament has approved the national law on gas, expanding the Regulatory Agency powers in 2009.

On the grounds of this picture the southern Balkans situation seems to be poorer than the northern part: like in BiH in the southern Countries the lack of infrastructure and internal production reflects the status of the market without a founded consumption level or a large number of big consumers.

Considering this circumstance the southern Balkans as BiH could be identified in Tier C status. In this case the new infrastructure’s role will be fundamental to open a new market still not in existence.

However, it is clear that no investor will bear the risk to build a pipeline or a network without a clear capacity allocation plan and, consequently, without a clear investment return mechanism.

So that, a market based approach will not work in case the market is not formed: actually, a return mechanism based mainly on the tariffs payment is not reliable in such situation.

Therefore, volume and price risk has to be managed by specific tools that could create a sound investment climate by mitigating the uncertainty on the investment.

Considering that the common approach to the investment is to participate according to the final result of the investment itself it is clear that a public involvement in such situation is legitimated.

Actually, a new and well managed infrastructure will set the base for a new market creation with positive outcome on energy affordability.

As a consequence, the energy availability and reasonable energy cost can be the key factor in the national production growing thus the national and international institutions, governments and donors can step in the investment with public finance to support a clear public interest.

There are several tools able to create a positive cooperation between public and private: first it could be possible for national Governments to plan a general revamping of the existing power plants that currently are running on diesel or heavy fuel oil: for instance in Vlore, Albania, a Combinate Cycle Gas Turbine (CCGT) power plant is working on diesel due to the lack of gas.

In this case, in order to make the investors more comfortable, the national Government could sign a time-definite binding Power Purchase Agreement that would assure the selling of the energy produced by the power plants supplied by the investor's gas infrastructure: in this way, the gas consumption would be guaranteed for the investment return period.

Another possible way to create a comfortable investment climate could be a direct subsidy granted by the Government in the construction phase.

Actually, this procedure could create distortions in the market since it could hardly transfer the financial risk on public budget thus generating significant and not balanced return for investors.

Secondly, paying a subsidy to an investor could hurt the strict European regulation on State aid.

Besides, an exemption from the current competition regulation could be another tool to attract an investor to an upcoming market. In fact it could be possible to grant to the investor a temporary monopoly on the market or to provide a Third Party Access regulation exemption for the period needed to assure the investment returns.

Latest, it is possible adopt a "cap and collar" contractual mechanism: in this way the investor returns cannot be lower or higher than a range defined by the negotiation with the national Authority: should the real infrastructure performance be lower than the expected the public budget will refund the investor but the public would receive benefits in case of infrastructure over-performance.

However, all these activities need a strong national Regulation Authority able to verify the TSO conduct and to negotiate with investors the possible solution or risk management tools.

Conclusion

The analysis of the Balkan area shows a very scattered situation and so it is not possible to think about a single action in order to create a sound investment climate for infrastructure investors.

Croatia and partially Serbia seem to be ready to develop a market orientated approach where the investment could be returned by the tariffs paid for the infrastructure capacity use and these Countries seem to have the appropriate institutional and legal framework even if not completely enhanced.

However, the most of the Balkans Countries seem to be not in position to implement a market based infrastructural policy due to the marginal market and the shortage of larger consumers.

In the current situation the main risk for investor is related to the volume and payment risks that could be minimized only by a regulated approach, sharing the risk with public budgets.

In some case the direct involvement of the public sector is really necessary especially where the market size is too small and the investment would not be justified considering the poor predictable return.

Public policies could be directed in two ways: first it is possible to promote the gasification of the existing power plants running on oil or lignite and to promote households gas consumption.

In this way, it could be possible to create "anchor loads" in the market that could be reliable enough to attract investments on infrastructure that will feed them: at the same time it is predictable that the presence of a new infrastructure will orientate other market's portion to the natural gas consumption.

Secondly, it is possible to operate by a regulatory and contractual point of view granting some temporary benefits on the market position to the investor that will bear the construction risks.

On the other hand, the public could be involved by a financial

approach granting incentives and subsidies: actually, this solution could be not in line with the European market's shape based on competition, fair and equal conditions within the respect of the overriding public interest principle.

However, the Gas Ring project needs a specific regional approach: considering the peculiarity of each Country involved and the international nature of the Gas Ring project, a cross-border regulatory cooperation it is clearly necessary together with a regional TSO shared governance.

An important role on this could be played by the Energy Community Regulatory Board¹¹ (ECRB) that is the coordination platform for exchange of knowledge and development of best practices for regulated electricity and gas markets in the Energy Community.

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11 The ECRB is an institution of the Energy Community established by Article 58 of the Energy Community Treaty headed by a Board of high level representatives from the national energy regulatory agencies of the Energy Community Contracting Parties, Observers and Participants.

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