

EXECUTIVE SUMMARY

This report continues the investigation of the origins, reasons and causes of bad governance and insecurity in Bulgaria's energy sector, which CSD has started in 2011 with its report *Energy and Good Governance in Bulgaria: Trends and Policy Options*. Several shortcomings in the governance of the Bulgarian energy sector have been identified, such as widespread corruption practices at all levels of the energy system, mismanagement of state-owned energy enterprises, as well as irregularities associated with public procurement contracts, especially those related to large-scale energy infrastructure projects. The report focuses on possible prevention policies and on overcoming the main governance deficits in light of the energy security risks, which Bulgaria faces. The report takes into consideration the following main framework conditions, which impact national energy sector:

- The EU common energy strategic framework and European Energy Union are in the process of formation;
- The continuous economic stagnation of the country, which has led to falling energy demand as well as the deterioration of the key financial indicators of the state-owned energy enterprises;
- The increasing geopolitical opposition between Europe and Russia as a result of the Ukrainian crisis.

Bulgaria's main energy security risks are determined on the basis of the country's ranking in the *International Index of Energy Security Risk* of the Institute for 21st Century Energy at the U.S. Chamber of Commerce.

The 2013 – 2014 events on national, European and international level proved that good governance in the energy sector is a matter not only of Bulgaria's energy security, but also of its national security. The existence of political corruption and state capture in the Bulgarian energy sector is the result of the systematic inability of the Bulgarian energy policy to introduce good market and governing practices and to mitigate long-term risks to the energy security of the country. A combination of the lack of adequate energy security strategy and close interdependence between corporate and political interests in the governance of the Bulgarian energy sector contributed to the prolonged political instability during the 2013 – 2014 period, and has even threatened the financial and fiscal stability of the country.

Bulgaria's energy sector is characterized by systematic governance problems, which lead to significant losses of public wealth:

- Discrepancy between European commitments and national practices on both strategic and project level;
- Frequent changes in the regulatory and legal environment that lead high rates of investment insecurity;

- Lack of coherent evidence based energy policy, and lack of publicly available information regarding policy performance and results;
- Dependency of the energy regulator on the executive, politicization of regulatory practices, and lack of adequate, transparent oversight of the sector;
- Presence of numerous conflicts of interest at the different levels of governance, accompanied by high risks of corruption, illogical decisions and financial losses;
- Weak management of state-owned enterprises; chronic abuse of monopolistic positions at the expense of customers;
- Politically controlled access of private companies to state-owned subsidies and guarantees.

As a result of the bad governance of the Bulgarian energy sector during 2013 and 2014 risks became higher when the international environment changed abruptly. This change creates additional challenges for national policies and requires careful planning and development of public consensus on decisions related to the future of the country's energy sector. Reducing the governance risks of energy security in Bulgaria require better understanding of national specificities, regional characteristics of South-East Europe and the Black Sea region, as well as the position of the country in the common energy framework of the European Union. Bulgaria's national energy strategy has to be based on the understanding that the energy sector is of vital importance to the national economy. Imports and exports of energy in Bulgaria constitute about 13 % and 21 % of the ingoing and outgoing trade flows respectively. One in four public procurement contracts is connected to the energy sector, which makes it one of the main cost centers for taxpayer money in the country.

BULGARIA'S ENERGY POLICY AND LEGISLATION IN THE CONTEXT OF THE EU ENERGY POLICY FRAMEWORK

In 2013 – 2014 the drive towards common European energy policy deepened. As the Ukrainian crisis aggravated and risks for the EU energy security increased as a result of it, the European Commission tabled a proposal for the creation of a European Energy Union. The European Commission called for a Common Energy Strategy Policy to be adopted. This was the first time when the EC officially admitted that its three main goals of sustainability, competitiveness, and security cannot be achieved at the same time, and as a result priority was given to energy security. This move comes at the backdrop of continuing pressure coming from the European industry for limiting energy price growth in the EU, and the growing discontent in the member states of Southern and Eastern Europe in regard to the high preferential feed-in tariffs for the development of renewable energy sources.

EU energy dependency on imports, especially gas, has been increasing during the last two decades. By 2035 estimates show that 80 % of the gas that Europe uses is expected to come from imports, taking into account no change in EU's position on unconventional gas exploration and development. Most of these

imports are secured through long-term contracts, one third of which are with Russia. Moscow has taken advantage of the lack of a common European policy and market in the best way by negotiating different (and often discriminatory) prices with each European country, depending on its gas supply alternatives and its relationship with the Russian government. In this way, Russia uses gas supply prices as one of its most important foreign policy tools. Ukraine has been the ultimate demonstration of this strategy. The latter was consistently implemented also in Eastern Europe during 2013 – 2014, where countries such as Bulgaria were the main targets due to their extreme dependency on fuel imports (90 % gas imports dependence and 100 % crude oil dependence).

During 2013 – 2014, policy tensions and energy security risks for Bulgaria increased due to the inherent contradictions between the country's EU membership, the declared and the actual implementation of European energy strategies and policies in the country, and Bulgaria's dependence and commitment to Russia-backed large-scale energy infrastructure projects. These contradictions have resulted in some of the worst governance practices in Bulgaria's energy sector, which have led to substantial financial risks for the country:

- The Bulgarian government and the national energy regulator failed in managing the introduction of new renewable energy sources such as sun and wind, which is an EU priority for 2020. During the 2008 – 2009 period state incentives for the development and exploitation of new renewable energy sources were adopted without the existence of adequate regulatory framework. In 2011 – 2012 the government responded to the booming interest in the renewables' investment with administrative and regulatory limitations instead of removing incentives. The latter created the ideal environment for corruption to thrive. All this resulted in BGN 700 million (~EUR 358 million) of unpaid debts by the public provider to renewables producers, and the blocking of further renewables investments in 2014. Even though the boom in renewables in Bulgaria will help the government achieve its commitment to the EU to have 16 % of final energy consumption coming from renewable energy by 2020, the country has paid a high price as it has destroyed public trust and the image of renewables among ordinary Bulgarians.
- In the public space renewable energy has been speculatively presented as the more expensive alternative to new nuclear power capacity, without taking into account the more recent innovations driving technological costs down, and important factors such as time and investment value. As a result of political decisions based on data manipulation for expected future energy consumption, a compromised tender for the construction of a new nuclear power plant (NPP Belene), and many violations (some of which clearly involving corruption) in the early stages of the implementation the NPP Belene project, as of 2014 NEC's debts related to the project have been estimated at BGN 800 million (~EUR 409 million). The project was suspended by the government in 2012, prompting the Russian contractor to bring an arbitrage court claim on the project worth more than EUR 1 billion. Similar to the renewables case, bad governance of the NPP Belene project threatens the future development of nuclear energy in the country and provides Russia with additional leverage in energy talks with Bulgaria. In addition, while focusing on building unnecessary new production capacity, the government has neglected the implementation

of the EU energy efficiency measures although energy efficiency is among the top EU 2020 priorities.

- When it comes to gas imports, in 2014 the Bulgarian government gave an illogical (from the point of view of the country's energy security position) priority to the South Stream project, rather than to the construction of regional interconnectors, or to the implementation of the EU provisions on the gas market liberalization. South Stream has been prioritized despite the ever-increasing risks associated with its implementation, and despite the government's inability to control the main financial parameters of the project. The cost of the Bulgarian section of the project increased three times since its start in 2008 reaching EUR 3.5 billion in 2014. Successive governments have obliged the Bulgarian Energy Holding (BEH) to take specific steps towards the implementation of the project despite the growing tensions between Russia and the EU in Ukraine, the rising debt of the domestic state-owned energy system, and the clear and persistent warnings from the European Commission that the project breaches EU legislation in the area of free competition and energy. BEH has received another loan for the capitalization of the project company and a consortium of companies associated with Russian-Bulgarian oligarchic circles has won the compromised construction tender. Meanwhile, the U.S. has imposed sanctions on the owner of the leading company in the construction consortium, further increasing the risks to the project. The main reasons for the disruption of the most powerful political-oligarchic network in Bulgaria, which threatened the banking and financial stability of the country during the summer of 2014, have been, on the one hand, the pressure coming from the EC and the U.S. for suspension of the project and, on the other, the stubborn insistence of the Bulgarian government to continue working on the South Stream project.
- During 2013 – 2014, the EC has initiated a series of infringement procedures against Bulgaria for failing to implement key EU directives such as the Third Energy Liberalization Package. At this backdrop, the Bulgarian government has introduced more than 10 significant changes in the main energy law in 2014, which have increased the insecurity and volatility of the sector. Arguably the most controversial among these reforms has been the attempt of two Bulgarian MPs to amend the status of the South Stream pipeline project in Bulgaria so as to circumvent the European legislative requirements. It was later discovered that the main project contractor has requested and prepared these particular amendments, which is a flagrant conflict of interest, and raises serious corruption concerns.
- In addition to the legislative insecurity, the Bulgarian energy sector is characterized by a lack of regulatory independence and oversight capacity.

BULGARIA'S ENERGY SECURITY: PERSPECTIVES AND CHALLENGES

According to the *International Index of Energy Security Risks* (IIESR) of the Institute for 21st Century Energy at the U.S. Chamber of Commerce, Bulgaria has been identified as the most vulnerable of all 75 studied economies in regard to energy security in 2014. The IIESR contends that the energy security situation in the country has been deteriorating in the last 10 years, but that the past two years have been

particularly difficult as energy prices have increased and Bulgarian households, being the poorest in the EU, have not been able to adequately satisfy their energy needs. The following factors influence Bulgaria's energy security challenges, and require adequate policy responses for limiting their negative impact:

- High energy poverty rates. At the moment, only approximately one third of Bulgarian households can afford adequate heating in their homes, while more than 60 % still use coal and wood as the main sources of heating. The economic stagnation since 2009 has led to further impoverishment of the most socially vulnerable groups of the population making any increases in electricity prices politically impossible. As a result needed price increases to guarantee the return on long-term investments in coal and renewables have been frozen, hurting investors and confidence in the country. As electricity prices have been kept fixed to curb social pressures, financial imbalances in the energy system have not disappeared but have moved from the state budget to the balances of state-owned enterprises, and will ultimately end up as a burden for the taxpayers.
- Very high energy intensity of the economy, both in the commercial and the household sectors, amplified by large energy losses in the transformation, transportation, distribution, and consumption of power. These losses have reached 50 % of the primary energy supply in Bulgaria, compared to 30% average for Europe. Even though energy efficiency has been constantly increasing during the past decade, the Bulgarian economy remains more energy intensive compared to the average EU level. When high levels of import dependency of non-renewable energy sources is added to the high energy intensity of the economy, the result is inelastic energy expenditures and, thus, significant fluctuations in total energy expenditures. Bulgaria's average annual expenditures for imports of non-renewable energy resources varies between 8 % and 13 % of GDP, which puts the economy under a serious stress when energy prices rise on international markets.
- If the domestic production of low-grade lignite coal is not taken into account, Bulgaria is almost fully dependent on imports of non-renewables. Dependency on gas imports is the highest because the market has not been liberalized, and the country relies on a single supplier and a single pipeline route. This is the main reason why Bulgaria's gas import price is among the highest in Europe. Not surprisingly less than 1 % of the households use gas for heating and cooking. The lack of alternative imports puts the country in an energy dependency trap – because of the high gas prices, the population uses subsidized electricity for heating purposes, practically obliging the government to preserve artificially low electricity prices which, at the same time, results in technological stagnation of the sector.

Having in mind that Bulgaria faces increasing energy security risks, the measures taken by the Bulgarian government could be defined as illogical and incongruous with the priorities listed above. The focus of the state energy policy during the recent years has remained the construction of the South Stream pipeline and the NPP Belene. These projects require substantial public investment and/or guarantees. What is more, they would not diversify energy sources and do not have the potential to lower prices and costs. Valuable experience from the past shows that such strategies lead to serious upward pressure on prices and

widespread public discontent – examples are the long-term contracts of power purchase from TPP Maritsa East 1 and TPP Maritsa East 3, the state guaranteed conditions of TPP Maritsa East 2 and the generous incentives for the development of solar and wind energy. The electricity prices kept artificially low by the government is another state policy implemented during the past 5 years that had led to debt accumulation by state-owned enterprises and to the blocking of the capital investment process, thus having a negative impact on the energy sector. As a result, the process of energy market liberalization has stalled and has put the system in a deadlock where the only possible way out is the usage of corruption practices at the expense of consumers and taxpayers. Corruption channels decrease transparency in the sector and create opportunities for the unregulated incursion of domestic and foreign interests.

GOVERNANCE DEFICITS IN BULGARIAN ENERGY SECTOR AS A SPECIFIC FACTOR OF ENERGY (IN)SECURITY

Apart from the Bulgarian traditional energy security risks, one specific factor has to be taken into account – the management capacity of the sector. The deficits are most visible in the management of state-owned energy companies, the energy sector public procurement, including for the large, state-led energy infrastructure projects.

Management of state-owned energy companies

The financial situation in the energy state-owned enterprises has been deteriorating in the 2012 – 2014 period. There are several key problems associated with that:

- The inner indebtedness of the energy sector;
- The ineffective and not fully transparent company management;
- Heavy political involvement in the decision-making of the state-owned energy enterprises.

The above have undermined the health of the subsidiary companies of the Bulgarian Energy Holding (BEH). Part of the problem consists in the continuing bad practices of administratively controlling energy prices for end-consumers, which creates large amounts of intra-system debt, accumulated on the balance sheets of the state-owned natural gas distributor, Bulgargaz, and the national electricity wholesale supplier, the National Electrical Company (NEC). The financial situation in both companies is extremely bad and practically makes them unable to compete in the liberalized market. They found themselves under bottom-up pressure from their private partners in the added value chain who demand an increase power tariffs and under top-down political and administrative pressure for keeping prices at a certain level. In the gas sector, additional pressure is generated by the de-facto monopoly of supply. Additionally, some state-owned enterprises are involved in large energy infrastructure projects which overload them with enormous financial and managerial commitments.

The lack of transparency in the management of state-owned energy enterprises creates insecurity in regard to the predictability of their cash flows, as it is in the NEC case. The indebtedness of the wholesale power supplier was a serious obstacle to the process of unbundling it from the Electricity System Operator – a condition required by the European Energy Liberalization Package. The separation of these two companies should have been finalized by March 2014, and for which Bulgaria is facing an infringement procedure for a failure to comply with EU regulations.

As a result of the bad governance of the energy sector, and particularly the bad management of NEC, the company has accumulated about BGN 3.5 billion (~EUR 1.8 billion) of debt by the end of 2014. NEC's outstanding debt will continue to grow if electricity prices are maintained at the current low level. NEC's main financial indices show that sooner or later there will be significant pressure on the company's assets, or there will be a need for a state debt guarantee. Adding to these, NEC's poor financial results can be directly attributed to its involvement in massive fraudulent infrastructure projects like NPP Belene and HPP Tsankov Kamak. As per 2014, NEC's long-term debt approximates BGN 627.2 million due to outstanding loans for investment projects realized by NEC, while the financial indicators of the company suggests that merely 4 % of the current expenses are readily payable.

Due to its central position in the electricity market, NEC debts have a significant negative impact on all private and state-owned participants of the system, especially on the profitable ones such as NPP Kozloduy. As a result, the investment activity in the sector has been squeezed. It is often the case that BEH redistributes resources from better performing companies to poor performers which alongside the mandatory prepayment of dividends to the budget (80 % dividend mandatory prepayable to the budget) has drained the coffers of BEH and its companies of liquidity and investments. Winning companies pay most of their profits as dividends to BEH, and these funds are later transferred to the losing companies in the form of loans with low interest rates.

Governance deficits in the sector are not solely related to the financial and regulatory conditions in the system but there are also large human resource deficits in the state-owned enterprises and in the energy regulator as well. The frequent change of the top management of energy companies has predisposed their lack of independence from political influence and has made the corporate strategy very inconsistent, often marked by inadequacies prompting financial and regulatory deficiency in their management.

The independence of the state regulator has also been compromised making the State Energy and Water Regulatory Commission (SEWRC) the victim of constant lobbying activity, political pressure and frequent changes of leadership. Understaffed and under budgeted, the regulator can hardly keep up with the complexity of the power system. It is also exposed to a lot of public pressure and blame for the problems in the sector, while it is not provided with the tools to adequately influence the system.

Public procurement and major projects in the energy sector

The planning and realization of major energy projects are among the areas where private interests have the greatest impact on the energy sector. Bad governance of the energy is not an isolated case but has been a recurrent phenomenon. There are many apt examples but the most indicative have been: HPP Tsankov Kamak, NPP Belene and the South Stream pipeline. There are several characteristics of bad governance during the management of such projects:

- Lack of justification for the realization of the proposed projects, including the prioritized national and European strategic goals, based on governance models of decision-making, rather than on the practical goals stated in national documents.
- Data manipulation in order to justify the need for realization of the project without any cost-benefit analysis of alternatives or the study of other spheres where planned public funds could be invested.
- It is often the case that the start of some projects has been only the result of political decisions, which are not based on any analytical and administrative preparation. When the particular project is then passed on to the lower hierarchical levels, it usually cannot comply with regulatory requirements. Decision about the start of major projects, which could lead to long-term financial debts that have to be paid later on by the taxpayers, are often taken without any political consensus.
- The EPC contractors of major projects have been chosen prior to the contractor selection procedure, which makes these procedures unlawful and non-transparent. Usually these contractors are somehow connected to the political-oligarchic circles of the country and thus their selection is guaranteed.
- The financial parameters of the projects are often not clear and it is far from certain to what extent public finance may be used and whether there will be state guarantees and state forfeit in case of failure. It is an unwritten law that projects are advertised on their lowest contractual price, which is done in order to mislead the wide public, even though in reality these projects would cost a lot more.
- There are aggressive local consultants who have direct, unauthorized and non-transparent access to the main political and administrative factors, who in this way could influence the decision-making process of large infrastructure projects.
- There is lack of clear structure for project planning with established particular obligations and control mechanisms and proofreading of discrepancies.
- Project costs are often multiplied without objective reasoning during the initial stages, and later on during the implementation phase. For example, the final cost of the HPP Tsankov Kamak project was 3 times higher than initially contracted. The situation with the South Stream project was the same, as costs have gradually tripled over the course of the negotiation stages.
- In 2014, the audit results for the implementation of the three projects – NPP Belene, HPP Tsankov Kamak and South Stream pipeline, showed that there is still BGN 1.7 billion of outstanding debt without taking in consideration direct engagements of more than BGN 1 billion and indirect ones at more than BGN 2.4 billion. There is also the potential risk of court ruling sanctions amounting to BGN 2 billion, which will be imposed on BEH for failing to implement a contract agreement for the construction of the NPP Belene.

Thus state-owned companies would potentially have to pay back more than BGN 7 billion in debt if 2 out of the 3 projects mentioned above are implemented, and this is not the worst-case scenario. In comparison, Bulgarian average annual health care expenses are two times lower, while the average annual education expenses – three times lower.

Public procurement is the main area where corruption practices thrive and state energy policy is captured by private interests. The energy sector is one of the two largest public procurers in Bulgaria. Due to its technical specialization, limited number of available experts and the direct link between the energy sector and the national security, the energy entities often avoid competitive public procurement procedures. Ambiguity in the public procurement of the Bulgarian energy sector is due to several key factors: the presence of specific access criteria and safety of energy production facilities (nuclear safety in particular); the effective technological monopoly of a limited number of providers at the micro level; the ambiguous legal nature of energy export contracts; the lack of an effective internal financial audit; the lack of monitoring and control by the authorized bodies in terms of public procurement effectiveness. About 40 % of all public procurement contracts have not gone through any competitive procedures. However, nowadays the number of competitive procedures has been consistently rising, especially in the energy sector, and this is arguably the result of an increased public control and intolerance towards corruption practices, as well as of the improved work of the Public Procurement Agency and the Public Financial Inspection Agency.

CONCLUSION AND POLICY RECOMMENDATIONS

This report shows the continued lack of transparency and good governance of Bulgaria's energy sector during the 2011 – 2014 period. It illustrates the main structural and governance problems in the energy sector and in the country's energy security in particular. The report concludes that there is lack of vision and strategic thinking in solving structural and governance problems related to the energy security of the country. Instead, the continuous failed attempts for countering long-term energy risks faced by the country lead to anti-social energy policy caused by political corruption and the state capture by private interests. State energy policy is ambiguous when it comes to national characteristics, regional specifics of South-Eastern Europe and countries of the Black Sea region, as well as the Bulgarian position in the EU energy strategy. Inconsistent decision-making impedes the adequate realization of national priorities and the sustainable development of the energy sector. This raises questions on the motivation of the Bulgarian government in dealing with both the problems faced by the sector and the danger of pursuing third-party's interests and speculative rent-seeking intentions at the expense of the public interest.

In order to improve the Bulgarian energy sector governance and the functioning of state-owned energy enterprises, several key measures have to be taken:

- The political elite has to intervene less in the current governance of state-owned energy enterprises. Instead, it must develop policies, and provide access

to information and exercise effective strategic control over the activities and the decision-making of the energy enterprises.

- In order to align the national energy policy with EU objectives, the country must change its focus from aspirations to develop new production power to ensuring the security and stability of energy imports, reducing energy poverty and improving energy effectiveness.
- Mandatory standards for corporate governance of state-owned energy enterprises must be adopted. They should correspond to the best international principles, such as *Guides for Corporate Governance of State-owned Enterprises* of the Organization for Economic Cooperation and Development.
- Changing the focus with the help of state subsidies and guarantees from adopting confrontational and punitive measures, which have negative influence on enterprises to measures that are developed as a result of dialogue with businesses and have positive social effects. For example, the funds collected through the 20 % taxation on the profit of producers of renewable energy since January 2014 should be used for financing developing programs in the renewable energy sector, programs that would have positive effects for all participants and would assist the technological advance, research, innovations, etc. These funds should not be used to transfer financial resources to the state-owned companies or the state budget.
- All options for encouraging research of potential unconventional gas development must be taken into consideration if they correspond to EU's ecological standards and are controlled in the right manner. Research for conventional gas in the Black Sea must be supported.
- Bulgarian government should call for an external and independent annual review of energy policies.
- Long-term strategy should be implemented in order to push through gasification and energy efficiency improvements in residential buildings, which together with the diversification of natural gas sources could relieve social tensions in the process of price formation in the electricity and gas market.
- Large investment projects have to be preselected and given priority only after clear and transparent procedures and analyses of facts, corresponding with EU goals.
- Full transparency has to be ensured by the Commission for Protection of Competition and the Bulgarian administrative courts when cartel practices are being investigated at the fuel, natural gas and electricity markets.
- The State Energy and Water Regulatory Commission has to be stabilized and developed in terms of independency from political and economic interests and in terms of transparency and reporting its activities to both the National Assembly and the public.
- Consensus must be reached when it comes to long-term priorities in the energy sector and their implementation in the national energy strategy, which in turn has to be approved by main political parties in the country if it corresponds to major EU goals. The Third Liberalization Package has to be implemented as soon as possible in terms of regulatory changes and changes in activities of regulatory bodies and regulated subjects.