IRMO
Institut za razvoj i međunarodne odnose
Institute for Development and International Relations

Hanns Seidel Stiftung
Ured u Zagrebu

2023: Turning Moment for European Energy Policy toward Balkans and the European Promotion of the Rule of Law

By Aleksandar Kovačević

Introduction

The year 2023 is likely to bring congruence of events that may cause a "perfect storm" of breaking down security of energy supply, fragile political stability in the Balkans and its unsustainable social contract. As the region grows fragmented from mid-1960's till nowadays, very few economic forces remain in place that may cause such impact to entire region in the given moment of time. Cross border trade in goods and services is negligibly small. Countries trade more with the rest of the EU than among themselves. The terms of trade favor imports against exports. After 20 years of infrastructure development and integration efforts, with support of donors and creditors, despite small improvements; Logistic Performance Index (LPI) for the Balkan countries remains slightly over half of best performers such as Germany. Port resources are not allocated in line with the commercial practice. That is not good enough for the region that links Mediterranean with the landlocked Danube area. Travel time along major railway

routes (Zagreb – Belgrade or Belgrade -Bar) are twice longer than during 1980's. Belgrade Port, that is the key destination for transport with all sea ports in the region is constrained by the city planning and kept below minimum throughput to be reported in European inland port statistics. Croatia, Montenegro or Albania, are hardly in position to engage into trade as their ports operate far below competitive thresholds. The transactions are prohibitively expensive.

Context for this excursion into the future

Climate change narrative is slowly emerging at the Balkan political scene. That reflects global political patterns. However, most Balkan jurisdictions (notably Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia) are among most carbon intensive economies in the world. The region is disproportionally exposed to floods (to areas with highest density of economic activity and infrastructure) and forest fires (across most valuable forests), as well as droughts (in its most fertile agriculture areas). For this region climate change is a dual risk: (1) emerging global regulation is forcing rapid decarbonization that exposes carbon intensive industries and (2) proliferation of weather events (floods, forest fires, draughts) that disproportionately affects the region. Remaining performing assets in the region are increasingly exposed to these risks. After the global climate conference in Glasgow at November 2021, during the 2022 one may expect tightening of international regime for financing or support to fossil fuel power generation.

German government implements a program to close coal fired plants with thousands of megawatts in capacity.

Reduction in dispatchable power generation capacity in Europe speeds up - German government implements a program to close coal fired plants with thousands of megawatts in capacity during 2021 and 2022, accompanied with complete nuclear phase out in 2022. Groningen gas field in the Netherlands and Ukraine gas storage capacity – so far the largest providers of flexible gas supply – are going off market by 2023. Taking into account that new gas infrastructure - Nord Stream and Turk Stream pipelines are very limited in flexibility and without storage capability - it seems plausible to consider shortage of power export capacity to the Balkans and reduction in security of supply. Prolonged pandemic as well as experience with past disasters (earthquakes, floods, environmental impacts)

makes population disillusioned about the quality of governance. The society is growing more sensitive to environmental issues while affordability of energy becomes more difficult.

Latent conflicts are deeply embedded into social fabric of the Balkans. Over 20 years after armed conflicts, key cross border hydro power facilities – among most valuable hydro power assets in Europe – remain constrained. Black Sea markets for cereals, fertilizers, crude oil, oil products and natural gas are growing that makes them relevant for price formation at the global scale. Although Balkan countries are linked to the Black Sea by the River Danube there is little reflection to local markets. Import of these commodities from the Black Sea toward Europe along the Danube remains astonishingly small. However, there is a latent price pressure: production of fertilizers from natural gas imported from Russia is now exposed to competition from Russian fertilizers if not directly, then by impact through the price of cereals.

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Deeper and Wider Suez Canal provides better access for containerized goods from Asia and commodities from the Middle East to Mediterranean markets including the Balkan ports. Even with suboptimal utilization of ports, imported industrial products rendered a range of industries uncompetitive. Productivity gap is way too large. It is now more profitable to export bauxite from Montenegro to China and import alumina, than to produce alumina from domestic bauxite.

New Gas Pipeline Bypass infrastructure built by Gazprom of the Russian Federation comes to results. Pipeline system in Ukraine and its major gas storage capacity is bypassed. First deliveries are recently accomplished via Turk Stream. In the same time, Turkey is now able to import gas from the open sea by LNG terminals, from Azerbaijan, Iran and Iraq. New discovery of large gas deposit in Iranian section of the Caspian Sea provides a new dimension to these transport routes. First Azeri gas to Bulgaria and Greece has been delivered via Trans Adriatic Pipeline (TAP) that connects Turkey to Italy crossing Greece and Albania. As a consequence, Bulgaria, Serbia, Greece and Albania are now served with several times larger capacity of gas infrastructure than their respective gas demand now or in the foreseeable future. It is also accompanied with great expectations about gas transit rents. Beyond these, EU Green Agenda for the Balkans from the end of 2020 envisages further gas pipeline investments across the

region and floats an idea to displace lignite fired power plants by new gas-to-power plants.

Pipeline system in Ukraine and its major gas storage capacity is bypassed.

Uncertainty about actual implementation of critical multilateral obligations emerges as a key impediment for investments in the energy sector. Although Green Agenda for Balkans envisages displacement of coal by gas, EU climate policy does not envisage use of public funds to promote natural gas. There is uncertainty if or when large gas resources in Romania may come to the market. Following the Council Decision 2006/500/EC, the EU engaged with the Energy Community Treaty (EnCT) in order to promote integration of gas and electricity markets, facilitate investments and reduce energy poverty as well as to improve energy security. There was no direct correlation with the EU accession process. Although the European Commission Report to the European Parliament of March 10, 2011 indicated lack of actual implementation of the Treaty, it linked the Treaty with the EU accession process. Eight years later, in 2019, Energy Community Treaty Secretariat published the first Report that contained indications on the status of actual material obligations from the Energy Community Treaty. Subsequent reports in 2020 and 2021 also went beyond harmonization of legislation and institutions and reported breaches of the Treaty by all Western Balkans signatory parties in nearly all material obligations including: environmental impacts, renewable energy and energy efficiency. Sixteen large lignite fired power plants in the Balkans reportedly cause more emissions of sulfur dioxide, nitrogen oxides and particulates (heavy metals, etc.) than remaining 250 coal fired power plants in the EU. These emissions are directly harmful for human health and life threatening. Beyond that, acid rains caused by such pollution contribute to loss of forest cover, erosion, landslides and floods all across the region and beyond. At this moment the Thermal Power Plant (TPP) Pljevlja in Montenegro still operates even though its derogation of 20000 hours prior to closure expired in November 2020. Nearly 6000MW of installed capacity or over 50% of actual power generation in the region still operate in breach of the National Emission Reduction Plans in Bosnia and Herzegovina, North Macedonia, Kosovo and Serbia. Newly built TPP Stanari in Bosnia and Herzegovina with Chinese technology have yet to demonstrate compliance with emission regulations after 2023. So far, breaches of the Treaty have not been listed in Progress Reports, chapters on the Rule of Law, within the EU accession process. Power system Adequacy reports (European Association of Transmission

System Operators or EnCT) envisage these plants to be operational for time being making for sufficient supply adequacy. Although these reports are based on Adequacy statements from national operators, rational observer would expect scrutiny on implementation of crucial international obligations. As this situation persisted for a number of years, it imposes uncertainty about the rule of law as well as about electricity supply situation. Beyond Weighted Average Cost of Capital (WACC) that is well above European levels, uncertainty appears as major impediment for commercial investments. Pouring public money into public infrastructure does not generate electricity. Private commercial investments do.

Thermal Power Plant Pljevlja still operates even though its derogation of 20000 hours prior to closure expired in November 2020.

Obsolescence Risk is immense across the region. Governments have been provided with virtually unlimited credits from Chinese export credit banks, EU and financial institutions, while credit available to commercial investors is constrained. Notable example is the recently built floating LNG terminal on the island of Krk in Croatia. Various commercial investors have been pursuing this project from 1996 till recently. Their intentions evolved toward commercially viable service to customers across the region and challenge to incumbent. Massive EU investment grant made available to the government enabled suboptimal solution that failed to restrain Gazprom to invest into new pipeline across Bulgaria and Serbia. More important is the message to commercial investors - if the private investment project is revealed to the government, it may displace it by its own venture.

Energy market trends

Further increase of investment risks in Balkans requires an active hand of the bad government to promote and grow uncertainties as well as to allow cumulation of risks. Entrepreneurial government that actively ventures into commercial projects and use coercive powers to pursue profits combined with proliferation of bonds to maintain liquidity is now a well-established standard. Despite nominal GDP growth there is an opaque accumulation of fiscal risks and immobilization of productive assets. The pattern of investments into roads against railways or waterways supports fiscal revenue only. Growing transaction costs are gradual but persistent drain of resources that may be needed in case of emergency.

Major failures in lignite mines or power plants are more frequent.

Probability of failures increases. Maintenance at major lignite fired power plants, district heating infrastructure, railway infrastructure and even roads and buildings are diminished. Probability of technical failure is inverse exponential function of maintenance: as reduced maintenance persists; probability of failure grows exponentially and when one failure is repaired by improvisation both probability and scope of other failures increase. A number of cities are now left without regular water supply. There is hardly a single one functional railway line in the region. Major failures in lignite mines or power plants are more frequent. While accumulation of risks is consequence of governance patterns, increase in probability of failures rapidly becomes technical pattern with self-inducing inertia.

Fable: Interplay between the energy company and its government

Being deprived from open sea markets, Balkan countries remain unable to optimize their energy portfolios with seaborne trade. That forces an awkward form of regional trade - when one country suffers supply failure, traders and rent seekers rush to take advantage of that. Although the regional electricity market is nominally established, no one can rely on it for regular competitive supply. Consumers that are sensitive to security of supply, such as Mostar aluminum smelter, are already out of business or only able to operate at occasions. This opaque gambling on cross-border energy trade is still able to deliver, somewhat bizarre, sort of supply security. Intermittent nature of electricity demand, weather sensitivity of demand accompanied with diversity of weather patterns and configuration of probability of failures, as well as lower utilization of cross-border high voltage lines than it was during 1980's, still allow a kind of coordination that maintains supply to population within politically bearable tolerances. That causes excessive transaction costs.

Balkan countries remain unable to optimize their energy portfolios with seaborne trade.

Energy company provides a good service to the government - it is offering a low price of electricity, it employs thousands of workers, it contributes to liquidity of the treasury or selected banks, it guarantees electricity supply to selected industries. Low price electricity makes very expensive natural gas or district heating somewhat affordable. It lowers direct cost of commodities such as aluminum, copper,

zinc, steel, ferronickel, making these exports competitive and actually feasible. Perception of liquid treasury and stable currency with stable while obsolete social contract make the government looking creditworthy. To extent there is no consideration of carbon intensity of sovereign bonds, Balkan countries may present themselves as legitimate issuers of government debt.

The interplay works for the company - low price is a barrier to entry. Accompanied with the lack of rule of law and uncertainty of enforcement, it keeps competition out and consumers in. Growing probability of technical failures is not of great concern as long as it is possible to lure the government to step in with cash or sovereign guarantee or to a turn blind eye to environmental impacts and human rights. Nearly entire population and fragile social contract are hostages of this interplay.

The interplay comes with the expenditures: delayed overburden removal in lignite mines, neglected maintenance, neglected environmental protection and massive hydro power capacity idled to intervene in case of technical failures. There are already signals that viable coal mines are associated with failing power plants while depleted mines are equipped with more operational plants. All across the region, lignite plants are running out of ash disposal capacity. In 2023, derogation for a number of plants expires. Remaining plants have to demonstrate compliance with emission standards. That is going to reveal an increase in carbon intensity of produced electricity, decreased efficiency and higher costs as well as more complexity and decreased availability, combined with higher electricity prices and shortage of dispatchable capacity in Europe that is likely to cause shortages. Remaining energy intensive industries are going to be exposed. In many countries, lignite resource rents are not going to be available to support fiscal structure and offset excessive costs of solid fuels, gas and district heating. Subsidies for intermittent renewable energy investments are going to add costs both to customers and dispatchable generators that are going to be less flexible if they comply with emission standards.

There are already signals that viable coal mines are associated with failing power plants.

In 2023 the international community is likely to be more sensitive to carbon intensity, financial markets less open to bonds based on carbon intensity while further deterioration of railway and port infrastructure is most likely. Growing probability of technical failures, floods, land-sliding and adverse weather events may result with further emergency situations. Obsolescence risks and uncertainty about

the rule of law prevent investments that may moderate risks and give scope for reliable supply capacity in immediate future. Therefore, bleak expectations may drive some investors and creditors to withdraw from the region (as already experienced).

Conclusion

Even if the EU immediately and truly commit to the rule of law and demonstrate commitment by enforcement of the EnCT and UNFCCC Paris Agreement as well as promotion of human rights and environmental standards, conventional capacity building and technical assistance support are not going to be sufficient to suddenly improve quality of governance enough to attract commercial investments. Lead time for energy investments is 2-5 years. There is a need for a tailor-made private investment institution to jump-start a range of cost-effective investments that are going to: (1) develop domestic renewable energy resources, (2) displace unsustainable lignite-to-power industry, (3) preserve security of supply and (4) uproot natural resource rent governance. That may unlock enormous flexible hydro power potential to ease the transition toward renewable energy in Poland and Ukraine or elsewhere in Central Europe, enhance security of supply and facilitate cooperative approach to transport infrastructure between the Danube and the Mediterranean.

Aleksandar Kovačević, economist, is an author with the International Energy Agency, the United Nations and the Oxford Institute for Energy Studies, based in Belgrade, Serbia.

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Institut za razvoj i međunarodne odnose
Institute for Development and International Relations

Hanns Seidel Stiftung
Ured u Zagrebu

Institute for Development and International Relations - IRMO
Lj. F. Vukotinovića 2, Zagreb, Croatia
www. irmo.hr

Hanns Seidel Stiftung
Amruševa 9, Zagreb, Croatia
www. hanns-seidel-stiftung.com.hr