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## REGULATORY ASSISTANCE FOR SOUTHEAST EUROPEAN REGIONAL ELECTRICITY MARKET DEVELOPMENT

### LESSONS LEARNED FROM SEVEN YEARS OF PROMOTING ENERGY REGULATORY CAPACITY IN SOUTH EAST EUROPE

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# TABLE OF CONTENTS

ACRONYMS USED .....	i
INTRODUCTION .....	1
EXECUTIVE SUMMARY .....	2
PROGRESS IN BUILDING ENERGY REGULATORY CAPACITY IN THE SEE .....	3
Contract Objectives .....	3
Reform Status and Progress .....	6
LESSONS LEARNED FROM PIERCE ATWOOD'S EXPERIENCE.....	15
Donor Leadership Paired With the Involvement of Many Stakeholders Is Critical to Success .....	16
Assistance Must Be Tailored to Fit Realities on the Ground, While Continuing to Push For Greater Reform: Flexibility in Approach Should Be Paired With Consistency of Message .....	21
The More Hands-On, Comprehensive Practical Assistance, the Better .....	26
Momentum and Follow-Up Are Invaluable .....	29
Transparency and Public Communication and Outreach Are Goals Themselves, but Also Serve as Important Catalysts for Change.....	31
Harmonization on the National Level Can Facilitate Regional Coordination .....	33
ISSUES FOR FUTURE ASSISTANCE .....	35
National .....	35
Regional .....	36
Suggested Approaches .....	36
ACKNOWLEDGEMENTS .....	38

# ACRONYMS USED

AMM	–	Albanian Market Model
ANRGN	–	National Regulatory Authority in Natural Gas Sector in Romania
ANRE	–	National Agency for Energy Regulation (Moldova) or Energy Regulatory Authority (Romania)
BiH	–	Bosnia and Herzegovina
CEE	–	Central and Eastern Europe
CEER WG	–	SEEER – Council of European Energy Regulators Working Group for South East Europe Energy Regulation
CERC	–	Croatian Energy Regulatory Council (now HERA)
EAR	–	European Agency for Reconstruction
EBRD	–	European Bank for Reconstruction and Development
EC	–	European Commission
ERC	–	Energy Regulatory Commission of the Republic of Macedonia or Energy Regulatory Commission (Croatia)
ECRB	–	Energy Community Regulatory Board
EPS	–	Electric Power Industry of Serbia
ERE	–	Electricity Regulatory Authority (Albania)
ERGEG	–	European Regulators' Group for Electricity and Gas
ERO	–	Energy Regulatory Office (Kosovo)
EU	–	European Union
ESM	–	Electric Power Company of Macedonia
ETSO	–	European Transmission System Operators
HEP	–	Hrvatska Elektroprivreda d.d. (Croatia – Electricity Utility)
HERA	–	Croatian Energy Regulatory Agency
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
INA	–	Industrija Nafta, d.d. (Croatia – Oil Company)
IQC	–	Indefinite Quantity Contract
KEK	–	Kosovo Electric Company
KESH	–	Albanian Power Corporation (Electricity Utility)
MOU	–	Memorandum of Understanding
NEK	–	National Electric Company (Bulgaria)
NGO	–	Non-Governmental Organization
NIS	–	Newly Independent States
OHR	–	Office of High Representative (United Nations)
OPCOM	–	Romanian Power Market Operator
PHLG	–	Permanent High Level Group
SEE	–	South East Europe
SETSO	–	Southeastern Europe Transmission System Operators
TDY	–	Temporary Tour of Duty
TSO	–	Transmission System Operator
USAID	–	United States Agency for International Development
SERC	–	State Energy Regulatory Commission (Bulgaria) (now SEWRC)
SEWRC	–	State Energy and Water Regulatory Commission (Bulgaria)
UN	–	United Nations
UNMIK	–	United Nations Mission in Kosovo
USoA	–	Uniform System of Accounts

# INTRODUCTION

Pierce Atwood's Indefinite Quantity Contract, *Legal and Regulatory Development* (EEU-I-00-99-00029-00), was signed in mid-1999 and work began in May of 2000 after the award of our first Task Order in Moldova. Five Task Orders were awarded to Pierce Atwood under the IQC; three have been country-specific multi-year projects: Bosnia and Herzegovina (September 2001–February 2007), Bulgaria (June 2003–December 2006) and Moldova (May 2000–March 2004); the fourth was a small Task Order in Bulgaria that lasted only a couple of months (December 2001–January 2002); and the fifth was for the South East Europe (SEE) region. This regional Task Order was awarded in September 2000 and has covered, to varying degrees and over different periods of time, numerous countries in South East Europe through both national and regional projects. Our SEE Task Order closed along with the IQC itself on the 30<sup>th</sup> of September, 2007. This *Lessons Learned Report* draws from experiences under all of the above Task Orders pursuant to Contract No. EEU-I-00-99-00029-00, yet concentrates in particular on the SEE Task Order in recognition of its breadth of reach, duration and regional significance.

Our focus from beginning to end has been energy regulatory development. Our overarching tasks have been to support regulators and ministry officials in the development of energy sector reform legislation and to provide institutional strengthening and capacity building measures for regulatory authorities. The aims are to promote competition and economic viability of the SEE countries; increase the quality of service, efficiency and security of supply of energy; and promote democratic and non-corrupt practices through transparent processes and rules, stakeholder and public access to information and fair governance. During the seven years that we have served USAID under this contract, we have seen remarkable progress in the SEE region, with incremental regulatory capacity building. “Two steps forward and one step back” has been the steady rhythm among South East European regulators, with some formidable missteps and giant leaps of progress interspersed.

The purpose of this Report is not to depict each activity performed and each product distributed by Pierce Atwood during the seven-year life of our work for USAID in the South East Europe region. That is done elsewhere in our closing reports, which provide a catalogue and narrative explanation of deliverables throughout Pierce Atwood's regulatory reform projects and are available for cross-reference.<sup>1</sup> Instead, this Report is intended to cull from our technical assistance efforts an understanding of overall progress and the wisdom we have gained over time regarding approaches that work. We identify here the factors that contributed to successful implementation of reform efforts, and offer insights as to potential barriers to progress as well as the catalysts and key factors in development. In doing so, we hope to assist the continuation of progress long after this Contract has concluded.

The lessons we put forth have been hard earned and the subject of extensive thought among those of us who have lived and breathed this project over its long life. We share with USAID a pride in the accomplishments under the IQC and thank USAID for the remarkable assistance opportunities this Contract has provided. We are indebted to the Chief of Energy and Infrastructure for the Bureau for Europe and Eurasia and our Cognizant Technical Officer for the unfailing guidance and direction we have received.

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<sup>1</sup> We delivered separate close-out reports for our contracts in Bosnia and Herzegovina (Task Order No. 801, February 2007), Bulgaria (Task Order No. 802, December 2006) and Moldova (Task Order No. 800, March 2004), respectively, and each is available on <http://dec.usaid.gov/>. Our SEE Task Order close-out report is being submitted concurrently with this Report.

# EXECUTIVE SUMMARY

Important lessons from our seven-year experience include:

- **Adapting to changing leadership.** Governments, ministries and regulators (not to mention regulatory bodies) have a tendency to come and go in this region; often newcomers have different agendas than the outgoing personnel; and those resisting reform cite looming elections as a basis not to act. It is important to develop strategies for moving forward as these political interests change. Some tactics include:
  - Institutional training that involves multiple persons, including high- and mid- level regulatory staff members (because often only the highest personnel change with the political winds); and
  - A multi-pronged approach (so that the overall program can maintain momentum as newcomers shift emphases).
- **Flexibility of approach.** As institutions and regional bodies gain life and traction, the concern of changing leadership might diminish. But it is always critical to maintain flexibility of approach while sustaining constancy of message: among donors, over time, and to every audience.
- **Benchmarking.** Done right, use of benchmarking reports can be highly useful in collecting information, obtaining buy-in, and reaching consensus. This is particularly true where, as here, a region experiences a wide disparity in levels of progress: use of benchmarking standards can raise the floor over time to drive progress and achieve reform on a regional level. Performing a benchmarking exercise, however, requires time, patience, and comprehensive follow-up to ensure accuracy and to present facts while avoiding political challenge. The nature of the benchmarking performed must also change over time, in response to a careful assessment of conditions and needs.
- **A Hands-On, Good Neighbor Policy.** When possible, training should be interactive as opposed to passive lecturing, and participants should create an actual work product. One of the most useful methods of training is to involve regulators and regulatory staff in a neighboring region that is respected by the counterparts and which has recently experienced the changes now confronted by the trainees.

Areas that will require additional attention going forward include:

- Tariffs
- Unbundling
- Transparency
- Natural gas
- Licensing
- Cross-border trade
- Protection of vulnerable populations
- Energy efficiency and renewables

# PROGRESS IN BUILDING ENERGY REGULATORY CAPACITY IN THE SEE

## CONTRACT OBJECTIVES

When Pierce Atwood's IQC was signed in 1999, the countries in the South East European region were moving through an economic and political transition affecting all aspects of their economies and societies. This Energy Regulatory IQC was created after the Stability Pact for South East Europe was signed on June 10, 1999, by leading countries and financing institutions as a pledge to work toward peace, prosperity, and stability for South East Europe. Energy systems and resources were rightly seen as integral to successfully creating democratic and prosperous economies in the region. Done properly, restructuring and privatization of energy systems have a major impact on improving environmental performance, national and local budgets, expanding capital markets and increasing democratic participation in decision-making through open regulatory systems. Over the last seven years, Pierce Atwood has worked under this IQC on developing regulatory capacity in the energy sectors of the region in order to assist achieving these objectives.

## IQC and Contract Tasks

Our overarching goal under the IQC, *Regulatory Assistance for Southeast European Regional Electricity Market Development* (EEU-I-00-99-00029-00), was to assist and advise the sovereign governments of Central and Southeast Europe and the NIS Region in connection with energy sector reform legislation, including emphasis on regional markets, integration, sustainable development, and environmental issues, as well as electricity markets, privatization, competition, tariffs, and customer protection and access. Assistance was directed primarily toward newly established regulators on a broad range of institutional strengthening and capacity building measures, including the development of rules and regulations for the utility sector, creation of markets and competition, tariffs, performance standards and public involvement in the regulatory process.

Pierce Atwood's Regional Balkan Task Order originally had five distinct tasks but was expanded through modifications that covered both additional regional and some country-specific goals. Regionally (which here refers to South East Europe), Pierce Atwood was tasked with advising regulators and ministry officials on licensing, market methodologies and rules, and identifying and analyzing key institutional and regulatory issues in the development of a regional trading and market system, including grid code development and harmonization of power market operators. Pierce Atwood was asked to develop model electricity purchase/exchange contracts and to conduct workshops and study visits to discuss international and regional electricity regulation issues. Additionally, Pierce Atwood was tasked, pursuant

to distinct contracting mandates via contract modifications, with country-specific legal and regulatory assistance in Albania, Croatia and Kosovo, and advised on a wide variety of secondary legislation as well as utility restructuring and energy regulatory development. Over time, Pierce Atwood was directed to concentrate on regulatory capacity and framework issues, while the other IQC provider was directed to focus on specific market designs and rules.

For the purpose of clarity, we list here the countries in which we provided assistance under the IQC and concerning which assistance efforts we draw many lessons for this Report: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Montenegro, Romania, Serbia and UNMIK-Kosovo.<sup>2</sup> Over the course of this Contract, Romania and Bulgaria became EU members (January 2007) and Croatia currently is an official accession country, in formal negotiations with the EU. We note that while Pierce Atwood provided assistance in each of these countries, to varying extents, over the course of our contract, the benefits of our work spread much further. The significant regional focus of our contract has meant that other countries have been an active part of our efforts. These include some countries that were new entrants to the EU in 2005, such as Hungary and Slovenia; some older EU countries, in particular Greece and Italy; and finally, Turkey, which has been involved in ongoing talks with the EU regarding possible membership for many years. A core feature of this project throughout has been the commitment by USAID and Pierce Atwood to assist the non-EU countries in South East Europe to integrate into the developing energy market of their neighbors in the EU and improve security of supply overall. With respect to the latter, diversification of resources is essential, thus also requiring a broad reach into the Black Sea region, Ukraine and eastward.

## Basic Terminology

We begin with a brief explanation of terminology.

By **building of regulatory capacity**, we mean the set of elements required so an energy regulatory authority can execute its regulatory duties. In particular, we focus on a sound legal framework, competence and autonomy.

A **sound legal framework** refers to a system of laws that meets internationally recognized standards in terms of providing for energy regulatory authority and autonomy. Such a framework consists of primary energy legislation and core secondary legislation, including regulations on tariff setting and methodology, licensing, dispute resolution, market design and operation, codes of conduct and rules of practice and procedure. It requires consideration of other legislation that affects the energy sector and in particular the regulatory role, such as constitutional powers, procurement rules, export and import rules, administrative codes and privatization legislation.

**Competence** involves not only the powers granted to regulatory authorities by law but also the knowledge, ability and resources of the individual regulators and their staff members to execute such powers effectively.

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<sup>2</sup> The Original IQC under which our Regional Balkan Task Order was awarded did not refer to any individual countries; instead, it referred to regions only: the countries of Central and Eastern Europe (CEE) and the New Independent States (NIS). The Balkan Task Order included all listed countries except Serbia and Moldova. We list both Serbia and Moldova here, however, because we had a separate Task Order for Moldova, Task Order No. 800, and have been asked to draw upon that experience for some of the lessons learned; we were asked in the course of our Balkan Task Order to provide limited assistance to Serbia; and we consider that experience along with our assistance efforts in the other Balkan countries when assessing technical assistance methodologies and mechanisms.

By **autonomy** we mean the authority and ability of regulators, their staff and the regulatory institutions overall to perform work based on substantive and technical merits, with reasonable protection from transient political interests and in a context of accountability.

Our work and the analysis of the regulatory capacity progress contained in the instant *Lessons Learned Report* is instructed by the internationally accepted indicators of autonomy, authority, accountability, predictability, clarity, transparency and proportionality – each of which is viewed as core to the development of effective regulatory practices.<sup>3</sup>

## Assessing Progress

The following sub-sections assess progress in the region, viewed through the lens of this Contract's objectives, namely regulatory capacity and competence. Thus, we focus not only on whether regulatory bodies were established, but if so, whether the Commissioners and staff of the established bodies participate in their respective energy sectors as active voices for reform. We also look at the extent to which legislative and regulatory frameworks, with transparent and predictable rules, are in place and serve to build investor confidence; create an investment-friendly atmosphere; and support an efficient, functioning energy market. For example, privatization can bring multiple benefits to the energy sector and the national (and regional) economy overall by attracting strategic investors, expertise, and diversity; it can also motivate further reforms, providing the impetus to create the framework necessary to facilitate various steps in the privatization process. Nonetheless, to start the privatization and investment process, experience shows that, prior to tender, investors seek established regulatory oversight authorities and an understandable and predictable legal framework. Similarly, after privatization, a regulatory authority and a supporting legal framework is needed to implement the new regime. Our mandate was to assist the development of the institutional regulatory regime in order to make reforms possible and fruitful. Thus, this is our target when we consider progress achieved.

The remainder of this report proceeds as follows. In the next section, "Reform Status and Progress," we summarize the progress made from 2000-2007, both nationally and regionally, using text and a table showing each jurisdiction. In the section that follows, "Lessons Learned from Pierce Atwood's Experience," we discuss the most important insights gained from our work, using specific case studies to illustrate each lesson. Finally, in "Issues for Future Assistance," we recommend the areas and approaches to take this work to the next step in reaching USAID's objectives.

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<sup>3</sup> See Archer, Robert, "Regulatory Autonomy, Authority and Accountability Key Characteristics of Regulatory Commissions"; "Handbook for Evaluation Infrastructure Regulatory Systems," World Bank, 2006.

# REFORM STATUS AND PROGRESS

## National

### *From nonexistent or rudimentary regulatory bodies and legal frameworks to universal establishment of these building blocks and implementation*

Each of the countries (and UNMIK-Kosovo<sup>4</sup>) where we have worked during this Contract has seen its regulatory legal framework evolve since 2000, in particular with respect to regulatory competence and autonomy. No country is perfect and no regulatory structure has developed without some weaknesses or without fits and starts in terms of progress.

As a threshold point of reference, when this contract began, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia, and UNMIK-Kosovo had no energy regulatory body, whereas all now have regulatory bodies supported by primary and secondary legislation. (See Status Table that follows) Under this Contract, Pierce Atwood has had the honor to be a core part of a team that helped to create these institutions. For the above-mentioned countries and also Albania, Bulgaria, Moldova and Romania (where regulatory bodies were in their infancy at the initiation of our Contract), Pierce Atwood helped to develop the system of laws on which these bodies were formed and by which they operate, assisted the development of energy policy, and trained the Commissioners and their staff members. We have developed market rules, supported market design reform and unbundling, advised on licensing regimes, drafted rules and procedures to support transparency in the regulatory regimes overall and created investment climates supportive of competition and privatization, while being considerate of social safety net and related affordability and efficiency concerns.

While it is not possible here to list all progress achieved, we offer a snapshot of regulatory activities in each country to highlight some of the more significant and successful reforms and show the transition between the status in 2000 and the current state of play.<sup>5</sup>

One point that goes toward the success of any and all national work under this Contract must be emphasized at the outset. Pierce Atwood approached all national projects with contextual expertise not only in subject matter, but in relation to the different international approaches applied to the substantive issues. Specifically, Pierce Atwood brought to all work performed in South East Europe a deep understanding not only of the tried and tested approaches applied in the United States, but also of SEE regional issues; the direction of EU laws, reforms and guidance; and accepted international best practices. The mandate was to assist regulators, their staff and other energy sector stakeholders to comport with generally accepted best regulatory practices (in which the United States, with its long traditions of a regulator-based regime, has historically led the way), in a manner that meets European needs so as to facilitate regional integration and national reform.

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<sup>4</sup> We note that UNMIK-Kosovo is a United Nations protectorate and not a separate country. For the purpose of the reader's ease and comprehension only, when discussing our work in South East Europe collectively, we use the terms *national* legislation, *state* rules and policies and *country* progress, and other similar terms reflective of sovereignty, to refer to activities across the various members of South East Europe. We make no statement as to the substantive question of independence of Kosovo.

<sup>5</sup> Again, we emphasize that separate close-out reports for our distinct task orders in Bosnia and Herzegovina, Bulgaria and Moldova (respectively, Task Order Nos. 801, 804 and 800) detail the progress made in each of these countries, and thus for the purpose of clarity, space and consistency, are not repeated here. We do, however, draw on experiences in all three for the focal section of this Report on lessons learned, per the request of the Chief of Energy and Infrastructure for the Bureau for Europe and Eurasia, Robert Ichord.

The length of this Contract and its reach across so many jurisdictions in the SEE made it possible to inform national stakeholders about activities and approaches that were being considered, adopted or used in the SEE region. Pierce Atwood also prioritized a careful and considered examination of EU and U.S. practices in order to inform national stakeholders fully and to respond to questions regarding international approaches. This proved of particular importance as this Contract progressed concurrent with developments in the South East Europe region, increasingly connecting and ultimately binding non-EU SEE members to certain EU energy legislative requirements and systems of operation.

## Regional

### *From minimal and informal cooperation to formal treaty and institutionalization*

Pierce Atwood's regional work has taken several forms, from conferences to issue papers to individual country assistance participating in regional meetings and benchmarking exercises. As part of our regional work we have:

- Organized and conducted conferences on issues of regional priority (from the *Preliminary Unbundling and Privatization of the Electric Sector*, held in Zagreb, Croatia in October 2000, and *Transmission, Pricing & Regional Electricity Markets*, held in Zagreb, Croatia in May 2001, and a grid code conference in Bucharest, Romania in October 2001 to the Regulatory Reporting and Accounting Systems Workshop: South East Europe in Sofia, Bulgaria in May 2007 and the Uniform Systems of Account conference in Tirana, Albania in September 2007;
- Prepared studies and papers on regional topics (e.g., "CEER Position Paper, Regulatory Benchmarking Standards for SEE-REM," November 2003; "Discussion Paper on the Guiding Principles and Issues in Formation of the South East European Regulatory Board," October 21, 2004; and "Supplier of Last Resort: An Overview of Its Implementation in ERRA Member States and Representative Countries in the EU," November 21, 2005);
- Drafted and commented on procedures and rules on behalf of regional institutions (such as the Internal Rules for the Energy Community Regulatory Board (ECRB)); and
- Developed and performed benchmarking and surveys (such as the Natural Gas Survey for the ECRB in 2007 or the 2003, 2004 and 2005 regulatory benchmarking reports for the Council of European Energy Regulators (CEER) Working Group for South East European Energy Regulation (CEER WG SEER).

During the course of this Contract, initially minimal regional cooperation evolved into broader but informal agreements then to increasingly comprehensive and institutionalized commitments, requirements and structures. The regional component of our Contract has evolved in tandem with and in promotion of regional institutional developments, set forth by a series of agreements, led by the European Commission. From the Thessaloniki Declaration,<sup>6</sup> on the heels of which this Contract was initiated, to the Energy Community Treaty<sup>7</sup> in force today, the regional component of our Contract has correspondingly developed in role and influence. A certain amount of national reform is required in

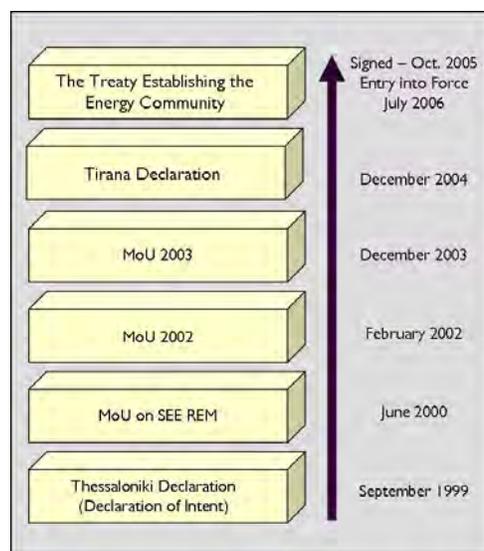
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<sup>6</sup> This early agreement marked the first document setting forth regional consensus and focused largely on general concepts and country action to develop a regional market. It was government-focused rather than regulatory-focused and was non-binding.

<sup>7</sup> This Treaty is now in force and all the signatories are bound to implement its terms. A copy of the full text of the Treaty may be found at [www.energy-community.org](http://www.energy-community.org).

each country before meaningful regional cooperation can occur. Disparities in competencies and capacities remain a challenge in developing and implementing regional reform initiatives. From a timing perspective, the early stages of this Contract were spent on getting in place the minimal levels needed in each country. This happened during the period when regional cooperation was made up primarily of informal dialogue. The regional work became more concrete as national legal and regulatory frameworks progressed.

While the 1999 and 2000 regional agreements represented the first stage of voluntary accord among the South East European countries to move collectively toward a regional market goal, the Memoranda of Understanding (MOU) of 2002 and 2003 are the first documents to contain references to concrete steps. The MOUs also signaled the beginning of Pierce Atwood's regional *institutional* efforts. By this we mean that, as the agreements evolved to include detailed necessary steps to move the regional market forward (such as the commitment to form regulatory authorities with discrete powers, albeit still primarily voluntary and non-binding), Pierce Atwood began to assist the process by which these commitments could be realized. Thus, work under our South East Europe Task Order ceased to concentrate only on the development of skills and understanding with respect to the treatment of regulatory issues to promote national regulatory capacity (though such work remained important and continued), but also focused on furthering institutional capacity building at the regional level. Pierce Atwood directed its technical assistance in this regard on the next tier of regional market development, consistent with the progressive nature of the regional agreements: specifically, the harmonization of national regulatory structures, laws and practices such that a regional market could become a reality.



**The 2002 MOU:** took steps toward the creation of a regional market, including the creation of a TSO, to manage the flow of energy across a nation's electrical system; and an electricity regulatory authority, independent of electric power industry interests, responsible for monitoring the electricity market.

**The 2003 MOU:** extended agreement to the gas sector; asks signatory countries to develop a regional energy strategy and timetable for its implementation by 2004.

**The Tirana Declaration:** committed to create a SEE regional energy regulatory board, which would facilitate coordination between national regulatory authorities and supervise the integration of regulation throughout the region.

**The Treaty establishing the Energy Community:** in addition to creating regional institutions, including the ECRB, requires the SEE signatories to adhere to the EU energy acquis in the EU Electricity and Gas Directives and Regulation within one year of the Treaty's entry into force.

In 2003, Pierce Atwood began working with the CEER WG SEEER to develop regulatory benchmarking standards; these were finalized in late 2003. In tandem, Pierce Atwood drafted regulatory benchmarking reports, which were designed to evaluate regulatory progress among the SEE countries, measured through international best practices and implementation of agreements to create a SEE regional energy market. The CEER WG SEEER was created as an informal outgrowth of the 2002 MOU process, which recognized that national action could not be achieved consistently across countries in the region without supporting regional frameworks. The brief sidebar description of the content of the

MOUs of 2002 and 2003, the Tirana Declaration, and the Energy Community Treaty (Treaty) provides the context for the trajectory of Pierce Atwood's regional work, which focused almost entirely on regulatory aspects of regional energy market development. All are non-binding, except for the Treaty,

which required the signatories, by July 2007, to implement requirements set forth in Directive 2003/54/EC concerning common rules for the internal market in electricity; Directive 2003/55/EC concerning common rules for the internal market in natural gas (hereafter, Electricity and Gas Directives); and the Regulation (EC) No. 1228/2003 on conditions for access to the network for cross-border exchanges in electricity, (hereafter, Regulation), among other obligations. Pierce Atwood's work with regulators on the development of regulatory standards to apply to benchmarking regulators was the product of much collaborative work with SEE and EU regulators and Ministry representatives (particularly where regulatory bodies did not yet exist) and is reflective of international best practices and regional agreements.

## Snapshot: 2000 to the Present

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### STATUS AT BEGINNING AND END OF PROJECT

Albania: 2000	Albania: 2007
<p>An Energy Regulatory Authority was set up in 1996, pursuant to a 1995 Regulation on the Power Sector, but no primary legislation was in place at the time, and the regulatory authority did not meet basic standards of independence.</p> <p>No Ministry of Energy existed, and no power sector policy or national strategy was in place.</p> <p>Losses were high and collections low; excessive dependence on hydropower.</p> <p>KESH was a government owned, vertically integrated monopoly, with no unbundling or commercialization in place.</p>	<p>Council of Ministers approved new Albanian Market Model in Fall 2007, based on earlier approved (but never fully implemented) Transitional Market Model. Working Group structure in place and active.</p> <p>National Energy Strategy first adopted in 2003; investments in interconnections with Macedonia and Montenegro to improve availability of power, though security of supply remains a constant concern and blackouts are common.</p> <p>Independent Transmission System Operator has been created and structurally unbundled from KESH (full ownership unbundling). Further unbundling of KESH (into generation and distribution/public supply) is underway.</p> <p>Government is taking concrete steps to achieve privatization of distribution/public supply; KESH losses are down and collections are up, though still major challenges.</p> <p>ERE is emerging as a distinct and independent voice in sector issues. Though it continues to face political pressures and requires additional hands-on, practical training and support, ERE is now reasonably strong with respect to principles, reform goals, understanding of key subject matters, such as tariff structures, market design implications, accounting and transparency requirements.</p> <p>Financial settlements and system flows addressed and developing consistent with transparency goals, though additional work required.</p> <p>Technical assistance included law and rule development, training, advice on market design to address investment and security of supply concerns.</p>

<b>Bosnia and Herzegovina: 2000</b>	<b>Bosnia and Herzegovina: 2007</b>
<p>No Energy Regulatory framework or Energy Regulatory Authority.</p> <p>Three vertically integrated utilities were run by each ethnic group (subdivided by region), with no unbundling.</p>	<p>Electricity laws in place since 2002 (the first adopted by Parliament without OHR imposition), and then amended in part; gas legislation is currently in draft form and under consideration by the government, with expectation that the State regulatory authority will assume responsibility over gas issues.</p> <p>Three regulatory authorities (State and each Entity) set up in 2003 and efforts are underway to unify the regulatory authorities, though this process is highly political and may take more time.</p> <p>A State-level Transmission Company and a separate Independent Operator were formed in 2004. Other than these functions, the electricity companies remain vertically integrated. Nationalistic approaches continue to dominate decisions regarding unbundling.</p> <p>Technical assistance included drafting the energy legislation, setting up and training the regulators from scratch, drafting a gas law, developing an incentive-based tariff regime, developing dispute resolution procedures, rules of practice and procedure, licensing rules, and code of conduct, and assisting their implementation.</p>
<b>Bulgaria: 2000</b>	<b>Bulgaria: 2007</b>
<p>The Energy Regulatory Authority (SERC) was formed pursuant to the 1999 Energy and Efficiency Law; a national Energy Strategy was also adopted in 1999; secondary legislation limited and the regulatory authority was in its infancy and with low institutional capacity.</p> <p>Heavy cross-subsidies in place.</p> <p>NEK (electric) and Bulgargaz (gas) utilities both vertically integrated, state-owned.</p>	<p>SERC given competencies over the water sector and expanded in 2005 (now SEWRC); the Energy Law was amended in 2003 and 2006.</p> <p>Successful privatization of both electric and gas distribution and electric generation companies. Regulatory authority trained in principles of privatization and assisted process of privatization; met with investors, contributed to perceived reduction in regulatory risk, sufficient to give confidence to investors.</p> <p>Revenue and price cap regulations in place for all three energy sectors, including performance-based tariffs with service quality indicators; pricing presents a challenge as prices are high relative to other EU countries and certainly neighbors in the SEE. Sector seeking to realign import/export needs in light of closing of nuclear power plant (per EU accession agreement).</p> <p>Various gas pipeline initiatives envision extensive use of Bulgaria.</p> <p>SEWRC's competences fairly strong in terms of training; more hands-on work required to integrate the regulatory authority into the regional initiatives and improve public outreach efforts.</p> <p>Technical assistance included setting the legal framework, then assisting in the process of privatization; developing rules and regulatory competencies; assisting the regulatory authority to address tariff considerations and safety net concerns.</p>

<b>Croatia: 2000</b>	<b>Croatia: 2007</b>
<p>No Energy Regulatory Authority or Energy Regulatory Framework.</p> <p>One vertically integrated, government-owned electricity utility, HEP, in place.</p>	<p>Primary and secondary legislation have been adopted (primary energy legislation package first adopted in 2001, amended in 2004 and 2007) and for the most part is acceptable/consistent with EU requirements.</p> <p>The regulatory authority is fully documented (legislative framework in place), and staffed (at 25), with resources and functioning. But the regulatory authority lacks the ability to set tariffs and enact regulations; empowerment in both areas would be optimal. Internal disagreements among the regulators have curbed its effectiveness as a voice for reform.</p> <p>Croatia has a new market model which approaches (but does not quite meet) all EU Directive and regulatory requirements.</p> <p>Lacks any privatization in electricity. INA (Croatia), a partially privatized oil and gas exploration and production company, operates over 50 oil and gas production fields.</p> <p>HEP's structure has improved financial settlement systems and flow of funds, though additional work is required, and the structure adopted, in which all assets remain held by the parent company, is cumbersome and complicates unbundling. New attention by companies and by regulatory authority to uniform systems of accounts shows promise. An independent market operator has been established and unbundling of the transmission system operator and other functions has taken place.</p> <p>Technical assistance included assistance in drafting primary and secondary legislation, extensive tariff methodology revision, regulatory training and implementation of a uniform system of accounts.</p>
<b>Macedonia: 2000</b>	<b>Macedonia: 2007</b>
<p>No Energy Regulatory Authority or Energy Regulatory Framework.</p> <p>Electric Power Company of Macedonia (ESM) state-owned, vertically integrated.</p>	<p>The Regulatory Authority (ERC) was set up in 2004; the primary energy legislation passed in 2003, and was amended in 2005. A new Energy Law entered into force in May 2006, replacing the Law on Energy of 1997.</p> <p>A reasonable body of secondary legislation exists and staffing could be at higher levels, but for the most part, Commissioners and staff are substantively strong. The ERC could assert itself more vigorously as a voice for reform.</p> <p>Successful privatization of the distribution companies. Privatization provided impetus for other sector progress, though tariff levels need additional attention as set too low relative to cost and market.</p> <p>Technical assistance included law drafting, licensing rules and terms and conditions assistance, advice on default supply, supplier of last resort and treatment of vulnerable customers contributing to greater involvement by the ERC in social memoranda and social safety net issues.</p>

<b>Moldova: 2000</b>	<b>Moldova: 2007</b>
<p>The Energy Regulatory Authority (ANRE) was set up in 1997 pursuant to a Government resolution that same year. No supporting energy primary legislation was adopted until 1998.</p> <p>First privatization occurred in February 2000, when Union Fenosa acquired 3 electricity distribution companies.</p>	<p>Primary legislation was amended in 2000 and 2003.</p> <p>The TSO, Moldelectrica, is a state-owned company managing the assets of the power transmission system and the dispatch center.</p> <p>Efforts to privatize the remaining state-owned distribution networks have not taken hold.</p> <p>The regulatory authority has struggled in part due to political pressure over decision-making and appointments of Commissioners, in the latter case resulting in the continued absence of one Commissioner (out of 3) for several years. Only recently does the situation appear to be improving, in part because the Government of Moldova has committed to certain reforms in its effort to become signatory to the Energy Community Treaty.</p> <p>Technical assistance included on-site regulatory competence development and training; drafting of rules, laws, model contracts, and licenses; and tariff assistance.</p>
<b>Montenegro: 2000</b>	<b>Montenegro: 2007</b>
<p>No Energy Regulatory Authority or Energy Regulatory Framework.</p>	<p>The regulatory agency was set up in 2004 pursuant to primary legislation passed in 2003 (no gas framework is yet in place, though a draft is under consideration).</p> <p>Electric Power Company has been functionally unbundled.</p> <p>Integration into the Athens Memorandum process has started, though many steps are still required.</p> <p>Still highly dependent on imports, as no new energy facilities constructed in last many years.</p> <p>Technical assistance included reviewing laws and supporting development of the Transmission Operator and the Market Operator.</p>
<b>Romania: 2000</b>	<b>Romania: 2007</b>
<p>The Electricity Regulatory Authority (ANRE) was set up in 1999, pursuant to an Emergency Ordinance in 1998. A separate Electricity and Heating Law was adopted at the end of 1998. The Gas Regulatory Authority (ANRGN) was formed in 2000.</p> <p>Restructuring of the sector had begun by 2000, with the unbundling of the vertically integrated utility and the formation of Transelectrica, with responsibility over the transmission system and also fulfilling the market operator role, through its branch, OPCOM.</p>	<p>In 2007 the electricity and gas regulatory authorities were merged. The current regulatory authority has a president, 3 vice-presidents and 2 regulators with a staff of over 200.</p> <p>Full wholesale market opening as of January 1, 2007.</p> <p>Participants in Romania's power market are a partially privatized system operator, a transmission operator, distribution operators, generators, suppliers, and eligible customers. Five out of eight distribution companies privatized, production still state-owned with plans to privatize. Electricity Market: 45% Regulated, 55% Competitive.</p> <p>Day-ahead market, balancing market, continuous trading, ancillary services market.</p> <p>Secondary legislation is extensive and among the most progressive in the region. The regulatory authority has high technical capacity and</p>

	<p>strong competencies under the law, though political influence remains and has been manifested over the years through removals of Commissioners and staff.</p> <p>Technical assistance included law drafting.</p>
<b>Serbia: 2000</b>	<b>Serbia: 2007</b>
<p>No Energy Regulatory Authority or Energy Regulatory Framework.</p> <p>The Electric Power Industry of Serbia (EPS) is vertically integrated, state-owned.</p>	<p>The Energy Regulatory Authority was established in 2005, pursuant to primary energy legislation, adopted in 2004.</p> <p>Staff was funded by EAR for three years, which ceased in the second half of 2007, and the progress will need to be carefully monitored to ensure retention of valuable staff and reform-oriented activities.</p> <p>As in Croatia, the Regulatory Authority does not fix tariffs, though it does set methodologies, with the government approving final prices. The Regulatory Authority issues licenses, but only subject to conditions set by the government. Technical regulatory competency is developing at a good pace, bolstered by some excellent hires in key fields.</p> <p>Technical assistance included primary law drafting, energy sector restructuring assistance, and energy regulatory development. EPS still state-owned and vertically integrated.</p>
<b>UNMIK/Kosovo: 2000</b>	<b>UNMIK/Kosovo: 2007</b>
<p>No Energy Regulatory Authority or Energy Regulatory Framework.</p> <p>KEK is vertically integrated, state-owned, and not commercially viable.</p>	<p>Regulatory authority (ERO) formed in 2004 partially, and fully in 2005 (first regulatory structure developed in 2003 but this was under a UN structure in charge of all regulatory bodies (i.e. water, waste, transport)). New Commissioners and some loss of key staff due to budget reductions should be watched carefully so that reform momentum is not lost.</p> <p>Ministry in charge of energy in place and highly active in the sector.</p> <p>Primary legislation in electricity, energy, energy regulator in place as of 2004. Draft gas law pending. Redraft of energy package anticipated, with goal to improve investment climate, remove transitional provisions to reflect developments in the sector and resolve some inconsistencies so that it is fully in line with Energy Community Treaty and incorporated legislative requirements.</p> <p>Efforts to bring investment for a new power plant heavily underway. Greater transparency in the process would be preferred.</p> <p>Change in management of the vertically integrated utility also underway.</p> <p>Technical assistance included regulatory capacity development, the implementation of transparent processes, the assessment of investment feasibility, training as to green certification and trading, tendering and authorization advice to the regulatory authority, and assistance in the implementation of a turnaround management structure for KEK.</p>

Regional: 2000	Regional: 2007
<p>No regional institutions for the SEE.</p>	<p>Today, several regional institutions have been formed, pursuant to the Energy Community Treaty.</p> <p>In 2005, the Energy Community Secretariat was formed (interim structure pending change in legal status) – facilitates and administers Treaty.</p> <p>The Ministerial, PHLG, Electricity and Gas Forum also formed (reformed) – policy arms.</p> <p>An Energy Community Regulators Board (ECRB) was formed in late 2006, with three working groups: electricity (run by Serbia); gas (lead by Greece); and customer protection (headed by BiH).</p> <p>The ECRB was preceded by CEER development of a Working Group of regulators for SEE, Athens Forum, PHLG and Ministerial (stemming from Athens MOUs).</p> <p>TSOs have joined to create SETSO, in cooperation with ETSO.</p> <p>All these organizations are contributing significantly to effectiveness of regional reforms.</p> <p>Increased attention to social safety net issues; importance of energy efficiency, renewables.</p> <p>Technical assistance included regulatory benchmarking reports and the development of regulatory benchmarking criteria, the drafting of ECRB internal rules of procedure, drafting a Gas Survey, and general input to CEER WG SEEER and the ECRB on internal best practices and institutional capacity building.</p>

# LESSONS LEARNED FROM PIERCE ATWOOD'S EXPERIENCE

**T**his section reviews some of the most important Lessons Learned from our experience over seven years of promoting regulatory reform in South East Europe.

To present our Lessons Learned, we have divided the case studies in a manner consistent with some overarching themes. We note, though, that many themes overlap, and certainly aspects of each of the areas mentioned have taken place in countries or regional work not profiled here. The case studies focus on discrete examples and include a reference to other projects and experiences where similar lessons were learned. The list and descriptions offered are not intended to be exhaustive, though we have sought to present here the lessons that we think will serve to contribute most to the continuation of progress going forward.

We think it worthwhile to first comment on the importance of donor coordination and ownership, while acknowledging the political issues and significant challenges presented by this objective. We have found that donor agreement on process and content is invaluable to reform. Consistency of message and application of leverage can drive forward progress to an extent no consultancy will ever achieve. In our experience, the USAID officers who have overseen the substantive work under our contract take donor coordination very seriously and have worked throughout this Contract to ensure a maximum of information dissemination and agreement among donor agencies (by which we loosely refer to the various financial and political international agencies supporting energy sector reform in South East Europe, including the European Commission). Yet political objectives cannot always be aligned, nor can all individuals be equally willing or able to fulfill the mandate. We recognize, too, that as consultants, our job is to provide excellent substantive technical assistance, while advising USAID when we think issues arise, including political, that could hinder or further reforms if proactively addressed. Throughout this contract, we have made strong efforts to inform and advise to the best of our abilities, but also to respect the limits of our role in the greater political negotiations that are the purview of the donors themselves. Consistent with this approach, the Lessons Learned that we profile here have to do with areas that we feel are appropriate within the mandate of consultants, not donors.

Two of the most important themes have followed us through all our projects and resonate loudly at the close of this contract. Namely: (1) education and training are cumulative over the years and (2) regional cooperation is instrumental in furthering national reforms. We discuss these at the outset, and then offer sub-themes and supporting case studies.

Through the seven-year life of this contract, we have provided training and education to regulatory authorities, government representatives and other stakeholders. While each SEE country, and indeed the respective bodies within each country's energy sector, have varying levels of progress, every country now has regulatory authorities and comprehensive primary and secondary legislation that were not in place at the start of the Contract. Market actors (including new regulators) generally now understand

the vocabularies and analytical tools crucial to the development of their energy sectors. The existence of fully functioning institutions and markets is uneven, for a wide variety of reasons, but across the SEE there is a growing group of energy sector professionals who understand the implications of various policy choices, market models and reform priorities. The country-specific and regional work has had a cumulative impact, resulting in real, though imperfect, progress.

The case studies that we present here fall within the following thematic areas:

- *Donor leadership paired with the involvement of many stakeholders is critical to success (e.g., Bulgaria, Macedonia, Albania)*
- *Assistance must be tailored to fit realities on the ground, while continuing to push for greater reform: flexibility in approach should be paired with consistency of message (e.g., BiH, Regional)*
- *The more hands-on, comprehensive practical assistance, the better (e.g., Croatia, Bulgaria)*
- *Momentum and follow-up are invaluable (e.g., Regional Benchmarking)*
- *Transparency and public communication and outreach are goals themselves, but also serve as important catalysts for change (e.g., UNMIK/Kosovo);*
- *Harmonization on national levels can facilitate regional coordination (e.g., USoA)*

## **DONOR LEADERSHIP PAIRED WITH THE INVOLVEMENT OF MANY STAKEHOLDERS IS CRITICAL TO SUCCESS**

A feature of this region is the transience of governments, ministers, regulators and sometimes regulatory authorities. To drive progress in the face of this situation and develop institutions that can survive the ephemeral political moment, strong donor leadership is key. Leadership in this regard means coordination and ownership, along with follow-through, from the law drafting stage through the implementation stage. Donor leadership has contributed heavily to the success of some of our projects, where we have responded by following in step with donor direction. Consultants can provide ready technical assistance and can tailor such assistance to the needs of the recipients and conditions on the ground.

Consistent with such leadership, frequent, early, repetitive involvement with stakeholders can drive forward success. Regulatory reform demands the involvement of more than Commissioners and their staff. Donors (including international financial institution representatives and funding governments), ministries, parliamentary members and/or working groups, system operators, utilities, suppliers, NGOs and indeed in many cases, customers and the public, must be part of the overall regulatory reform process. Though the extent and nature of involvement may shift depending on the immediate task at hand, approaching reform in isolation with the regulator is, as a rule, a recipe for failure. The more that is put into stakeholder and public involvement at the initial, interim and final stages of a project, the better the long-term chance for success.

## **Bulgaria Law Reform: Frequent, Donor-Supported, Repetitive Involvement with Stakeholders Can Drive Successes**

Donor leadership and multiple stakeholders' involvement in Bulgaria spearheaded legislative reform. In 2003, the existing electricity and energy law was undergoing substantial change in order to comply with EU Directives and obligations under the Athens MOU (later to become the Energy Community Treaty); to reflect benefits of the experience obtained under the existing law and the existing regulator; and to better prepare the electric and gas sectors for privatization. When the USAID project commenced, a draft law had been prepared, largely by the Ministry of Energy and Economy, with some donor assistance, including assistance from Pierce Atwood under prior engagements. The draft energy law as presented by the government and Council of Ministers to the Parliament reflected the draft prepared by the Ministry and was by international measures a good law. In Parliament, mischief began, and a number of amendments to the law that would have turned back reforms, thwarted the intended efforts of the draft, and even rolled back some of the authority and autonomy of the Commission under the existing law were proposed and came uncomfortably close to passage. The law that was ultimately adopted by the Parliament, however, avoided most of these difficulties and now functions appropriately, contributing to Bulgaria's EU membership.

*A clear, modern energy law is critical to successful privatization. We promote progress in adopting such laws by providing local stakeholders with explanations as to the reasons and sources we use, with concrete examples from language in existing laws from other jurisdictions, offering these directly in the draft, provision by provision, for an optimal, user-friendly approach. In doing so, we seek not only to offer the most sound, reform-minded, yet realistic, legal framework to suit the environment, but also to empower local stakeholders and develop a sense of ownership and buy-in to any legal reforms ultimately adopted.*

This result was possible in part through quick, effective, unified and targeted donor intervention. On numerous occasions, with USAID assuming a leadership role, the entire donor community involved in energy sector work in Bulgaria (including the World Bank, IMF, EBRD and the EU, in addition to USAID) promptly met with Bulgarian government officials, the Minister of Energy and Economy, the regulator, and Parliamentary Committees; prepared white papers; suggested alternative drafting mechanisms and generally helped guide passage of the law to a proper conclusion. The effectiveness of a coordinated and unified donor outreach was complemented by USAID's having a program that included an in-country residential advisor and a project, with sufficient support for TDY activities so experts could be brought in to assist in this process as needed.

## **Macedonia and Bulgaria: Assisting the Development of the Regulatory Foundation as Part of a Broad Based Donor Led Effort to Support a Successful Privatization and Develop a Sound, Investment Climate**

### ***Macedonia***

Macedonia successfully privatized its distribution companies, and now enjoys private investment from outside Macedonia. The collaborative approach of donors to assist Macedonia in its efforts to privatize

facilitated the success. Pierce Atwood was part of a team that assisted the creation of a climate suitable for investment, with Pierce Atwood's efforts concentrating on the regulatory, institutional components.

The work began with the drafting of amendments to the Macedonian Energy Law, supplying comments explaining the basis of proposals and follow-up with Task Force members. The comments, providing sources and reasoning for choices made, were embedded in the draft text. In this way, the Task Force was able to assess whether the underlying reasons fit Macedonia's objectives, and also research the sources cited by Pierce Atwood to draw independent conclusions as to the value of the proposals. The Regulatory Authority for Macedonia (the ERC) was created following the adoption of the Energy Law.

To further facilitate the supporting regulatory structure, Pierce Atwood provided, among other things, licensing assistance to the ERC. Fundamentally, the energy sector requires a stable, predictable and clear licensing structure, with transparency as to what licenses must contain and the rights of licensees, the payment for the licensing procedure, and the circumstances under which licenses may be suspended, withdrawn or amended. In addition to drafting and offering comment on the Licensing Rule, Pierce Atwood conducted a three-day workshop in Skopje to discuss specific licensing questions raised by the ERC and to give the ERC additional information as to the licensing model used in Romania. Use of Romania as an example proved important for moving progress forward. Romania, while a member of South East Europe, also was the most advanced of the neighboring countries in terms of opening its sector up to competition and was in negotiations with the EU for membership by 2005, when the licensing assistance from Pierce Atwood was underway. Thus, Macedonia was interested in how a similar but more progressive country in the region had approached the issue, while needing the insight provided by Pierce Atwood to explain the various components of the Romanian model and how these fit into a broader understanding of international best practices.

Additional work to support a sound regulatory structure involved tariff reform, code of conduct revision, a supplier of last resort workshop with follow-up explanation, and alternative dispute resolution rule drafting. While the ERC continues to fear political reprisals and shy away from more controversial subject matter, and its resources also are somewhat limited, with minimal staffing, it now has the increasing level of competence and knowledge required to implement extensive reform.

## **Bulgaria**

The privatization process in Bulgaria in 2003 was similarly important for the government in several respects. As a matter of credibility, the government needed a privatization that reflected modern business practices and processes. Prior privatization efforts, including that of the tobacco company and the telephone monopoly, were at the time mired in controversy, litigation and failure. Thus, a successful privatization effort in the electricity and gas sectors would demonstrate government competence and commitment to a market-oriented economy. In addition, the government was pursuing privatization in order to remove assets and liabilities from the state balance sheet and to generate cash income to assist with other government programs and budgetary issues.

The privatization process for the electric distribution companies began in the summer of 2003 and was completed approximately a year later, in the autumn of 2004. It was in many respects a model process, characterized by a responsive and responsible Ministry of Energy and Economy, close collaboration with the regulator, and the participation of high quality, strategic international bidders, including well known European and North American investors and utility operators. The government commitment to privatization and to a process that was transparent and corruption-free helped Parliamentary efforts to

*Privatization is valuable to reform efforts not just as an end to itself; it offers collateral benefits to the sector. The prospect of a transparent, well run privatization process can act as a catalyst to additional regulatory reform.*

adopt progressive and modern energy legislation (see comments above) and enabled the regulatory authority to design tariff methodologies and initial tariffs that reflected true economic costs of generation and supply and covered legitimate and reasonably included items such as depreciation and return on investment (but also resulted in aggressive tariff hikes for end-use consumers). The political resolve of the government to see through a successful privatization helped give SEWRC the political confidence it needed to enact tariff methodologies consistent with cost recovery and privatization. The end result of the privatization process exceeded the expectations of virtually all involved. The bids were from quality companies, with minimal conditions, and for sums that at the time were beyond expectations and among the highest values paid for privatized distribution companies in Central and South East Europe.

## **Albania Market Model Development: Building Consensus for Change by Engaging the Local Stakeholders and Donors at the Outset and Throughout the Process in Order to Maximize Political Buy-In and Avoid Retardation of the Reform Process**

*Applying a Working Group model to build local stakeholder consensus made possible the adoption at the highest government level of the Market Model and its accompanying clear implementation schedules.*

USAID, through Pierce Atwood and other consultants, has provided ongoing support to the Albanians on their market model (beginning as early as December 2002). On November 17, 2005, a Working Group was formed to monitor the implementation process as proposed by USAID and Pierce Atwood. That Working Group was made up of representatives of the regulatory commission, the incumbent electric utility, the TSO, and the Ministry of Economy, Trade and Energy. After numerous collaborative meetings over

more than two years, the Albanian Market Model (AMM) was approved by the Council of Ministers in early Fall 2007. If carried out, the AMM is a sound market model that promises to assist Albania's integration into the Energy Community.

The AMM reflects a careful balance between developing an efficient and transparent market structure that complies with sound economic principles and the EU and Treaty mandates, on the one hand, and recognizing and accommodating Albania-specific conditions on the other. Thus, for example, the AMM is based on a straightforward bilateral contract model and contains a reservation of the value of the Albanian hydro production for tariff customers, while also creating an overall structure -- characterized by transparent rules and the separation of functions into legally separate entities -- that will promote the commercialization of all elements in the electricity sector and will permit the requisite degree of market opening. The involvement of USAID and Pierce Atwood throughout the process as a guiding force for the Working Group was essential in forging a sufficient degree of agreement among the members of the Working Group and to facilitate the ultimate approval by the Council of Ministers. In addition to providing extensive drafting assistance to the Group to memorialize the substance of the agreements among the members, USAID and Pierce Atwood were able to provide the analytical assistance and experience from other countries in the region to assist the Working Group members in evaluating the policy choices before them. Other donors and international financial institutions, in particular the World Bank, have been involved over the years, providing insights and comments during the evolution of the Albanian Market

*Leadership from one donor is optimal. Informing other donors during the early stages and throughout the process ensures that other donor views are sufficiently considered and addressed before positions have hardened, avoiding decisions being debated after the fact.*

Model from the Transitional Market Model. Some of these comments, especially concerns about the structure of the distribution and supply functions and the reservation of the value of the hydro supply for tariff customers, tied in directly to issues that had been central to many of the discussions of the Working Group. There were concerns about the degree to which the treatment of the hydro supply and the combination of the distribution and public supply functions would be consistent with EU directives. The Working Group had, however, fully considered these issues in reaching its conclusions, and the final product reflected the balance between the immediate needs of the Albanian sector, including a degree of price protection for tariff consumers and the practical advantages of privatizing the distribution and public supply functions in a single transaction, with the need to develop fully open markets. The AMM that ultimately emerged from the Working Group nevertheless provided a framework for further progress towards full compliance with the EU and Treaty obligations.

The World Bank had been kept apprised of the discussions of the Working Group, and this was a vital step toward cross-donor coordination. For various reasons, however, the World Bank did not become fully engaged in the substance of the work until late in the process, by which time the renewal of discussion on these issues would likely have introduced significant additional delay. There was also a significant time lag between the initial IFC involvement and their substantive contribution to the discussions about the AMM structure, which, like the World Bank comments, came at a point when the Working Group had already reached agreement and, therefore, additional discussion risked introducing delay.

Although some of the delay in full engagement of other donors and consultants had to do with factors outside the control of USAID or this project, the overall pattern of engagement suggests that it might have been useful to reach out more aggressively to the donor community to ensure that others were informed about relevant activities. While the periodic general donor meetings provided an important opportunity to review issues in general, time constraints and the breadth of the agendas do not lend themselves to detailed illumination of the issues that may prove important. One approach might be to use the broad donor meetings to identify areas where particular donors may have an important interest, and ensure follow-up discussions (and, if appropriate, encourage direct involvement, for example in working groups) through proactive outreach that is made part of the USAID (and its consultants') mandate. Of course any such proactive outreach must be approached with realism and sensitivity to donor and political dynamics.

Similar lessons are drawn from other Pierce Atwood projects under the SEE Regional Task Order and the IQC. The passage of the first electricity law in Bosnia and Herzegovina on April 12, 2002, could not have been achieved without the leadership of one donor, USAID, the strong consulting role USAID defined for Pierce Atwood, and the involvement of multiple stakeholders from each of the two Entities in Bosnia and Herzegovina and each of the three ethnic groups. In Kosovo, the absence of multiple stakeholder involvement in the decision regarding allocation of tendering authority resulted in numerous debates in the years after the passage of the law, and these debates continue today. Given the early stages of the law development, proactive donor outreach on this issue may have been premature in any event, though certainly ongoing outreach and consultation on this and some other trigger points could have benefited the sector.

# ASSISTANCE MUST BE TAILORED TO FIT REALITIES ON THE GROUND, WHILE CONTINUING TO PUSH FOR GREATER REFORM: FLEXIBILITY IN APPROACH SHOULD BE PAIRED WITH CONSISTENCY OF MESSAGE

As technical assistance projects are designed and then implemented, it is critical that flexibility is incorporated into expectations and execution. Realities on the ground may result in some deviations in course. Tailoring aid to meet these realities, while keeping a vigilant eye on the longer-term goals, is perhaps the most difficult and challenging aspect of assistance.

While it is important that clear achievement objectives are met within discrete periods of time, it is equally important to recognize that deadlines may ultimately need to be revised in order to allow progress to continue, even as political, financial and technical pressures are exerted. For instance, when a project begins with elections looming, reforms may be influenced or delayed. Likewise, where technical disputes or limitations are pending, certain goals may be retarded (a gas law can be developed to support gas transport, for instance, but if the infrastructure is weak, the development of an actual gas market will be delayed, and thus assistance should look toward principles, training and framework development, but cannot expect implementation).

A clear lesson learned here is that a multi-pronged approach to institutionalized reform is needed in light of ever constantly changing governments. The leaders often fluctuate and upcoming elections are cited as excuses to do nothing. The less senior personnel may remain in place, but have insufficient clout to push forward reform. There is, therefore, a need for a two-level response, at the political and technical levels, advanced in a manner that survives as governments come and go.

*Transience of political leadership in the counterparts demands constancy of donor message and guidance as well as flexibility in approach.*

In some cases, political realities may require the adoption of non-optimal structures or legislative frameworks. As long as these are steps forward, heading toward an overall reform objective, they may be worth implementing even when not reflective of the end objective and, in some cases, even when riddled with serious flaws. Projects of this nature may retain significant value as part of the reform process, as long as they are conducted with a clear understanding of the limitations that such political expediencies may create and that they are executed in a manner that does not compromise the greater reform objectives in the long-term.

Building upon the prior theme of flexibility and long-term vision, regulatory reform requires an open mind that incorporates changes in thoughts and perspectives over time. The first step is to learn the lay of the land, then be realistic in response, and finally, use this information to mold the game plan for making progress. Go beyond the regulatory authority and toward the government, industry, donors and other stakeholders as well, to find a way of pushing forward reform through the use of a consistent message that reaches many. Changeovers are common and frustrating: changes in individual commissions and staff across South East Europe, in particular in Croatia, Romania, Bulgaria and Albania (not to mention Turkey, which has proved important for our regional work) have characterized this

Contract. Through consistent application of the overall reform message across different groups, individual departures, while still significant, can have a diluted impact overall.

Market development by itself is a clear long-term goal, with competition a tool to spur investment and benefit energy customers in terms of the quality, price and options available to them. Yet the structures and approaches necessary to get there may change over time, consistent with international developments in thought on these issues. For instance, the California energy crisis taught important lessons regarding regulatory oversight and market design that are valuable to consider as projects move forward. Donors and contractors together must keep apprised of watermark experiences such as the California case and changes in academic and practitioner thinking regarding approaches; and they must work together to consider whether new perspectives should be brought to the tasks already underway.

## Bosnia and Herzegovina and Moldova: Taking the Long-Term View Through the Political Obstacles

### *Bosnia and Herzegovina*

Multiple regulatory bodies within one country make reform very difficult. Bosnia and Herzegovina, as a result of the 1995 Dayton Peace Accords, has a weak, federated system of government. There are two Entities, the Republic of Srpska and the Federation of Bosnia and Herzegovina, which are subdivisions of the State of Bosnia and Herzegovina. Pursuant to agreements with the international community, the State of Bosnia and Herzegovina has limited authority over energy matters, primarily over transmission and cross-border trade for electricity. Each Entity has authority to regulate its generation, distribution, and supply.

*Donor leadership and flexibility is invaluable when reforms are held up by politics. USAID's readiness to accept a non-optimal but intermediate structure made up of three regulatory bodies in order to jump start the energy reform process, combined with the flexibility it showed in the execution of the scope of Pierce Atwood's work, allowed for the creation of the first energy framework in Bosnia and Herzegovina adopted by agreement of local stakeholders and not imposed by the international community.*

At the time our work commenced in Bosnia and Herzegovina in September 2001, there were no energy laws in place at either the State or the Entity level, even though stakeholders in Bosnia and Herzegovina and the international donor community had expected that such laws would have been in place by that time. Thus, though not in our original scope of work under our Task Order, USAID asked Pierce Atwood to begin its work by assisting in the drafting and adoption of modern, practical energy laws (primarily electricity) for the State and for the Entities.

Following this process, the next stage was to assist in the appointment and establishment of three regulatory commissions, one at the State level and one each at the Entity level, and then to assist the newly formed commissions with respect to literally every aspect of their operations, from staff selection to organization, training, implementation and substantive decision making. Three regulatory bodies, nine Commissioners, and multiple staff members in a country of four million people created a substantial burden on the overall energy sector reform effort. The sheer task of creating not one but three regulatory authorities (in a state that had no significant prior history with the concept of independent, transparent regulatory authorities), and the staffing and the training of the same, literally trebled the amount of work required for a customary reform effort. In addition, practical and legal issues constantly arose with respect to issues of jurisdiction, legal competency and application. While these issues were no different than one would expect under any federated system (such as in the United States, with our

constant debates over whether federal or state public utilities commissions have primary jurisdiction over a particular issue of utility regulation), the issues were confounded in a political structure where the concept of a federated system was barely six years old and arose from a war, and where there had been no history of substantive law adoption by the State Parliament at the time the electricity law and associated legislation were first passed in 2002.

Issues with respect to the scope of tariff authority, transit of electricity within the borders of Bosnia and Herzegovina, internal market design, unbundling, and related issues would be difficult enough with one regulatory authority; they were magnified with three regulators, three seats of political power and overlapping jurisdiction. Clearly, having one regulatory body as opposed to multiple regulators is preferable if the political situation permits this result. But understanding that this was not politically possible, USAID and Pierce Atwood proceeded to make reason from the overlapping jurisdictions, train Commissioners and their staff to the highest extent possible, and as capacity increased such that ultimate implementation could be realized, continued to push for a unified regulatory authority structure.

*Much can be accomplished even when the structure created, in response to political exigencies, is flawed. Regulators can be trained, regulatory principles enforced, and sound frameworks developed in order to prepare the sector for more broad reaching reform. The constant struggle is to keep sights on the long-term objective and to ensure that the assistance serves to enhance possibilities for change rather than entrench an intermediate compromise.*

## **Moldova**

By contrast, in Moldova, the project suffered from ongoing political interference, and in that case, USAID chose to terminate the project after four years in response. Respecting reality can include eliminating a program, at least temporarily, when there is no hope of progress. Pierce Atwood's assistance to the regulatory authority, ANRE, fell within three general areas: continued development and implementation of an appropriate legal and regulatory system, ongoing advice and support on regulatory issues, and training. A major threat to continued reform was Government interference in ANRE's sphere of activity through blatant pressure and behind-the-scenes influence. Thus one of the primary Task Order activities centered on enabling ANRE to withstand such interference. As the Project progressed, this threat often materialized, and Pierce Atwood's efforts frequently were devoted to assisting ANRE in counteracting Government intrusion. ANRE did not have a full slate of Directors (Commissioners) for the first eight months of the Project as a result of the volatile political climate, and three months into the Project, ANRE's General Director (Chairman) resigned, leaving only one Director in office rather than the three provided by the law. In sum, the political environment made implementation of reforms difficult if not impossible during the duration of the Project. Yet regulatory capacity and a strong framework still could be developed, to ready the country for greater reform as the political conditions changed. But greater multi-donor impetus was required to realize even this level of assistance. Still, the assistance provided by Pierce Atwood through USAID during this time is realizing benefits now. Moldova's inclusion as Observer to the Energy Community Treaty, and expected change in status to signatory in the near term, are spurring along reform, with the government obliged to take certain key steps toward energy sector reform. Among these is regulatory development, and ANRE is now revisiting much of the work accomplished with Pierce Atwood, and using this work to assist it to rise to the level required by the Treaty.

So too, in Albania, where instability in supply and politics created an atmosphere resistant to speedy reform, a long-term vision toward assistance has been invaluable. Thus, intermediate phases, including the transitional market model design or the tariff system, have been important stages, sowing the seeds for realizing the objectives of sector reform.

## Regional: The Development of Regulatory Benchmarking Standards

In 2003, when Pierce Atwood worked with the CEER WG SEEER on developing regulatory standards, there was little guidance as to the characteristics of a sound regulatory authority, though the MOUs had directed the SEE participants to create regulatory bodies. Thus, benchmarking presented a concrete problem: how to measure regulatory competencies when no clear criteria for doing so were in place? USAID led the way in emphasizing the importance of a regional understanding of regulatory criteria. At the same time, USAID recognized that reaching a common understanding as to the optimal criteria was itself a lengthy and evolutionary process. Thus, USAID supported the regulatory benchmarking process as steps in the path toward a fuller understanding of regulatory independence, authority, and accountability.

In the European Union, benchmarking was proceeding (by 2003, the European Commission had issued its second benchmarking report, covering only the then 15 EU member states), although such benchmarking concentrated more on market structure and performance than regulatory competencies. No distinct standards existed on which to base an evaluation of whether adequate competencies had been given to regulatory authorities, and indeed whether the structure and function of regulatory authorities constituted good regulatory practice.

In March 2003, the European Commission, at the Athens Forum, tasked CEER with leading the effort to create regulatory benchmarking standards for the SEE states and oversee benchmarking work. It was widely understood that regulatory benchmarking in the SEE would help move forward regional electricity and gas market development by strengthening regional cooperation among SEE states and focusing on the role in the regulatory authority in achieving the conditions for integration into the EU's internal market. Stemming from the 2003 regulatory benchmarking report produced by Pierce Atwood (which relied primarily on work performed and information gathered in 2002), the regulators were aware of Pierce Atwood and USAID's commitment to this issue and had developed a basis of trust upon which future work could be built.<sup>8</sup> As a consequence the donors and regulators, with Pierce Atwood, agreed on a cooperative approach for future benchmarking efforts.

From this point until the conclusion of this Contract in September 2007, Pierce Atwood worked closely with the regulators of South East Europe (individually and via the institutional frameworks of the CEER WG SEEER and then the ECRB) on its regional work. This maximized buy-in and effectiveness over time, as well as basic access of information.

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<sup>8</sup> Benchmarking is an effective mechanism for persuasion when top-down enforcement is unavailable or counterproductive. Regional cooperation, particularly at the inception, requires consensus. To start the process toward consensus, and avoid the pitfalls of finger-pointing and defensiveness that can cause benchmarking reports to devolve into toothless platitudes, or worse, inaccuracy, Pierce Atwood took a two-pronged approach. First, the benchmarked participants needed to reach agreement regarding standards, as described in this text. Second, the early benchmarking reports focused more on presenting a comprehensive snapshot of substantive information, as opposed to characterization or comparison. Letting the facts speak for themselves (rather than ranking or criticizing individual countries) minimized arguments regarding whether any participant was "better." As time went on, and the participants became more accustomed to the process, and changes from the starting baseline could be measured applying agreed-upon standards, it became easier to describe more concisely the status of each participant.

To be successful, this progressive benchmarking approach demands accuracy in setting out the facts. For more on the benchmarking process, see *infra*.

Though benchmarking is generally quantitative and seeks to set identified, usually numerical targets (i.e., the European Commission's EU energy sector benchmarking, which looked at numbers of eligible customers, size of the open market, percentage of market opening), regulatory benchmarking is less mathematical. Only a few issues are easily quantified and the remainder involves more qualitative assessments of how to achieve optimal performance. Thus, where agreements commit to the establishment of regulatory authorities with responsibility for market monitoring and the resolution of disputes, as is the case with the Athens MOU, an assessment as to whether these goals are met requires a multi-step process. It is essential to examine (1) substance – what the actual measures should be, such as size of the regulator, budget level, tariff and licensing powers; and (2) process – how decisions regarding actual measures should be made and by whom.

After much back and forth discussion with regulators from the CEER WG SEEER, at working group meetings regionally, individual telephone calls and collective email exchanges, it was determined that

*Sensitivity to the views of regulators and the challenges they faced, crucial to buy-in, could not have been achieved without a ready willingness on the part of donors, regulators and Pierce Atwood to move at a steady forward pace that was dictated less by deadlines than by the execution of a group process of review and comment.*

standards would need to be developed and agreed upon by all before any analysis could be made. In sum, effective regulatory benchmarking that is conducted in order to spur

forward change must involve consensus-building at the outset. Targets or measures must be accepted by participants, or results will be immediately rejected. Consideration of temporal elements, such current status and methods of transition, were also important to show a full understanding of the path facing the SEE regulators.

In order to maximize the cooperative approach, Pierce Atwood sought out several leading regulators who served as promoters of this work internally, thus complementing outreach to individual regulators by Pierce Atwood, and promoting efforts and ultimate outcome. As with the 2004 and 2005 benchmarking reporting work done by Pierce Atwood, an important component of the buy-in and capacity building part of this effort was our readiness to work behind the scenes rather than to promote the products as our own. Thus, for most of the regional meetings, including presentations at the Athens Forum, for the standards and for the benchmarking reports, Pierce Atwood drafted presentations for the SEE regulators, who took the lead in making the presentations and explaining the value of the work to regional stakeholders.

The standards that were ultimately adopted (by late 2003), while the subject of some compromise given the importance given to local buy-in, were largely reflective of international best practice and were the first standards for regulatory competences in the region. Because they were developed with the regulators, they have taken on their own life, and have become understood as hard measurements, rather than mere consultant recommendations. It is these standards upon which Pierce Atwood's 2004 and 2005 regulatory benchmarking reports with CEER WG SEEER were based, and the same standards became widely used to instruct assessment of regulatory competencies by CEER and ERGEG in the EU.

*The regulatory benchmarking standards offered guidelines by which the following categories could be assessed:*

*Independence  
Information Access  
Security of Supply  
Market Operation and Monitoring  
International Organization  
Resources and Capacity  
Procedures for Core Regulatory Activities  
International Activities  
Enforcement  
Accountability*

## THE MORE HANDS-ON, COMPREHENSIVE PRACTICAL ASSISTANCE, THE BETTER

Rules and theory are of critical value, but left alone without appropriate guidance they may accomplish little. The best draft rule may never be adopted if its nuances are not explained and carefully crafted to fit into the web of already existing local law and policy. The greatest theories may never be applied if the manner of their integration into the existing framework is not understood. Thus, drafts, Power Point Presentations, workshops and lectures can go only so far. The challenge is to take work to the next step, optimally through ongoing line-by-line drafting and/or explanatory sessions that maximize understanding on all sides, and through applying the rules and theory in practice, such as by implementing a tariff system and fixing or approving a group of tariffs. Particularly since a goal in itself here was development of regulatory capacity, ongoing, hands-on, active work, instead of theoretical teaching, was key.

Resources of course are not infinite. Different projects may have greater or lesser funding, due to a variety of circumstances that are not tied directly to the substantive issue at hand. As a result, methodology and approach should be matched with funding reality. For instance, follow-up that extends throughout or even to the start of implementation may be fiscally unrealistic; so too may line-by-line explanation of proposed draft language, via a working group structure. The contours of the assistance provided must take into account the limitations in duration and scope. Where the working group structure cannot be executed due to budget limitations, any drafts produced must be created so as to stand, as much as possible, alone. This means that detailed explanation, references and background documents should be provided with any drafts or comments, to enable stakeholders to understand the full reasoning behind the drafting.

As various technical issues are tackled, explanation for approaches should be as inclusive as possible, so that local actors can make informed choices. Thus, where a consultant views a certain technical model as optimal, it is the consultant's job to promote this model by explaining its benefits relative to other models, while still providing a fair forum for discussion of other models. Working Groups (involving multiple stakeholders, but at minimum, more broad based than individual or one on one assistance) can be more productive than submission of drafts or workshops by themselves. Of course, buy-in is necessary for real progress to take place, though the Working Group approach can have the collateral benefit of stimulating such buy-in. This was true in Albania with respect to the AMM model; for the ECRB with respect to the international rules of procedure; and for the tariff work undertaken in Croatia.

Where possible, examples from neighboring jurisdictions – particularly those viewed as further along the reform path by the country for which assistance is targeted, with care to avoid matching countries with a history of recent conflict – should be used to maximum effect. Thus, in the SEE Pierce Atwood looked often to Romania, Hungary and Austria to provide models on which to base explanations regarding successes and difficulties with certain approaches. In this way, Pierce Atwood could merge its extensive U.S. and international expertise with concrete, tangible explanations from neighboring regulators and governments. Using actual exemplar text from neighboring jurisdictions not only presents concrete

*The use of concrete examples, not generalities, leads to a genuine understanding of possible implementation paths and hurdles. Care must be taken to use examples from other jurisdictions that have similar structure, related challenges, or are of particular value and interest to the assisted country.*

reality, but facilitates cross-border cooperation and provides another source for background and explanation.

## Croatia: Success in Tariff Methodology Reform

Pierce Atwood has worked in Croatia under this Contract from 2000-2007. During that time, assistance has included structural reform in the establishment of a modern legal energy framework, an independent energy regulator and transparent, unbundled tariffs. The majority of Pierce Atwood's technical assistance has been directed toward the establishment and development of its regulatory authority, known as the Croatian Energy Regulatory Council (CERC) from 2000-2004 and as the Croatian Energy Regulatory Agency (HERA) from 2004 to the present. This case study looks at one aspect of our assistance to the regulatory authority: substantial work from 2002 to 2005 in the development of unbundled tariff methodologies for the electricity sector, specifically for the electricity transmission and distribution.

The culmination of this work was tariff methodologies for the distribution and transmission networks, the most recent adopted in December 2006. The current network methodologies are essentially compliant with the 2003 EU Electricity Directives and international standards. While the Croatian tariff process remains non-optimal, in that the Government is still in control of setting the actual tariffs, the regulatory authority establishes the tariff *methodologies*, and Pierce Atwood has worked closely with the regulatory body and the utility, HEP on those methodologies since April 2002. From the perspective of international best practices, it is preferable for the regulatory authority to set the actual tariffs – and thus ensure that the tariff setting process is as non-political as possible (important particularly in Croatia where state-owned enterprises dominate the sector). Nonetheless, the current, active work by HERA in setting methodologies marks concrete progress in Croatia, where a reluctance to cede authority to the regulatory body, and a corresponding resistance by the regulatory body to assert authority, has been a recognizable pattern over the last seven years.

*Continuity in using the same process for each working group, with consistent end-products facilitated communications, as the members became familiar and comfortable with the process.*

At the outset of our work on tariff methodologies, we established a working group on transmission, consisting of a small team of Pierce Atwood lawyers and technical experts, and HEP and CERC/HERA representatives.

The same template was then used over a multi-year period to address distribution, and later discussion of generation and supply issues. Over the years, the working group prepared comprehensive reports addressing various issues raised along the way, with Excel sheets demonstrating illustrative results from the proposed approaches. The working group members discussed various examples of alternative systems from various countries, weighing the benefits and disadvantages of each, and determining how and whether such systems could work within the Croatian context.

By working on this same subject matter over multiple years, using the same general template, with overlap among the participants, in a process with multiple visits, continuity could be developed in the most efficient and cost-effective manner.

## **Bulgaria: The Value of On-Site Responsiveness, Continued, Close Work with Commissioners, Staff Members and Other Stakeholders on a Regular Basis**

Duration of the regulatory agency does not necessarily mean that acceptable levels of authority, autonomy, and accountability, as well as subject matter knowledge and overall competence, have been achieved. The Bulgarian regulatory authority was established in 1999, pursuant to post-socialist energy sector reform laws that the Bulgarian Parliament adopted as part of prior assistance projects.

When our Task Order commenced in June 2003, the regulatory authority, the State Energy Regulatory Commission (SERC, now known as the State Energy and Water Regulatory Commission (SEWRC) due to the addition of water regulation to its portfolio of responsibility), was well established with seven Commissioners (many of whom had been in office for several years), an experienced staff and a deep knowledge of operations of the electric and gas systems within Bulgaria. Notwithstanding this positive background, it became apparent that the regulatory authority needed significant advice, coaching and general assistance across several core areas, including: tariffs, particularly tariff methodology and tariff design; unbundling and restructuring of the utilities; market design; appreciation and understanding of reasonable, legitimate investor-backed expectations; development of regional markets; cross-border trade in electricity and gas; establishment of cost-based transit tariffs; and separation of the import/export function from the incumbent utility. Virtually all of these issues had arisen at one point or another during SEWRC's prior existence, but due to a number of reasons, primarily lack of consistent, sustained assistance on the ground on a daily basis, and a series of prior governments that had not been as committed to the reform process as the Bulgarian government that was in power in 2003, the regulatory authority had not mastered these skills. Thus, in many respects, the regulatory authority was like a newly formed body in another country, but with the added twist that on the one hand it had gained some knowledge but on the other it had developed some bad habits that had to be corrected.

A three-and-a-half year sustained effort working literally on a daily basis with SEWRC, coupled with other factors, some of which are discussed below, has led to a regulatory authority that is effective, independent, accountable and competent. Indeed, SEWRC gained such a reputation for effectiveness that the Government of Bulgaria decided to add the water regulatory function to its responsibilities, in the hopes that serious shortcomings in water supply, water regulation, quality standards, investment and customer service could be addressed in the same fashion as had similar deficiencies in electricity and gas service over prior years. The result was to nearly double the size of the SEWRC, from 7 to 13 Commissioners, add considerably to its responsibilities and complexities, and effectively force the regulatory authority to start from the beginning again on yet another area of responsibility, where the learning process is still ongoing through other donor assistance programs.

*Where resources allow, the resident advisor model can greatly assist real reform on a long-term basis, especially in the early phases of regulatory development. At the same time, this on-the-ground assistance must be matched by short-term technical assistance, and caution is required to ensure that residents do not become too entrenched and lose perspective. Once the regulator has demonstrated a certain level of comfort in its role, short-term targeted assistance in specialized areas may be appropriate.*

The resident advisor model proved similarly valuable to our work in Bosnia and Herzegovina, where the on-site presence allowed for a level of assistance and responsiveness that was dearly needed. In Kosovo, by contrast, the absence of a resident advisor may have harmed some efforts. Difficult personal dynamics,

some diplomatic missteps by the regulatory authority, and insufficient outreach to other stakeholders

and the public could have benefited from on-site assistance, so that technical issues could have been addressed with greater coordination, calm and transparency. This allows trust to be built, local knowledge and in-depth assistance, while avoiding personal entrenchment and the loss of international perspective and expertise that experience outside the country can provide.

## **MOMENTUM AND FOLLOW-UP ARE INVALUABLE**

The hardest part of many projects is not preparing the actual deliverable, but rather ensuring that what is prepared fits the context in which it is needed and is actually applied. Context requires more than an understanding of the energy infrastructure, the existing legislation or even the political exigencies involved. It requires an understanding of the various expectations and perspectives of key stakeholders and partners. A study that does not address certain issues that stakeholders expect to have addressed, however technically sound the ultimate product, will be considered to fall far short and as a consequence may not be used. Answers provided to questionnaires may use terminology that has a different meaning for the respondent than it does for the consultant. Projects may be held up due to bureaucratic issues or even perceived but unintended slights, rather than substantive missteps. Such confusions can be addressed through personal follow-up discussions and a ready ear on the part of the consultant and donor.

While short-term projects have value, they are generally a waste of resources unless they fit into a longer-term involvement by a donor and group of supporting consultants. The adage that one gets back what one puts in has proved true over the course of this Contract. Immediate results can be elusive, but the benefits of work conducted can be readily seen a few years later, as understanding, trust and circumstances evolve.

### **Regional: The 2005 Regulatory Benchmarking Report for South East Europe**

Although all three regional benchmarking reports Pierce Atwood conducted under this Contract have assisted the regional reform process, the 2005 Regulatory Benchmarking Report for South East Europe is profiled here. It continues to be used, and has served as a model for work done in the EU by ERGEG and CEER, and as background information to assist the benchmarking efforts of the Energy Community Secretariat, once the Secretariat was established and assumed regulatory benchmarking authority, pursuant to requirements of the Treaty.

When the benchmarking work first began, it was a USAID effort distinct from other donor efforts in South East Europe. The goal of the project was to outline where the countries stood with respect to certain internationally accepted practices, pursuant to a questionnaire developed by Pierce Atwood in 2002 and reliant upon responses by regulatory authorities. At that time, Pierce Atwood had not yet begun the bulk of its regionally oriented work, and thus the benchmarking served as a first comprehensive step toward the greater goal of harmonizing sector structures and competencies

sufficiently to facilitate the development of a regional market.<sup>9</sup> As a reminder, 2003 also marks the beginning of the CEER WG SEEER, and other regional institutional efforts led by the Europeans to set up the institutions necessary to facilitate such harmonization and supervise regional market development. As a consequence, the benchmarking report produced in 2003 was a valuable document that offered information regarding the status of regulatory development in the SEE that was not available elsewhere. As time passed, Pierce Atwood was able to rely on in-depth knowledge of actual reforms, and by 2005, when its regional efforts, including close work with the CEER WG SEEER had progressed (spurred forward in large part by the collaborative development of the regulatory benchmarking standards detailed earlier, and work performed pursuant to the 2004 report), and national efforts were well on their way. By 2005, Pierce Atwood had strong relationships based on hard earned trust with individual regulators in each participating SEE country.

While the 2004 report marks an interim phase in which the standards were applied and the collaborative work with the CEER WG SEEER was begun, 2005 signifies a maturity in this effort such that the work became an example for regulatory benchmarking practice in the EU. (See the CEER Regulatory Benchmarking Report for the EU countries, issued in December 2005, which is extensively modeled on the report produced by Pierce Atwood, under this USAID Contract.)

The 2005 Regulatory Benchmarking Report for South East Europe has several components which contributed to its wide success and use. First, the body of the Report is itself relatively short and manageable as an immediate, hands-on resource. After having presented a comprehensive baseline, the reports could start focusing on changes in that baseline. At twelve pages, the 2005 Report offers a regional analysis as to the core areas where room for improvement is required to facilitate the regulatory component of regional market development (unbundling, third party access, market design and implementation, data access, market monitoring, staffing, enforcement, accountability and international cooperation). At the request of regulators, it did not name individual countries but rather looked at progress and status from the perspective of ratios. The objective was to maximize willingness of regulators to provide full and accurate information on which conclusions could be drawn, to create full buy-in to these conclusions, so as to engage the regulators and their regional institution, the CEER WG SEEER and then later, the ECRB, to address existing shortcomings. By assuring regulators that they would neither be ranked nor named in the body of the document, regulators were forthcoming with us regarding actual status, differentiating in many responses between what was set forth in law (which by 2005 in many cases was relatively progressive) and the realities of barriers to actual implementation.

*A fine line is required to conduct regional studies, with a clear understanding at the outset of the overall purpose of the study. Where the objective is long-term reform and participant buy-in, as with our regional regulatory benchmarking work, the studies must be approached and expressed in a manner that maximizes the opportunities for action taken on the conclusions reached. This requires care with respect to maintaining full accuracy of information while minimizing blame or finger pointing, and offering clear, concrete steps forward.*

At the same time, much data was collected, and the honesty of this data assured through repeated follow-up, phone interviews and cross-referencing with assistance experiences and knowledge we had through our separate national endeavors. An important component of the data gathering was seeking clarification as to the meaning of written answers, and not settling for initial responses that appeared inadequate, internally inconsistent, or weak in certain areas when compared against the primary and secondary legislation or our own experiences working with the regulators themselves. This data had

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<sup>9</sup> During the 2<sup>nd</sup> meeting of the South East Europe Electricity Regulation Forum, 26-27 March 2003, CEER was invited to develop standards to benchmark the performance of the regulators of the SEE region. CEER was invited to present these standards at the 20-24 October, 2003 Forum in Sofia and, following that, Pierce Atwood, under USAID, was invited to undertake a further benchmarking exercise.

the potential to serve important information functions for regulators, government representative and other local stakeholders, as well as donors and consultants alike – and thus could not be lost. Too often reports can consist of ambiguous summary, to which is attached the vague answers to a general questionnaire, with the result that nothing is clear and no one can rely on the report. While sensitivity must always be shown to participants who, for political reasons, are hesitant to admit shortcomings, it is critical that these reports not become a vehicle for whitewashing a participant’s status. The facts can speak for themselves, if they are set forth clearly and confirmed beyond dispute. After consultation with the regulators through the CEER WG SEEER (a practice that was used regularly to ensure consensus), it was decided to present the collected and verified data in an Annex to the report, with clear divisions of the information into categories (e.g., licensing, dispute resolution, quality of service, confidentiality rules, and the like) so as to make the report readily accessible as a resource. In this way, information was reported factually, without judgment, and in a manner that could be used by all. To maximize transparency, the Report also included an Appendix, with the full titles and dates of applicable energy sector primary legislation, the Questionnaire utilized, and the Supplemental Questionnaire, the benchmarking standards applied, and a list of acronyms.

Consensus and buy-in throughout the benchmarking work contributed heavily to the progress this work achieved. Not only was the final product a valuable resource, having been used as a model and to instruct work conducted by others, but regulators developed their own thoughts regarding approach and reform through the actual process of developing the report. This started perhaps most concretely with the development of the regulatory benchmarking standards, which required the regulators to think carefully about international best practices (pursuant to the leadership offered by this consulting project), acknowledge the criteria by which they were willing to be judged, and consider answers with detail and care, prompted by the continued, ongoing follow-up we conducted. It continued with the repeated work done by regulators in commenting on the questionnaire we developed, and then later on the supplement to that questionnaire, which, though again developed by us, was approved and revised prior to its use pursuant to input from regulators. By the time the report was issued, the regulators viewed it as their Report, rather than a separate consulting document, which meant also that they promoted its use in their own countries.

*Proper buy-in and consensus building, with active participation by counterparts, can make the final product their product, with pride of authorship and promotion by those authors.*

## **TRANSPARENCY AND PUBLIC COMMUNICATION AND OUTREACH ARE GOALS THEMSELVES, BUT ALSO SERVE AS IMPORTANT CATALYSTS FOR CHANGE**

Perhaps one of the most important assistance lessons is the value of continued communications and transparency throughout the life of a project. The manner in which assistance is provided is often of equal importance to the actual outcomes achieved.

Because the issues involved in energy regulatory development have the potential to affect a country in significant ways – from the quantity and quality of actual power received and the pricing pressures faced by energy customers to the breaking up of large state-owned companies and the consequential impact

on state revenue and union employment – work in this area must be approached with sensitivity. Stakeholders must trust the approaches used to implement reforms, and access to information must be readily available. Corruption is of course a serious concern within the energy sector, so reform projects must be approached in a manner antithetical to corrupt practices.

## **UNMIK/Kosovo: Progress in Institution Building: The ERO's Growing Understanding of Public Consultation and Transparency**

*Going beyond theory to practice – sitting in on tariff and licensing proceedings and working side by side on an ongoing, in-country basis with Commissions and senior staff – allowed Pierce Atwood to provide the ERO with concrete examples as to performance and a tangible context to the meaning of public participation. Only in this way could internal procedures relating to such hearings and a manual of operations be developed with full implementation in mind.*

Pierce Atwood's assistance in Kosovo targeted the development of the legal and regulatory framework, assistance to the regulatory authority (the Energy Regulatory Office (ERO)), attention to the reform of the Kosovo Electric Company (KEK) and furtherance of the investment climate in Kosovo. We concentrate here on our work with the ERO on institution strengthening, in particular assisting the ERO in drafting secondary legislation and developing an understanding of the importance of a public consultation process and outreach.

Public consultation and outreach are concepts and practices that were highly uncommon in the former Yugoslavia and indeed in most of the countries of the SEE and some existing EU countries. The EU is finally making a heavy push toward the development of rules that promote transparency. In the SEE, we have directed our assistance over the duration of our Contract on incorporating transparency, public consultation and public outreach principles into all regulatory reform efforts.

Due to the unique structure of UNMIK/Kosovo, many laws and decrees have been imposed on Kosovars through UN adoption processes since 1999, and by the Yugoslavian government prior to that. For these reasons, it has been rare in the past to find open and transparent processes whereby rule-making, tariff decisions or licensing applications and amendments are considered. The ERO, however, has evolved during the course of our Contract to put all draft legislation out for public consultation and to hold public hearings on tariff and licensing issues. There remains room for improvement, but the very fact that such public processes have been introduced signifies concrete progress in an area still lacking in many other sectors in Kosovo and indeed among many other energy regulators in the region.

In particular, in 2005, after the ERO had been established for a little over a year, Pierce Atwood assessed the ERO's regulatory needs and prioritized targeted assistance. In 2005, to address frustration by other stakeholders, including a newly formed Ministry in charge of energy, regarding lack of knowledge and input into the ERO activities, Pierce Atwood provided training sessions to the ERO on considerations for public participation in tariff reviews and on the conducting of public meetings and hearings. These trainings were supported by an ongoing in-country presence by Pierce Atwood regulatory experts who sat in on hearings and offered comments as to the ERO's performance. From the assessment component of the work and on-site observations of the ERO's internal operations (with extensive side by side work with its Chairman, other Commissioners and heads of department and senior staff members), Pierce Atwood observed that no internal procedures or norms governed the sharing of information internally in the ERO, let alone externally with stakeholders. This contributed to the uneven level of participation and access to information, exacerbating the internal and external imbalance created by a strong international (non-Kosovar and UNMIK-appointed) Chair of the regulatory authority.

To build a sustainable system by which the ERO raises its public profile, involves stakeholders in decision-making, and operates internally to make communal decisions through public comment processes and sound transparent approaches to participation, Pierce Atwood applied a three-fold assistance system, executed concurrently: (1) the inclusion of such practices into drafts of the ERO procedures and various secondary legislation (including but not limited to Licensing Rules, the Rule on Confidentiality, Tariff Rules, the Rule on Dispute Resolution and the Rule on Conditions of Supply); (2) the development of internal governance rules, primarily but not entirely through the Manual of Operations, that require clear, inclusive and transparent internal decision-making processes that then are reflected externally through transparent information provided to the public through the ERO website, among other methods; and (3) direct, on-site observation of the ERO Commission and senior staff in practice, and feedback to them personally on ways to improve public participation, public outreach and transparency.

On issues, including rule development, for which Pierce Atwood was not the primary contractor assisting the ERO (such as tariff rules) or on which Pierce Atwood worked in collaboration with contractors funded by other donors (such as the Manual of Operations), Pierce Atwood took the opportunity to share its experience on public participation and transparency aspects and to include comments on these issues in the draft legislation.

*Fundamental principles of public consultation, outreach and transparency require constant reinforcement and consideration to ensure their incorporation and mainstreaming into regulatory practices.*

Today, these principles are incorporated into the ERO's practices. Public consultation is held for all decisions, including tariff setting and rule adoption. Work is still needed to hone the public participation skills, and involve more stakeholders, with increased notice and comment. The framework and institutional knowledge are in place to realize efforts to enhance public consultation, outreach and transparency, though vigilance is required to ensure their execution in the current climate of political pressure and budget limitations, and to stem the effect of the inevitable knowledge drain that results from some of the recent (and ongoing) staff and Commissioner departures brought on by the fiscal and political challenges currently facing the ERO.

Additional attention is required to implement practices of public outreach. Such practices would promote considerably the ERO's reputation, reduce concerns regarding regulatory risk, and encourage confidence building across the sector. These steps are particularly important now, when the Ministry of Energy and Mining is exerting significant authority over the energy sector and various proposals are afoot to revise the existing legislation, some of which seek to reduce the ERO's competencies. At USAID's request, Pierce Atwood has recently provided a draft revised law to USAID which offers revisions to the legislation that protect the sector overall, including the regulatory and Ministry roles, in part by providing for additional public consultation and transparency requirements.

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## **HARMONIZATION ON THE NATIONAL LEVEL CAN FACILITATE REGIONAL COORDINATION**

As noted, experience reflects that, as to regional coordination, progress moves from informal cooperation to establishment of a regional institution that can implement top-down regulation. Because each state is sovereign, the road toward a top-down body is slow and requires consensus-building

processes. As at least an interim step toward one regional, top-down template, efforts can be made on a horizontal level, to harmonize national rules and regulations.

## **USoA: Progress in Harmonizing Information Gathering**

Facilitation of information gathering is an important aspect of aiding each national regulatory authority to exercise its licensing and market monitoring duties. To promote common mechanisms for such data collection, Pierce Atwood conducted a series of regional workshops on regulatory accounting in 2007. Each built upon itself. The first, held in May 2007 in Sofia under World Bank auspices, provided an overview of the value of regulatory charts of accounts and gave regulators an opportunity to exchange information on their current practices. It also provided detail concerning the structure and value of a uniform system of regulatory accounting and allowed for representatives of utilities in the region to engage in a frank exchange of views concerning accounting requirements. The second regional workshop, with USAID backing, in Tirana in September 2007, provided an opportunity for a detailed review of the progress made in each jurisdiction and discussion of the key regulatory issues that were emerging as the accounting systems were implemented. As an outgrowth of the regional approach and expressed need from the Croatian regulatory authority, Pierce Atwood provided a three-day USAID sponsored training session in Croatia to examine issues particular to that country.

This approach – starting with an overview, focusing on generally applicable standards, then one-on-one sessions to apply those standards to an individual jurisdiction – emphasizes harmonization of standards across the region, while allowing each jurisdiction to remain comfortable that its sovereignty is protected. The first session allowed regulatory staff to gain a better understanding of the issue, a critical step where utility personnel often has greater knowledge and can use that knowledge to its advantage in dealing with staff. Holding the session with utility representatives present also permitted regulators and their staff to stress to the attending companies the importance of the subject matter to the regulatory authorities, and to start the dialogue as to what materials should or should not be maintained confidential, stressing the goal of transparency. The common needs of each jurisdiction could be identified, with country examples then adjusted to meet other countries' specifics – leading to a convergence of approaches that ultimately can facilitate the development of unified regional template, and ease of cross-border activity.

# ISSUES FOR FUTURE ASSISTANCE

With respect to articulating steps forward, we recommend that the following is seen as part of a bigger picture, with the national and regional work viewed as a collective whole. We have experienced – and anticipate going forward – extensive gains on the national level through regional work, as well as the reverse. We separate assistance by national and regional only for ease of review, but emphasize the importance of cross-over and the visionary aspect of our contract with USAID in this respect.

## NATIONAL

On the national level, there are three areas we think of greatest importance going forward. Broadly described, these are: **tariff design** (and harmonization across countries); **unbundling**; and **transparency**.

With respect to tariff design, pricing presents significant challenges in the region, with continued cross-subsidies in some countries, and accompanying concerns regarding affordability. The implementation of incentive-based systems, with real teeth in terms of application, would improve quality of service and customer protection, as well as promote market-based mechanisms and investment potential. At the same time, the need for consistent interim approaches during transitional periods is well understood and must be part of any approach applied (as it has been, for instance, in Albania). The approach applied for tariffs (and by tariffs, we include the traditional references to transmission and distribution tariffs, but also refer broadly to the more difficult tariff category of retail/end-user tariffs) should be instructed by a regional focus, so that incentive based structures are harmonized, to the benefit of cross-border trade initiatives. In the gas sector, particular attention to transit and long term contract structures is required to further transparency and open, non-discriminatory behavior. Increasing concern over **vulnerable populations** and encouraging **energy efficiency** should be built into national pricing frameworks, as well as addressed in stand-alone measures. The EU's renewable mandates, to which these jurisdictions have committed in part via the Treaty process, will present a real challenge and require considered attention to substantial hardships.

The progress of real, practical unbundling continues to be besieged by roadblocks. Certainly unbundling is required to further the key reform objectives of investment and privatization. Yet politics and corrupt or opaque practices hinder some efforts in this regard. Momentum created by regional requirements (via the Treaty and incorporated EU Directives, as well as activities by the institutions of the Treaty (e.g., the ECRB), and donor driven projects, such as infrastructure investments) should be used as leverage to spur forward unbundling efforts.

The need for transparency is ever-present. A variety of technical assistance efforts can incorporate transparency. These include technical assistance to national regulatory authorities and regulated companies in the implementation of uniform systems of accounts, data access, public consultation and outreach, as well as the development of open procurement processes and trading practices. So too efforts to enhance national regulatory monitoring powers and know-how, along with the more regional look at market monitoring with respect to cross-border exchanges and congestion, serve to increase transparency, thus creating the necessary climate for non-discrimination, competition and investment.

## REGIONAL

Regionally, three substantive areas that will require additional attention going forward are: development of the **gas** regulatory framework; **mutual recognition of licenses**; and **cross-border trade**.

With the closure of Kozloduy in Bulgaria, combined with environmental concerns regarding coal and diminishing coal supplies, natural gas is becoming increasingly important in the South East Europe region. The regulatory framework for natural gas is far behind the electricity framework (consistent with the relative development of infrastructure in the SEE). While the latter has received extensive attention over the course of this Contract, far less has been paid to the gas frameworks. Work has begun recently (in early 2007) with the ECRB Gas Survey, which provides a baseline for the existing gas regulatory regime and articulates areas where additional work is needed. The gas frameworks require expansion on the national level; but regionally, a focus is required at the forefront, with examination of capacity constraints in particular. Geopolitical elements raise issues as to how different approaches from that used in the electricity sector may be appropriate for the gas sector. This should be developed further going forward, with attention also paid to LNG frameworks.

Trade and cross-border exchanges are vital in order to facilitate investment. Existing national licensing regimes, particularly with respect to trade and supply licensing, present some challenges that will require considerable attention going forward. The mutual recognition of licensing, or some intermediate step of reduced requirements, would serve to alleviate many of the existing barriers. Any steps in this direction must be approached in a two-pronged manner, *i.e.*, horizontally through national frameworks on the one hand; and vertically, via regional frameworks on the other hand. Because of the impact on trade from the licensing of suppliers and traders, the vertical attention to the regional framework must have a strong voice in inspiring national action.

With respect to cross-border trade initiatives, further attention must be given to developing the regulatory frameworks in the SEE countries to enable capacity allocation mechanisms and monitor congestion. The ECRB offers a good venue to lead this discussion, and such activity is already underway through work dedicated to the coordinated auction office.

## SUGGESTED APPROACHES

South East Europe is unique in the world for the importance that regional institutional development has played (and plays) as part of the overall energy reform process. The institutional frameworks that have been created during the Energy Community development should be exploited positively in order to gain needed traction and support for energy sector reform efforts. The ECRB offers a good regulatory foundation for advocating harmonized approaches in key areas. Though the ECRB meetings are often restricted to the regulators and the European Commission, the working group meetings are open to consultants. New ideas and approaches to difficulties or barriers to regional market development are welcomed in the ECRB working group meetings. Technical assistance offered on a national and regional level can and should be supplemented through these regional institutional venues.

Trust is needed to implement reforms. Because most reforms are politically, economically and institutionally challenging, it is vital that consultants be trusted as they move forward. The more key stakeholders and partners in the process are familiar with the consultants and the consultants' record of performance and methodologies, and the more the consultants communicate a familiarity with the conditions specific to the region and national interests, the more secure such stakeholders and partners will become with the work proposed. Ideally, one or a core group of consultants will be available on a consistent basis. Having someone who can travel easily to meetings on short notice and provide proactive attention – without imposition and with cultural sensitivity – goes a long way to building the needed atmosphere of confidence and trust. Formal meetings are not always where the most important work gets done. The willingness and ability to get out to the field quickly for informal meetings is critical to achieving real progress.

Lastly, listening to local actors is essential. Targeting assistance in a manner consistent with concerns of local stakeholders can be the difference between long-term success and irrelevance.

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