

Annex 1: Action Fiche for the Republic of Moldova – AAP 2011

1. Identification

Title/Number	Support to Reform of the Energy Sector (CRIS/2011/22515)		
Total cost	EUR 42.6 million		
Aid method /Method of implementation	1. Sector Budget Support (SBS) – centralised management 2. Project mode – centralised management		
DAC-code	230	Sector	Energy Generation and Supply

2. RATIONALE AND COUNTRY CONTEXT

2.1. Country context and rationale for Sector Policy Support Programme (SPSP)

The Republic of Moldova (hereinafter Moldova) is one of the poorest countries in Europe and is almost totally dependent on imported energy, mainly in the form of natural gas from Russia. The cost of this imported gas is imposing a severe burden on the economy and the historical accumulated debt to Gazprom and Moldovagaz is a serious liability to the energy sector, creating uncertainty and deterring inward investment.

A critical first step is to stop the accumulation of the debt by making sure that the energy tariffs are set at the cost recovery level. The country is also heavily dependent on electricity supplied by the Russian-owned power station in Transnistria. Thus the energy sector is the main economic influence on the country.

The government's institutional capacity will need to be strengthened to meet the challenges in the energy sector, especially in the skills related to energy efficiency (EE) and renewable energy (RE) activities. Until now, the sector has been under funded and capacity building has been regarded as a low priority. Public spending on infrastructure dropped from 7.5% of GDP in 2007 to 5.3% of GDP in 2009 whilst, in the energy sector, the allocated budget fell from 0.3% to 0.1% in the same period. Between 2010 and 2015 the balance of payments deficit is expected to stabilize at under USD 700 million from a low of USD 1,000 million in 2007.

Moldova has acceded to the South East European Energy Community Treaty (EnCT) and as of 01 May 2010 is a full member and will assume the presidency in 2011. This responsibility will test the capacity of the MoE and it is highly likely that technical assistance will be needed.

The purpose of this SPSP is to strengthen the capability within the sector with the objective of achieving measurable progress against a series of defined conditionalities. The mechanisms within the financial management of the energy sector funds will also be subject to closer scrutiny.

2.1.1. Economic and social situation and poverty analysis

Moldova has the lowest GDP in Europe, ranking 131st in the IMF world list at USD 2,839 per capita in 2009. There was rapid growth in 2007 (3%) and 2008 (7.8%) as foreign remittances and inward investment fuelled the economy but in 2009 GDP fell by 6.5% due to the global downturn. The government developed an anti-crisis plan for 2009-2011 aimed at stabilizing

public finances, economic recovery and adequate social protection system. Strong fiscal adjustment has focused on restraining spending. The 2009 deficit was well below forecast as a result of increased tax revenue and expenditure cuts. The level of fiscal adjustment has been maintained so far in 2010.

The IMF is cautiously optimistic concerning the short-term outlook for the economy. The recovery is better than expected with GDP growths of 2.5% in 2010 and 3.6% in 2011 projected. The present level of inflation (8% compared to October 2009) is expected to ease back to 6% in 2011.

Increasing exports is key to achieving sustainable growth in the medium term. Manufacture, trade and agriculture are recovering and exports are projected to increase steadily from USD 1,300 million in 2009 to USD 2,700 million by 2015 as trade procedures are simplified. The government is showing strong determination to improving the business climate and promoting investment. Refunding of VAT for investment goods, reducing red tape, reducing agricultural land for industrial use and generally lowering the cost of doing business will all contribute to maintaining growth. The budget deficit should be eliminated within the next 4 years mainly by cutting current spending, tackling tax policy anomalies improving tax collection. Revenue increase and expenditure savings contained the budget to 6.4% of GDP in 2009 and this will improve in 2010 with additional revenue of 0.7% of GDP reducing the deficit to 5.4%.

The government is using the improved economic recovery as an opportunity to reduce poverty. The budget for 2010 allocates more funds for social assistance. In 2010 the guaranteed minimum monthly revenue of a family has been increased from MDL 430 (in 2009) to MDL 530 (USD 45). In 2009 social aid went to 17,000 families, in 2010 this now goes to 31,000 families. Expenditures for social aid has increased from MDL 114 million in 2009 to MDL 270 million (USD 23 million) in 2010. Aid has also been extended and increased to a wide range of vulnerable groups such as pensioners, the disabled, orphans and child allowances and there have been significant improvements in the quality and efficiency of the social services.

In July 2010, the IMF concluded the Article IV consultation with Moldova whereby it was agreed that the government effort to restore fiscal, external, and financial sustainability and stimulate growth was to be supported by two arrangements, the Extended Credit Facility and the Extended Fund Facility, amounting in total to SDR 369.6 million (USD 546 million).

2.1.2. National development policy

Moldova and the EU established a Partnership and Cooperation Agreement (PCA) in 1998 and negotiations on an Association Agreement began in January 2010. The 2007 National Development Strategy (NDS) 2008-2011 provides the main medium-term strategic planning document. The NDS was developed to pursue reforms outlined in the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) and the Moldova-European Union Action Plan (MEUAP). This aligns Moldova to EU standards with the objective of European integration. National policies focus on economic development and reduction of poverty by increasing access to the key sectors: education, healthcare, social protection and employment. NDS initiatives are reflected in the national budget and in the Medium-Term Budget Framework (MTBF).

The energy sector has not benefited from budget support in recent years but will be included in the MTBF as of 2011 so that public funds will be provided from 2012. In the past there

has been heavy reliance on company investments and financing from donors with very little contribution from the government.

The MTBF process was introduced in 2002 and is now an integral part of the budgeting process. From the 2012 budget, there will be a new budget classification system. There will be more use of non-financial performance information and the new system should ensure that priorities in national policy are reflected in the budgets.

Successful implementation of the budgeting process will require further improvements in the MTBF. The Sector Expenditure Plans (SEPs), covering 85% of the state budget, will need to be developed as an effective tool for strategic sector prioritisation and ex-ante approval for technical assistance projects introduced. The programmes need to be better defined and the performance information streamlined. Capacity building across all the ministries will be needed to achieve this.

The Economic Stabilization and Recovery Plan (ESRP) approved in 2009 aimed at resuming economic growth within two years. The ESRP is not a substitution for the NDS but deals with economic crisis management and implementation of reforms. A new NDS will be developed based on the new European Union – Republic of Moldova Association Agreement.

2.2. Sector context: policies and challenges

The energy sector is beset with difficulties. High dependence on imported gas and electricity, historical debts, outdated electrical generation systems, inefficient district heating systems, together with tariffs set well below economic levels all contribute to the poor performance of the sector.

The key document is the Energy Strategy 2020, which sets objectives, measures and activities designed to create a more efficient, competitive and reliable national energy industry with the aim of integration into the European energy market. This is part of the NDS and the Government Activity Programme for 2009-2013 as well as the European Union - Republic of Moldova Neighbourhood Action Plan and the energy *EU acquis*. ANRE (the national energy regulator) has responsibility for setting economic tariffs with an annual budget set by parliament.

The accumulated gas debts require long-term solutions. Legislation in November 2008 canceled intercompany debts and in early 2010 the Concept on Energy Sector Restructuring was adopted. The World Bank is helping to resolve these issues. In order to mitigate the rapidly rising prices for imported gas, the government is attempting to renegotiate the gas transit fees with Gazprom. An increase from the current fee of USD 2.5 per 1000 m³ per 100 km to an increased fee of USD 3.5 – 3.8 is being suggested by the government negotiators.

The coordination of energy policies with the Energy Community improved in 2009, when task force representatives were appointed by the new Energy Security Department. A new Agency for Energy Efficiency (EEA) is planned by the Law on Energy Efficiency passed in July 2010. The new Agency will support the MoE in training energy managers, energy auditors and boiler inspectors, thereby creating new jobs and energy services. The Energy Strategy 2020 commits Moldova to restructuring in order to meet the requirements for integration into the European energy system. Recent negotiations have been held with Ukraine and Romania for electricity interconnections and supply contracts.

ANRE has adopted a methodology for approving RE electricity tariffs including a feed-in tariff and grid connection but the tariff methodology needs revising. An Energy Efficiency

Fund is sanctioned for private investment in RE and EE, but not yet created. Most of the EU Directives are now being transposed with donor support and a revision of the 2020 Energy Strategy is being considered for Sida support. A report in October 2010, jointly funded by DFID and Sida, has examined the link between priority setting and budgeting. The Ministry of Finance (MoF) is to introduce a new budgeting system to reflect development priorities in the annual budget. The report concludes that the present MTBF process does not make for accurate resource allocation.

There will be a need to build capacity within the MoE in order to implement the new procedures and relate them to the updated Energy Strategy 2020 and National EE Programme 2010-2020. The financial systems are now being subjected to close scrutiny and show signs of improvement.

2.3. Eligibility for budget support

On eligibility criterion 1, sector development, reform policy and strategy, the proposed budget support falls into the category of 'non-traditional sectors', as defined in the internal Guidelines Support to Sector Programmes. Energy laws and a detailed strategy exist and these can be expected to have a positive impact on the sector.

On eligibility criterion 2, stability-oriented macroeconomic policy, the Government adopted an *Economic Stabilization and Recovery Plan 2009-2011 ('Anti-Crisis Plan')* that has gone some way to stabilize public finance, foster economic recovery and provide social protection. This action has shown signs of success and has met with the approval of the IMF.

On eligibility criterion 3, relevant programme to improve public finance management, there is cooperation between the MoF and the World Bank on a Public Finance Management (PFM) project, and with the EU on Public Internal Financial Control (PIFC) and Public Procurement. The latest ECFIN country operational assessment, undertaken in May 2010, takes a positive view of the PFM system transparency and effectiveness. The recent, November 2010, World Bank implementation monitoring visit report is also positive about PFM developments indicating the reform being on track to achieve its objectives.

2.4. Lessons learnt

Based on previous EU budget support programmes, the following lessons have been learned.

- There is need for commitment to the programme at high government level.
- The government relies on donor support funds for general budgetary purposes and has given little support to the energy sector thus a dedicated mechanism needs to be in place which ensures that resources are used for purposes for which they were intended.
- A permanent and well defined system has to be in place which will monitor and manage the projects and compare these against a list of conditionalities, which are achievable, realistic and agreed in advance between the Commission staff and Governmental bodies responsible for implementation.
- A financing mechanism provided by the Law on Renewables in 2007, which is based on revolving principle and is meant to financially support EE and RE projects needs to be put in operation in order to support EE and RE efforts.
- Priority should be given to sectors with the largest EE and social impact potential.

- The monitoring system must differentiate between results obtained by means of the application of a particular budget so that it is clear what was achieved by the specific EU budget support.
- Subsequent tranches must be disbursed only upon strict fulfilment of the conditions of the Financing Agreement.

2.5. Complementary actions

Major donors have been consulted during the formulation stage and nearly all are actively involved in the energy sector on a significant scale.

USAID has a grant fund of USD 2 million for investment into municipal EE projects. The aim is to strengthen EE by training energy managers at local level.

Sweden has made energy a priority of its assistance to Moldova. Support includes setting up of the EEA and identifying investment needs in district heating. Support to the government on donor coordination will also be a key focus for attention.

EBRD is developing the Moldovan Residential Energy Efficiency Credit Line (MoREECL) with a fund of EUR 20 million for financing residential EE for the next four years. This will require EUR 8.1 million of donor support for technical assistance and capacity building. EBRD considers that the historic energy sector debt remains the critical issue hindering financing of the restructuring of state-owned energy sector assets. Further assistance is provided, together with Sida, to the Ministry of Construction and Development for legislation on EE in buildings. Energy consumption in buildings accounts for 45% of all usage and is a major opportunity for energy saving.

The World Bank has a technical assistance component on sector reform. Work is being done on the regulatory framework and tariff methodology. The bank will provide a USD 20 million credit line for investment in the district heating sector in Chisinau with Sida providing technical assistance. Around USD 25 million has been committed to Moldelectrica and a further USD 10 million to heating systems in small towns. Work is planned on estimating the value of the Moldovan gas network.

UNDP is working under the GEF on EE in the residential building sector and is also working with Sida on the establishment of building codes. A first draft of the National Low Emission Strategy will be available by the end of the year and work has begun on the biomass heating project which is funded by the EU. UNDP is also helping the Ministry of Environment (MoEn) by engaging technical specialists on a short-term basis and the MoE where support is being given to the upcoming chairmanship of the Energy Community Treaty.

GTZ has a new five-year, EUR 3 million, project aimed at modernizing local authority services. There will also be EUR 500,000 of development assistance from the Government of Romania. Projects may include water, sewage, solid waste, alternative energy sources, and EE in buildings.

All the donor organizations interviewed are very supportive of the proposed EU budget support and their close cooperation can be assumed as being very likely. The donor energy initiatives are complementary to the EU budget support.

2.6. Donor coordination

The MoE is in charge of donor's coordination in the sector with all the major donors - 15 organizations - participating. In order to improve the coordination it has been agreed with the MoE and the major donors that SIDA will take a lead role in organising the donor coordination with immediate effect, using technical assistance as necessary. This is an important initiative as most of the major donors are involved in the energy sector.

3. DESCRIPTION

3.1. Objectives

The main objective of the SPSP is to support the reform of the energy sector and to facilitate technical improvements in its operation. It will offer a flexible instrument to support the government's efforts towards further progress on the implementation of the Moldovan energy strategy and energy sector development. This will be achieved through the support of interventions in the preparation and adoption of appropriate legislation that are set out in the policy matrix, as well as technical assistance and policy dialogue.

3.2. Expected results and main activities

Expected results of the programme are:

- Policies, primary and secondary legislation on energy efficiency and renewable energy updated/harmonised in line with the relevant EU Directives and the Energy Community Treaty commitments;
- Progress in the implementation of the national legislation on EE and RE and the Energy Strategy, with special focus on the development of Energy Efficiency Action Plans achieved, including human and financial sources identified and allocated for implementation thereof ;
- Appropriate institutional capacities for energy efficiency and renewable energy developed.
- Energy tariffs set at cost- and investment-recovery level;
- Renewable energy potential researched and developed; renewable energy targets set and achieved;
- Financing instrument for energy efficiency and renewable energy, provided in the Law on renewable energy of 2007, made operational.
- Public awareness on energy efficiency (EE) and renewable energy (RE) increased;

In order to realize these results, the following main activities will be supported.

- Development and revision of the national policies, primary and secondary legislation on energy efficiency and renewable energy (e.g. Energy Strategy 2020, Renewable Energy Strategy, energy auditing regulations, energy services regulations, minimum energy performance requirements for buildings, eco-design and energy labelling regulations, etc.), in line with the relevant EU directives and the Energy Community Treaty requirements and the adaptation of the EN standards;

- Implementation of the national legislation (both primary and secondary) and policies on energy efficiency and renewable energy;
- Development of Energy Efficiency and Renewable Energy Programmes and Action Plans (National EE Program until 2020, National EE Action Plans 2011-2013, 2013-2016, RES Action Plan, etc.) and identification and allocation of funds for their implementation;
- Strengthening the existing institutional capacities (Energy Security Department, Energy Efficiency Agency, etc.) in charge of promoting EE and RE;
- Strengthening the independence and institutional capacity of the energy regulator, e.g. ANRE and improving the energy regulatory framework (methodologies to set tariffs at cost and investment recovery levels, gas assets assessment methodology, supply rules and norms, etc.);
- Capacity building for energy managers, energy auditors, building inspectors;
- Performing energy audit of public buildings, retrofitting thereof and issuing Energy Performance Certificates;
- Support of research and development in the field of EE and RE technologies, including provision of a wind map for Moldova;
- Development of media communication and public awareness campaigns;
- Strengthening the energy sector financial capacity and donor coordination;
- Improvement of communication channels between the MoF and MoE for energy budgeting purposes;
- Further support of the financing instrument provided in the Renewable Energy Law 2007 to finance EE and RE projects (operational manual and rules approved, team created, etc.).

3.3. Risks and assumptions

The political environment is volatile and repeated elections do not give long term stability for implementation of reforms. The conditionality's are, however, prepared in such a way as to reflect the obligations under international agreements which have already been accepted and signed by the Republic of Moldova. Thus the conditionalities are achievable and practical so as to be acceptable to whichever government is elected.

The government relies heavily on donor support which provides a substantial proportion of the government budget but it should be understood that the SPSP funds are intended for support of the energy sector. Progress will be monitored against an agreed list of conditionalities, on the completion of which the continued transfer of funds will depend.

The government departments in the energy sector will need help in coping with the demands being made as a result of the number of projects being proposed by international aid organizations. One of the main challenges will be to provide training and capacity development to improve the linkages between the policy and implementation functions.

It is assumed that the donor organisations will welcome and will cooperate to achieve better coordination and be willing to speak with a common voice to the government. There is ample scope for donors to work together.

3.4. Stakeholders

Aid coordination in the Republic of Moldova is the task of the State Chancellery under the Prime Minister and this will be the European Commission's institutional counterpart in this budget support. Other institutions which are closely involved in the energy sector include the Ministries of Economy and Trade (including the Department for Energy Security), Finance, and Construction and Regional Development.

3.5. Crosscutting Issues

This budget support is intended to have a positive impact on the environment by encouraging EE and investment in RE. Mechanisms for stakeholder participation will be strengthened to increase the influence of energy consumers on relevant decision-making. Consideration of economically vulnerable groups should be maintained in all programming and projects.

Where resources are directed at energy projects in the housing sector, there should be a positive impact on the well-being of the inhabitants. The funds will also involve the recruitment of staff for capacity building and also various training opportunities. Gender equality will be given priority in these areas of budget assistance.

4. IMPLEMENTATION ISSUES

4.1. Method of implementation

A Financing Agreement (FA) will be signed with the government with the main modality of aid delivery being Sector Budget Support under centralised management with funds being directed through the State Treasury. The technical assistance component of the programme will be managed centrally and directly by the Commission. Sector Budget Support (SBS) is the most appropriate financing modality for this action. Capacity building actions and technical assistance in the energy sector would be also needed.

4.2. Procurement and grant award procedures

All contracts implementing the action must be awarded and implemented in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of the launch of the procedure in question. The only EU procurement foreseen under this SPSP is that of the Technical Assistance component.

4.3. Budget and calendar

The foreseen budget for the budget support component is EUR 40 million with a first fixed tranche of EUR 13 million and two variable tranches to a maximum of EUR 13 million and EUR 14 million. The variable tranches will be subject to independent reviews of the implementation of the Policy Matrix in 2012 and 2013.

A technical assistance package of circa EUR2.6 million will be defined before the signing of the Financing Agreement.

The indicative operational implementation period is 36 months from the signature of the Financing Agreement.

4.4. Performance monitoring and criteria for disbursement

A Steering Committee will be established to monitor the implementation of the programme under the Chairmanship of the Ministry of Economy. The Committee will meet at least twice a year. A Policy Matrix has been developed together with a List of Performance Indicators. The adherence to these monitoring instruments will be measured on the basis of government data by independent reviewers appointed by the European Commission. The disbursement of future tranches of the funds will depend on the progress made in the energy sector on the following main indicators.

- Adoption of relevant legislation on EE and RES
- Strengthening of energy sector institutional capacities
- Promotion of research and development
- Support to the municipalities on energy related issues
- Education and public awareness
- Progress towards increasing the transparency and effectiveness of the financial management

Eligibility for budget support will be assessed by the EU based upon, inter alia, IMF and WB reviews as well as reports from other national and foreign institutions and experts.

4.5. Evaluation and audit

Prior to the completion of the sector budget support programme, the European Commission will appoint consultants to carry out an independent final evaluation of the programme. Thus the programme will be subject to independent reviews that will assess the level of compliance with the indicators set forth in the Financing Agreement. The European Commission reserves the right to employ consultants to carry out, in close cooperation with the Chamber of Accounts of Moldova, an audit of a sample of expenditures related to the implementation of the government's energy sector policy.

4.6. Communication and visibility

As part of the Financing Agreement, the Moldovan government undertakes to ensure that the visibility of the EU contribution to the SPSP Programme is given appropriate coverage in the various publicity media. The project will endeavour to further enhance the positive image of the EU in the context of its work in Moldova. At appropriate milestones during the project duration and after appropriate events, press releases will be issued, in co-operation with the EU Delegation in Chisinau. The EU visibility guidelines will be applied.