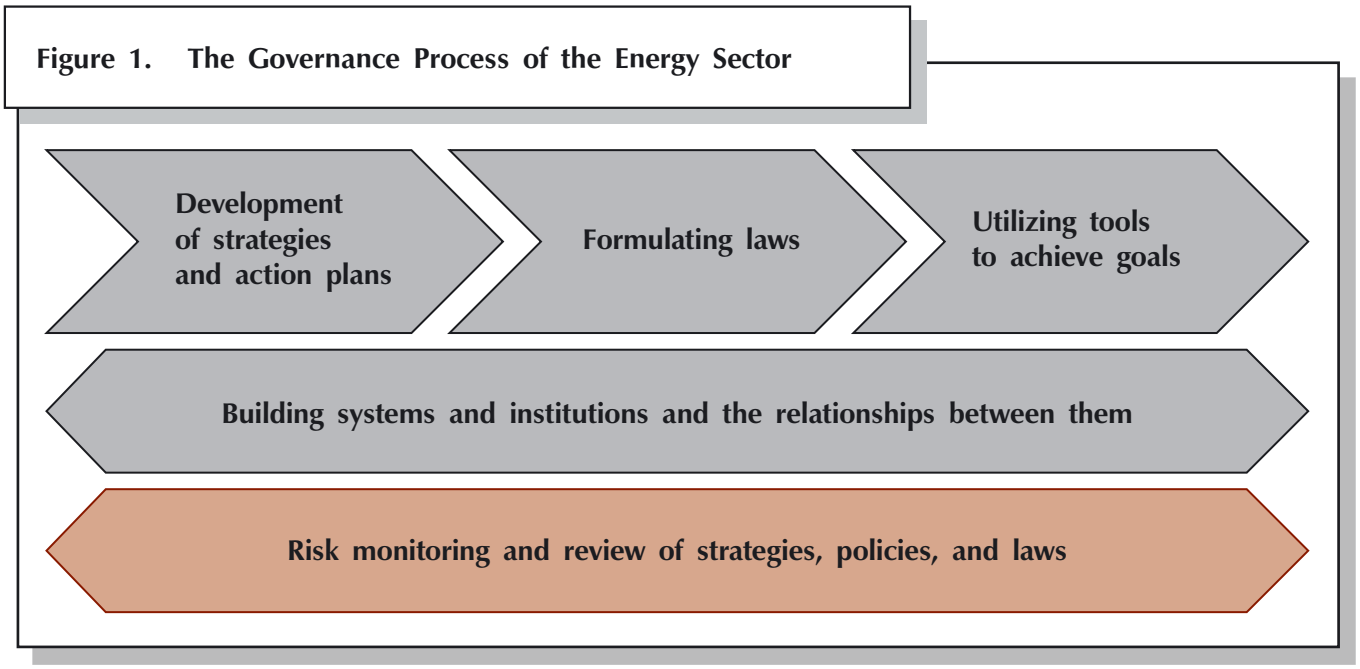
1. THE INSTITUTIONAL STRUCTURE OF ENERGY SECTOR GOVERNANCE

1.1. ENERGY STRATEGY

The *Energy Strategy of Bulgaria* is the framework document outlining the political vision, government policies, and priorities for the development of the sector. It lays down the foundations for shaping the legal framework, and for reaching informed decisions on key investment projects. The Strategy should serve as a reference point when determining the state and evolution of the institutional structure governing the energy sector. It should also act as a coordinating mechanism for the activities of the numerous state institutions responsible for achieving of the sector's development goals.

Figure 1. The Governance Process of the Energy Sector



Source: Center for the Study of Democracy, 2010.

The first Bulgarian energy strategy was adopted in 1999 and endorsed by the National Assembly under the title *National Strategy for the Development of the Energy Sector and Energy Efficiency until 2010*. Three years later, a new *Energy Strategy until 2010*[2] was adopted, and is still in effect. A new Concept for a Bulgarian Energy Strategy until 2020[3] was developed and announced in 2008. The Concept was

[2] Decision of the Council of Ministers No 279 of 11.05.2002, endorsed by decision of the 39th National Assembly (SG No 71 of 23.07.2002).

[3] See www.mee.government.bg/doc_vop/Koncepcia_2008.pdf (last accessed on December 27, 2010).

updated and open for public discussion in June 2010.[4] It should be noted that despite the delayed adoption of the latest Concept by the Council of Ministers and the National Assembly, the process of its development reflects the views and opinions of all stakeholders to a greater extent than its predecessors, and constitutes a significant improvement in strategic planning.

A review of the three energy strategies reveals a number of **shortcomings of energy-related strategic planning in Bulgaria** over the past decade, most notably:

- **Inconsistencies between specific government actions and the strategic framework.** For example, the 2002 Strategy stipulated that large-scale energy projects should be postponed "owing to uncertain long-term consumption forecasts and a dynamically changing electric power market".[5] Yet only two years later, the construction of Belene NPP was resumed – a project exceeding in scale and costs all other investments in the energy sector over the past 20 years put together. Similar shifts in policy decisions should be preceded by an update of the strategic framework. In fact, many government decisions over the past ten years, having the potential to shape the development of the Bulgarian energy sector and the economy until 2050, were not based on or supported by the national strategic framework. The latter demonstrates a lack of stability in strategic planning and **a lack of continuity in the country's energy policy**. Each consecutive government should either endorse or update the strategic goals laid down in the respective planning document;

- **The absence of proper financial justification of adopted strategic goals.** Bulgaria's energy strategies do not include financial assessments of the necessary investments for planned projects or the impact of various policies on the economy, the budget, and individual stakeholders. This results in the adoption of an excessively optimistic outlook and of numerous goals and priorities that allow for broad discretion in decision-making, which ultimately undermines the very point of strategic planning. The resulting **imbalance between the actual significance of a given energy subsector and/or issue for the economy and its place in Bulgaria's strategic plans** is evident. For example, the nuclear power sector accounts for roughly 40 % of electricity production in the country, yet its future and development are referred to in Bulgarian energy strategies merely in general terms and in scarce few pages. Moreover, priorities in the nuclear power sector, gas supply, renewable energy sources, energy efficiency, coal mining, trade in greenhouse gas emissions, etc. are set without coordination or evaluation of the returns on planned investments;

- **The lack of a good governance framework for strategy implementation –** the absence of specific timelines, clearly defined institutional responsibilities, and performance indicators. Bulgaria's energy strategies lack statistical and other data on starting points and target values for key energy indicators. It is thus impossible to evaluate the relevance of the priorities that have been set to actual market needs. A case in point have been the financial forecasts of the National Electric Company (NEK) used to justify the need to construct new power generation facilities in Bulgaria since 2004. NEK foresaw an abrupt

[4] For a more detailed analysis of the draft strategy of 2008 see: Energy Strategy of Bulgaria 2020: Commentary and Proposals for Improved Governance, Policy Brief No 19, Center for the Study of Democracy, 2009 <http://www.csd.bg/artShowbg.php?id=9945>.

[5] Energy Strategy of the Republic of Bulgaria (SG No 71 of July 23, 2002).

surge in energy consumption around 2015, the year in which Belene NPP had been intended to start generating power, with no consideration of market supply and demand in the region.

The shortcomings outlined above point to yet another significant problem of strategic planning in Bulgaria's energy policy – **the absence of publicly stated long-term goals**. Bulgarian governments have tended to give preference to medium-term (up to 10-year) strategic frameworks. Aside from the unstable economic environment, another justification for the absence of longer-term planning could be the lack of administrative mechanisms and capacity for long-term forecasting (e.g., through foresight).

The *Concept of a Bulgarian Energy Strategy until 2020* **attempts to overcome some of the deficiencies** outlined above through:

- **A notably clearer outline of national priorities**, namely energy security and energy efficiency. It also includes, even if not fully elaborated, the Bulgarian government's position on reducing the country's natural gas dependency and on the future of the nuclear energy sector. For example, the Concept rightly assigns priority to building **intersystem gas connections to neighboring countries, completing the Nabucco project, and building up the domestic gas market**;

- A far **more cautious position on government budget expenditure in the energy sector**, regarding Belene NPP and renewable energy sources subsidies;

- An initial attempt at **scenario planning in energy development** and at setting quantifiable goals (e.g., in energy efficiency) to aid investment planning in the sector.

Though the latest Concept has shortcomings,[6] it **provides a good basis for public discussion** and outlines well developments in the energy subsectors. The text put forth for discussion also incorporates guidelines from the new *European Energy Strategy until 2020*, which places special emphasis on energy efficiency.[7] In order to achieve its goals, however, **the Council of Ministers and the National Assembly should adopt the proposed Concept no later than March 2011**. The strategy should include an estimate of the funding necessary to implement the proposed measures. This would help identify opportunity costs of alternative decisions and evaluate their relevance and feasibility.

Political and public pressures to set ever more ambitious targets for the energy sector have increased in accordance with international efforts to ensure sustainable development and prevent climate change and environmental pollution. As a Member of the European Union (EU), and in accordance with the EU's Energy and Climate Package of January 2007, Bulgaria has adopted binding commitments on reducing green house gas emissions, on achieving a minimum share of renewable energy sources (RES) in final energy consumption, and on reducing energy intensity. This **necessitates close coordination between energy**

---

6 On the Draft Energy Strategy Bulgaria 2020, Position of the Center for the Study of Democracy, July 2010 <http://www.csd.bg/artShowbg.php?id=15193>.

7 Energy 2020 A strategy for competitive, sustainable and secure energy, COM(2010) 639 final, Brussels, 10.11.2010.

and environmental protection policies. In this context, Bulgaria's new energy strategy should place an emphasis on streamlining the organizational structure and coordinating the activities of state authorities and institutions responsible for policy-making and policy implementation in these two fields. The development of the *National Energy Strategy 2020*, the *National Strategy for Sustainable Development*, the *Strategy for Energy Efficiency*, and the *Strategy and Law for the Development of Renewable Energy Sources* should be coordinated and executed simultaneously.

In a number of Member States, such as Spain, the Netherlands, and Italy, good coordination has been achieved by means of **specially established inter-ministerial bodies** synchronizing policies and actions of related institutions with respect to climate change: environment, energy, industry, housing policy, agriculture, technology development, local self-government, and forestry. This is a logical step, since sustainable development and effective energy sector governance are likely to affect a number of sectors and all levels of government. Only the coordinated actions of various government bodies and a functioning control system can result in achieving the country's energy goals. It should be noted that the latest draft of the energy strategy Concept, envisions a considerably **higher degree of interconnectedness between energy, environmental, and technological factors** in the development of the energy sector than previous strategic documents.

1.2. ENERGY LEGISLATION

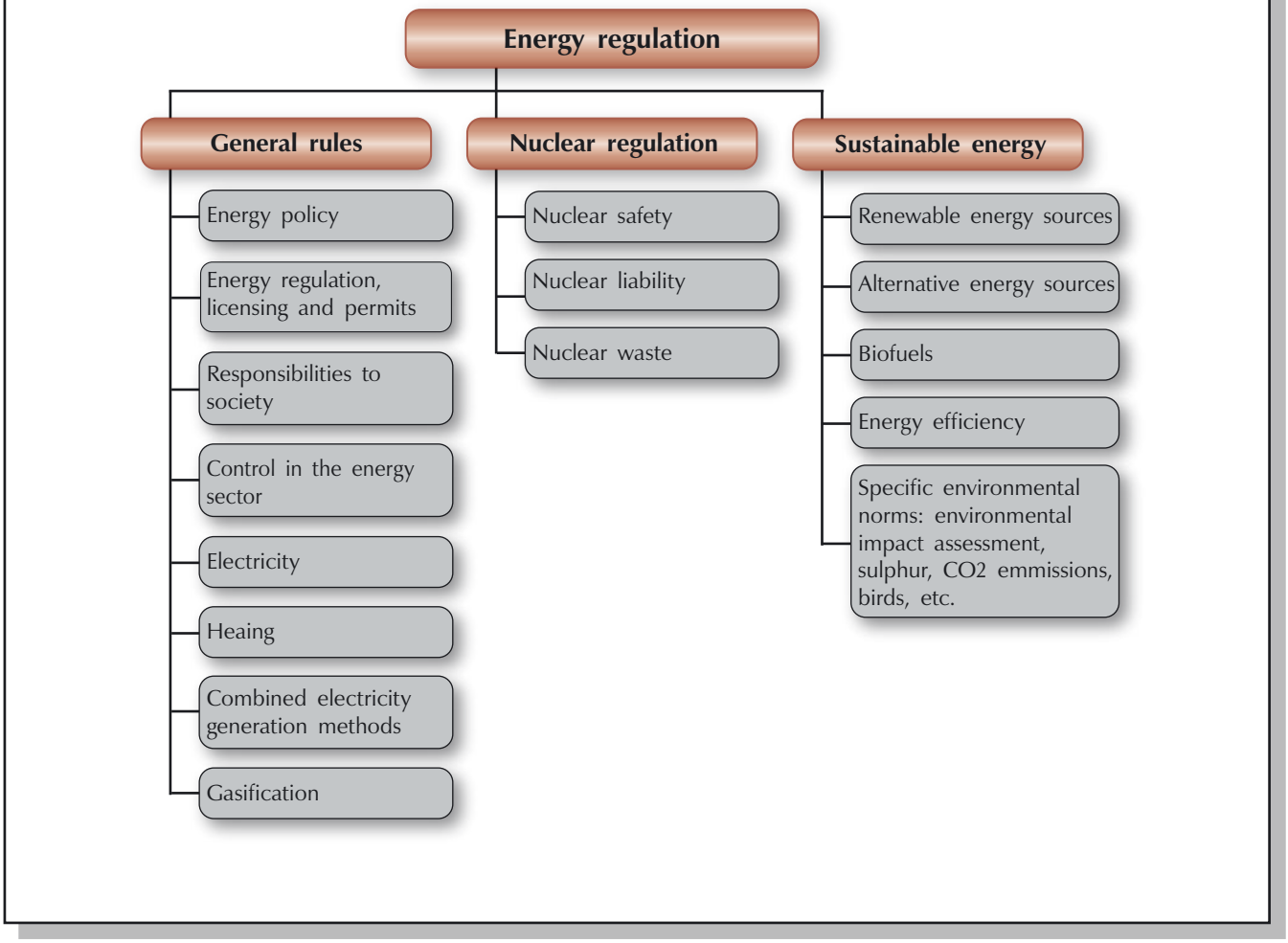
The Bulgarian energy sector is regulated by several laws and more than fifty pieces of secondary legislation. There are **three relatively differentiated regulatory subsystems**: (1) general sector regulation provided by the *Law on Energy 2003*[8] (LA); (2) nuclear energy and nuclear safety regulations; and (3) sustainable energy regulations – energy efficiency, RES, and bio-fuels.

The three subsystems have evolved in parallel over time, with occasional intersections. A differentiating factor for each subsystem is the varying degree of exposure to and influence of external factors. While the general sector regulation has developed relatively independently, nuclear regulation is entirely based on a series of international treaties and agreements to which Bulgaria is a party. These have been duly ratified and have become an integral part of the domestic law. What distinguishes the third regulatory subsystem – energy efficiency, RES, and bio-fuels – from the other two, is the strong influence of Community Law on its development since 2006. The regulatory framework for sustainable energy is based on joint directives of the European Parliament and the Council of the European Union.

[8] Prom., SG, No 107 of 9.12.2003; Am., No 18 of 2004; Am., No 18 of 2005; Am., No 95 of 2005, No 30 of 2006; Am., No 5 of 2006, No 74 of 2006; Am., No 49 of 2007; Am., No 55 of 2007; Am., No 9 of 2007, No 36 of 2008; Am., No 3 of 2008; Am., No 98 of 2008; Am., No 35 of 2009; Am., No 41 of 2009, No 42 of 2009; Am., No 82 of 16.10.2008, Am. SG No 103 of 29 December 2009, Am. SG No54 of 16 July 2010.

The bulk of the Bulgarian energy legislation has been transposed from the market and system regulations of more advanced countries. These transposed regulations, together with relatively little national experience with their implementation, result in substantial discrepancies between practice and legislation, while also providing ample opportunities for (powerful) corporate interests to capture the (weak) public administration in the energy sector. The Bulgarian government needs to make sizable investments in strengthening the regulatory and governance capacity in the country to overcome the above-mentioned tendencies. Otherwise, there is a real danger that the transposed good regulations, such as reference purchase prices for green energy, become conducive to abuse, incl. **to penetration of questionable capital and to misappropriation of government and European funds**.

Figure 2. Scope of Energy Regulation[9]



Source: Center for the Study of Democracy, 2010.

[9] A more detailed examination of the three areas of Bulgarian energy legislation is provided in Annex 1.

Mining remains outside the scope of energy regulation, since it serves to a varying degree not only the energy sector, but also other extractive industries. The Law on the Obligatory Reserves of Oil and Oil Products[10] passed in 2003 is also of importance to the maintenance of the country's energy balance although its scope is limited and by definition excludes natural gas.

Problems in the Bulgarian Energy Legislation

The dynamic political and economic development in Bulgaria, the new realities imposed by the global financial crisis and the deficiencies in the existing legal framework call for amendments to the energy legislation and, above all, the Law on Energy. The other two sub-systems – nuclear legislation and the sustainable development laws – are less sensitive to domestic political priorities and depend on the will of the international community and the EU institutions. Bulgarian energy legislation faces the following main challenges:

Transposition

Typically, the process of transposition and implementation of the legislation of the European Union, poses **new challenges to national legislation, which require further legislative action**.

Inconsistency

The development of the Bulgarian energy legislation has often been marred by loopholes, which allow for unexplained **digressions from publicly stated principles and commitments**, including such laid out in EU's legislation. Most notably, these include unjustified restriction of competition, reducing the scope of independent energy regulation, and extending hidden state aid.

Box 1. Draft Amendments of the Law on Energy (LE)

A few days after the promulgation of the *Law on Energy* at the end of 2009,[11] two new draft amendments and addenda were introduced by the Council of Ministers and by MPs, demonstrating starkly legislation inconsistency. One was aimed at removing the consequences of an open procedure for establishing the infringement of Bulgaria's obligations regarding the conditions for access to the cross-border electricity transmission network (laid out in *Regulation (EC)* No 1228/2003). The other draft law concerned the procedures and competences in developing and adopting the country's energy strategy. It proposed restoring the role of the National Assembly in the final adoption of the Energy Strategy of Bulgaria. Both changes, were produced in reaction to a specific problem, rather than being an outcome of a strategic vision for the sector's development.

[10] Prom., SG, No 9 of 31.01.2003; Am., No 107 of 2003, No 95 of 2005; Am., No 105 of 2005, No 30 of 2006, No 82 of 2006; Am., No 109 of 20.12.2007; Am., No 69 of 2008, No 102 of 2008, No 12 of 2009 – in force since 01.01.2010; Am., No 82 of 16.10.2009.

[11] *Law on Amendment and Addenda to the Law on Energy* (Prom. SG, No 82 of 16.10.2009).

Unstable Strategic Framework

Bulgarian energy legislation must unconditionally adhere to the country's energy strategy and the stated government policies. The Bulgarian Parliament continues adopting amendments to energy laws without a valid national energy strategy. Since the four-year legislative cycle overlaps with the period for updating the energy strategic framework, stability of legislation can hardly be expected, yet, it is possible to at least ensure coherence between strategic intentions and legislative initiatives.

It normally takes two to five years to adopt a legislative act, such as the *Law on Energy*, to create the respective institutional framework, and to harmonize implementation. This implies that the main elements of the energy strategy need to remain unchanged for at least 5 years to ensure stability of the legislative framework. Achieving such stability requires **a long-term agreement among the main political parties, institutions, and the civil society** on the energy strategy and on the specific domestic and foreign energy policies that consecutive governments will pursue. The task may sound unrealistic but it is feasible provided the existence of an adequate procedure for consulting stakeholders, such as the one organized for the latest review of the energy strategy concept in June 2010. In this way energy sector investors and stakeholders can familiarize themselves with each others' positions and can prepare better in the event of political changes.

Energy Legislation, Judicial System, and Public Consultations

The constitutional and administrative court cases resulting from complaints against specific energy legal norms are of particular importance for preserving public interests. **So far, the Constitutional Court has never ruled to repeal any act of energy legislation**. The practice of the Supreme Administrative Court in the energy area has been very limited, but the Court has set a precedent by repealing certain regulations concerning the implementation of the *Law on Energy* provisions.

The absence of structured public consultations on major government legislative and investment initiatives poses a serious obstacle to the development of energy legislation in Bulgaria due to the lack of corrective feedback. Publicity requirements for the law-making process are merely formally observed.[12] The low level of citizens' participation and the absence of independent public expertise on the energy issues under consideration exacerbate the problems. All too often the same experts are engaged as consultants to lawmakers, to private investors, and as participants in public discussions, which raises legitimate doubts for conflicts of interest.

[12] Indeed, art. 26, para. 2 of the *Law on Regulatory Acts* stipulates that prior to introducing a draft regulatory act for adoption by the competent authority, the initiator must post the draft on the website of the respective institution together with the motives and related report, and stakeholders must be given a minimum of 14 days to submit proposals and opinions on the draft. The provided minimum timeframe is quite unrealistic, especially when it comes to subjects of such complexity that require special knowledge.

Box 2. Time Frames for Public Consultations of Regulatory Initiatives

Announcing draft legislation in the public domain, such as the website of the respective administration that drafted the bill, at least 14 days before the deadline for public consultations runs counter to the principles of openness and coherence laid out in Art. 26, Para. 1 of the *Law on Regulatory Acts*. In essence, the administration can take advantage of the minimum time frame and treat it as a maximum period for comments. In this way stakeholders are often deprived of the opportunity to get informed about the respective legislative initiative and to react in a timely manner.

1.3 MANAGEMENT OF THE ENERGY SECTOR

It is difficult to carry out a comprehensive analysis of the functioning of each and every government unit for coordination and management of the energy sector in Bulgaria. Yet, even a general overview shows the need for strategic review and reform of the operations of these units and the respective legal and regulatory norms that guide them:

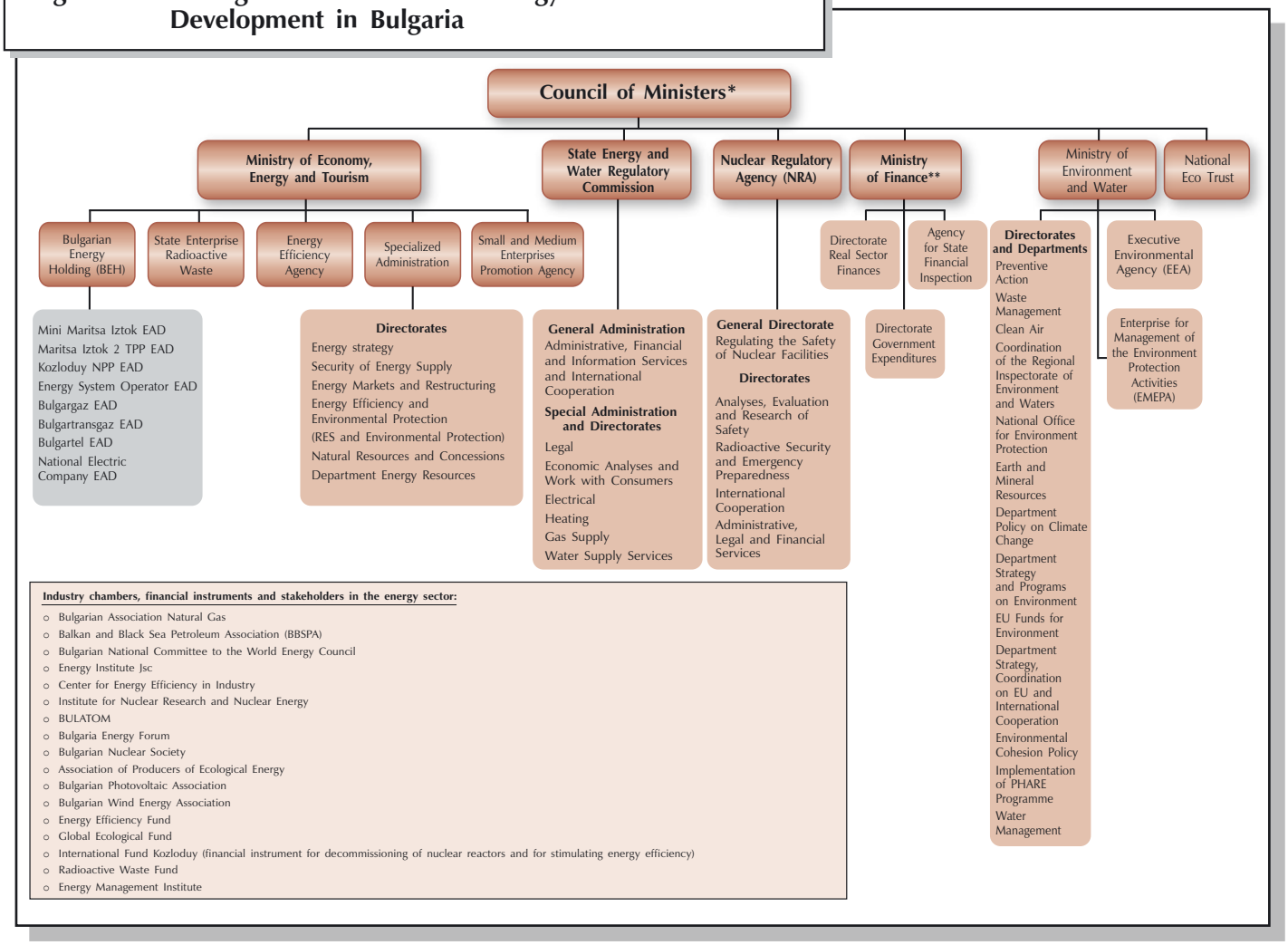
- **Energy governance in Bulgaria remains focused on state-owned companies rather than policies**, which makes it is hard to separate the public from the private, lobbyist interests;

- Although the sector remains largely state-owned and consists mainly of natural (geographic) monopolies, **state assets management remains fragmented** – each state-owned enterprise acts as if it were not a part of a system but an independent unit;

- In response to the fragmentation of management of state-owned companies and to compensate for the vertical integration that existed in the past, the government has created **additional management layers**, such as the Bulgarian Energy Holding (BEH). In effect, BEH duplicates many of the functions of the Ministry of the Economy, Energy and Tourism. Despite the presence of BEH, the Ministry remains engaged in the daily operational management of the companies, particularly the larger ones such as Kozloduy NPP and the National Electric Company (NEK).

The management of the energy sector has been entrusted to various ministries, agencies, directorates, and state-owned companies, with frequently overlapping responsibilities and conflicting interests. Changes in the management structure of the Bulgarian energy sector are most commonly the result of external pressures. For example, the unbundling of generation, transmission, distribution and supply of gas and electricity seems to be driven by a formal compliance with the directives of the EU's Third Liberalization Package, rather than the logic of national specifics. The establishment of the Bulgarian Energy Holding in 2008 by mechanistically pooling the assets of a number of state-owned companies created the impression that the government aimed to actually reduce transparency and find alternative approaches for the implementation of resource-intensive infrastructure

Figure 3. Management Structure of Energy and Sustainable Development in Bulgaria



Notes:

* *Other participants in the sector: Ministry of Regional Development and Public Works (permits for construction of new energy units), Ministry of Health (specialized control) and Ministry of Environment and Water (Environmental Impact Assessment, etc.).*

** *Regarding the Ministry of Finance, it is difficult for all the departments, relevant to energy policies to be identified from the publicly available information.*

Source: Center for the Study of Democracy, 2010

projects in the energy sector, rather than secure strategic advantages. A strategic review of the management structure in the energy sector should clearly map out the responsibilities of each management level and should lay out mechanisms for better interaction between them. The following aspects should be taken into particular consideration:[13]

- Distribute the management responsibilities for crafting climate change policies (energy efficiency and RES development) and a Bulgarian strategy for sustainable development between the Ministry of the Economy, Energy, and Tourism (MEET) and the Ministry of the Environment and Waters (MEW). Determine

[13] Energy Strategy of Bulgaria 2020: Commentary and Proposals for Improved Governance, Policy Brief No 19, Center for the Study of Democracy, November 2009.

the type of activities and the level of coordination between the two ministries, as well as the leading management authority in the green energy sector. Differentiate between MEET and Ministry of Finances' control functions over state-owned energy enterprises. Energy projects take up billions from the national budget in the form of direct investments and government guarantees, yet **at government level it is not clear who is ultimately responsible for making the investment decisions** and how those decisions are taken, who collects and archives the financial information of the state-owned energy sector, and/or who decides on how state-owned enterprises' finances should be run in order to ensure their financial stability;

- **Reinforce the role of the National Assembly in strategic decision-making in the energy sector**. The National Assembly endorses the country's energy strategy. It is necessary to also boost its role and involvement in large-scale infrastructure energy projects, when the latter involve explicit or implicit national budget guarantees (e.g. through long-term agreements for purchasing electricity at fixed prices) or when such projects are implemented through joint ventures with companies that are over 50 % state-owned. For example, in 2008 NEK undertook financial obligations under the contract for the construction of Belene NPP amounting to nearly EUR 4 billion. This amount constituted more than 80 % of the entire state debt as of the end of the same year and should have been subject to parliamentary endorsement similar to the procedure for increasing the government debt level;

- Delineate more clearly responsibilities between the regulator – the State Energy and Water Regulatory Commission (SEWRC), the ministries in charge of policy – MEET and MEW, and the management of state-owned enterprises. In 2010 SEWRC conducted and announced publicly audits of private electricity distribution companies under pressure from the Prime Minister, while no similar audit was carried out for upstream state-owned enterprises. The manner, in which the audits were carried out raised legitimate **concerns about the independence of the regulator** and the impartiality in evaluating the performance of state-owned vs. private companies in the sector. It would seem that, instead of striving to raise efficiency and reduce the price of energy for end users, most of the state management units actually enter into implicit agreements to reinforce the monopoly positions of the enterprises from the sector.

As a result of the fragmentation of management functions and structures across the sector, authority and responsibility get blurred. There is no platform for inter-institutional and/or civic control and checks and balances of the functioning of the multitude of agencies, directorates, and enterprises in the energy sector in Bulgaria. There is a lack of transparency and public information about the activities of and the results from state management of the energy sector. An additional problem is the quality and impartiality of management selection in the state-owned energy sector and **the use of term limits to cement political appointees at important positions**. The lack of national experience in independent regulation is conducive to a revolving door practice: experts switch back and forth between positions in the regulator and in regulated enterprises. There are no publicly available guidelines or codes of ethics in state-owned or private energy enterprises or the energy regulator for preventing of conflicts of interest.

Table 1. Vulnerability to Corruption: Government Policies

Activity	Areas vulnerable to corruption	Red flags
Estimates of the additional capacity required to meet demand	Manipulation of the estimates	No or inadequate analysis of demand No public consultation Lack of transparency in demand forecasting
Norms and procedures for licensing	Alteration of licensing criteria to favor particular interests	Ad hoc revisions or exceptions made to criteria Nontransparent process for revising norms
Statutory and other clearances	Dilatory and repetitive procedures with no time limit for final decision	Vague procedures Authorities with overlapping jurisdictions
Sale of the energy generated	Restrictions on who may buy the energy and the price payable	Noncompetitive procurement of independent power producers (IPPs)
Acquisition of land and rehabilitation of project-affected persons	Payment of compensation to landowners Payment to and resettlement of project-affected people	High level of activity in land transactions before government notification of zoning or land acquisition A few transactions registered at inflated prices to raise the benchmark for rates of compensation Opaque procedures for payment of compensation Several partial payments
Subsidies to specified consumer groups	Administration of subsidy, including selection of beneficiaries	Unmetered supply Absence or weak linkage with means criteria
Selection of regulators and top management of utilities	Manipulating selection criteria Corruption in appointments	Undue delay in appointments Lack of transparency in the selection process

Source: Gulati, Mohinder and Rao, M.Y. Corruption in the Electricity Sector: A Pervasive Scourge, in The Many Faces of Corruption: Tackling Vulnerabilities at the Sector Level Washington, The World Bank, 2007.

1.4 MANAGEMENT OF STATE-OWNED ENTERPRISES

A number of **organizational changes have been made to the state energy sector** in Bulgaria during the past decade. Yet, these changes are characterized by **conflicting goals and results**, as they were seeking to meet multiple aims, such as secure revenues from privatization, meet the provisions of European legislation, or attract investments. Furthermore, the dynamically changing

external environment, the development of new technologies for conventional energy sources, and the market penetration of renewable energy sources are all factors that imposed changes on the sector. The results of these divergent restructuring efforts in Bulgaria can be summarized as follows:

- **Decentralization and privatization:** in 2000 NEK was separated into 15 companies for generation, transmission, and distribution of electricity. The stated aim was to privatize distribution and to ensure greater competition in and liberalization of electricity supply. In continuation of this policy and in an attempt to meet EU goals for market liberalization, the electricity and gas distribution were privatized and transmission system operators were established;

- **Reverse integration:** in 2008 the largest state-owned energy companies were pooled into the Bulgarian Energy Holding with the stated purpose of creating a national energy champion likely to have better access to financial resources and capable of investing in the regional and European energy markets.

Yet another restructuring is forthcoming in 2011 in order to meet the requirements of the EU Third Liberalization Package concerning the separation of transmission from supply and distribution of gas and electricity. This calls for a transformation of BEH and a reinforcement of the functions of the State Energy and Water Regulatory Commission. The process of restructuring, however, is being delayed and meanwhile **problems within state-owned companies are accumulating**:

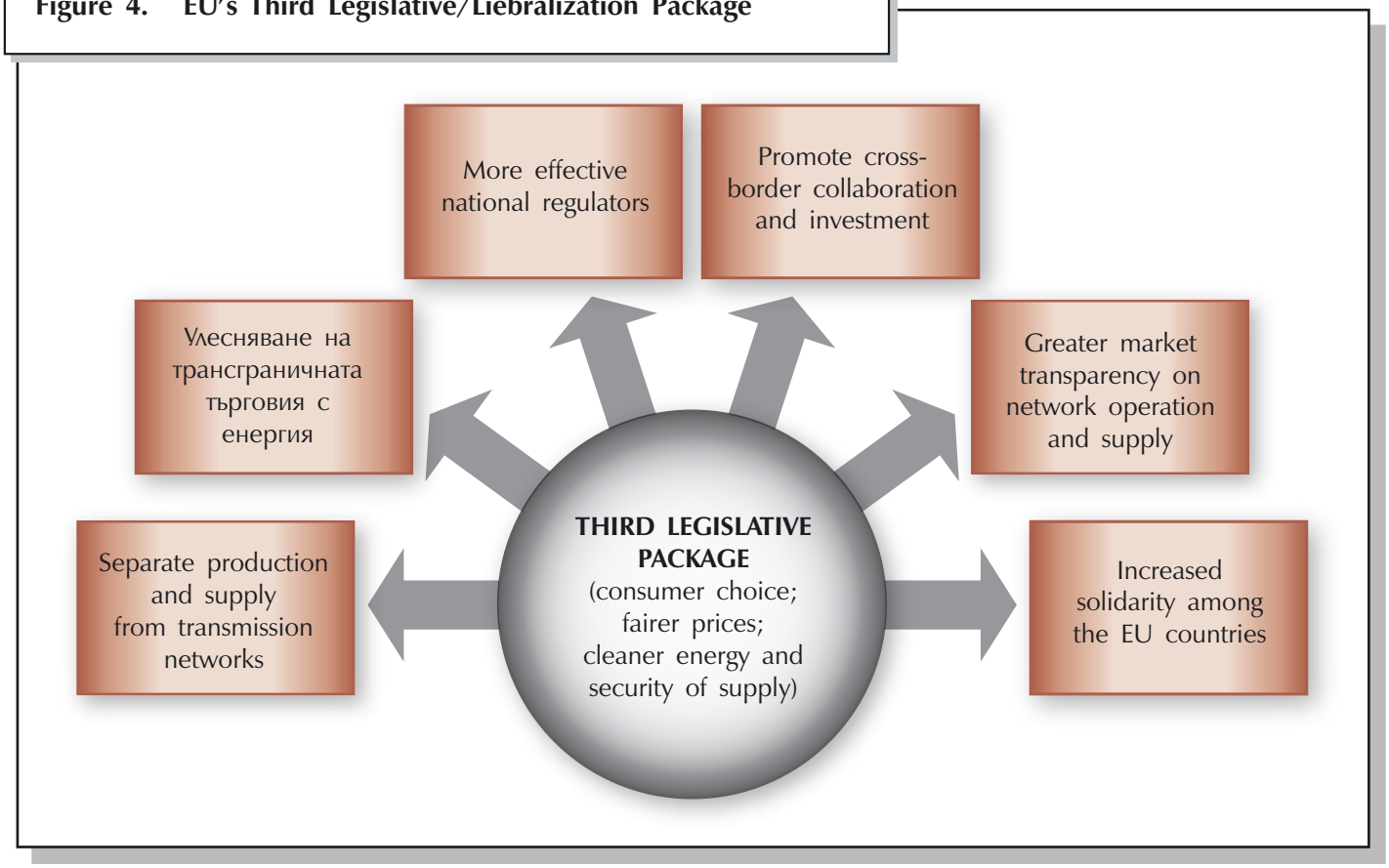
- **The central heating companies are seriously indebted,** which results in a relapse of the financial condition of the public gas supplier and a deterioration of important central-heating infrastructure. Failure to resolve this problem would affect roughly 2 million customers;

- **The financial condition of the state-owned companies is unclear**. The Ministry of Finance is tasked with collecting quarterly financial reports from state-owned enterprises with a majority government stake.[14] The release of the quarterly financial reports of state-owned enterprises on the web page of the Ministry of Finance since the beginning of 2010 has improved public access to information about the condition of the companies. This commendable first step should be followed by the adoption of **uniform financial accounting and reporting standards** for all state-owned enterprises. The publicly available quarterly reports are still of low quality. In this sense, the aim should be to achieve a level of public accountability comparable to the accountability of publicly traded companies. It would be worthwhile to improve the data usability for external users by entering the information into an accessible database;

- **There are no adequate criteria for choosing Bulgarian state-owned partners in investment projects**. For example, some gas interconnection projects are implemented by BEH, while others by Bulgartransgaz. It would

[14] Council of Ministers Decree No 114 of June 10, 2010 on monitoring and control of the financial condition of state-owned enterprises and companies with a majority government stake and the companies under their control (Former CM Decree No 87 of 7 May, 2008).

Figure 4. EU's Third Legislative/Liebralization Package



Source: Center for the Study of Democracy, 2010.

seem that the decisions about the involvement of Bulgarian state-owned companies in such projects are random, which is hardly recommended in light of the long-term commitments under these projects;

- **The added value of the BEH and NEK holding structures is unclear**. This has become particularly obvious in the management of government funding for Belene NPP: the then Ministry of Economy and Energy transferred funds to BEH, which in turn transferred them to NEK, which invested the money on behalf of Belene NPP project, yet, assuming the investment risk. In this way responsibilities were blurred, and the financial liabilities remained with NEK, while its management did not have the operational freedom and means to manage its investments;

- **The responsibilities and the authority of the executive and the regulator have not been clearly delineated.** The Prime Minister's intervention in the audits of the electricity distribution companies in 2010 demonstrated the absence of a guarantee for the independence of the energy regulator on the one hand, and the inadequate control over the regulator's performance by the Bulgarian parliament, on the other;

- **Relations between state-owned enterprises and their private counterparts**. In a number of publicized cases signed contracts between state-owned energy companies and their private partners proved to be detrimental to public

finances.[15] This prompts an analogy with the schemes for siphoning state-owned enterprises' resources by their management in the beginning of transition in Bulgaria through installing phony private contractors on the companies' entry and exit. For example, intermediaries handle the import of gas despite the presence of a single import pipeline. Similarly, the export of electricity produced by state-owned enterprises is entrusted to private companies in the absence of any notable gains in efficiency or profitability. While state-owned companies are in a dire financial state, their private counterparts in the energy sector are amongst the most profitable.[16]

The lack of a strategic vision for the development of state-owned enterprises in the energy sector places them in an extremely vulnerable position and under the **risk of covert privatization**, incl. through the entry of foreign hostile interests. On the one hand, state-owned enterprises are burdened with a number of government infrastructure projects and social functions limiting their investment capacity. On the other hand, private interests are pushing state-owned enterprises out of the profitable market segments. Such a governance model is not sustainable and calls for development in two directions: (1) gradual privatization through placing government's shares on the stock market, while retaining control over key companies such as NPPs, transmission system operators, etc; and/or (2) development of national champion companies capable of penetrating the regional and European markets. The imminent restructuring of BEH announced by the Bulgarian government in 2010 could serve as the starting point for this process.

1.5. RESTRUCTURING OF THE BULGARIAN ENERGY HOLDING[17]

The Bulgarian Energy Holding has failed to achieve its stated goals – improving the financial and economic performance of the companies within it. The holding group has not developed internal organizational cohesion and has remained a perfunctory collection of companies with disparate areas of activity (coal, electricity, natural gas, telecommunications). BEH's aspirations to operate as a financial holding structure streamlining the financial management of individual companies has also not been realized. The holding company receives payments from its constituent companies for services that they themselves continue to perform, i.e. there is a duplication of efforts. BEH is in fact turning into a separate auxiliary structure in the state-owned energy sector, acting as a clearinghouse, taking on claims and liabilities and redirecting financial flows between its subsidiaries.[18] Owing to the administrative restrictions imposed by BEH, a large share of the production-related, technical, and/or

[15] For a more detailed discussion of specific examples, see the section Energy Policy Instruments: Public Procurement in the present Report.

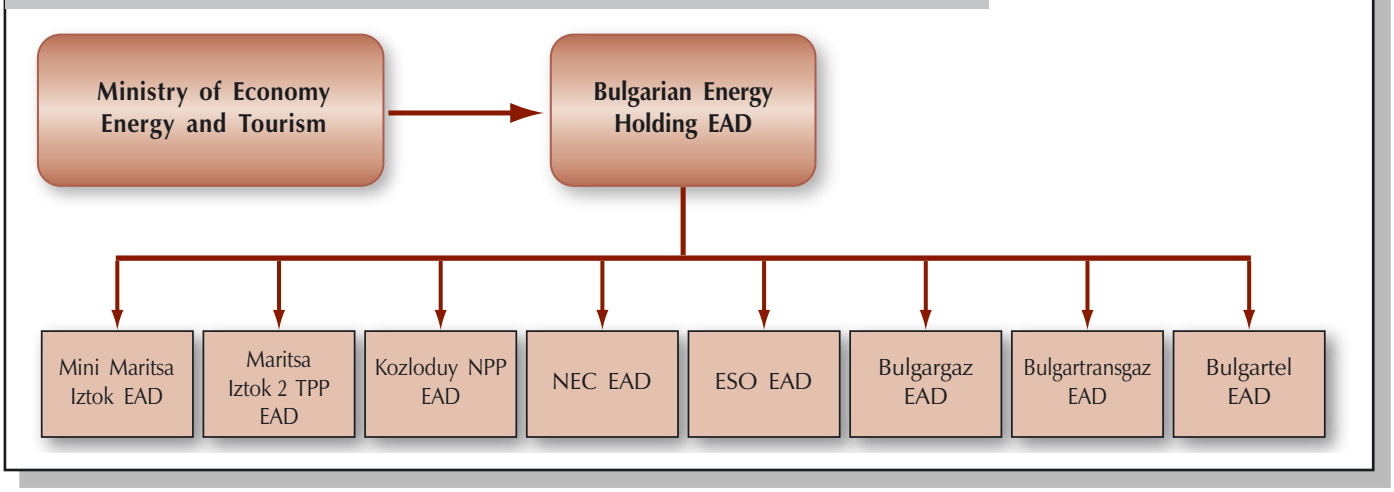
[16] The Energy Sector in Bulgaria: Main Governance Problems, Center for the Study of Democracy, 2010.

[17] The Bulgarian Energy Holding EAD was established on September 18, 2008.

[18] Bulgarian Energy Holding AD, Financial Report for the nine-month period ending on September 30, 2010. Last accessed on 23.11.2010 and accessible at the website of the Ministry of Finance <http://www.minfin.bg/bg/page/605>.

financial decisions in the subsidiaries have to go through a number of bureaucratic procedures, which delays their implementation. Common accounting and reporting standards have not been adopted within the holding group. There are no mechanisms for pooling procurement for similar goods and services that would reduce their unit costs. No analytical reporting is in place to enhance the transparency of the holding group.

Figure 5. Organizational Structure of the Bulgarian Energy Holding



Source: BEH, 2010.

The main problems for BEH's management are:

- **The indebtedness of subsidiaries.** This is particularly alarming in the cases of the two former holding structures, namely NEK AD and Bulgargaz AD. Their liabilities might be transferred over mechanically to BEH, which would relieve temporarily their burden but would hardly resolve the problem. In September 2010, BEH capitalized its receivables and took on liabilities from the two companies amounting to more than BGN 400 million.[19] In 2010, there was a general improvement in the financial condition of the companies within BEH (with the exception of Bulgargaz) owing to the more favorable market conditions, the efforts of MEET to cut costs in all companies, and the forced delay of payments on infrastructure projects, supplies, and other contracts. Nevertheless, NEK and Bulgargaz face decapitalization. By September 30, 2010, both companies were in a liquidity crisis:

  ◊ **NEK is in violation of all of its contracts with credit institutions.** Its obligations under these contracts have in fact become immediately payable upon request, which would result in the company's bankruptcy. **Investment expenditures are financed by operating capital.** The unforeseen rise in capital investments in the construction of the Tsankov Kamak hydro power plant have hindered planned investments in grid development. In 2010 there were practically no expenditures on the Belene NPP

[19] Reports of BEH AD and the companies within the holding group for the period January-September 2010. Last accessed on 23.11.2010 and accessible at the website of the Ministry of Finance <http://www.minfin.bg/bg/page/605>.

project.[20] The poor financial condition of NEK is beginning to affect other companies in BEH due to delayed payments. For instance, Kozloduy NPP cites its accumulated claims on NEK, amounting to BGN 140 million, as a major risk to the sound operation of the company;[21]

◊ **Bulgargaz is the company that has incurred the largest loss within BEH in 2010.** In addition to the low regulated gas prices on the domestic market, which the company is forced to take, it is burdened with obligations under contracts with monopoly suppliers from Russia. As of September 2010, the company had unpaid liabilities under gas import contracts amounting to USD 80 million;

- A large portion of the loans of BEH companies is backed by **government guarantees or entails government aid**. The analysis of the financial condition of the companies as of 2010 shows they are unable to secure, either independently or as a holding group, the implementation of large infrastructure projects without implicit government guarantees. Therefore, the companies' poor financial condition should be perceived as a direct threat of **exposure of the national budget to the risk of incurring liabilities under these projects**. To ensure sound financial discipline, the obligations of BEH or its constituent companies with respect to large infrastructure projects should always be considered to imply government guarantees and be treated accordingly;

- **The equity structure of BEH subsidiaries is unjustified from an economic point of view**. One possibility for dealing with the high levels of indebtedness of BEH companies and raising additional investment funds is to list all or part of their equity on the stock market. In this respect the size and structure of equity is of utmost importance. Optimizing the equity structure of BEH could maximize shareholders' value. The actual equity of the holding group is several times higher than the statutory (or authorized) share capital. This is economically unsound and does not reflect the actual government stake in these companies. **It is feasible and it is recommended that the government increases the share capital of each state-owned energy company in BEH at least twice** prior to its listing on the stock market. Optimizing the equity structure would ensure more adequate protection of the government's stake, it would boost the company's credit rating, and it could lead to a significant increase in revenues from sold shares.

Due to the failure to achieve the goals set with the establishment of BEH, in April 2010 the Government of Bulgaria announced its intention to break up BEH and restructure the management of state-owned enterprises. Although there is as yet no final decision on the restructuring, several **alternatives for the regrouping of the holding group** have been publicly announced, such as:

- Dividing BEH on a **sectoral basis**: (a) creating two new holding groups that would control electric and gas companies, respectively; (b) keeping BEH but with a merger between NEK, Kozloduy NPP, and Maritsa Iztok 2 TPP;

---

[20] NEK EAD Activity Report for January-September 2010. Last accessed on 23.11.2010 and accessible at the website of the Ministry of Finance <http://www.minfin.bg/bg/page/605>.

[21] Financial analysis and assessment of the state of NPP Kozloduy EAD as of 30.09.2010. Last accessed on 23.11.2010 at the Ministry of Finance webpage <http://www.minfin.bg/bg/page/605>.

- Dividing BEH on a **functional basis**, with one company controlling the transmission operators (Electric System Operator and Bulgartransgaz) and a second one controlling the remaining production and supply companies.

Table 2. EU Models for Unbundling Transmission System Operators (TSO) as per the Third Liberalization Package[22]

Model	Ownership Unbundling – Separate TSO	Independent System Operator (ISO)	Independent Transmission Operator (ITO)
Model features (all models must ensure effective separation of transmission from generation and/or supply)	Separate legal entity assumes ownership and operation of the transmission system. Vertically integrated company (BEH/successor) may retain only a minority stake, without voting rights in the operator. Control (exercise of property rights, etc.) is entrusted to a public authority other than the authority controlling the vertically integrated company (MEET).	Vertically integrated company (BEH/successor) retains ownership of the transmission system. The regulator certifies an independent system operator, which must be legally separate from the vertically integrated company (BEH/successor) and be under the control of a public authority other than MEET.	Vertically integrated company (BEH/successor) transfers the assets and management of the transmission network to an operator who can be part of the group but a separate legal entity with guaranteed autonomy of management (a separate building, IT systems, audit, administration, etc.). MEET/BEH can participate in the supervisory body of the ITO.

Source: Center for the Study of Democracy, 2010.

Before proceeding with the restructuring of BEH, the Bulgarian government needs to carefully assess the needs for restructuring, define clearly its goals, and analyze the costs and benefits of changing and/or preserving any management structures. **Mergers and acquisitions are among the most complex and time-consuming processes in managing enterprises**, often ending in failure owing to the lack of clear strategy and goals. Best practices in company strategies for mergers and/or restructuring show that they take at least 18 months to implement and should **pursue at least one of the following goals:**[23]

- Expansion of market share and/or increase in market power;
- Diversification into a new sector or industry;
- Protection from takeover and/or penetration of market competitors;
- Internal restructuring: increasing revenues, reducing costs, tax benefits, reducing the cost of capital;
- Penetration of new geographic markets;
- Access to skills and/or technologies.

[22] Commission staff working paper, Interpretative note on Directive 2009/72/EC concerning common rules for the internal market in electricity and Directive 2009/73/EC concerning common rules for the internal market in natural gas: the unbundling regime, European Commission, January 22, 2010.

[23] Jackson, Tim and Liza Spence, Hearts and Minds: the Keys to Successful Mergers, Booz Allen Hamilton, 2004.

The Bulgarian government should implement the provisions of the EU's Third Liberalization Package[24] regarding the separation of energy and natural gas transmission from generation and supply by March 3, 2012. By that date the government should have also accomplished the restructuring of BEH. The transmission system operators (ESO and Bulgartransgaz) must be effectively separated from BEH, and ownership rights control should be transferred to a public authority other than MEET. Bulgaria will have to choose between one of the three models proposed by the EU for the effective separation of transmission of gas and electricity from generation and supply.[25] The approach may differ for the various operators, and Bulgaria has already taken steps to implement the selected models in the two sub-sectors:

- **Bulgartransgaz** has the basic characteristics of a separate TSO (ownership unbundling model) and/or an ITO (having ownership of the grid). Since Bulgaria is still an **isolated market** in terms of the EU liberalization directives, i.e. it is not linked to another Member State through an interconnected system and has only one major external supplier of gas, it would make sense to choose a model that would preserve the shareholding structure of the operator and would guarantee its independence – the ITO model**.** Although the country may request derogation from the provisions for effective unbundling, it would be better for the selected operator to deny access to third parties, other than the public supplier Bulgargaz, until the interconnectors with neighboring countries (Romania and Greece) have been constructed. This would safeguard the position of Bulgargaz as a public supplier, while guaranteeing *de jure* the effective implementation of the provisions of the European gas liberalization directive. **A clear-cut time frame for building the interconnectors should be set** in order to start planning for the *de facto* liberalization of the market;

- **The Electricity System Operator** possesses some of the characteristics of an ISO (it currently does not own the grid). A possible transfer of ownership of the grid from NEK to ESO would bring the latter closer to the Bulgartransgaz model. Undertaking such a step may, however, lead to destabilizing the financial standing of the electric company. This could be offset by a merger between NEK, Kozloduy NPP and Maritsa Iztok 2 TPP, but should be well justified by clear long-term goals and specific implementation steps.

The implementation of the Third Liberalization Package will increase pressures to improve the management structure of state-owned enterprises in the energy sector and will place the issue of restructuring and/or dismantling BEH on the agenda. The Package also entails a significant strengthening of the authority and the functions of the independent regulator – the State Energy and Water Regulatory Commission. The latter calls for enhancing the existing, and generating new, technical and regulatory expertise of this institution. The restructuring of BEH, and particularly the formation of new entities, should not be an aim in and of itself, but the result of careful analysis and assessment of the alternatives, incl. preserving elements of the status quo and/or disbanding the holding company.

---

[24] The Package includes the following five documents: Directive 2009/72/EO; Directive 2009/73/EO; Regulation (EO) No713/2009; Regulation (EO) No714/2009; and Regulation (EO) No715/2009.

[25] The provisions of the directives should be transposed to Bulgarian legislation by March 3, 2011.