



THE ROMANIAN ENERGY REGULATOR (ANRE)

- THE SECOND ASSESSMENT -

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The Romanian Energy Regulator ANRE

Second Assessment

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In October 2010 we published the first assessment of the Romanian energy regulator ANRE. The present paper is an updaters of the previous report, analyzing the observed changes in ANRE's regulatory governance and substance. The report examines recent developments, including the proposed legal changes in the status of ANRE and relevant orders and decisions issued between October 2010 and March 2011. The section on regulatory substance also examines in more detail aspects covered less in the previous report, related to gas, cogeneration and renewables. In exchange, the present report focuses less on the electricity market issues covered extensively in the first report.

In both reports we followed the same methodology (World Bank¹ and Inogate²), to ensure consistency of approach and comparability of evaluation results across time.

¹ http://rru.worldbank.org/Documents/Toolkits/infra_regulation/FullToolkit.pdf

² http://www.inogate.org/inogate_programme/inogate_resource_center/trainingmaterials/Training_Handbook_engl.pdf

Introduction: Competition issues in the gas and electricity markets

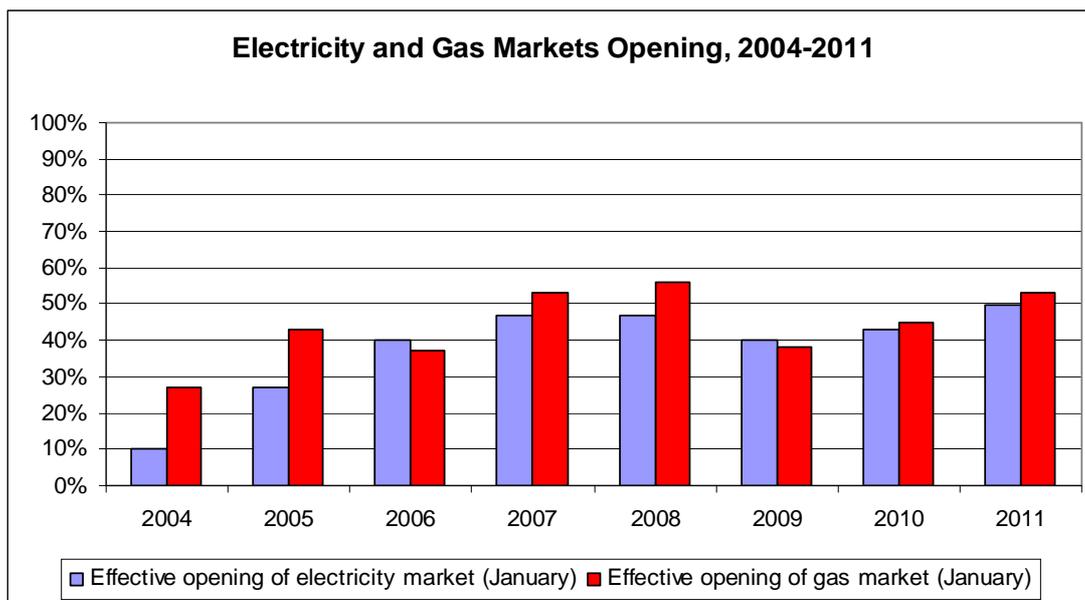
The Romanian electricity and gas markets are still far from ensuring effective competition, consumer choice, and low but economically justified prices that would ensure sustainable investments that lead to improved security of supply. Thus:

- **in electricity**, generation is dominated by SOEs owned by the Ministry of Economy, which is effectively a monopoly of production with above 95% of capacity. Some competition is still possible due to the fact that MEC operates these companies in a non-coordinated manner, as a “soft cartel”; however, even this limited competition is jeopardized if the Government goes ahead with its intention to set up two integrated power companies with monopoly positions in various market segments, instead of allowing private and public investments to compete³. Currently, energy SOEs do not behave as fully commercial companies but operate under soft budget constraints (thermal sector) or do not maximize profits (hydro and nuclear), because they sell at below market prices, in regulated portfolio contracts or to non-competitively selected partners. Half of the market, comprising residential users and a significant part of business consumption, continues to be regulated, and prices are artificially kept at a level that does not fully cover costs or promote much needed investments, private or public; more than half of the market is subsidized, comprising regulated residential users and businesses that receive preferential prices. It is estimated that necessary investments to upgrade the obsolete capacities (e.g., about half of the power generation) could be as high as 35 bn USD for the next 15 years. On the deregulated market, SOE practices distort competition. One large SOE (Hidroelectrica) has been accused frequently in the past 6 years in the media of contracting sales of cheap hydro power at below market prices with private partners and purchasing expensive power from inefficient thermal plants, which has spillover distortion effects on the competitive part of the energy market. Only in 2009, the foregone profits amounted to an estimated 220 mn EUR from such practices⁴; this takes out of the market the most competitive sources of energy, which leaves the higher cost, less competitive energy on the remaining market. At best, truly competitive market is limited to possibly 20-30% of the total transactions.

³

http://www.consiliulconcurrentei.ro/documente/Raport%20concurrenta%20sectoare%20sensibile_18766ro.pdf

⁴ <http://www.sar.org.ro/files/Corruption.pdf>



Source: ANRE, 2004-2011

- **in gas**, market opening has also stalled at about 50%, but in effect it is zero, since practically all consumers have the option to return to the “captive consumer” status and benefit regulated prices. Gas available on the Romanian market comes from a private company (Petrom), a SOE (Romgaz), and imports from Russia through Ukraine and, since the second half of 2010, Hungary. For the moment, in the regulated market, gas prices are kept at an artificially low level, by the Government imposing a “basket” price (an average of domestic and import prices weighted with the respective quantities), together with strict regulation of the domestic prices for both the private company and the SOE. In practice, the Government has managed to enforce better the regulated price on the SOE than on the private company. In 2009-2010, the Government has issued legislation in the benefit of several large consumers (in the fertilizer, chemical and cogeneration facilities), which gained preferential access to cheap domestic gas, mainly from the SOE Romgaz. Since the regulated price has not been amended to match the new basket structure (mainly, lower available domestic quantities once those were sold to the beneficiaries of the law), the subsidy to these consumers has been supported effectively by the SOE Romgaz and the two private retail gas suppliers, which purchased expensive gas from the market and sold at the lower, regulated price. Losses to the two suppliers to date amount to above 250 mn EUR. Implicit gas suppliers (subsidiaries of large European players EON and GDF) are effectively on the brink of insolvency and there is a risk that at some point the holding companies in Germany and France would decide to discontinue operations in Romania.
- SOEs in both gas and electricity operate under **soft budget constraints**, meaning they can survive at a loss or do not maximize profits. The situation is acknowledged in Romania’s recent agreement with the IMF which requires an overhaul reform of SOEs if the country’s prospects for economic growth are to be realized. As long as both electricity and gas markets are dominated

by companies that do not operate in commercial terms, competition is in danger in both energy and downstream markets. In addition, loss-making SOEs in other sectors such as railways do not pay electricity bills and arrears are growing (400 mn EUR at end-2010 to the 8 implicit suppliers, of which 5 are private). As in the gas sector, private electricity suppliers EON, CEZ, ENEL are close to insolvency and Romania risks that these companies would withdraw if this situation continues indefinitely.

- **two changes** are noteworthy in both markets and would require improved capacity in ANRE: the start of private generation in electricity (860 MW power plant in Brazi, by Petrom, 300 MW wind farms by CEZ); and the possibility of reverse flow on the Arad-Szeged gas pipeline, allowing exports of domestic gas in EU's internal market, on which the EC will insist. ANRE will have to ensure that private companies benefit the same conditions (level play) with the SOEs in the same markets, without positive or negative discrimination. The possibility of gas exports would force the Romanian government to either abandon the basket or face shortage of gas supply on the domestic market, as at least the private Petrom would export if local market conditions remain unfavorable. Also, there are cross-cutting issues between electricity and gas markets. The Government is in a conflict with Petrom as it wants to impose the private company to use basket price gas instead of its own gas production for the operation of the gas-fired plant in Brazi. The only legitimate solution to the problem is the abandonment of the basket regulation, which is at odds with EU Directives because it is effectively a ban on exports and a regulated price not compatible with the market economy.
- **foreign investors have lost confidence** in the Romanian energy sector, and the country must resume reforms if it is to regain that trust. 4 out of 6 private investors (RWE, GDF, Iberdrola and CEZ) have withdrawn from Romania's second largest investment project ever (4 bn EUR, Energonuclear 2x700 MW nuclear units). This happened before the incident at the Fukushima reactors in Japan. The Romanian government needs to consider carefully the reasons behind this withdrawal, as it is a clear warning that foreign investors do not believe in what Romania has to offer in terms of competitive market prospects. In the 3 years of negotiation on the project, investors have complained about several constraints: the change in Government's share from 20% (that it can afford) to 50% (which it cannot finance); favorable conditions to one of the private investors that benefits cheap electricity; uncertainties about the electricity market structure which could be dominated by two SOE energy giants operating in a non-commercial manner, if the government goes ahead with its plan to merge power capacities; uncertainties on whether the liberalization would actually take place in the energy markets, allowing prices to reach market levels for Energonuclear to be viable. In addition, there is no private interest in making other investments in power generation except for projects that were started several years ago (Petrom – Brazi) and renewables projects that are partly

driven by speculative gain (wind farms, supported by a proposed green certificate scheme viewed by many experts as too generous – however, even in this case the legislation is not yet approved, so the interest may drop).

Under these conditions, the regulator faces tremendous challenges to promote competition and predictability in the energy markets, effectively challenging various Government or Parliament initiatives that are contrary with market development. Independence, accountability and quality of regulation are as critical as ever for the country to become an attractive destination for investments and ensure good quality supply to the consumer. Having these challenges in mind, this second assessment report focuses on what ANRE must do to become an effective regulator up to the task at hand.

Part I. REGULATORY GOVERNANCE

As in the previous report, we examined the current status and also the recent developments in terms of regulatory independence from government and industry, accountability to all stakeholders, transparency and predictability of the regulatory environment. On regulatory governance, the main aspect considered in the report consists of the two draft emergency ordinances available on the website of the Ministry of Economy before end March, which are not yet effective. We understand the government is redrafting the legislation and a new version would be available after the cut-off date for the current report (April 1, 2011).

The main conclusions and recommendations are:

1. ANRE continues to be dependent on the Executive, being directly subordinated to the Prime Minister, and the recent proposals to amend the law do not address core issues of the regulator's autonomy. The newly proposed legislation gives ANRE back its financial autonomy, but maintains and even slightly deteriorates on paper the existing mechanisms for the appointment of ANRE's management, regulatory committee and consultative council, enhancing to a certain degree the discretion of the President.
2. Whether formal or informal, political pressures on ANRE remain visible and affect the regulator's credibility. If truly independent, ANRE must assert its own views in public by having a clear reaction on the most controversial, politically-driven, measures that have a negative impact on competition and investment in the energy sector. In effect, ANRE must have an ex-ante challenge function to the energy policies promoted by the Government from the point of view of market development and competition. Examples on such energy policy measures or actions of Government owned companies in energy and that should be challenged include the infamous preferential contracts for sales of cheap electricity / gas, which potentially affect competition; and the establishment of the two integrated energy champions, which increases market concentration.
3. ANRE needs to have a committed regulatory road map where proposed regulations must be linked to market development objectives expressed clearly; and the regulator must report at the end of each year to Parliament and its stakeholders on the accomplishment of these objectives.

1. Independence of the regulator

1.1 Independence from political interference

As will be explained below, recent proposed amendments to the law increase the financial independence of the regulator, but enhance and formalize the subordination of ANRE to the Prime Minister and favor politicization. In effect, the functioning of the regulator would depend on the relationship between the PM and the appointed president of the regulator.

The Romanian government is required to transpose in the national legislation recent EU Directives and regulations on gas and electricity (the so-called 3rd Energy Package). While the deadline for transposition was March 3, 2011, the government and Parliament did not manage to pass the needed amendments in time. Despite the fact that member states had a year and a half to transpose the legislation, the actual preparation of the amendments had not started before November 2010; currently the government intends to issue them as emergency legislation, and in effect this is shortcutting extensive debate. Thus, around the deadline, the Ministry of Economy has posted for comments on its website two draft laws/ emergency ordinances, which should contain the amendments needed for an appropriate transposition; at the same time, various legislative initiatives are debated in Parliament and another new version of the laws is being prepared by ANRE. The extent to which the initiatives are correlated and all comments received by the three institutions from various sources would be consistently incorporated in the final version of the law is still unclear. All in all, the draft legislation has not yet been approved and the draft available on the Ministry's website (the only version actually available on a website) does not transpose adequately the Directives of the 3rd Energy Package. At the same time, despite receiving in 2010 a serious warning from the European Commission to solve immediately the subordination of ANRE to the Prime Minister occurred in 2009, the Government has not addressed in the meanwhile EC's concerns by at least a temporary solution, before the final transposition of the 3rd Energy Package. A Commission set up in summer 2010 and consisting of ANRE, MEC, MPF and GSG representatives could not reach an agreement to return the financial independence and repeal the law for subordination of ANRE to the Prime Minister. This issue has to be solved however now in the new laws.

Effective and independent regulation is however a core issue in the 3rd Energy Package, and the Commission places great emphasis on imposing adequate institutional structures for national regulators that would be conducive to regulatory quality and governance. However, in the Romanian proposed legislation, ANRE remains very dependent, both in law and practice, on a single person from the Executive, and the functioning of the regulator would rely excessively on the good personal cooperation between the president of the regulator and the Prime

Minister. Also, the laws perpetuate issues of regulatory accountability from the previous legislation.

Box 1: The 3rd Energy Package and Romania

The EU adopted in July 2009 the 3rd Energy Package, to make the internal EU energy market fully effective and to create a single EU gas and electricity market. The final goal is to help keep prices as low as possible, but economically justified, and increase standards of service, security of supply, and consumer choice. The Package consists of two Directives (on common rules for the internal market in electricity (2009/72/EC) and gas (2009/73/EC) and three Regulations (on conditions for access to the natural gas transmission networks (EC No 715/2009), conditions for access to the network for cross-border exchange of electricity (EC No 714/2009) and the establishment of the Agency for the Cooperation of Energy Regulators ACER (EC No 713/2009). Member States had 18 months, till March 3, 2011, to transpose the two Directives into national legislation, and the Regulations became applicable as of March 3, 2011.

The package provides for (a) effective unbundling of energy production and supply from the networks; (b) increased transparency rules including retail markets and strengthening of consumer protection; (c) more effective regulatory oversight by independent and competent national regulatory authorities; (d) establishment of the Agency for the cooperation of Energy Regulators (ACER) to ensure effective cooperation between national regulators and to harmonize and integrate the operation of national and cross-border infrastructure; and (e) better cross-border collaboration and investment and a new European Network for Transmission System Operators (ENTSO) that brings together EU electricity and gas grid operators to cooperate and develop common commercial and technical codes and security standards.

Member States need to adopt the new rules and ensure that the existing legislation supports full energy market liberalization. For Romania, this means mostly dealing with the existing barriers to market competition, on which it was already in breach of the previous Directives of the 2nd Energy Package of 2003 and received an infringement in 2009; and supporting effective unbundling and improving substantially the governance and quality of regulations issued by ANRE to meet the new Directives. The unbundling requirement can be easily met by separating the ownership of TSOs and of state-owned energy producers. The easy – and correct – way to do it is to transfer state-owned electricity producers (Termoelectrica, Hidroelectrica, Nuclearelectrica, energy complexes) and gas producer Romgaz to the Ministry of Public Finance, whereas TSOs Transelectrica and Transgaz, plus a new operator of gas storage, should remain under the Ministry of Economy. This would also align properly the responsibilities of the two ministries with the objectives of the companies: the Ministry of Finance would want to increase profitability of SOEs to get higher dividends for the state budget, whereas the Ministry of Economy remains in charge with security and quality of energy supply, for which TSOs under MEC are instrumental.

There are several paragraphs in the proposed legislation that concern the institutional arrangements within ANRE, its leadership, regulatory committee and consultative council. These bring some improvements on certain aspects, but are far from enough, while on others they even show a slight deterioration. Thus, in the proposed new laws, the regulator is indeed taken out of the direct subordination of the Prime Minister, but continues to remain under the PM's coordination. The difference between coordination and subordination is not substantial in practical terms. "Coordination" means that ANRE is granted budgetary independence, but the PM decides on the appointment or removal of the president of ANRE, which is possible mid-term under certain (albeit strict) conditions. Also, the members of the regulatory committee and of the consultative council are proposed by the president of ANRE and approved by the PM. The Law should establish precise criteria for selection of appointees (so that not only a person is considered) and the candidates

(for all positions). There are indeed provisions regarding fixed term mandates for the leadership of the regulator – the mandate of the president and the vicepresident (now one compared to previously 3) is fixed term, for 6 years. The regulatory committee is composed of ANRE's president, vicepresident and 7 regulators, for a period of 7 years. There is no fixed term mandate for the consultative council. Members of the regulatory committee, as well as the president, can be revoked only under certain circumstances (death, final criminal conviction, resignation, unavailability for over 60 days, by revocation of the PM). The conditions for revocation in the previous law 13/2007 allowed however for the replacement of the president for failure to meet his tasks, and in case of incompatibility (e.g. having another public service job or having commercial interests in the regulated industry), and this is a good mechanism to ensure accountability. While incompatibility is not explicitly mentioned now as one of the instances in which revocation is possible, this indeed does not exclude the possibility that the National Integrity Agency (an institution that checks incompatibilities and conflicts of interest in public office) would request the revocation in cases of incompatibility. Like until now, all members of the regulatory committee are selected from ANRE's staff, which generates a potential conflict of interest, as explained below.

One aspect which is indeed improved in the new proposed legislation is the financial independence. At this moment, ANRE does not have budget from own revenues. The newly proposed legislation in draft specifies that ANRE would return to its previous financial sources (e.g., from license fees) and would be exempted from the unitary pay law, which has caused the reduction of salaries by about 60% on average and a high turnover of the key technical staff. If the laws are approved, the change would probably be effective starting next year, but at present ANRE remains dependent on the budget. A change in the budget and institutional arrangements for the financial flows in the middle of the fiscal year is legally very difficult, and would require the change of status of the regulator plus a budgetary rectification (which is in theory more difficult this year as the new Fiscal Responsibility Law is effective).

These provisions however are not in line with good practices adequate for ANRE. To understand what arrangements would make sense, one needs to look at the institutional arrangements of other energy regulators in the EU and other Romanian well-functioning regulators for other markets. The following principles should apply:

- as detailed also in the previous report, ANRE should **not** be subordinated to or under the coordination of one individual member of the Executive. Preferably, ANRE should be subordinated to the Parliament, to whom it should report annually on its activities, budgets and accomplishment of its regulatory objectives. This avoids excessive political influence, which is an issue considering that the Government is also the owner of key companies in energy, from which the regulator must be independent; and also because there will be a temptation of every politician to pressure the regulator for low energy prices before elections or in sensitive moments (see Box 2). At the same time, Parliamentary review ensures accountability to the general public. This

arrangement works well in practice for regulators with relatively good reputation in Romania, such as CNVM (Romania's securities commission), or BNR (the National Bank).

Box 2: Informal pressures to keep prices down

Following information that had been published in the media on the possible future increases of prices for gas consumers, on March 2 the Ministry of Economy issued an official statement. According to the press release, the Ministry's view is that gas prices in general and gas prices for residential consumers in particular should not increase in the future. The Ministry also affirms that the only institution with powers to decide on natural gas prices is ANRE. The statement can be however interpreted as an informal political pressure on ANRE to keep gas prices at a low level.

Source:

http://www.minind.ro/presa_2011/martie/2_mart_comunicat_pret_gaz_e.pdf

Box 3: Why anything less than Parliamentary review is suboptimal

In the case of the highly politicized Romanian administration, well functioning institutions need both a reasonable mechanism of checks and balances and external support. For example, the Romanian Competition Council, one of the relatively well functioning regulators, has another arrangement which ensures more autonomy from the political pressures than in the case of ANRE. The Council has a Board, with rotating membership, nominated by the President at the proposal of the entire Cabinet, and whose members need to be free of any political affiliation; while suboptimal, this arrangement ensures more checks and balances than the organization of ANRE provides and works fairly well partly also because of an additional strong external scrutiny of EU / DG Competition. However, in decisions concerning Government measures with substantial political backing, the Council is still not very assertive, such as in the case of the energy integrated champions where the Council's approach was to postpone a decision as much as possible – until the Government changes or a new idea of energy sector reorganization emerges.

- members of the regulatory committee should not be staff of ANRE, but to be regulators with solid public reputation and professional expertise from outside the Authority. They can be fewer than they are now (e.g. 4, plus the President), and not employed full time, as the workload is not very high but requires top specialization (mostly, they should debate, study and analyze relevant documents). They can be organized as a Board or similar body (such as the board of specialists called GEMA in the case of the UK regulator Ofgem). The fact that currently the regulatory committee members are directors from ANRE poses a dual problem. First, the way in which regulations are approved depends on negotiations between directors to approve each other's proposal, as highlighted in the previous report. Second, ANRE's regulators are directly subordinated to the President, who is their superior and also decides their pay (according to the proposed legislation, ANRE's president must prepare the internal rules of functioning of the Authority and the pay scale for ANRE's staff).
- the criteria for the selection of management, regulatory committee or consultative council remain not clearly defined. Thus, for the President and regulatory committee there is simply no criteria, whereas in the new laws the members of the consultative council have to be "persons with remarkable experience" in one of the fields regulated by ANRE. There is however no concrete specification on what represents relevant experience and what should

be the minimum number of years in a similar position, which leaves room for discretion, particularly when coupled with the removal of representation criteria for the consultative council (see Accountability section).

- the nomination of the members of the regulatory committee and consultative council should be made by the Parliament, at the advice of the relevant appointing commission, instead of the president of ANRE nominating and PM approving the membership.

1.2 Independence from the regulated industry

ANRE needs to be independent of interests in the regulated industry, an issue as critical as ever after the appearance of new private companies in power generation, where regulated third party access to networks and transmission congestion tariffs must ensure no discrimination between public and private generators.

1) A major issue in practice, noted by many stakeholders and also highlighted by us in our previous report, is the fact that **staff leaving ANRE are not forbidden to seek employment in the regulated industry, for a specified minimum period (e.g. for one or two years)**. This has an impact on independence or impartiality of the regulation. First, the person in such a position could in principle make use of confidential information obtained during office in ANRE about the competitors of the company that has employed the person in question. Second, the staff could in principle also make use of his or her personal relationships with former colleagues remaining in ANRE to effectively lobby in the company's interest. Such situations need to be avoided by safeguards, such as a clear requirement for ANRE's staff not to seek employment in companies; however, staff should also benefit a form of compensation for this interdiction, particularly if they are leaving because of too low salaries in ANRE or are laid off.

2) An improvement in the new proposed legislation is the **interdiction for members of the regulatory committee plus next of kin to own shares in the regulated industry**. As highlighted in the previous report, there have been cases in recent years when members of the regulatory committee owned shares in the regulated industry. Even though in the case involved the number of shares held by some members of the regulatory committee was minor, the subject has been in the media as one of the many scandals affecting ANRE's credibility.

3) A necessary but not sufficient prerequisite for independence is that the regulator's **budget and resources be adequate**. In the new laws ANRE would have both financial autonomy and would set up its own salary policy, but for the moment ANRE remains financed from the state budget in conditions applicable to civil servants. There is wide consensus within and outside ANRE that the recent wage policy, as salaries dropped by 60-70% after 2009, has led to departure of a significant part of the skilled staff to the private sector. Also, a matter of concern is that ANRE shares

its premises with one of the regulated state-owned companies (Hidroelectrica). While entry in the building is restricted / checked, there is no access restriction inside the building among different floors, which could affect the security of sensitive information at the regulator's premises.

2. Accountability

The energy regulator must be legally accountable for all its decisions and actions as against major stakeholders in the energy sector: energy consumers, regulated industry, and the taxpayers. In the new proposed laws, ANRE is not made more accountable than at present to these stakeholders. For example, a prerequisite of good accountability is existence of impact assessment for each new regulation and quality assurance system pursuant to ISO 9001 standard. However, without improving the accountability it is very likely that the Government would be under renewed pressures from the public opinion to reduce again the independence of the regulator, on both financial sources and its capacity to hire or fire staff. At the same time, ANRE would again become vulnerable to excessive politicization, with people being appointed in key positions on political loyalties because of the relatively good pay. Therefore, any increase in independence without a matching proper improvement in accountability is strongly advised against, as highlighted in the first report: once ANRE becomes independent and gains additional powers, it would be much more difficult for the Parliament or Government to enforce regulatory accountability except by a radical measure such as those of 2009-2010 (subordination to PM's office by a new law).

As mentioned in the previous report, there are several ways in which the regulator can be held accountable to its stakeholders, while at the same time remaining autonomous.

2.1 Annual reporting

Ideally, the energy regulator must prepare annual activity reports to be approved or rejected in Parliament session. An acceptable, but not recommended, alternative is for the Cabinet of ministers as a collective body to approve the activity report. The annual activity report must contain critical information on: ANRE's decisions and actions to meet its broad objectives, the regulations approved in the year of the report, the regulatory road map and its implementation explaining deviations if the case, report on dispute settlement, detailed assessments of the impact of previous regulations to justify the need for amendments or new regulations, but also responses to requests from various stakeholders, and the use and allocation of budgets, together with an independent audit.

The latest annual activity report is for 2009, and we examined it in the previous assessment. As explained then, there is no currently formal requirement for the annual reports to be approved by an external body, Executive or Parliament. In the proposed new legislation, the report must be approved only by the president of ANRE, which means there is no effective outside check on the activity of the regulator; in addition, there is no specific requirement on what information the report should contain, beyond the usual market monitoring that ANRE already does publish.

A critical aspect of the annual activity report is ANRE's internal monitoring of performance indicators. We have asked and received from ANRE a list of performance indicators that would match the information made available by ANRE in previous annual reports (e.g., 2004). ANRE has provided this information. However, we are concerned about the quality of the performance indicators, and believe this information has been prepared specifically to respond to our request, instead of performance indicators being actually used to monitor and improve ANRE's operation. To enhance the relevance of performance information received from ANRE, the following aspects must be considered:

- ANRE needs to have a plan with clear objectives, at least defined by the regulatory committee in full consultation with the Consultative Council composed of representatives from all stakeholders. Performance indicators must measure ANRE's progress during the year of the report against this plan. This plan needs to be broader than the regulatory program that ANRE already publishes, because it must contain objectives achievable not only through regulations but also by other actions (e.g., monitoring of markets, legislative proposals, reviews / regulatory impact assessments etc.)
- performance information must refer specifically to actions within ANRE's control and the link between objective and action must be clear. For example, in the table submitted to us by ANRE there is a line on regulatory independence from regulated industry. The column on actions contains information not related to the objective and not connected to ANRE's own actions (containing mainly excerpts from the regulator's statute and general responsibilities included in the laws)
- the performance indicators must summarize all major regulatory actions undertaken by ANRE within the reference year and link them to broad regulatory objectives (e.g., market liberalization / promotion of competition; consumer protection – meaning not social protection, but for example measures undertaken to increase consumer choice etc.)
- preparing and publishing performance information must not be viewed as an additional burden on the regulator, but as a useful tool to increase predictability of regulation and orient the major regulatory activity towards a well-defined purpose. It also enhances the credibility of the regulator and improves the poor image that ANRE has had in recent years.

Box 4: UK Ofgem's corporate plan and performance indicators

Ofgem publishes a 5-year corporate strategy and plan, which reflects priorities agreed with stakeholders; and each annual activity report highlights the accomplishments during the year compared to the measures programmed for that year.

On the corporate strategy plan, "*Each year Ofgem is required to consult on and publish its corporate strategy and plan by the end of March. This strategy and plan takes account of responses to the open letter we published in July 2010 and to our consultation on the Proposed Corporate Strategy published in January 2011. Responses indicated substantial support for our four priority themes.*

We shall revisit the strategy later this year in the light of the Government's conclusions to the reviews of our role, the electricity market, the delivery landscape and the competition and consumer protection landscape."

In the annual report, Ofgem publishes statistics on how much of the plan has been achieved and performance indicators are divided on key priorities: contribution to EU strategy, better regulation, promotion of competition, fuel poverty, effective network regulation, sustainable development programmes.

2.2 Accountability to stakeholders in the Consultative Council

In every law since its creation, ANRE had a Consultative Council composed of representatives of consumers, regulated industry, local authorities, Ministry of Economy, employers' associations and trade unions. The council has by definition a mere consultative role, but in some cases previous presidents opted to use in practice the results of the consultation as mandatory directions for all new regulations, effectively granting the Consultative Council substantial powers and limiting the discretion of a Regulatory Committee formed of ANRE's directors. In effect, the consultative council is meant to represent the real economy and businesses, for which energy is an essential service. This practice has been beneficial to limiting the inherent conflict of interest between membership of regulatory committee and directors and shows that it is not necessary to have perfect formal rules as long as there is willingness of the management to enforce accountability (see report 1). But despite the benefits of consultation with the stakeholders, in recent years the role of the Consultative Council has been very limited in practice. For example, it seems in 2010 the Council has met only once, whereas previously it used to gather frequently (even monthly).

The new proposed legislation maintains the Consultative Council, but eliminates the representation criteria. The members of the Consultative Council would be only experts in energy sector, without representing the broad range of stakeholders. In effect, the nomination of Consultative Council members by the President of ANRE eliminates the double check on ANRE's mission and objectives, as well as the opportunity of stakeholders to express their views on regulatory needs, and also grants excessive powers to the President.

2.3. Means of redress

In the previous report, we showed that ANRE's actions, orders, regulations can in principle be contested in courts, but so far ANRE has won most of the lawsuits. At that time, we reported that this might happen because the complaints are not valid, but also because Romanian courts could have a tendency to rule in favor of public institutions except in the cases of labor conflicts (salaries, dismissals). This could explain in part why several private companies, such as those operating as implicit suppliers, are reluctant to seek remedies in court appeals, despite the fact that they complain ANRE's current price regulations drive their supply business straight into insolvency (see the Regulatory substance part).

However, there are additional means of redress for the cases in which Romanian regulations violate market principles, as Romania is an EU member and subject to EU's strict rules concerning state aids and internal market liberalization. The most important issues affecting energy markets and supply businesses, and on which their associations complain⁵, concern either the regulator's failure to promote effective market liberalization, or a form of hidden state aid on which DG Competition might act. The latter is connected to the supply of cheap electricity to some companies, at the expense of one hydro power SOE, and the supply of cheap gas to another select group of companies, at the expense of a gas SOE and of the two private implicit suppliers of gas. The theoretical discount between market price and the prices at which the favored companies benefit cheap energy is in effect state aid, and the EC can take actions, through DG Competition which is currently investigating one of these contracts. At the same time, both matters concern the incomplete liberalization of energy markets, for which EC has issued an infringement in July 2009 and a reasoned opinion in early April 2011, which means that by summer the EC could bring Romania to the European Court of Justice.

2.4 Clarity of regulatory roles

As highlighted in the previous report, the roles and accountabilities of ANRE must be clearly separated from the other regulators or public bodies, so that it can be held responsible for its own actions and not someone else's. For example, ANRE is meant to be primarily an ex ante regulator of competition in the energy sector, concerned with access to networks, but also regulation of investments and maintenance of networks, network quality indicators, monitoring the application of license conditions, whereas the Competition Council an ex post regulator, particularly on issues of market domination and notification of state aids. However, the Competition Council is requested by the law to be both, while ANRE does not perform effectively a challenge function to the Government's proposed policies and measures that have an impact on the competition in the energy sector. Thus, ANRE

⁵ <http://economie.hotnews.ro/stiri-energie-8499478-companiile-utilitati-din-energie-preturile-energie-sunt-mentinute-artificial-nivel-scazut.htm>

was not required in law to issue an official, public position on the big issues that distort market competition or outright don't allow a well-functioning market or create the prerequisites for dominant position, issues that generally are highly politically sensitive, such as:

- creation of one or two integrated energy champions (market concentration). ANRE issued only informal positions disseminated to Competition Council

bilateral contracting practices of SOEs that sell cheap energy to private partners without a competitive tendering, which leaves in the competitive market only the more expensive sources of energy and distorts competition on the entire gas and electricity market (the avoidance of a Ministerial Order 445/2009). ANRE has never even launched an official investigation on the issue. It is actually unclear whether ANRE actually makes use of its legal rights to access sensitive but relevant market information. In addition, one can expect that private companies operate for profit maximization, whereas SOEs seem not to function on the same principles; if ANRE must ensure level play between SOEs and private companies, SOEs must be required by law to sell competitively, "copying" private company behavior towards seeking best market opportunities for profit maximization;

- cross-subsidization practices, such as an SOE's purchases of expensive power from inefficient plants and resale at low prices, particularly when there is no need to do so to meet sale obligations. ANRE has never brought to public attention such matters, nor is it investigating ways by which SOEs eliminate redundant capacities;
- market impact of Government's laws that allowed the fertilizer and chemical industry to purchase cheap gas. ANRE has at best communicated informally a position, if any;
- impact of the legislation of renewables on the competition in the electricity market (L220/2008 – 139/2009). ANRE has made some comments in Parliament, suggesting that the law is too generous and would both affect competition beyond acceptable levels (any state aid affects competition, but could be acceptable as long as gains exceed costs) and would also increase energy prices for end-users to excessive levels.

Box 5: Bilateral contracting practices of Hidroelectrica

Hidroelectrica, a major power producing SOE, made headlines in recent years for suboptimal contracting practices and nontransparent deals. Hidroelectrica featured prominently in several media claims that it sells a part of its electricity production at prices below the market level to companies selected without competition. It also engages in sale contracts that exceed the production capacity or estimated production for the year, which means Hidroelectrica is then forced to purchase very costly electricity from other producers to fulfill its sale contract obligations. Hidroelectrica does not put its electricity production for competitive sale on the transparent transaction platform OPCOM, in standardized terms (essentially, to “auction” its electricity in order to get the highest available price on the market in transparent and competitive terms). Hidroelectrica has always argued that it cannot put up for tender all this production due to the long-term contracts concluded in 2000-2004 which expire gradually in 2009-2014.

In 2009, all of Hidroelectrica’s production available for the competitive market has been sold in non-competitive terms, on these previously concluded contracts. However, by the end of 2009, some of these long-term, non-transparent contracts had expired and about 2 TWh would have been available for competitive auctioning on OPCOM starting from 2010 onwards. Nevertheless Hidroelectrica’s management approved in 2009 the extension of some of these contracts to ‘smart guys’ by another five years, at indeed slightly higher prices.

Though the terms of these contracts are not public, apparently, the price in these contracts is negotiable yearly. It is unclear why these ongoing contracts cannot be negotiated at prices comparable to those for one-year contracts on OPCOM (see Table). For 2010, Hidroelectrica traded indeed on OPCOM at end- 2009 a quantity of 1.7 TWh. However, the manner in which the transaction was organized showed that it is possible to formally follow the law but yet abuse it. Thus, instead of selling competitively, which meant placing an offer for sale and wait for the highest bidder, Hidroelectrica responded to a purchase offer at a very low price (138 instead of 160 RON/MWh average price on OPCOM at the date), making a loss of 37.4 mil RON.

A second problem is that Hidroelectrica buys energy from other producers (notably the very inefficient Deva coal-fired plant, Paroseni, or ELCEN) to meet its sales obligations. In 2009, Hidroelectrica produced 15.5 TWh, less than its average production in normal weather conditions of 17.4 TWh, but this decline in production was at least in part foreseeable (a scheduled interruption for the rehabilitation of Lotru power plant, which led to a decline in production of 7-8%). So Hidroelectrica should not sell electricity for higher-than expected production, knowing that for the quantity it cannot produce it will have to purchase expensive energy on the market. 2.5 TWh of the gap in 2009 was covered from purchases from Termoelectrica (at 238 RON/MWh), Deva-Mintia (at 239 RON/MWh), Turceni (179 RON/MWh), or Craiova (195 RON/MWh). These amounts were contracted directly, without being traded competitively on OPCOM, and are at higher prices than those on OPCOM (205 compared to 190 RON/MWh on average).

The losses from these transactions, caused by the fact that Termoelectrica, Deva etc. do not sell on OPCOM and Hidroelectrica does not purchase competitively the needed electricity (in breach of MECOrder 445) are illustrated also below and represent actual cross-subsidies mainly to Termoelectrica and Deva. This in turn allows these operators to continue with their high operating costs, inflated and eventually benefiting a network of private suppliers of the power thermo plants. Put simply, Hidroelectrica sold electricity below market prices, in quantities that exceeded its own available production, and purchased power at above market prices to cover the gap; and by this deal it lost almost 0.9 bn RON, in a conservative estimate. ANRE has never investigated this practice, despite the impact on competition in the power market. Neither has the Competition Council.

<i>Hidroelectrica: loss from non-competitive bilateral contracts in 2009</i>	RON/M Wh	TWh	Mil RON, total
Average price, bilateral contracts domestic market, 2009	102		
Price for one-year electricity sales on OPCOM, Dec 2008 (for 2009)	170		
Price difference	68		
Quantity of electricity in domestic bilateral contracts		11.6	
<i>Lost revenue on domestic market</i>			788
Average price, bilateral contracts for export, 2009	163		
Price difference	7		
Quantity of electricity sold for exports		1.3	
<i>Lost revenue from exports</i>			9
<i>Total loss on non-competitive sales, 2009</i>			798

Data sources: OPCOM, Money Channel. The table offers a conservative estimate, comparing Hidroelectrica's potential prices with prices on OPCOM for base load energy. In normal market conditions, Hidroelectrica's competitive advantage would be to sell the bulk (up to 2/3) of its available energy for peak consumption, which is more expensive (the premium for peak consumption varies from 20% to 200%).

<i>Value of Hidroelectrica's cross-subsidy to Deva, Termoelectrica and other inefficient producers (and ultimately to their suppliers)</i>	RON/M Wh	TWh	Mil RON, total
Average purchase price electricity for Hidroelectrica	200		
OPCOM average price PCCB	170		
Price difference	30		
Quantity		2.5	
<i>Loss from Termoelectrica, Deva etc. by not selling on OPCOM to Hidroelectrica</i>			75

Data sources: OPCOM, Money Channel

We stress again the need for ANRE and Competition Council to prepare a formal collaboration framework for matters concerning competition in the energy markets, particularly as there are substantial bottlenecks in developing a well-functioning energy market and the Government is proposing various measures with an impact on competition (market concentration, state aids). This shared function must be detailed in laws. Currently, the Competition Council has such a formalized collaboration with the public procurement authority, since indeed public procurement could be one of the critical areas where competition issues among bidders may arise.

Two other regulatory items need cooperation with other regulators:

- Consumer protection, where ANRE must ensure consumer choice by ex ante regulations on obligation of suppliers to provide offers to any potential buyer of electricity, and the Consumer Protection Authority ANPC which must deal with other matters concerning the contractual relationships and obligations after contracts are signed.
- Municipal energy regulation, where ANRSC regulates heating and municipal utilities. Regulations on promoting energy efficiency, for example, need to be coordinated among the two regulators and some stakeholders (such as the French Chamber of Commerce) have even proposed the merger of the two regulators to ensure a coherent regulatory framework for the promotion of energy efficiency.

Also, activities that are not in the competence of the regulatory agency must be divested to the public entities that are in charge with similar tasks. Thus, in 2009, ARCE (a government agency in charge with energy efficiency projects) has been merged into ANRE, despite the fact that ARCE has no regulatory function but coordinates the national energy efficiency Action Plan and administers support schemes for energy efficiency projects. This function and its staffing would make more sense to be included in a department of the Ministry of Economy.

2.5 Accountability on use of resources

As mentioned, before ANRE regains its financial independence it must show that it would be accountable for the use of its resources, avoiding waste and having effective controls in place to mitigate risks of mismanagement of funds. We again encourage ANRE to hire an independent auditor to review both its financial records and its key processes (particularly licensing), and to publish the results of such an audit on its website and in its annual activity report for approval by the Parliament.

Of particular concern is the low capacity of ANRE's internal audit department, which is its most understaffed office, with 6 positions of which only one is actually filled as per ANRE's own data. An internal audit department must have at least 3 persons (uneven number), to ensure there is both capacity to monitor internal processes of ANRE and checks by different people on sensitive areas.

A return to its financial arrangements before 2009, as proposed in the new draft legislation, should also ensure that ANRE does not return to its previous financial and budgetary control mechanisms, which were both excessive and ineffective (see previous report). Instead of having a budget approval process that is delayed until after the first quarter of the year, by this making impossible any spending in ANRE except salaries in the first three months, and then there is no external check of the actual budgetary execution, ANRE should have a more streamlined budget procedure coupled with external audits on use of funds and resources. Also, there must be an external verification of the licensing process, to avoid media scandals such as the one mentioned in the previous report (when a bankrupt supplier with

fictitious headquarters allegedly received in 2005 a license to supply to the steel plant Mittal with power bought at below market prices from Hidroelectrica).

2.6 Ethics code

ANRE still has no ethics code (nor has it tried to reinstate the 2005 Code of Conduct) and a committee to monitor staff's behavior, in reaction to various scandals in the media. However, such a code is critical to restore credibility of the regulator, particularly because the primary legislation simply cannot cover all situations and an ethics code could be amended in a more flexible manner to adapt to specific cases. As explained in the previous report, the ethics code also has the role to define what is appropriate behavior for ANRE's staff, which is very important as in some cases people in good faith simply might not consider certain actions as incorrect or inappropriate. The ethics code should detail for example amounts of gifts that are acceptable, confidentiality issues, define what is appropriate use of employer's assets and resources, behavior in public, interdictions of activities in which ANRE's staff is allowed to engage beyond what is already included in various laws, interdiction to seek employment in the regulated companies after leaving ANRE, and also to give advice on how various pressures from politicians or regulated industry could be handled. Publication of such a code and the enforcement by a committee created specially for this matter would boost the credibility of the regulator and is a **quick win**.

2.7 Capacity to enforce its own regulations in a non-discriminatory manner

While this is mainly a matter of regulatory capacity, it also has a very important effect on the regulator's accountability towards the regulated industry, ensuring that all market players benefit same rules of the game (level play). Any accusation of discriminatory approach must be examined responsibly by ANRE and its reaction must be public. At the same time, the regulations made by ANRE and other regulators must ensure non-discriminatory treatment, but also that they follow higher rank legislation (primary law).

Box 6: accusations that some companies benefit preferential regulations

In recent years, the private gas producer Petrom has been accused of having benefited preferential arrangements regarding its gas sales. Both SOE Romgaz and Petrom are required to produce a certain amount of gas at a regulated price for the so-called basket. Petrom has managed to bypass sometimes the regulation – a media investigation in 2006 showed that, while Romgaz puts into the basket about 99% of its production, Petrom was contributing only 30% of its gas to the basket, the remaining being registered as own technological consumption for one of its chemical plants.

The problem resurfaces this year because Petrom has built a gas-fired power plant of 860 MW at Brazi, to be commissioned in 2011, for which it intends to use own gas, effectively bypassing the basket. This has prompted a reaction of ANRE, ANRM and MEC to issue an order to stop Petrom from using its own gas for the power plant and instead buy the basket.

Both sides bring arguments for their position: Petrom that they are investing in gas extraction and that the basket is illegal according to Romania's own gas law 354/2004; ANRE/ANRM/MEC that allowing Petrom to use cheap gas for its power plant would put it at a competitive advantage on the power market compared to its current and future competitors. Petrom has sued the Romanian government to be able to use own gas. (<http://economie.hotnews.ro/stiri-energie-8419476-cum-vrea-petrom-utilizeze-18-din-productia-interna-gaze-pentru-centrala-electrica-brazi.htm>)

In reality, the whole discussion revolves around a distortion in the gas market that ANRE, ANRM and MEC refuse to address, despite pressures from EC and an infringement received by Romania already in 2009: the whole basket concept is incompatible with gas market liberalization, which according to the primary law should have been achieved in July 2007. Instead of deteriorating Romgaz' prospects for development and attempting to do the same with the private Petrom, the Romanian government needs to abandon the basket once and for all. While the basket is not fully under ANRE's control (the fact that orders are issued jointly by ANRE/ANRM/MEC dissipates responsibility), ANRE must 1) state publicly that the basket must be abandoned as soon as possible, to continue market liberalization and to respect the Gas Law and 2) refuse to sign any common ANRE/ANRM/MEC order or other law that perpetuates the basket concept.

3. Transparency

In order to effectively account for its actions, ANRE's decisions, orders, regulations and activities need to be as public and transparent as possible. We welcomed ANRE's willingness and efforts to respond to our FOIA inquiries and openness for discussion (we also appreciated the availability of ANRE's president to discuss ways to move forward and the shortcomings discovered in the previous report).

In the previous assessment, we have requested ANRE to respond to a request on FOIA. We have received the answers after the finalization of the first report, but within the deadlines for responses on the Freedom of Information Act Law 544/2001. Some of the responses have been very informative, and we strongly encourage ANRE to publish the data sent to us also in ANRE's annual reports or website (these consisted of financial statements; information about meetings of the regulatory committee, including the minutes etc.).

We have also asked ANRE to provide information on performance indicators, based on the model that ANRE itself used to publish in previous annual reports (e.g., 2004).

We indeed appreciate the efforts of the ANRE officer for FOIA to prepare such information specifically for our request, and encourage ANRE to resume the publication of performance information in the annual reports. However, we are concerned about the quality of information on sensitive or difficult matters. Thus:

1) On some items we have not received full responses. This is the case with the CVs of the management and members of the regulatory committee, which is considered personal information. We strongly encourage ANRE to publish the professional records of the people in key regulatory and managerial positions, particularly the highlights of the activities that demonstrate that the people appointed to run the regulator are indeed competent to perform their duties. This is standard practice for other regulators in the EU⁶. In addition, publication of relevant information about the competencies and experience of ANRE's key people (president, regulatory committee, and consultative council) would increase political costs of parties seeking to appoint people with little experience in the field, simply based on political affiliation.

Another item which has not been well explained is the mechanism by which regulated prices are created (we asked for data on how ANRE allocates quantities that producers need to supply in the 8 regulated portfolio contracts. The only available information, also in ANRE's published market monitoring reports, is that ANRE determines the allocation in such a manner as to ensure a similar level of prices across regions, but without providing evidence that this is indeed so).

2) We also asked for the results of an audit, if such an audit exists. Since we did not receive data about an audit, one can presume that the accounts of ANRE are not externally audited yearly in a systematic manner, e.g. by a private auditor or at least by the Court of Accounts. Also, the report of the Court of Accounts in 2009 does not indicate ANRE as one of the entities subjected to their audit in that year. Particularly if ANRE regains its financial autonomy and considering that the regulator has been subject to various scandals in the past, audits are critical to restoring credibility and ensure that the funds, resources and powers entrusted to ANRE are managed responsibly.

3) The quality of the performance information is relatively poor and indicates ANRE is not fully aware of its mission, direction, and goals (see also Accountability section)

⁶ For example OFGEM (UK):

<http://www.ofgem.gov.uk/ABOUT%20US/WHOSWHO/Pages/Who'sWhoatOfgem.aspx>

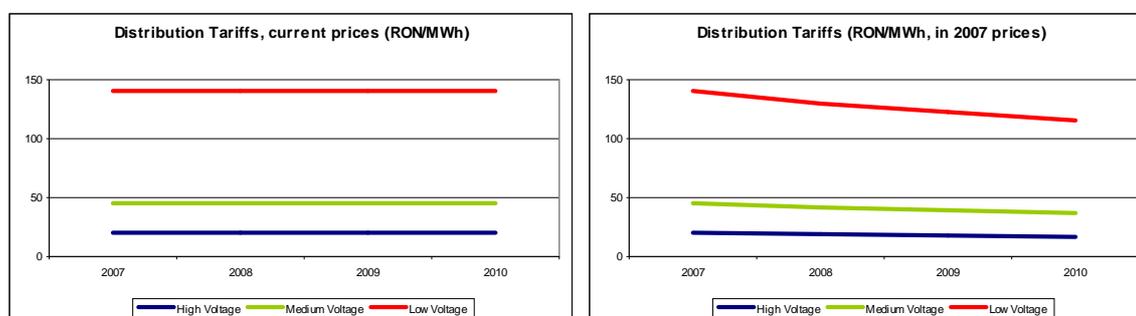
E-Control (Austria): <http://www.e-control.at/de/econtrol/unternehmen/abteilungen-der-e-control/vorstand>

4. Predictability

ANRE's regulations need to be predictable so as to allow the regulated industry to adequately plan their businesses. However, the number of orders and decisions of ANRE continues to be very large and a part consists of amendments to the existing orders (for example, 4 out of 16 Orders in 2011 in electricity).

As explained in the previous assessment, in order to ensure predictability of regulations, methodologies to establish tariffs for networks (transmission, distribution) are set in regulatory periods (the first regulatory period was of 3 years, 2005-2007, the second covers 5 years). In the past, ANRE has received substantial consultancy on tariff setting methodologies, from both EU and the World Bank, and the existing methodologies are sound. Within the regulatory periods, tariff adjustments should be made for inflation or changes in environment not foreseeable at the beginning of the regulatory period. There is a higher rate of regulated return for private investors than for public distributors, as private investment is considered riskier, particularly for exchange rate risks. The tariff methodology for distribution is based on network operating costs and maintenance costs, own technological consumption, depreciation of assets, and reduction of losses.

Distributors (private and public) are not particularly concerned about tariff regulations, though there is some room for improvement. One aspect to be considered is the fact that tariffs are in fact not adjusted to inflation in practice (despite provisions in the law), which erodes the revenues of distributors in time, particularly considering that Romania still has a high level of inflation despite constant efforts to contain it for accession in the Eurozone (5-7% per year). However, private companies and particularly suppliers of both gas and electricity are very concerned about several regulatory items, examined in detail in the Regulatory substance part (secondary legislation for renewables, decisions concerning energy sector restructuring, liberalization of markets, cogeneration incentive scheme etc.). Particularly the non-implementation of cost pass through of regulated gas supply and, to a lesser extent, electricity, is a serious uncertainty mainly for private companies.



Source: CEZ, BNR. Tariffs have been kept constant, but they are in fact eroded by inflation

Part II. REGULATORY SUBSTANCE

As noted in the previous report, the regulations issued by ANRE are not conducive to improved market competition, which is actually its key mission as ex ante regulator of competition. We have analyzed more in depth regulations on gas, and the consistency of regulations that promote climate change mitigation measures and reduction of GHG emissions (ANRE's involvement in the debates on the primary legislation for renewables, and its own regulations for district heating and the high efficiency cogeneration bonus). The following section focuses on two aspects of regulatory substance, regulation of tariffs and prices, and market monitoring.

The main conclusions of our assessment concerning the quality of ANRE's regulations and market monitoring are:

- 1) ANRE continues to be excessively focused on setting prices in competitive business areas (generation and supply), instead of promoting competition in the energy market whenever possible and regulating only when necessary, as a modern regulator should operate. The public debate surrounding ANRE concerns only the regulation of prices for gas and electricity.
- 2) Being subject to pressures to maintain regulated prices at below market levels, ANRE is effectively not implementing its own regulations, particularly in what concerns the cost pass through in the case of regulated gas supply. This is leading to substantial losses for implicit suppliers and could cause them to run insolvent.
- 3) ANRE has been particularly shy in challenging Government-promoted legislation and conflicting measures on climate change mitigation and in correlating its own regulations for support schemes for high efficiency cogeneration with the broad objective to support emission reductions. As a consequence, in the long run, consumers might end up paying excessive prices for electricity with little benefit in reduction of CO₂ emissions and with additional distortions on the energy markets.
- 4) ANRE's capacity to independently monitor market competition is rather limited and possibly subject to political pressures, as hinted also in the Regulatory Governance section.

1. Setting the tariffs

1.1 Tariffs and prices

ANRE regulates tariffs for monopolies (transmission and distribution networks) or dominant position activities (such as gas storage or ancillary services in electricity), but also and prices for some categories of consumers. The latter are the so-called “captive” users, representing the segment of residential and industrial consumers who have not opted to exercise their right to switch suppliers. No changes in the mechanisms for regulating prices and tariffs have been operated since the previous report, and there have also been no changes in tariff methodologies.

Box 7: Amendment of tariff methodology in response to differences in ANRE and distributor investment plans (update from previous report)

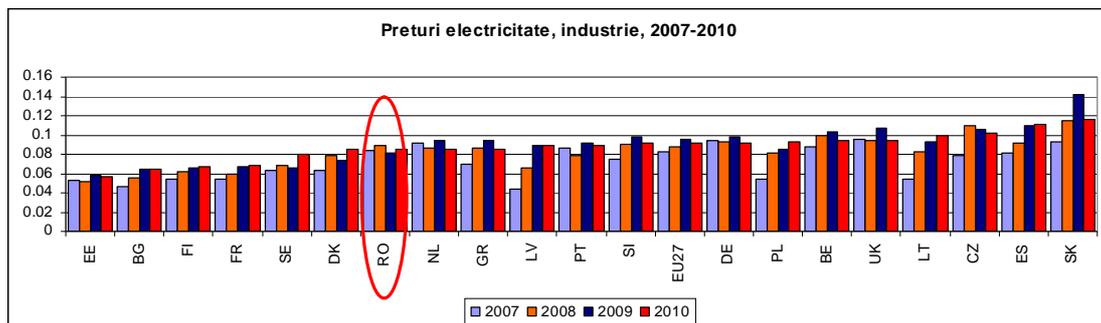
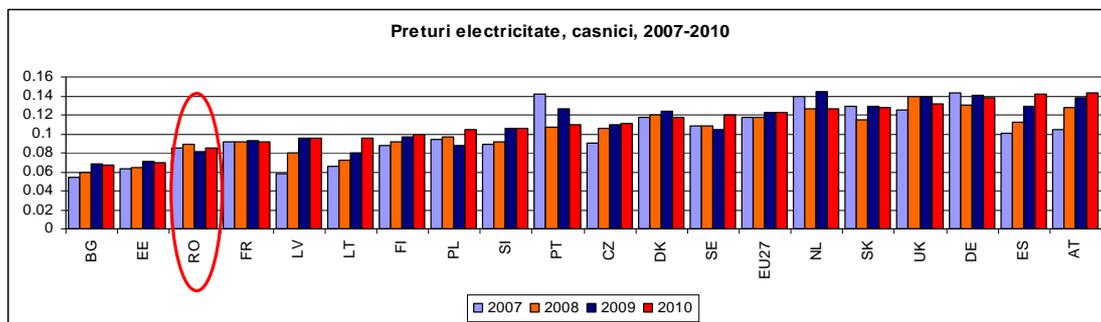
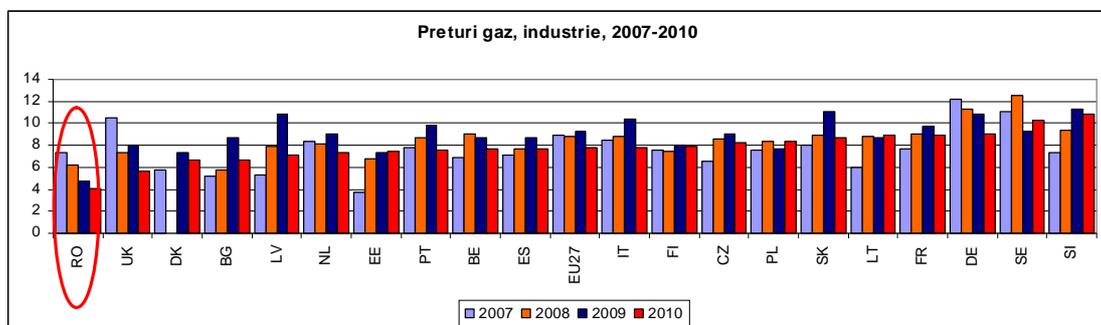
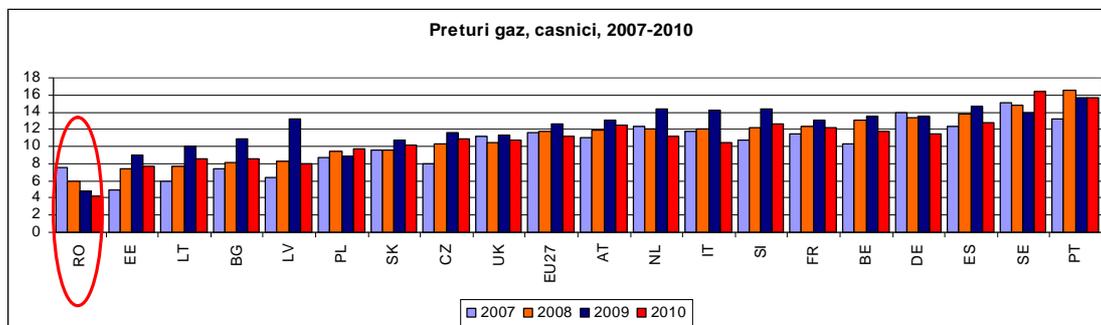
One aspect highlighted in the first report concerns a revision of a tariff methodology in the course of the regulatory period, following an investigation done by a commission in the Senate (for ENEL Muntenia Sud distribution). In the case of the ENEL investigation, a Senate commission had concluded that the investments in ANRE's plan for tariffs approved in 2007 for 2008-2012 have not been met and accused ENEL of delays in the implementation of the investment program. ENEL has responded publicly to the accusation arguing that the difference between ENEL's program and ANRE's program was caused by the fact that the actual takeover of the distribution subsidiary in the privatization process had been postponed by more than one year compared to the original plan (2008 compared to 2007), and hence the program in the privatization contract has also been delayed by one year, thus appearing a gap between ANRE's program and the investments.

http://www.adevarul.ro/financiar/Enel-Ne-am_indeplinit_toate_obligatiile-_Comisia_de_ancheta_confunda_planurile_de_investitii_0_293971127.html

ANRE has amended in late August 2010 the tariff methodology to deal with situations when distributors do not meet investment programs. After our FOIA request, ANRE has also provided to us in the meanwhile the justification behind Order 24/2010, which amends the tariffs if one distributor has not met its investment obligations. Thus, if one distributor invests less than 80% of its investment program, its regulated revenue is amended in the next year. This amendment of the tariff methodology has not been contested by the distributor.

But of particular concern is the **persistence of regulated prices**, which affect market development and, as demonstrated in the previous report, does not allow the full commercialization of the energy sector and transformation of the energy markets in truly competitive ones. Thus, Romania continues to regulate prices for (at least) half of the market, in both electricity and gas, and it has received an infringement on the matter in July 2009. On April 6, 2011 the European Commission has issued a reasoned opinion on Romania's failure to liberalize gas and electricity markets: the Romanian legislation still allows a regulated market for electricity where residential users and parts of the industry benefit regulated prices if they don't switch suppliers. In the gas sector, regulated prices for end users are still applicable to all gas consumers. This reasoned opinion has been issued because Romania has not taken measures to effectively liberalize the gas and electricity markets after having received the infringement in 2009. In theory, the EC might decide to sue Romania to the European Court of Justice to enforce market liberalization by heavy sanctions. In response to the reasoned opinion, the Prime Minister stated that the market

liberalization would be finalized in 2013 for industrial users and in 2015 for all users (residential and industrial), as agreed with the IMF. It is unclear to what extent such an arrangement would please the European Commission, which has also demanded that gas exports be fully liberalized by 2013 (which de facto implies full gas market liberalization before then).



Source: Eurostat, 2010. Romania has the smallest prices in the EU for gas, and decreasing, particularly for the industrial consumers, which have benefited “cheap gas from domestic sources”; electricity prices have been kept low for residential consumers, at the expense of the industrial consumers; in the competitive market (for industry), they are higher than in truly liberalized markets, such as Denmark, Sweden or Finland.

What is more, **even for the regulated supply, ANRE's regulations are not consistently applied**, which indicates either political pressures to keep prices at a low level or incapacity to fully enforce regulations, for various reasons (e.g., market liberalization measures are superseded by Government ordinances or laws to provide cheap gas supply to certain consumers). Thus:

1. **in the gas sector**, ANRE's regulations provide for cost pass through of acquisition price for gas for the implicit suppliers, but the non implementation of which has caused the two implicit suppliers (EON and GDF) to incur losses. In recent years, the two suppliers have threatened in various occasions with lawsuits or even went to court (see previous report). But the situation has been particularly worsened in 2009 and 2010 when the Government issued legislation that allowed large interruptible consumers of gas with consumption about 1 mn m³/day (Emergency Ordinance 54/2009 and Law 332/2009) to benefit exclusively domestic gas, for a period of 16 months.

Box 8: ANRE does not follow consistently its own regulations on gas cost pass-through

Since Q1 2009, ANRE has not been allowed to change the regulated end-user prices for gas. These prices consist of distribution, storage, transmission tariffs and the gas "basket" price. The current basket price does not match the actual mix and prices of gas purchases of the two implicit suppliers, which then have to sell at lower, regulated prices to the end users. The approved basket price is based on the following assumptions: the consumption consists of 80% domestic gas and 20% imports; 1 USD = 2.9 RON; the domestic gas price is 160 USD/m³ and import prices are 290 USD/m³. The shares of domestic and imported gas available to the gas basket fluctuated and reached as high as 40% import 60% domestic gas in March 2011 as domestic gas was diverted from the basket to preferred consumers and the existing domestic gas in storage has been depleted. The exchange rate fluctuated between 1 USD = 3.1 – 3.5 RON; and the import gas prices rose up to 380-400 USD / m³. Since the two implicit suppliers GDF and EON import gas in real market price and quantity conditions and are allowed to recover only the regulated basket price, they incurred heavy losses: about 500 mn RON in 2009-2010 and 90-120 mn RON in the first 3 months of 2011. Despite protests of the distributors and a promise to revise the formula in early April 2011, ANRE still maintains prices at 2009 level, an increase is not in sight, and distributors continue to incur losses. Thus, though the share of domestic gas has increased after the high consumption during winter, the price of imports remains much higher than in the approved basket formula. This is a violation of the cost pass-through principle of regulated prices under which implicit suppliers are allowed to recover in full the gas acquisition price from their regulated clients.

This happened because in 2009-2010, the Government had approved legislation (to primarily support the fertilizer and chemical industry, plus some electricity generation), according to which large, interruptible industrial consumers with a consumption of more than 1 mn m³/day were allowed to use domestic gas instead of the basket. In reality, consumers in this category were never interrupted, exhausting stored gas, but they received the benefit of low-price domestic gas. It must be noted that the consumption of the two largest fertilizer companies was as high as Romania's total gas imports during 2009 and 2010, or as high as the total consumption of the households (20%). In other words, the regulator and the basket price practice forces Romania to import expensive gas to give domestic gas to the two fertilizer companies; and impose not only the state-owned Romgaz, but also private suppliers to subsidize out of their own revenues select companies.

2. **in the electricity sector**, one particular situation arose in December 2010, when an increase of costs associated to regulated production has not been recognized in the regulated tariffs for 2011.

Box 9: Regulated prices are not full cost recovery

A Government Decision (1202/2010)¹ issued in December 2010 has increased the prices for water that electricity producers have to pay. The increases are substantial, prices for Hidroelectrica's water being about 4 times higher than previously, for example (1.1 RON / 1000 m³ compared to previously just 0.26). For some of the power plants, the water consumption can reach as high as 40% of the production costs. However, these price increases have not been considered by ANRE in the approval of regulated prices for its portfolio contracts for 2011, which remained at 72 RON/MWh since the previous year, while the quantities to be delivered in these portfolio contracts actually increased by about 30%. In other words, hydro production regulated price is no longer cost recovery. Something similar happens with the nuclear producer Nuclearelectrica, who also uses cooling water that is charged more and costs are not recognized by ANRE.

1.2 Consumer protection

As explained in the first report, regulated prices are not only an obstacle for market development (since switching of suppliers is discouraged by the fact that in the liberalized market only the more expensive energy sources are available, and producers need to recover losses incurred in the regulated contracts by cross-subsidizing with the open market transactions); but also an ineffective way to ensure consumer protection.

ANRE's and the Romanian Government's understanding of consumer protection is not in line with EU Directives and guidelines. In reality, ANRE should not be involved in any form of social protection but ensure electricity and gas market development, whereas all matters of social protection should be left to the Ministry of Labor, which can provide targeted subsidies to the poorest. For example, one critical aspect of the 3rd Energy Package is the correct definition of vulnerable consumers, which should focus on the poorest categories and some public institutions such as schools or hospitals for which disconnection at critical times is not allowed. Vulnerable consumers should benefit support not in the form of lower prices that continue to distort the market, but to receive a social, targeted income support and pay the full price. These issues are explicitly included in the Directives of the 3rd Energy Package.

Despite the spirit and letter of the 3rd Energy Package, in the new draft legislation for the transposition of the Directives and Regulations, vulnerable consumers are defined as all residential consumers, regardless of assets or income. Also, the notion of regulated prices continues to feature prominently throughout both emergency ordinance drafts for gas and electricity, in connection with vulnerable consumers. However, this does not constitute adequate consumer protection:

- 1) One aspect of consumer protection concerns consumer choice. If prices available on the competitive market are 20-50% higher than for the regulated

supply, the consumer switching is effectively prohibited, despite the legal possibility for consumers to change suppliers.

- 2) Particularly the most vulnerable consumers are not protected, those who are so poor that they cannot afford connection. At the same time, the richest categories with high gas consumption (e.g., owners of villas with gas heating) receive more support.

As a consequence, limiting market liberalization with the argument that consumers would not be able to pay the entire electricity or gas bills is not justified; actually, the most affected consumers from effective market liberalization are particularly the large industrial consumers that benefit cheap sources of electricity or gas, whereas the prices for residential users might not skyrocket if market players (particularly SOEs) would employ transparent, fully commercial practices (see Box 10).

Box 10: What would happen if gas and electricity markets were immediately fully liberalized?

We have played a game of imagination by asking several main players in the energy sector (companies, experts) what would actually happen if Romania decides to liberalize immediately both the gas and electricity markets. Of course, the assessment is a theoretical “guesstimate”, since market evolutions are rather unpredictable, and the main actors do not actually believe, or consider possible that the Romanian government would do such an aggressive liberalization. However, the results are interesting:

On electricity, our panel answers that market prices would increase by around 25% for residential users, would decrease by 35% for small industry, and for large users prices would remain largely the same, except for two large steel and aluminum companies which now obtain preferential prices from Hidroelectrica and in a liberalized market would possibly see a price increase of about 80% from what they get now. The assumption is that market demand for electricity is inelastic, except for the two large companies, which would probably reduce their consumption substantially (they operate in energy intensive industries, and the two companies represent 8-9% of total consumption). On the supply side, several projects amounting to 50 TWh by 2020 would be profitable, particularly if the market is liberalized and without excessive support for renewables. These comprise wind farms 13 TWh (3500 MW by 2015, 7000 MW by 2020, operating 1800 h/year); hydro (Tarnita pumping storage and micro HPPs, 2TWh); replacement of thermal capacities 30-32 TWh on lignite (6 TWh) and gas (24 TWh consisting of cogeneration plants and capacities to balance wind); nuclear (700-1400 MWh). Without liberalization and in the current conditions, nothing would be invested except wind power, which would benefit excessive support and would cause significant problems to the system.

On gas, demand is inelastic, except for energy intensive fertilizers which consume 15-20% and which would reduce substantially their consumption, but without closing full capacities. Current prices are now 160 USD/1000 m³ for domestic gas and 400 USD/1000 m³ import price from Gazprom. If markets were liberalized, gas import prices would possibly drop by 20% (currently, Gazprom sets prices knowing that the Romanian government would adapt its domestic price to keep the average at an affordable level; it thus behaves worse than a monopolist, who also has to consider demand elasticity). Domestic producers would probably increase prices by about 30%. This means that domestic gas prices would be at 210 USD and import prices at 320 in an initial stage, particularly because domestic suppliers would still want to give some discounts to the large consumers. In time, domestic and import prices would converge, but not immediately. On the supply side, additional production would make sense (the offshore reserves in the Black Sea, expected to cover Romania’s consumption for 18 years); storage; and the prospects for Romania to have money for the construction of interconnection lines such as Nabucco would improve significantly.

2. Market monitoring

The market monitoring capacity in ANRE is relatively low, particularly when it comes to politically sensitive areas. The regulator's market monitoring reports do not highlight issues that should be investigated, such as anticompetitive practices of some SOEs, including opportunities for collusion in the market. In addition, the very regulation of market prices distorts not only the half of the market that remains regulated, but also the so-called competitive part, since the behavior on the market of the major players is influenced by the regulations on the captive market.

Box 11: ANRE does not have a clear position on energy policy measures with an impact on competition

ANRE has been extremely shy in challenging Government proposals with high political support but having a possible significant impact on the competition on the gas and power markets. For example, since 2007, Romania's cabinets have proposed several ways of restructuring the power sector by merging the key generation assets in one or two integrated companies, a measure that means high market concentration and possible cross-subsidies. The measure has substantial implications on competition, acknowledged even by the Romanian authorities by the legal obligation to seek the prior approval of the Competition Council. ANRE has indeed submitted comments to the Council, but it has never expressed publicly its own official position regarding the creation of the energy champions. ANRE should have launched its own investigation in the matter and the results should have been made public and reported in the Annual Activity Report of the regulator. By comparison, the Competition Council had officially launched its own investigation and published a request for information from the public together with the Government's proposal submitted for analysis

(<http://www.consiliulconcurentei.ro/?pag=59&com=18632&year=2010&coms=0&month=0>)

A similar attitude was visible in ANRE's approach to another matter hotly debated in the media: the sale of cheap electricity or gas by state-owned enterprises administered by MEC. The sale of cheap power or gas on non-competitive terms by one large SOE is however equivalent to a form of state aid to the buyer, the size of the state aid being the discount from the market price. Also, this cheap energy is simply taken out of the competitive market, which distorts the competition on the wholesale market where more expensive products are available to the other purchasers. In their turn, producers and suppliers that incur losses on the regulated market need to cross-subsidize demanding higher prices on the competitive market, which discourages consumers to switch suppliers and perpetuates the low level of market opening. Instead, if truly independent from political pressures, ANRE should have investigated whether various such practices are indeed compatible with market liberalization objectives and, if not, to have courage to impose sanctions.

Another good example of price distortion caused by price regulations is the case of import prices for gas from Gazprom. As explained above, the Government's practice to maintain the basket concept and mitigate import price increases by lowering prices for domestic gas is one of the possible causes of the very high gas import prices from Gazprom. Another possible cause is the fact that import contracts, by which several importers buy from Gazprom and sell on the Romanian market, are also not very transparent, and ANRE is not looking into the matter. Both causes make it virtually impossible to see what would be the real price that Gazprom is willing to charge Romania for its gas; it can however be expected that this price would be significantly lower than it is today.

Market distortions in the drive for energy efficiency and climate change mitigation

A very contested matter recently is the extent to which various regulations, rules, laws promoting energy efficiency and climate change are indeed consistent with sound principles of market competition. Among these new laws and regulations are the high efficiency cogeneration bonus updated by ANRE in 2011; the Law on renewables (220-139) that is now under analysis with the EC for state aid; plus, beyond regulation, all programs by which various ministries subsidize directly users to reduce energy consumption (for example the thermal insulation of buildings).

In reality, from an economic point of view, the optimal solution would be to charge in full energy prices, so that consumers (residential and industrial) are stimulated to rationalize consumption; and these energy prices must internalize negative externalities, such as the CO₂ and NO_x emissions. Various countries in the EU have other mechanisms that are suboptimal judging on economics principles, such as stimulating low-emission technologies (state aids to producers, in the form of priority purchase of energy in the system plus a guaranteed price – feed-in tariff; or an obligation of users to purchase their energy at higher prices by the means of green certificates); limiting by administrative fiat the amount of CO₂ or NO_x that each country or plant can produce; or supporting directly the users to reduce consumption or switch to other low-emission energy sources. However, the option closest to market principles and towards which the EU seems to be heading is the internalization of CO₂ costs in the European trading of emissions, a market based mechanism in which the polluter pays. The extent to which other support mechanisms for energy efficiency and climate change mitigation would still be employed in the following decades or if they would be gradually phased out is still a matter of debate and depends on various factors and international negotiations on emission reductions.

Romania has in place several policies to reduce GHG emissions, and ANRE is also involved in setting the regulatory framework for some of these measures, mainly to promote renewable energy production and high efficiency cogeneration. Many of the schemes to promote GHG reductions involve higher costs for the end user:

- energy producers are either stimulated for renewable production or reduction of emissions, or sanctioned for the actual emission of CO₂ and NO_x. Romania has in place a law that provides for green certificates granted to renewable energy producers and which suppliers are required to purchase. The law, prepared in 2008 (220) has still not obtained the final approval of the EC, as it seems to reward in excess the production of renewables, which would possibly cause significant market distortions (e.g., an increase in the end user prices by at least 5-7%⁷ if not much higher, plus needed investments in other sources of energy to balance the network, and needs for investments in the grid). . Many experts view the current law that promotes renewables as providing excessive incentives for producers (50% above the average

⁷ <http://economie.hotnews.ro/stiri-energie-8482476-cum-influenteaza-regenerabilele-preturile-energiea-electrica.htm>

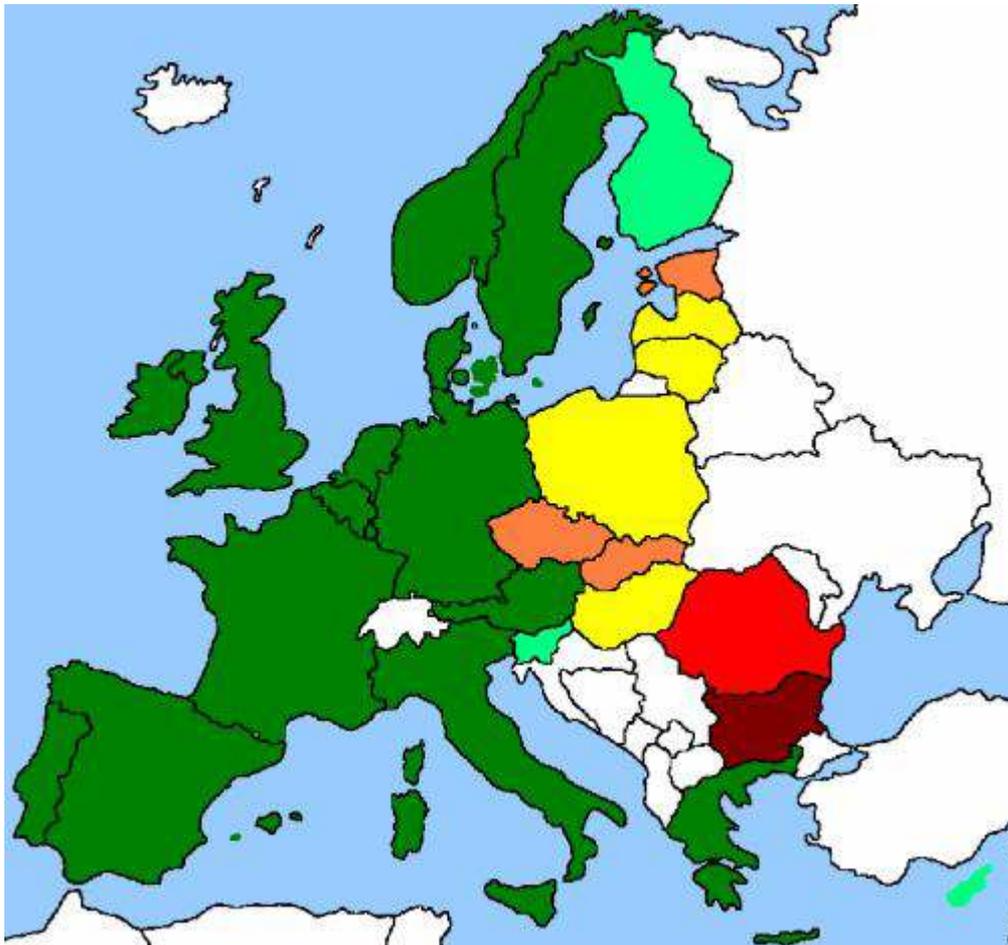
European support price, or 12-18 RON/MWh according to some estimates for the current law).

- also, a part of the generation capacities would have to either be upgraded or shut down to meet EU's environmental conditions, which could reduce supply if actually implemented and thus increase prices on the market.
- The mandatory EU-wide ETS scheme by which thermal power producers would have to pay for each ton of CO₂ emitted starting in 2012, increasing the prices on the market
- A cogeneration bonus scheme by which high efficiency cogeneration is supported with 4 bn EUR until 2020: for each unit of electricity produced in cogeneration meeting certain criteria the producers get a bonus, which is in effect paid through higher prices for consumers. Though the EC considers as gains from cogeneration not only CO₂ emissions but also the efficiency per se, in our personal view, this is simply an overcompensation. (If cogeneration indeed has high efficiency, it should not be supported, as the market would reward exactly the efficiency represented by lower costs for fuel and higher supply of useful products. Also, rewarding increased cogeneration capacity where cogeneration is high efficiency only a part of the year is also overcompensation, because cogeneration needs not be designed for peak heat consumption and peak heat consumption can be covered by efficient boilers operating only during the winter.).

Some of the measures above are overcompensating low emission technologies; in our view, a well-functioning ETS mechanism should be enough to reduce CO₂ based on its real negative impact on society and following market mechanisms. For example, using at the same time ETS – that internalizes CO₂ costs for thermal generation - and green certificates for renewables is already known to over-reward low CO₂ emissions; initially, green certificates were supposed to be phased out once the ETS mechanism would become operational in 2013.

But above the overcompensation issue, at the same time, Romania pursues other policies that go against the objective to reduce emissions. For example, it continues to support also subsidies for inefficient coal-fired plants and hard coal mines by 2018 and possibly beyond, while these technologies are obsolete and have high CO₂ emissions. Regulatory inconsistencies such as the failure to finalize liberalization of prices also provide more support to those who consume more, by keeping energy prices below competitive levels for the “captive” consumers; particularly energy-intensive industry seems to benefit most the cheap energy sources (see picture). Also, the regulation of bonuses for high efficiency cogeneration promoted by ANRE contains favorable conditions for cogeneration facilities that have actually low efficiency (among the list of beneficiaries are included highly inefficient generators such as Deva or the not yet upgraded Braila and Galati TPPs). What is worse, private investors show little interest in investing in high efficiency cogeneration, as they are worried about other market issues, such as the fact that the heat market is distorted by various forms of state aids granted directly to municipally-owned CHPs and amounting to as much as two thirds of the price, plus the fact that heating networks

and CHPs continue to operate under soft budget constraints, as they have always done.



Map: energy intensity in Europe. Cheap energy supply to energy-intensive industries (fertilizers, chemicals, aluminum, steel) lead to little incentives for reduction of energy consumption per unit of GDP.

Scorecard ANRE

	2004	2010	2011	2012*	2013*	Immediate measures (by 2012, to reach target)	Mid term measures (by 2013, to reach target)
GOVERNANCE							
Independence						Govt: no direct control on ANRE; only approval of ANRE's report	Govt: control only through approval of ANRE's Report in Cabinet
Budget and subordination						Govt: repeal HG 1428 (budget, subordination to GSG); good transposition laws for 3rd Package	Govt: check financial statements in Report
Change in leadership						Govt: amend and implement Law 13, leadership changed only for performance	Govt: replace leadership if Report is rejected
Informal political pressures						Govt: abstain from statements on prices, integrated cos, or laws to give cheap energy to some	Govt: social protection, if any, completely outside prices
Relations with regulated sector						ANRE: interdiction of staff to leave to cos	ANRE: no inappropriate relations to cos (shares, nepotism)
Accountability							
Reporting and confirmation of leadership						ANRE: report on activity at 2004 level and full audited report on finances	ANRE: performance and financial reporting
Accountability to consumers, industry, public						Govt: change management only by Parliament decision, on performance	Govt: change management only by Parliament decision, on performance
Financial and auditing						ANRE: respond adequately to complaints, accusations in media	ANRE: full reporting on activities targeted to different audiences
Ethics and enforcement						ANRE: publish audited financial statements	ANRE: publish audited financial statements
						ANRE: reinstate Code of Conduct, adapt, enforce, publish	ANRE: continue to publish results on ethics enforcement
Transparency							
Publish decisions (regulations + decision-making process)						ANRE: publish and consult on all major decisions; 2004 level reports on website	ANRE: full performance reporting on website (Ofgem target)
Proper consultation						ANRE: publish reg committee decisions and link decisions to objectives	ANRE: all decisions on objectives, monitor deadlines, explain delays
FOIA responses						ANRE: Consultative Council, public hearings or e-comments on all major decisions	ANRE: launch e-debates on all major decisions, publish all comments
						ANRE: respond in full to all FOIA requests	ANRE: respond in full to all FOIA requests
Predictability							
Consistency and justified amendments						ANRE: maintain consistency on regulatory periods	ANRE: link decisions to sustainable goals & objectives
Adaptability to environment changes						ANRE: publish justifications for all amendments to Orders; work program on objectives; cost pass through	ANRE: full work program on objectives, explain deviations or changes
						ANRE: full debates on changes (tariffs, regulations)	ANRE: identify and launch debates on changes in environment, e.g. private participation in generation
SUBSTANCE							
Tariffs							
Economically sound						ANRE: eliminate distortions on tariffs	ANRE: revise tariff policy to enhance competition, eliminate regulated prices for producers & consumers
Periodic reassessments						ANRE: review tariffs for regulated consumers; abandon talk about regulating prices	ANRE: review tariffs for networks (transmission - transit, zonal tariff)
						ANRE: change of tariffs only on fundamental changes in environment, but with inflation	ANRE: announce in time reassessment of tariffs and debate
Monitoring markets and licensing							
Enforceability of decisions						ANRE: clarify and enforce regulations	ANRE: refocus its activity on markets, not tariffs
Transparent criteria for licensing/withdrawal						ANRE: better sanctions, monitor sensitive aspects in market, challenge function to Govt measures	ANRE: Enforcement code with full procedures
Consumer protection, management of complaints against industry						ANRE: start work to streamline Enforcement guidelines	ANRE: Enforcement guidelines
						ANRE: respond to complaints with clear justifications, no talk of social tariffs or prices	ANRE: Definition of vulnerable consumers; consumer rights

Legend

*	Achievable target
■	Unsatisfactory
■	Moderately satisfactory
■	Good
■	Best practice
■	N/A or no evidence

Reason to change or maintain scores 2010 - 2011 (explanations in Detailed Assessment):

- 1. Independence:** ANRE would not be depoliticized in the new proposed laws, it recovers only financial independence, appointments in key positions would be made just as now by the PM, at the proposal of president of ANRE, without clear criteria.
- 2. Accountability:** New draft laws do not provide for additional safeguards for better accountability to stakeholders (Consultative Council is not representative); ANRE would not account for its performance to an external body (preferable to Parliament); it is not audited
- 3. Transparency:** Fair response on FOIA, though the quality of responses on the most sensitive matters could be improved; public reports do not contain politically sensitive information, such as ANRE's position on the set up of the two integrated champions or hydro's bilateral contracts.
- 4. Predictability:** Tariffs follow methodology, but ANRE does not follow consistently its own regulations (cost pass through)
- 5. Tariffs and prices:** The practice of regulated prices continues.
- 6. Market monitoring:** ANRE does not monitor the contracts or measures of Government that have a potential anti-competitive effect.