SUMMARY

The governance of Bulgaria's energy sector is faced with a number of problems of a technical, legal, and institutional nature. Recent audits of the implementation of large energy infrastructure projects have exposed some **serious governance issues**:

- A lack of sound energy strategy with clear priorities;
- Apparent conflicts of interest at the highest political level, leading to suspicions of corruption;
- Poor management of state enterprises;
- An absence of adequate independent oversight and numerous monopolistic abuses at the consumers' expense;
- Politically motivated privatization of assets and uncontrolled access of questionable capital to the energy sector.

The dynamic international environment places additional pressures on the national energy policy and requires **careful planning and public consensus in deciding future priorities for the sector**. Several factors have a large effect on Bulgaria's energy policy:

- Climate change and the related international agreements and binding targets of the European Union (EU) for the reduction of greenhouse gas emissions;
- The use of new technologies to reduce energy intensity and increase the share of renewable energy sources (RES);
- The global economic crisis associated with a more rapid decline in energy consumption than in GDP in all developed countries in contrast to emerging markets;
- Political pressure related to external geopolitical and economic interests.

The main **elements of energy sector governance**, which the current report reviews, comprise: (1) the strategic framework; (2) the legal framework; (3) the institutional structure; (4) the development and management of projects; and (5) public procurement as a tool for energy policy implementation.

A clear medium to long-term energy strategy outlining valid and realistic priorities should be at the basis of the decision-making process in Bulgaria's energy

sector. The June 2010 *Concept of the Bulgarian Energy Strategy until 2020*, currently under discussion, reflects the views and opinions of stakeholders to a greater extent than its predecessors. Yet, the analysis of existing energy strategies reveals some **recurring and persistent shortcomings of strategic planning** with respect to the Bulgarian energy sector:

- A **mismatch between the government's actions and the strategic framework**, given that the majority of the Bulgarian government's decisions over the last decade have been taken without proper strategic justification;

- Signs that **public policies have been captured by private interests –** for example, the predominance of projects that steer substantial funds to a limited number of private undertakings, e.g. constructing large generating capacities, instead of more promising solutions, e.g. stimulating energy efficiency;

- The **absence of financial justification** of pledged goals, leading to numerous and overly optimistic priorities and objectives. The latter allows for broad discretion in government policy making and, effectively, renders strategic planning meaningless;

- The **lack of a good governance framework** for the implementation of the energy strategy, with exact deadlines, clear responsibilities of institutions, and indicators for the assessment of results.

Compared to its predecessors, the June 2010 ***Concept of the Bulgarian Energy Strategy until 2020*** outlines more clearly the national priorities, is more responsible in budget terms, and attempts the introduction of scenario planning in the development of the national energy sector. The proposed strategy provides a good basis for public discussion as it incorporates the main guidelines of the *Energy Strategy for Europe 2020*. In order to achieve its objectives, the Cabinet and the National Assembly should adopt the Bulgarian Energy Strategy, including a budgetary framework for its implementation, as soon as possible. As a member of the EU, and in accordance with the EU's Energy and Climate Change Package from January 2007, **Bulgaria has undertaken a binding commitment to reduce its carbon emissions, reach a minimum share of RES in final energy consumption, and reduce its energy intensity**. Achieving these goals requires collaboration and coordination between government bodies and institutions involved in energy and environmental protection decision-making, as well as simultaneous and interrelated development of energy and climate change policies.

The second major energy sector governance element, which this report analyzes, is the **legal framework**. Activities in the country's energy sector are governed by a number of laws and over fifty regulations. Energy legislation in Bulgaria can be grouped into the following three categories:

- General regulation of the sector, as stipulated by the *Law on Energy* (2003);

- Nuclear energy and nuclear safety regulations;

- Sustainable energy (energy efficiency, RES, and biofuels).

The bulk of Bulgaria's legislation has been transposed from regulations in more advanced countries, most notably the European Union. This, together with the relatively limited national experience with implementation, has resulted in substantial **discrepancy between legislation and practice**. It has also provided **ample opportunities for the capture of the (weak) administration by (strong) corporate interests**. To overcome the above tendencies, the Bulgarian government needs to undertake sizable investments in strengthening the regulatory and governance capacity in the energy sector of the country.

The **organizational structure of the country's energy sector governance** is characterized by natural (geographical) monopolies on the one hand, and by fragmented management of state-owned assets on the other. The management of the energy sector is entrusted to various ministries, agencies, departments, and state enterprises, leading to **overlapping responsibilities and conflicts of interest**. Changes to the institutional structure of Bulgaria's energy sector governance are most commonly the result of external pressures. For example, the creation of the Bulgarian Energy Holding (BEH) via the pooling of the assets of a number of state-owned companies did not result in tightening financial discipline or in greater transparency of the government corporate sector. Two key energy enterprises **– the National Electric Company (NEK) and Bulgargaz – are in dire financial state** despite cutting their expenses in 2010. Moreover, BEH virtually duplicates the functions of the Ministry of Economy, Energy and Tourism, while NEK on its turn duplicates BEH's functions.

Bulgaria's binding commitment to separate energy transmission from energy generation and supply, as per EU's Third Liberalization Package, should be duly applied in order to eliminate the above inefficiencies. National specificities, such as the existence of a single supplier utilizing a single gas pipeline, should be carefully taken into account when implementing the Package. **Guaranteeing independence form the government and the proper functioning of the national energy regulator** (the State Energy and Water Regulatory Commission) should be a priority. Currently, the regulator has not demonstrated high regulatory potential and its functioning is not clearly separated from the executive.

The current governance model is not sustainable. On the one hand, state-owned enterprises are overburdened with numerous infrastructure projects and social services that limit their investment opportunities; on the other hand, private interests push them away from the most profitable market segments. There is a revolving door stream of personnel from the state to the private sector and back with no adequate assurances with respect to avoiding conflicts of interest. A more sustainable model entails pursuing one of the following two strategies: gradual privatization of state-owned assets via the stock exchange (while maintaining state control over key enterprises such as nuclear power, network operators, etc.); and/or developing a strategy to expand and position state enterprises on the regional (South-East Europe) or European market.

Project development is the fourth key element of energy sector governance, which the current report reviews. The construction of new generating capacities is among the activities most prone to corruption worldwide. During the past decade, the experience with managing large energy infrastructure projects in Bulgaria has pointed to major corruption-related risks and deficiencies:

- Due to their size and scale, the projects challenge the national economy's absorption capacity and **exceed the Bulgarian government and administration's management capacity**;

- These projects involve **considerable consulting fees** often for services provided prior to launching the project. Moreover, consulting services are difficult to quantify and are accompanied by intransparent accounting, which makes them the most commonly abused instrument for political corruption. Thus, large infrastructure projects create sizeable lobby groups that swamp the public with subjective judgments, while concealing their conflicts of interest. The latter obstructs the independent and impartial analysis of risks that inevitably arise;

- Finally, such projects are usually signed on a bilateral basis with countries that are characterized by higher corruption risks than Bulgaria, and with companies that are subject to no international ethical standards.

Belene Nuclear Power Plant (NPP) is the largest infrastructure project in Bulgarian history. It epitomizes the full range of opaque practices observed in the energy sector and the management of state enterprises over the past twenty years:

- It feeds a **strong nuclear energy lobby** of experts, politicians, and a number of private firms. The lobby aims to monopolize public debates and policies on nuclear energy. As a result, while supportive of nuclear energy, Bulgarians are **the least informed consumers in the EU** as regards the facts and risks associated with this kind of energy;

- It **contradicts the key priorit**y of both European and national strategic documents, namely, achieving energy security through diversification;

- It is **based on misleading market demand forecasts and ambiguous construction pricing mechanism** that excludes a number of hidden costs. The comparison of Belene NPP to similar projects carried out in the EU suggests that the **final project cost will amount to EUR 10 – 12 billion –** an amount that exceeds all EU funds earmarked for Bulgaria for the 2007-2013 period. Considering the serious difficulties that Bulgaria is facing with the absorption of EU funds and the substantial delays in the implementation of all large infrastructure projects in the sector, implementing a project of this size **may seriously threaten the long-term financial stability of the country**;

- It has been characterized by a number of violations and breaches of **good governance principles**. Public funds have been spent in a frivolous manner without regard to achieving project objectives. Consultancy costs have kept escalating and the conditions of already awarded public procurement contracts have been repeatedly altered at taxpayers' expense;

- The Bulgarian government has appointed as project manager the National Electric Company (NEK), whose financial condition has deteriorated continually and, as of 2010, the company was in violation of all of its credit obligations on other investment projects.

In light of the above, the memorandum for the creation of a joint project company (between NEK and Rosatom, Russia) signed in 2010 calls for **a careful reconsideration of the alternatives** and for the establishment of a national position based on the country's strategic priorities.

As Bulgaria faces tight budget and other resource constraints, its government should **sequence the implementation of all planned infrastructure projects based on clear priorities**. The planned gas infrastructure projects guaranteeing the necessary energy resources to meet national market demand (security of supply considerations) at the lowest price (maximal gain considerations) should take precedence. Using cost-benefit analysis from the point of view of energy security clearly demonstrates **the order in which projects should be implemented**:

- Developing **Bulgaria's own gas reserves** in the Black Sea shelf and exploring the option of using shale gas and other local alternative energy resources;

- Connecting the national gas system with neighboring countries' systems (gas **interconnectors**);

- The **Nabucco project**, which contributes to the diversification of both gas sources and supply routes, and its financing is supported by the EU;

- Building a **LNG terminal** at the Black Sea coast or jointly with Greece and/or Turkey at the Aegean Sea coast. This would ensure considerable flexibility of supply, though at a comparatively high cost;

- The **South Stream project**, which contributes to the diversification of gas supply routes only, yet its management is non-transparent and its implementation could prove costly due to its underwater segment.

The Bugras-Alexandroupolis oil pipeline project does not fit into the strategic framework for the development of the Bulgarian energy sector, defies established environmental standards, and is not expected to be a source of substantial future financial and/or economic benefits to Bulgaria.

The analysis of the management of key energy projects, such as Belene NPP, the Tzankov Kamak Hydro Power Plant (HPP) project, Maritsa Iztok 2 Thermal Power Plant (TPP), Toplofikacia Sofia, etc. has revealed **complete disregard for even basic rules of good governance**, leading to skyrocketing project costs at the expense of taxpayers and consumers. The absence of good governance practices has resulted in poor accountability, has threatened the financial stability of state-owned enterprises, increasing the risk of losing state control over them (i.e. hidden privatization), and has jeopardized the energy security of the country. This has exposed the **failure of the entire monitoring, regulatory and compliance control system**, including the political leadership, the internal control units of state-owned companies operating in the sector, as well as the independent regulator.

The failure of the checks and balances system, together with the mushrooming of project costs, raise **legitimate concerns of corrupt practices at all levels in the energy sector**, including the political leadership. Ultimately, this rampant lawlessness and lack of controls in the implementation of energy projects provide

significant grounds for **questioning the state's ability to manage large infrastructure projects worth over EUR 500 million**. This, in turn, raises doubts as to the benefit from developing such large projects at all.

Improving the functioning and management of state-owned energy enterprises entails, at the very least, the implementation of the following actions, which would require significant funding and at least 2 to 3 years to be completed:

- The **political leadership should reduce their direct involvement in the operational management** of energy enterprises and instead focus on policy development, the provision of public information, and control functions;

- The allocation of responsibilities and activities between the line Ministry and BEH should be reconsidered. **Duplicate functions and the blurring of responsibilities that are characteristic for the sector should be eliminated**. Extraneous expenses of state-owned enterprises need to be cut to optimize their financial performance;

- A publicly available online **energy information system and database** should be created;

- A system of financial controls of all activities in the sector should be put in place, including requirements for the financial auditing of the enterprises. Maintaining a **registry of public procurement contracts** of state-owned energy enterprises is also necessary;

- **Annual energy policy review** by the National Assembly that includes: evaluation of policy implementation vis-à-vis stated priorities, assessment of the financial standing of state-owned energy enterprises, and outline of the following year's priorities;

- Decisions concerning major investment projects in the energy sector must incorporate **comprehensive and transparent financial, economic, social, and environmental impact assessments**. The longer the delay in implementing these decisions, the higher the resulting sunk costs, and the stronger the incentives for corruption and the political pressures on key decision makers.

Accomplishing the suggested strategic, legal, and structural changes is not possible without **prosecuting and bringing to justice those responsible for the financial mismanagement of large energy projects and state-owned enterprises in the past**. The absence of administrative and criminal proceedings, especially at senior management level, in spite of publicized information about unprecedented increases in project costs, mismanagement, and abuses, creates an environment of impunity and non-transparency. This compounds the problems that Bulgaria is facing in counteracting corruption and organized crime, generating preconditions for the **penetration of the energy sector by national and international criminal interests**. Therefore, good governance in the energy sector becomes a prerequisite not only for the country's energy but also for its overall security.

Public procurement is the key instrument for implementing energy policies and projects. The disproportionately large concentration of public funds in energy public procurement puts this instrument at a constant risk of corruption, fraud, and/or misappropriation. Bulgaria's large energy companies top the list of major contractors in public procurement.

About 56 % of all registered public procurement procedures in the energy sector are not competitive. If contracts awarded through no public procurement procedure at all are added, it becomes clear that **the avoidance of market competition is the rule, rather than the exception**, in this sector of the economy.

The analysis of public procurement practices in the energy sector has revealed the following **problems**:

- Avoiding competitive bidding;
- Restricting public access to signed contracts and their terms;
- Awarding contracts without using public procurement procedures at all, negotiating strategic partnerships bypassing the law, and the common use of special procurement (e.g. citing national security concerns);
- Ambiguous or insufficient control systems and procedures;
- Launching inadequate public procurement procedures (serving no legitimate public interest) aimed solely at the expenditure of allocated funds or at private gains;
- Purposeful manipulation of procedures and/or application documents, as well as technical specifications, to fit the qualifications of the "desired" (preselected) applicant;
- Purposeful manipulation of the application criteria - inadequate qualification requirements;
- Applying political and/or administrative pressure to channel funds to specific beneficiaries;
- Abuse of trust or misuse of information, etc.

Almost all energy public procurement cases audited by the authorities have revealed **violations of procedures and best practice**, yet a few are emblematic:

- The bulk of **state – owned energy enterprises' funds are disproportionately concentrated into a handful of banks**, deposited without proper public procurement procedure;
- The **expenses for consulting services relating to Belene NPP** are so substantial that they exceed the rates elsewhere in Europe to such a degree that they defy market logic;

- The **management of special public procurement**, such as the maintenance of closed nuclear reactors at Kozloduy NPP, the supply of fresh nuclear fuel, and the hiring of a security company in Maritsa Iztok 2 TPP.

The absence of properly structured control and sanction mechanisms with respect to the large public procurement contracts obstructs the transparency and efficiency of spending in the energy sector. Sanctions for serious versus minor violations are not well differentiated and fines have insufficient deterrent effect. The National Audit Office and the Public Financial Inspection Agency are in charge of monitoring public procurement, yet they lack a sufficient number of qualified, narrowly specialized in energy matters, experts. While the outcomes of energy public procurement contracts affect all consumers, their content is not published or publically accessible. In a number of cases contractors have failed to publicize the signed contracts in accordance with the law, or these contracts have been publicized too late and/or without sufficient details.

There is no **mechanism for assessing the public benefit of individual public procurement contracts**. In addition, state enterprises do not have a practice of making public their annual plans for public procurement and/or for providing a justification for intended expenses. The audits of leading state-owned energy enterprises conducted by the Public Financial Inspection Agency have elucidated that **the time lag between disclosing an investment decision and opening a public procurement on it is utterly insufficient** for proper preparation of potential bidders.

In light of the above, **introducing a system for monitoring of public procurement in the energy sector** is essential. The first step towards making such a system operational could be the identification of a set of corruption risk indicators in the energy sector. Such indicators could include:

- Unjustified and/or unexpected increases in state-owned enterprises' expenses;
- Unwarranted decreases in state-owned enterprises' profits coupled with suspicious increases in the profitability of related lines of business;
- Changes in the management team immediately before and/or after parliamentary elections without clear justification;
- Multiple consecutive public procurement procedures with one and the same task;
- Unjustified termination of public procurement procedures;
- Using one and the same experts/consultants in various assignments;
- Systematic avoidance of open, market-based procurement procedures.

INTRODUCTION

The energy sector is the lifeblood of any economy: oil, natural gas, and electric power are crucial to maintaining sustainable economic growth. The safe, affordable, and reliable energy supply to any point along the value added chain is indispensable for the economic and social welfare and development of any state. Thus, good governance in the energy sector is a matter of national, rather than merely economic, security.

Bulgaria's energy sector is of key importance for the development of the country's economy. Over the past ten years, energy exports and imports accounted for 13 and 21 %, respectively, of the value of the total outgoing and incoming trade flows.[1] One in four public procurement contracts relates to the energy sector, which renders it one of the biggest spenders of taxpayer money. In 2008 alone, the Bulgarian government committed to energy projects that required investments equal to the entire EU budget allocated to Bulgaria for the period 2007-2013. Just two years later, these projects do not seem feasible **in the context of the global financial and economic crisis**, demonstrating the lack of capacity for good governance in the energy sector. They continue to consume considerable public and political attention. The pressure exerted by the financial crisis on public finances and audits in the energy sector have revealed **serious governance failures at multiple levels**: a lack of public information about national energy strategy and policy; clear conflicts of interest at the highest political level and related suspicions of corruption; poor management of state-owned companies; a lack of adequate supervision over the sector; abuse of monopoly powers at consumers' expense; politically motivated privatization of assets; and uncontrolled access of capital to state-subsidized newly emerging energy production markets.

The poor management of Bulgaria's energy sector is set against a rapidly changing international environment that presents additional challenges to national policy and calls for even more careful planning and public consensus in decision-making concerning the future of the sector:

- Climate change and the related **international agreements and binding commitments** of the European Union aimed at cutting greenhouse gas emissions;

- The development of **new technologies** for reducing energy intensity and increasing the share of renewable energy sources (RES) in final consumption;

[1] According to BNB data on exports (FOB) and imports (CIF) by end use.

- **Economic pressures**, which have increased in the context of the global economic crisis and have entailed more rapidly declining energy consumption compared to GDP in all developed countries in contrast to emerging markets;

- **Political pressures** from foreign geopolitical and economic interests.

The current report **analyzes the key components of governance in the energy sector**: (1) the strategic framework, (2) the legal framework, (3) the institutional structure, (4) project development, and (5) public procurement as a key instrument for energy policy implementation. Special attention has been devoted to large-scale infrastructure projects, which scope and investment weight are of particular importance to the Bulgarian energy sector and the economy, as a whole, and which attract broad public and international attention. Some of the **most notable problems** related to energy sector governance are:

- Lack of transparent and stable institutional environment and obscure principles of decision-making;

- Poor coordination and cooperation among major stakeholders in the sector;

- Low levels of implementation of strategic goals, laws, and obligations under international and EU agreements;

- Inconsistencies between the legal framework and strategic goals on the one hand, and the real needs of the energy sector and the economy, on the other;

- High corruption risks and lack of transparency in large-scale energy infrastructure projects and in the areas of public procurement, concessions, and licenses;

- Excessive influence of lobby groups on the decision-making process in the energy sector, which leads to unprofitable decisions for the state-owned companies and the misuse of the country's natural, financial, and administrative resources;

- Low efficiency of the energy sector public administration.

The report reviews the strategic, institutional, and legal framework and illustrates the major structural and governance problems in the management of state-owned enterprises and in the energy sector as a whole. In addition, the report explores governance practices in the planning and implementation of large-scale energy infrastructure projects, focusing on Belene NPP, South Stream and Nabucco gas pipelines, and Burgas-Alexandroupolis oil pipeline. It discusses various management problems of state-owned energy companies, with a focus on the Bulgarian Energy Holding, as well. Finally, the report provides an analysis of the sector's governance process at the macro level and at the level of public procurement.