UNBUNDLING AND PRIVATE SECTOR PARTICIPATION

AT KEK

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“The need to achieve lasting benefits for customers in the shortest possible time should drive the restructuring process. This should be the raison d’etre of restructuring. Actions which do not achieve or are inconsistent with this goal, such as waiting to try to improve the performance of distribution companies before (concessioning) them, should be rejected.[1]”

No doubt there are many reasons that are given to slow the entrance of the Private Sector into KEK. Raising the value of KEK prior to concessioning is one of the most appealing. Against this must be counted the cost of keeping KEK in government control. Since 2000, KEK has directly cost the budget of Kosovo €433.2 million (this includes KEK’s 2007 budget request). This is just a fraction what KEK’s operations cost Kosovo. This does not count the full direct cost of KEK. KEK does not collect enough revenues to cover the cost of operations, maintenance and investment in the system. Government transfers also do not cover the full cost. KEK is living off its assets by not maintaining them. The impact can be seen in the constant power cuts and in the number of persons unserved. The true cost of a Government controlled KEK are the economic losses, the losses to the Kosovo because of inadequate power. This can be partially measured by the lost revenues when power is unavailable. Equipment and appliances must be replaced earlier than they should because erratic, poor quality power shortens their lives. Consumers purchase generators to supply power when KEK is unavailable. Recently, one municipal water company estimated its lost revenue as a result of KEK outages to be over €300 million. These are just a few examples of the cost of KEK to the economy. General rules of thumb indicate that KEK may be costing the Kosovo Economy on the order of billions of euros per year.

The Government of Kosovo can ill-afford to continue to provide transfusions to KEK – the money is needed elsewhere and KEK, as it is, is costing the Government much more in lost tax revenues. KEK, as is, is costing the economy even more in lost jobs, manufacturing, opportunities and other real, hard costs. Kosovo simply can’t afford to continue KEK in a business as usual scenario.

[1] ADB, Development Best Practices for Promoting Private Sector Investment in Power, page 22.

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Executive Summary

Generation is failing; line losses are mounting; metering, billing and collections remain a major problem; and, without some major change, Kosovo will face mounting periods where demand far exceeds supply. In short, the system is broke and failure to fix it quickly increases the probability of social and political instability. Kosovo is at the point where the inevitable must be acknowledged and action quickly taken: Kosovo's electric utility is beyond repair without private sector intervention in investment, operation and management. Kosovo must with all due speed prepare KEK and the electricity sector for a public-private partnership. It must concession! Moreover, to support Kosovo C and to lower risk and cost, concessioning is required.

The principal issues are how and when to concession, what can be done in the interim recognizing the severe lack of institutional capacity, and what are the next steps.

It is recommended that KEK be unbundled into two companies: A company that combines regulated operations of Distribution and Public Supply and another company that contains mines, generation, eligible supply and other operations.

Concessioning should take place as soon as possible and the quickest that meaningful concessioning can take place is in 24 months.

The following steps should be taken to finalize the sector restructuring.

1. Circulate this paper to selected stakeholder participants.

2. BE to facilitate stakeholder discussion to discuss and reach consensus.

3. Begin a public awareness program. Educate the public about the need to restructure and involve the private sector, about Kosovo C and what it will mean to the country, and how increasing tariffs and the social responsibility to pay (and the consequences or non-payment).

4. Begin a phased elimination of subsidies and cross-subsidies. Government should directly pay the utility for social customers and for other commitments that result in below cost sales – such as unrecoverable service to "minorities". At this time, the Government provides the utility with capital for imports, operations and equipment. It should reduce this by the amount of the service cost to unrecoverable minorities and include payment for unrecoverable minorities as a specific line item.

5. Decide on unbundling/concession option. Establish a speedy timetable to concessioning and amend the law to demonstrate the Government's commitment to the private sector and to the timeline.

6. Amend the laws to support minimum unbundling, concessioning and Kosovo C.

7. Educate the utility employees about the path to unbundling and concessioning. Do this early on and continue to do this throughout the process.

8. Government reconciles debts between the utility and other Government agencies so that they are off the books prior to concessioning.

9. Undertake and Complete unbundling simultaneously.

10. Choose whether the parts will concessioned simultaneously or separately. Option 2A is the recommended unbundling and concession model. Ideally, both generation and KEK PS JSC should be simultaneously concessioned. Before Kosovo C comes on line the Government will need to get additional power from imports and through enhanced operations at Kosovo A&B. Imports are partially constrained by transmission. Generation enhancements are constrained partially by Government control/management. Both imports and generation enhancements are constrained by the lack of Government funds and the inability of KEK to initiate full cost recovery. Either imports or generation enhancement means mounting Government losses unless it solves the full cost recovery issue.

    Concessioning the KEK PS JSC first will start resolving the full cost recovery issue but does nothing in the short run to address the need for additional power. Full cost recovery is made more difficult when there are routine and continuing outages.

    The Government is faced with a real dilemma. Increased outages immediately following status can lead to greater political and social instability. This not only has serious implications for a fledgling government but also has real implication for Kosovo C and concessioning. But how to pay for increased imports without increased revenues? Concessioning will take time to yield results, if for no other reason than the time needed for physical improvements. Concessioning will only increase losses unless revenues are increased. These considerations lead to the following recommendations.

    a. Concession generation and the KEK PS JSC together.
    b. Institute a five year PPA between generation and the KEK PS JSC to ensure a revenue stream for the generation concessionaire and to provide price stability for the KEK PS JSC.

1 INTRODUCTION

Kosovo's final electricity market will be one of competition among generators and among suppliers. Many customers will ultimately be able to choose their supplier. The system will be efficient because of competition and because of both the incentives and investment that private sector participation (PSP) will bring to the sector. The network component (transmission and distribution) will be efficiently regulated and involve the private sector. Power cuts and wide voltage swings will be things of the past. Kosovo will be creating jobs and valued added exports in the electricity sector and the availability of power and export earnings will serve as an economic engine.

Kosovo's membership in the South East European Energy Community and its attempt to adhere as closely as possible to EU directives defines the ultimate destination in the sector's journey; it describes the outcomes of that journey but it does not describe how Kosovo will get there (the route it will take) or time required to complete the journey. There are many routes to this final destination but which one is best for Kosovo depends on Kosovo's unique characteristics and its objectives for the journey.

The purpose of this paper is to help prepare a roadmap for unbundling of the electric utility that leads to private participation in the sector: or helping Kosovo's choose the best route to the final market destination. The objectives of the assignment are:

- To assess the status of efforts at KEK that lead toward unbundling and private sector participation or concessioning[2];
- To provide recommendations for unbundling and concessioning that a) support the WB Kosovo C project, b) are consistent with Government goals for the sector, and, c) meets the minimum EU directive requirements for the sector;
- Where the direction is not clear, to set forth the questions that must be asked and answered and provide lessons learned from other countries' experience; and,
- To set forth the next steps.

1.1 Kosovo Realities

1. Demand for power far exceeds supply in both generation and the ability to import (financial and physical).

2. The size and simplicity of Kosovo's market; Kosovo's market is quite small with less than 400,000 customers and fewer than five with demand greater than 5 MW.

3. KEK is insolvent.

4. Many customers are unbilled; collections of billed customers are low; and, metering is a major problem.

5. Significant transmission bottlenecks exist.

[2] Concessioning is the only form of private sector participation suitable and available to Kosovo at this time.

6. Nascent electricity institutions.

7. The limited pool of high quality, experienced talent in Kosovo available to the electricity sector.

8. Kosovo has a high-grade resource (lignite) that it can exploit (in the form of value added electricity exports) but a narrow window in which to do it before other investments overtake it.

9. Kosovo wants to conform as much as possible to EU directives.

1.2 Implications

As a result of these and other realities, there are a number of important implications for policy and unbundling. Principal among these are:

- The economy is severely constrained by availability and quality of power. Power is being rationed in a manner that does not reward bill payment.

- Since the utility is in poor financial condition, major investment by the utility to expand capacity is not an option. Private investment is the only feasible solution.

- Since the market is small, has a record of poor payment and the utility is in poor condition, a sovereign guarantee in the form of a power purchase agreement (ppa) will be required or some other creative mechanism.

- Competition will be introduced, at least in the construction and operation of power plants, because private power is the only option available to Kosovo.

- The PPA combined with the transmission bottlenecks will insure that there is little competition in the wholesale market for power in the medium term.

- There is a fiscal imperative to reduce government's losses and a physical imperative to increase system efficiency (eg. Increased billing and collections) and investment (eg. new meters, new substations, etc). The only way this will happen is through some form private sector participation

- The Kosovo electricity sector is much different than the EU member countries' electricity sectors as they began reform in 1996.

At this time there are minimum requirements for unbundling that are set forth in Kosovo's laws, some of which are required by EU Directives. Because there are different types of unbundling and the term unbundling is often used without reference to the specific context, it is important to define these terms before setting out the minimum requirements.

2 WHAT IS UNBUNDLING

The term unbundling is used to represent several different actions and often used inappropriately. It is important, therefore, to adequately define unbundling. ***Accounting unbundling*** is the separation of accounts of different functions. This is the first step. ***Functional unbundling*** is the separation of functions within the company and the imposition of restrictions on activities such as physical separation of people, of management, separation of information that competitors may need, separation of services that should be regulated from those that are competitive in nature, etc. Functional unbundling can either take place within the same company or be unbundled into an affiliate company. Functional unbundling also means accounting unbundling. ***Legal unbundling*** "does not imply a change of ownership of assets and nothing prevents similar or identical employment conditions applying throughout the whole of the vertically integrated undertakings. However, a non-discriminatory decision-making process should be ensured through organisational measures regarding the independence of the decision-makers responsible.[3]" Legal unbundling will of necessity include accounting and functional unbundling. ***Ownership unbundling*** is the divestiture of a function completely by selling it so that it is no longer part of the company.

2.1 Why is Kosovo Unbundling its Utility

There are several reasons why Kosovo is unbundling its electric utility. The most important of these are:

(a) to meet the minimum requirements set forth by the EU Directives and then made part of Kosovo's electricity laws:

(b) to address the needs and/or concerns of attracting a private power plant and mine developer; and,

(c) to prepare the utility to be concessioned.

Each of these is discussed in greater detail below. Findings of the work that remains to be done are presented at the end of each section.

2.2 EU Minimum Unbundling Requirements

Kosovo has two electricity sector companies KEK Holding J.S.C. and Transmission System and Market Operator Holding J.S.C. (TRANSKO J.S.C.). These two holding companies have two operating companies. KEK J.S.C. is a vertically integrated undertaking (VIU) that combines generation, distribution, supply, mining and support activities. As a VIU specific unbundling actions are required. The TRANSKO combines only market operations and system operations.

As VIU, KEK J.S.C. would need to functionally and legally separate distribution. "In order to ensure efficient and non-discriminatory network access it is appropriate that the distribution and transmission systems are operated through legally separate entities where vertically integrated undertakings exist"[4].

1. Where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision making from other activities not relating to distribution. These rules shall not create an obligation to separate the ownership of assets of the distribution system operator from the vertically integrated undertaking.

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[3] EU 2003/54/EC
[4] EU 2003/54/EC.

2. In addition to the requirements of paragraph 1, where the distribution system operator is part of a vertically integrated undertaking, it shall be independent in terms of its organisation and decision making from the other activities not related to distribution. In order to achieve this, the following minimum criteria shall apply:

(a) those persons responsible for the management of the distribution system operator may not participate in company structures of the integrated electricity undertaking responsible, directly or indirectly, for the day-to-day operation of the generation, transmission or supply of electricity;

(b) appropriate measures must be taken to ensure that the professional interests of the persons responsible for the management of the distribution system operator are taken into account in a manner that ensures that they are capable of acting independently;

(c) the distribution system operator shall have effective decision-making rights, independent from the integrated electricity undertaking, with respect to assets necessary to operate, maintain or develop the network. This should not prevent the existence of appropriate coordination mechanisms to ensure that the economic and management supervision rights of the parent company in respect of L 176/46 EN Official Journal of the European Union 15.7.2003 return on assets, regulated indirectly in accordance with Article 23(2), in a subsidiary are protected. In particular, this shall enable the parent company to approve the annual financial plan, or any equivalent instrument, of the distribution system operator and to set global limits on the levels of indebtedness of its subsidiary. It shall not permit the parent company to give instructions regarding day-to-day operations, nor with respect to individual decisions concerning the construction or upgrading of distribution lines, that do not exceed the terms of the approved financial plan, or any equivalent instrument.

(d) the distribution system operator shall establish a compliance programme, which sets out measures taken to ensure that discriminatory conduct is excluded, and ensure that observance of it is adequately monitored. The programme shall set out the specific obligations of employees to meet this objective. An annual report, setting out the measures taken, shall be submitted by the person or body responsible for monitoring the compliance programme to the regulatory authority referred to in Article 23(1) and published.

Ownership is not at issue. The KEK Holding JSC can still own the DNO (Distribution Network Operator) but it must be functionally and legally separated.

As a VIU, KEK must separate their internal accounts between public supply and eligible supply and among KEK's different functions "with a view to avoiding discrimination, crosssubsidies, and distortion of competition."

Findings: At a minimum KEK must legally separate distribution from the other functions and must further properly account for costs for transfer pricing. The DNO unbundling must be completed by July 1, 2007 to be compliant with the EU Directives. Public supply and eligible supply must separate their internal accounts.

2.3 Kosovo C and Unbundling

Kosovo C will be a BOO or build-own-operate PSP project, an IPP. If Kosovo C goes ahead as envisioned, the IPP developer will develop the mine, Kosovo C and, perhaps, rehabilitate Kosovo A. No additional unbundling is required! However, Kosovo's market structure will greatly impact the risk, cost and success of Kosovo C and to support this market structure unbundling does need to take place. As before, Policy Makers must ask and answer important questions regarding Kosovo's market. Well functioning, efficient electricity markets must be planned with a great deal of thought. California, the Philippines and Indonesia are just a few examples of the great problems and great cost that can arise from ill-conceived markets. This section discuss the questions that the IPP's raises (and have been raised by stakeholders in Kosovo) with regard to unbundling and Kosovo's market structure.

Four issues are paramount for the Kosovo C project:

1. The project sponsor's investment in Kosovo A must be recovered.
2. Mine assets must be transferred from KEK to the project sponsor.
3. Dispatch and transmission operation and investment must be impartial.
4. Kosovo needs to be able to pay for the power

Kosovo A Rehabilitation

The Kosovo C project may require the IPP investor to rehabilitate Kosovo A. The manner in which Kosovo C is awarded will determine exactly how the IPP investor is rewarded for rehabilitating A. The rehabilitation can be structured so the IPP recovers their investment through a variety of mechanisms. Depending on the mechanism, no further unbundling may be required. Structuring the least cost Kosovo C transaction may mean not burdening an IPP investor with ownership of an old plant. It increases risk. It increases market concentration in generation.

Rehabilitation can be handled a variety of ways that do not require a transfer of assets and it happens all the time. This would leave Kosovo A intact to be part of some other private participation scheme. The IPP developer could offer their bid for the package after making allowance for the cost of developing Kosovo A. The Government could escrow a specific amount of mineral royalties to pay for the investment in Kosovo A. Or, it could include Kosovo A in the Kosovo C development plan with a prescribed level of investment.

Questions:

1. Are the electricity sector policy objectives better supported by transferring ownership and/or control to the Kosovo C developer?
2. Are the electricity sector policy objectives better supported by separating Kosovo A and B into separate companies?
3. How is the objective of concessioning in generation best served[5]?

2.3.1 Mine Assets

Prudent regulation will call for the unbundling of mining from generation, if for no other reason than to establish a transfer price and to ensure that non-regulated coal sales (and investments) are not part of the regulated enterprise. Thus, accounting unbundling of the mines needs to take place regardless of how mine assets are transferred to the Kosovo C project sponsor.

[5] Note that this was considered separate and different from IPPs by the drafters of Kosovo's Energy Strategy. They conceived of a separate IPP project and a separate concession of Kosovo A.

There are two options for transferring the Sibovc mine assets to the project sponsor. The first is to simply transfer the license. The second is to concession or sell the mine company with or without existing assets including the license for Sibovc.

Questions:

1. Can KEK simply transfer the Sibovc license to Kosovo C or is another legal arrangement required?
4. If another legal arrangement is required, how best can this be accomplished?
5. Does burdening the Kosovo C investor with existing mine assets and liabilities increase or reduce the costs of Kosovo C?

2.3.2 Transmission and Market Operations

As a long as the Government owns/controls generation, the IPP investor may perceive that the Government has an incentive to favor its own plants over those of the IPP through the transmission system and/or market operations. An independent Transmission/Market Operator is important to reduce risk for the IPP developer. There needs to be transparent rules of dispatch and rules for investment in and maintenance of the transmission system. The creation of a separate JSC for and unbundling of transmission and market operations is the first step forward in this process.

Questions:

1. How do the conflicting issues of Government ownership and operation of generation contribute to increased IPP risk and cost?
2. How is the required additional investment in the transmission system best handled in light of Kosovo's policies, laws and energy sector objectives?
3. Is PSP desirable in transmission?
4. If so, what form of PSP in transmission is best and when is the best time to enter in to it, before an IPP contract or afterwards?

Finding: No further unbundling is required for transmission to EU Directives but the market operator must be legally separated from transmission to meet Kosovo law. As long as Government owns/controls generation and the transmission/market operator, the cost of Kosovo C will be greater than it otherwise would. Additionally, the Transco needs money for new investment.

2.3.3 Kosovo's Ability to Pay for Power

If Kosovo C goes ahead as planned, there will be more power and more coal. While important, this won't come without substantial costs. KEK does not have the financial resources to pay for the power. KEK's track record of poor performance and the lack of a credit worthy off-taker will increase the risk for the Kosovo C investor and, therefore, the cost. In this case, not only will the utility be hemorrhaging from theft, poor collections and technical issues but it will have the added payments of the IPP. Painful lessons learned elsewhere have shown a high incidence of IPP failure when the distribution/supply side of the business remains unable to pay for the power. This has led industry experts and DFI's to call for concession or sale of distribution and supply first.

Questions:

1. How do KEK's poor performance and inability to pay contribute to the increased cost of Kosovo C?
2. Will a turnaround at KEK more likely influence the cost of Kosovo C or the value the Government gets for KEK?
3. What is more important in the bigger scheme of things, or put otherwise, is the increased value of KEK from possible turnaround actions greater than the increased cost of Kosovo C and ongoing losses at KEK?
4. Knowing that it eventually must bring in the private sector if efficiency is to be achieved, is it worth it to postpone the inevitable?
5. How soon should concessioning begin?
6. What is concessioned first and how is the deal structured?

Findings: Experience in many other countries provides an important lesson to Kosovo: Concession the distribution and supply as soon as possible. Further delays often do not increase the value significantly to compensate for the losses, both financial and economic.

3 CONCESSIONING AND UNBUNDLING

3.1 Private Participation and Unbundling

Kosovo is in a crisis; the electric utility is mismanaged, billings and collections are low, metering must be replaced, extensive investment is required in the existing transmission and distribution system, the utility is insolvent and the country won't get sufficient power in a business as usual situation. If Kosovo is going to fix the rest of the electricity sector and do it quickly, then it must embark on a public-private partnership where Government does what it does best and the private sector is called upon to finance and manage the sector. It is common sense and it is supported by the painful lessons learned from other countries' experiences.

The success of the energy sector in Kosovo, and the entire economy rests upon this sector's health, requires a major realignment of ownership, management and/or operations. In short, private participation in Kosovo's energy sector is not an option and should not be in question. There is no other choice. Kosovo does not have the money to develop the sector. Government control of the utility has resulted, as it has in so many other countries, in inefficiency, waste and under-investment. Kosovo must go the way of all enlightened Governments and introduce private sector participation into the utility sector. The major questions concerning PSP then are not if, but rather:

1. What are the objectives and their relative importance?

There are many objectives that countries try to achieve in restructuring. They can be grouped into two categories: investment and competition. One is not more important than the other but they are quite different. Those objectives that are most often mentioned by stakeholders in Kosovo are:

- Lower prices
- Increase the efficiency and reliability of the sector
- Increase investment
- Reduce the drain on public funds
- Raise money

3.1.1 Lower Prices

PSP results in greater efficiency and this has led some proponents to conclude that prices will go down. Experience has shown that this is rarely the case. Several factors account for this. Tariffs are often subsidized. The cost of building power plants or other major capital investments are often part of state budgets and the utility has not had to recapture the full cost of investments in the tariff. A great deal of new investment is required. These factors have typically outweighed any efficiencies and the result has been increased electricity prices.

Lower prices are unlikely to be the result in Kosovo.

3.1.2 Increase Investment

Private sector participation can result in new investment in the sector provided that the right PSP vehicle is chosen. Increased investment comes about two ways. First, it can be required as part of the transaction that brings in the private sector. Second, if the private sector can earn a profit on the new investment, then it will make the investment.

The recent privatization of Macedonia's distribution and supply resulted in a guarantee of €96 million in new investment.

3.1.3 Increased Efficiency and Reliability

The private sector has the capability to improve system operations compared to state owned utilities and experience has borne this out. For example, increased investment can improve efficiency. The problems at Kosovo B that are reducing its efficiency would be dealt with promptly because the private sector has the funds for investment and incentive in the form of lost revenues. If lower loses and increasing billing and collections will meet their concession agreements and regulatory performance measures, and raise returns, then the private sector will do so.

3.1.4 Reduce the Financial Burden on the Government

This is one of the primary reasons for PSP and it is an important factor for Kosovo. The funds that the Government currently spends on building, operating, maintaining and subsidizing the power sector will be available for other areas.

3.1.5 Raise Money

Funds can be raised through the sale, lease or concession of the utility. Both the amount of money raised and the manner in which it is raised influence the investment patterns of the private sector. Also, there is an impact on electricity prices. The higher the amount paid, the higher electricity tariffs must be to recover it.

The privatization in Macedonia raised €225 million. The type of PSP chosen will influence the valuation.

Some of these objectives reinforce each other, while some compete against one another. For example, the desire to raise money reduces the amount that the private participant will invest in the system. Increased investment and value from sale are often competing objectives. Given that there are tradeoffs involved, such as value versus investment, Government policy should be clear on the objectives of private sector participation and their relative importance. For example, if Government's major objective is loss reduction, then it may accept a lower value for the assets. Likewise, if a major objective is to get new investment into the sector to jump start it and the economy, then value may take a back seat. Each of the competing and complementary objectives needs to be discussed in detail, consensus reached and clear and concise instructions provided.

Comment: Based on discussions with stakeholders and previous policy declarations, Kosovo's main objectives in bringing in the private sector are to (1) increase investment, (2) increase efficiency and reliability, and (3) reduce the drain on public resources. Clearly, the Government would like to raise as much as possible given these objectives.

2. What form should it take?

Private sector participation can take many forms and the table below presents options for PSP.

PSP Option	Ownership	Financing	Management
Service Contract	Public	Public	Public/Private
Mgmt Contract	Public	Public	Private
Lease	Public	Public	Private
Concession	Public/Private	Private	Private
BOT	Private	Private	Private
BOO	Private	Private	Private
SALE	Private	Private	Private
Stock Mrkt/Vouchers	"private"	"private"	Public/Private

As can be seen there are many different ways of involving the private sector, each with its own advantages and disadvantages. Lessons learned from other countries indicate that two of biggest failures were (1) the failure to carefully consider the objectives of PSP and then (2) the failure to choose the right PSP mechanism to support those objectives.

Build Operate Transfer (BOT) and Build Operate Own (BOO) are for new infrastructure. This paper is focused on existing assets so they won't be considered for KEK. At this time, ownership of the Utility assets can't be sold, so sale and vouchers are out of the question. This leaves only service and management contracts, leasing and concessioning as option.

While Kosovo has not had good results with a management contract, it is useful to look at other countries' experiences to help answer the extent to which management contracts versus other forms of PSP are the best route in the power sector. One way to view this is to look at the number of countries that seek to go this route. In Asia, less than 5 percent of governments have chosen a management contract for PSP in the electric utility. In Africa, it was fewer than 15 percent with most of the contracts either being cancelled prior to their contractual end or not being renewed after the contract ends. Experience shows unequivocally that management contracts have not been successful instruments of PSP in the power sector. This is not to suggest that there have not been success. However, successful management contracts are the exception not the rule. "There appear to be several keys factors driving failure of contracts:

a) failure of government to comply with their contractual obligations, such as undertakings to increase tariffs or to pay for power consumed;

b) poor performance by the private sector operator, including in achieving efficiency gains or poor management of local employees;

c) contractual frameworks that are ill-adapted to the underlying realities (e.g., mismatch between financial fundamentals and private sector financial undertakings), at times the result of misconceptions at the negotiating stage;

d) inability to overcome the hostility of public sector players;

e) the emergence of conflict in the country; and

f) corporate retrenchment by the private sector (which, in several cases, was overly ambitious and over-estimated the prospects for profit).[6]"

Another problem with the management contract is that it relies on public sector funding and KEK does not have the funds for much needed investment. Service contracts and leases suffer from the same problem, investment must come from the Government and improved utility operations. Utility operations will not improve quickly enough and without additional investment to justify these methods for anymore than a few years and experience has borne this out.

Finding: Concessioning is the only viable route at this time. It leaves ownership with the Government, turns to the private sector for investment, operation and management and leaves the door open for future options once the concession period is over.

3. When should it take place?

There are many factors that go into choosing the timetable for PSP. They include the state of the economy, the Government's objectives in PSP, country risk, ongoing PSP efforts, and the urgency of the sector itself. As mentioned above, if the Government's main objective is to reduce loss or jump start the economy, then PSP can go forward much quickly than if the objective is to maximize Government revenue from the sale.

Based on the Government's objectives for PSP and the issues associated with bringing in an IPP, concessioning should take place as soon as possible. There are number of things which need to be done prior to concessioning and unbundling is clearly the most important.

The following section presents the current market structure. It is followed by options for unbundling and concessioning that conform to EU requirements and Kosovo's laws, is guided by the principles set forth in earlier work such as the ESTAP Future Structure of the Energy Sector and the KEK Corporate Structure Discussion Paper, and based on the needs of Kosovo C and PSP. Each option is a different route to the final destination. What makes one option better than another depends upon the country's unique characteristics and its objectives. For example, if a country's electricity sector is relatively efficient and requires only minimal investment, then they may take the slower route, concentrating on raising the value of the utility before concessioning. However, if the system suffers from gross underinvestment and inefficiency, bringing in private sector investment and management is often the key. Government will opt for a faster route to concessioning.

There are numerous ways of unbundling and concessioning. However, only those options that are most relevant to Kosovo are presented here. The purpose is two fold: To provide assistance and advice so that (1) unbundling can begin immediately to support Kosovo C and the concessioning and (2) to spark debate and lead policy makers to asking and answering questions to determining the route that Kosovo will take.

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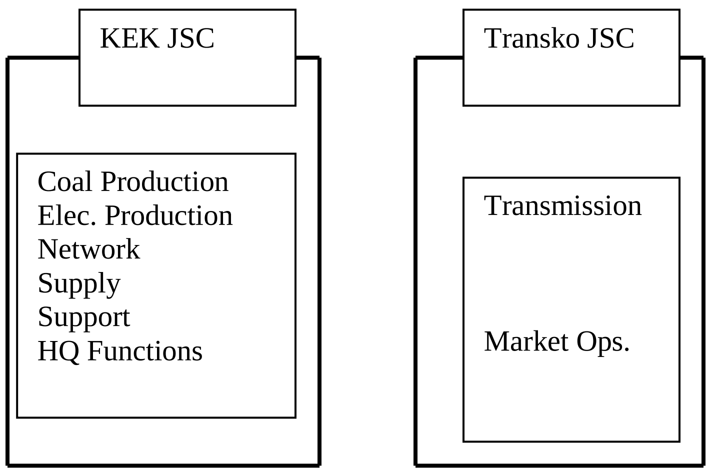
[6] World Bank, A Snapshot of PPI in Sub-Saharan Africa's Power Sector.

4 THE CURRENT SITUATION

Situation as of August 2006.

Kosovo's current market is represented in Figure 1. This figure will form the basis for subsequent descriptions of transitional market structures or options 1 and 2. These transitional market structures follow the advice put forth in the ESTAP Report "Future Structure of the Energy Sector, Final Report" (July, 2002). The structures have been somewhat modified to take into account changes in the law, EU Directives, and circumstances since the report was finalized.

Figure 1 Kosovo's Electricity Sector



The current market is characterized by two state-owned Joint Stock Companies. KEK JSC handles mining, generation, distribution, supply and support. Transko JSC is the transmission system and market operator. KEK purchases all power from self generation, imports and, to a very limited degree, from a small hydro IPP. Although, there are eligible customers, there is only one supplier and the system can be characterized as a single buyer model.

KEK JSC has separated accounts of Coal Production, Electricity Production, Transmission & Network (distribution), supply and Head Quarters Support. However, because of the manner in which common assets are used and not charged to the divisions, accounting unbundling should not be considered as complete. Functional unbundling is also incomplete. For example, each of the four operating divisions has a new office of business support. This office will eventually carry out most of the functions that are now done through the HQ and these staff will report to division managers rather than the head office. This is not complete. Additionally, KEK must legally separate distribution. As is, KEK JSC is not compliant with the legal requirements. Even if compliance were not an issue, there are important reasons for continuing to unbundle KEK such as Kosovo C and future concessions.

At the time of KEK's incorporation a lot of very good work was done in presenting various possible configurations along with their advantages and disadvantages. A conscious decision was made to move slowly, not overtaxing KEK and other institutions human resources. This was a sound decision. Now, however, additional work is required.

4.1 Compliance with EU Directives and Kosovo's Law

The following things must be done to be in compliance with the EU directives and/or Kosovo's laws.

Distribution - Legal separation will entail the establishment of a separate legal entity, transfer of assets and liabilities, and transfer pricing.

Questions:

1. In the Kosovo market structure, do we want distribution to be included along with generation in one company?
2. In the Kosovo market structure, do we really want to separate public supply from distribution? Kosovo's energy strategy suggests that this is something to consider. "For some years the legal framework could allow the distributor(s) and public supplier(s) to remain in one legal entity with accounting separation. "
3. What is the role of the single buyer in Kosovo and if this is desired, how best should the industry be structured?

Generation - Within the old KEK J.S.C. generation and supply must have their accounts unbundled and within supply accounts must be separated between public supply and eligible customers.

Questions:

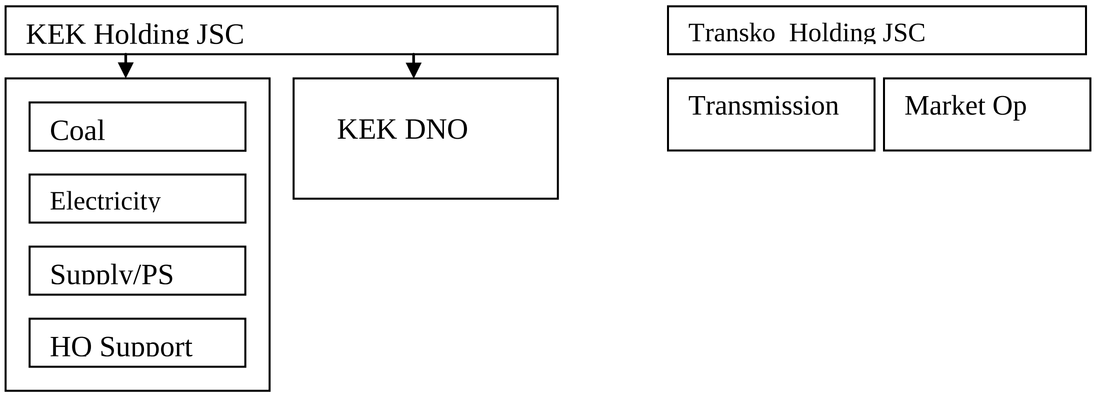
1. Will the market structure of Kosovo or concessioning of generation best be served by unbundling generation assets into two or more companies?

Transko JSC is much further along the road of unbundling simply because the company includes only two functions of the transmission network and the market operator. A great deal of work still remains at KEK JSC and time and effort will be saved if the unbundling work is undertaken along the lines that concessioning will take place. For example, if generation and supply were concessioned together, then this would be supported by unbundling KEK along these lines. This approach will minimize cost and disruptions.

Option 1 is the minimum that is required to meet EU directives and Kosovo's Law. It supports concessioning of distribution separately from other operations. Option 2 represents a better concessioning model and meets EU directives and Kosovo's Law. If KEK JSC meets requirements for transfer pricing and accounting unbundling of generation from the remaining operations, the generation and the KEK PS JSC can be concessioned simultaneously or closely following one another. Option 2A is similar in all aspects except that it does not legally separate public supply from distribution and requires a waiver from the EU and a change in Kosovo's law.

4.2 Option 1: DNO subsidiary, MO subsidiary

Time Scheduled: 9/1/2006 to 2/28/2007



This transforms KEK Holding JSC into a company with two subsidiaries. KEK DNO is responsible for the wires only and KEK JSC contains all remaining aspects of the former company. Public supply must be separated from supply to eligible customers at an accounting level for this and all other options. At Transko JSC the Market Operator must be separated from Transmission according to Kosovo's law. (In subsequent options, the Transko will not be mentioned since no further changes are contemplated.)

Advantages:

- ✓ Accounting, functional and legal unbundling of DNO from other KEK operations.
- ✓ Complies with the current Laws that distribution be legally unbundled.
- ✓ Will meet EU DNO unbundling requirements by 1 July 2007 deadline.
- ✓ No further reorganization required to meet local law and EU directives.
- ✓ Makes it easier and quicker to concession DNO when appropriate.

Disadvantages:

- ✓ Separation of Supply from DNO results in increased cost and higher tariffs.
- ✓ Investment in DNO still restricted due to KEK financial issues.
- ✓ Not sustainable in the long run with out private sector investment and operation.
- ✓ Does nothing to reduce the repayment risk on the IPP Power Purchase Agreement (PPA).
- ✓ Does nothing to address the risk associated with Government ownership and control of generation and other parts of the system.
- ✓ Less desirable asset for concessioning than if combined with supply.

Concessioning:

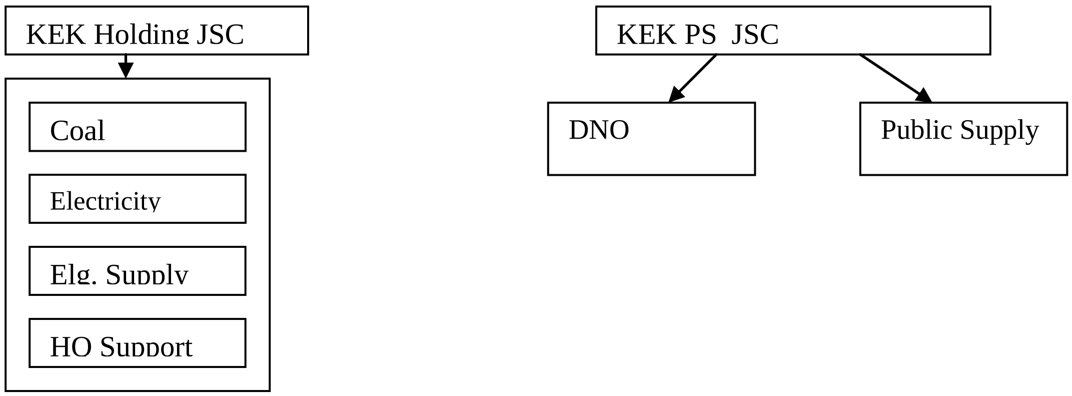
This unbundling configuration presupposes that distribution and other parts of KEK will be separately concessioned. The DNO will have approximately 24 months to form a solid corporate entity before concessioning.

Next Steps:

- DNO to be established legally.
- Organizational design and additional staff hired to fill new positions and some staff transferred from headquarters functions such as procurement and finance.
- Assets transferred.
- Board to be identified and recruited.
- Establish transfer pricing.
- KEK wide meetings held to make employees aware of the new direction of the company.

4.3 Option 2. Combine DNO and Public Supply

Time Scheduled: 9/1/2006 to 2/28/2007



This requires the development of a new holding company which for simplicity we call KEK PS JSC which has two subsidiaries, the DNO and public supply. KEK Holding contains mining, generation, eligible supply and other functions.

Public supply is a regulated monopoly. According to the Electricity Law:

Article 21
21.1. The public supplier shall be an enterprise with a license to conduct the public supply of electricity.
21.2. Under its license, the public supplier shall have the right to:
a). sell, on an exclusive basis, electricity to non-eligible customers at regulated prices and tariffs, in accordance with license terms and conditions;
b). purchase capacity and electricity from producers with an installed capacity above 5 MW which exists on the date of the promulgation of this law at a regulated price;
c). purchase capacity and electricity from other producers at an unregulated price;
d). import capacity and electricity in the event that its customer's demand for electricity increases beyond the capacity contracted for;
e). export capacity and electricity in the event that its customer's demand for electricity is reduced below the capacity contract for;
f). bill and collect payment from its customers;
g). handle the complaints of its customers.

This gives the public supplier monopoly status.

There is a very strong reason for combining Public Supply with Distribution. Public Supply revenues are a function of the tariff, metering, meter reading, billing and collections. The Public Supplier (PS) would need to pay for all generation its customers consume. However, once electricity is put into the distribution grid, the PS can't control where it goes. It will flow to those that are metered and those that are not. This is confirmed by the ERO's market rules:

"Non-eligible Customers

6.6.1 It is acknowledged that, for the time being, there is no requirements under the **Market Rules** pertaining to the **Metering Systems** of **Non-eligible Customers**. The offtake of **Non-eligible Customers** will be determined in aggregate for the **Distribution Zones** in which they are connected by reference to the **Metering Data** provided by the **System Operator** for each **Distribution Zone** and **Metering Data** provided for **Eligible Customers** and **Auto-producers** and **Embedded Generators** in the same **Distribution Zone** pursuant to Paragraph 18.4."

Arguably in a perfect world, this would just be the difference as described in the market rules. However, metering is the responsibility of the DNO. At this time, not all those consuming electricity are metered and not all meters are reliable. As the situation stands, the PS would be charged far in excess of the electricity its customers actually used. This is not tenable. The Government does not have funds for metering, nor the management/operational discipline to ensure that meters are properly installed, calibrated and accurately read. Concessioning PS under these conditions, if it happened at all, would come with very strong conditions and very high costs. This shows the high degree of interrelatedness of public supply and distribution and points to the urgent need to concession PS with the DNO.

Advantages:

- ✓ Accounting, functional and legal unbundling of DNO.
- ✓ Will meet EU DNO unbundling requirements by 1 July 2007 deadline.
- ✓ Economics of combined DNO are improved to a small degree.
- ✓ Economics of company are improved because of the efficiencies of connecting, metering, billing, and collecting through the same holding company. This is weakened, however, because of the firewalls that EU directives put between supply and networks.
- ✓ More attractive for concessioning.

Disadvantages:

- ✓ Does nothing to reduce the repayment risk on the IPP Power Purchase Agreement (PPA).
- ✓ Does nothing to address the risk associated with Government ownership and control of generation and other parts of the system.
- ✓ Not sustainable in the long run with out private sector investment and operation.
- ✓ Increases costs because of the legal need to legally separate supply from distribution.

Concessioning:

This increases concession value because it combines supply with the distribution network, thereby reducing some transactions costs and reducing the risk of non-payment.

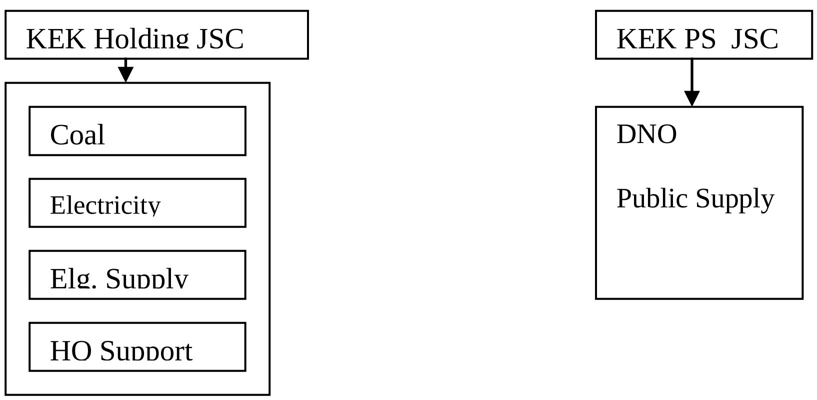
Next Steps:

- ➢ Formation of a KEK PS JSC
- ➢ DNO and Public Supply assets and liabilities including staff to be transferred to new holding company under two Subsidiaries.
- ➢ Public Supply Subsidiary to be established legally defined.

- Organizational design and additional staff hired to fill new positions and some staff transferred from headquarters functions such as procurement and finance.
- Assets transferred.
- Transfer pricing established.
- Board to be identified and recruited.
- Five year power purchase agreements established with KEK JSC.
- KEK wide meetings held to make employees aware of the new direction of the company.

4.3.1 Option 2a.

It would be better not to legally separate public supply from distribution. The EU requires this separation because of the potential adverse impact on competition posed by the owner of the distribution wires wanting to first promote sales of its own supply. This is a real concern under normal circumstances where customers are free to choose their supplier. However, in the case of Public Supply, there is no competition by definition. Public supply provides service to only those persons that are not eligible to choose their supplier. Requiring legal unbundling of public supply from distribution will do nothing to promote competition but it will raise costs. It is our recommendation that Kosovo pursue an exemption from the EU directives in this case and that public supply simply be a separate division of the regulated company structure shown above. This will facilitate coordination and lower costs.



5 LESSONS LEARNED IN RESTRUCTURING

The experience of others provides some general guidance to Kosovo as they prepare for unbundling and concessioning. This section will provide general lessons learned

"The need to achieve lasting benefits for customers in the shortest possible time should drive the restructuring process. This should be the raison d'etre of restructuring. Actions which do not achieve or are inconsistent with this goal, such as waiting to try to improve the performance of distribution companies before (concessioning) them, should be rejected.[7]"

Both the experience of other countries and the imperatives of the impending crisis in Kosovo strongly recommend that concessioning take place as soon as possible. In our view this is perhaps 24 months from the start of the concession process. It means that the Government should not delay concessioning but move forward with all due speed and that it should continue to seek to improve the financial condition and performance of the utility but not at the expense of doing what is required for concessioning and the IPP.

Government makes an unequivocal commitment to involving the private sector including an aggressive timetable for action. Amend the law to restructure the power sector with a strict timetable specifically mentioning (a) sector unbundling, and (b) concessioning.

Once the Government adopts an option for unbundling and concessioning, it should establish a timeline. The law should be amended to show that the Government is committed to both private sector participation in the industry and to the timetable. It is important to act quickly for a variety reasons that were discussed above and are specific to Kosovo.

It provides the legal basis for the unbundling and concessioning and provides momentum for restructuring. It also helps to assure the private sector and reduce risk. In 1997, Poland passed a comprehensive law setting up a National Transmission company and providing share in the regional distributors to cities. "After the passage of the law, there was a high level of enthusiasm in Poland for entertaining private sector proposals and making the power sector more efficient."

Make sure that the law is rational and that any timetables are realistic. They require full compliance with the law.

Unbundling and concessioning will be unpalatable to some, particularly those who have been able to profit from the existing system. These individuals have a strong incentive to subvert the process. Putting into law and requiring full compliance provides the momentum and stick needed.

If the timetables are unrealistic or the law not rational, then this will only increase risk and take the teeth out of the law and erodes confidence in the law. This raises the costs of concessioning and IPPs. To date, Kosovo does not have a good track record of complying with timetables in the law. For example, Chapter 12, Article 38, requires distribution system operators to install metering devices for every connected person or purchase their meters within 1 year of the law's promulgation or May 31, 2005. Or, both the distribution system operator and the market operator were to be legally unbundled entities. They are not. There are several other examples of not meeting the requirements of the law.

[7] ADB, Development Best Practices for Promoting Private Sector Investment in Power, page 22.

Subsidies and cross-subsidies in both power and fuel should be removed prior to concessioning. Universal service obligations should be directly funded through Government payments to the utility.

Any subsidies need to be identified and made transparent during the unbundling process and removed. Customer should pay what power costs them and identifying and removing them prior to concessioning reduces cost and increases the success of the concession. If this is not done before concessioning, the concessionaire will most certainly have to do it and will be held responsible for the price increase and public pressure could put the concessioning process in jeopardy.

Keep the public informed and proactively seek to build public support for concessioning. Tariff increase should be phased.

The process of unbundling and private sector participation needs broad public support and it will impact the public not only in the form of higher prices but in the form of increased availability and better quality. Fewer disruptions and surges bring big economic benefits. The public will also benefit from the higher taxes. The Government needs to put a public education program in place to make the public aware of these changes.

Public support will be greater if tariff increases are phased in over time. Hungary raised rates every six to nine months until it reached the rates necessary for the private sector investor to get an adequate rate of return. This reduced the impact on the public and allowed them to adjust. Indonesia, on the other hand, increased electricity so rapidly at one time that the public rioting brought down the Government.

Attempt to clean up the utilities books as much as possible prior to concessioning.

Often times the utility is owed money by Government entities and it owes money to other Government entities. When this problem persists, it results in liabilities to concerned parties. If the Government requires mutual debt cancellation or reconciliation, the balance sheets of both entities are better. Debt which is truly uncollectible should be written off. Additionally, in Kosovo the utility is obligated by the Government to provide power to minorities that do not pay and they are prevented from disconnecting these delinquent minorities. The Government should treat this just as it would social cases, pay the utility fully.

"Take initial steps to improve the operation of existing entities before concessioning them, if this can be done expeditiously. However, countries should not delay for this purpose."

It is no secret that the private sector will pay more for a well functioning utility than one which is not. There is also the need to cut Government losses and increase investment. Based on many countries' experiences, the rule of thumb is to act quickly. "It is better to improve the operations of existing assets, but only if that can be done quickly." One of the main reasons for bringing in the private sector is to increase performance because Government has already proven that it can't effectively manage and operate the sector. If bringing in the private sector is motivated by the need for significant investment, it is best not to delay. In several Eastern Europe countries, a number of state owned power plants required significant investments to meet environmental standards. Rather than making the investment first, the governments chose to privatize them first. They simply did not have the funds for the investments but needed the power.

Unbundle and concession Generation with short term power purchase agreements (if PPAs are required).

PPA's are a necessary tool for attracting private investment in many countries but they are not without problems. The downside potential can be limited by fixing their term to the shortest duration possible within the confines of cost and sound practice. EU directives stipulate that PPAs should be no more than five years.

Set goals and a timetable for energy efficiency, demand side management and cogeneration and establish a means of achieving those goals.

Phase in customer choice beginning with large customers and then move the threshold size down to most customers. Conduct a pilot program for residential consumers before opening the sector up to retail choice.

Often there are priorities in market restructuring that far outweigh retail choice and against the backdrop of very limited institutional capacity to undertake them. Most of the gains can actually be had with a minimal number of eligible consumers. Implementing a pilot program for residential consumers provides a mechanism for suppliers and consumers to understand the process and become accustomed to competition. It also provides the time needed to workout the details of trade.

5.1 Next Steps

The following section outlines the steps, in logical order, that can be taken to finalize the sector restructuring.

1. Circulate this paper to selected stakeholder participants.

2. BE to facilitate stakeholder discussion to discuss and reach consensus.

3. Begin a public awareness program. Educate the public about the need to restructure and involve the private sector, about Kosovo C and what it will mean to the country, and how increasing tariffs and the social responsibility to pay (and the consequences or non-payment).

4. Begin a phased elimination of subsidies and cross-subsidies. Government should directly pay the utility for social customers and for other commitments that result in below cost sales – such as unrecoverable service to "minorities". At this time, the Government provides the utility with capital for imports, operations and equipment. It should reduce this by the amount of the service cost to unrecoverable minorities and include payment for unrecoverable minorities as a specific line item.

5. Decide on unbundling/concession option. Establish a speedy timetable to concessioning and amend the law to demonstrate the Government's commitment to the private sector and to the timeline.

6. Amend the laws to support minimum unbundling, concessioning and Kosovo C.

7. Educate the utility employees about the path to unbundling and concessioning. Do this early on and continue to do this throughout the process.

8. Government reconciles debts between the utility and other Government agencies so that they are off the books prior to concessioning.

9. Undertake and Complete unbundling simultaneously.

10. Choose whether the parts will concessioned simultaneously or separately. Option 2A is the recommended unbundling and concession model. Ideally, both generation and KEK PS JSC should be simultaneously concessioned. Before Kosovo C comes on line the Government will need to get additional power from imports and through enhanced operations at Kosovo A&B. Imports are partially constrained by transmission. Generation enhancements are constrained partially by Government control/management. Both imports and generation enhancements are constrained by the lack of Government funds and the inability of KEK to initiate full cost recovery. Either imports or generation enhancement means mounting Government losses unless it solves the full cost recovery issue.

    Concessioning the KEK PS JSC first will start resolving the full cost recovery issue but does nothing in the short run to address the need for additional power. Full cost recovery is made more difficult when there are routine and continuing outages.

    The Government is faced with a real dilemma. Increased outages immediately following status can lead to greater political and social instability. This not only has serious implications for a fledgling government but also has real implication for Kosovo C and concessioning. But how to pay for increased imports without increased revenues? Concessioning will take time to yield results, if for no other reason than the time needed for physical improvements. Concessioning will only increase losses unless revenues are increased. These considerations lead to the following recommendations.

    a. Concession generation and the KEK PS JSC together.
    b. Institute a five year PPA between generation and the KEK PS JSC to ensure a revenue stream for the generation concessionaire and to provide price stability for the KEK PS JSC.

5.2 The Law and Restructuring

Kosovo's electricity law and law of the energy regulator were written in large part through reference to the EU Directives. However the laws are actually more restrictive than the EU Directives, Directives which have a lot of thought and research behind them. Several of the Laws' requirements need to be relaxed to allow the market structure to be more flexible and to allow possibilities that we may not yet have considered. The following are areas in the law that require attention.

1. There needs to be consistency in the Law. The Law defines a transmission network operator but constantly refers to a transmission system operator.

2. The Law requires the separation of Transmission and Distribution. There is no apparent reason for this and it is certainly more restrictive than the EU Directives. In Kosovo's case, there is every reason to bundle these two regulated operations together. This is further reinforced by the Law of the Regulator

32.3. The energy enterprise who holds a license for the transmission network operator of electricity may not obtain a license for the generation, distribution, supply or trade of electricity, or for the generation of heat.

32.5. An energy enterprise who holds a license for the distribution network operator of electricity may not obtain a license for any other activity in electricity subject to licensing under this law.

49.1. Energy enterprises operating the electricity transmission or distribution networks shall be independent in terms of its legal form, organization, and decision making in accordance with the Law on Electricity.

3. Article 10 is designed to promote renewables and this is an admirable goal. Section 10.3 states "Public suppliers shall give purchasing priority to electricity for which a certificate of origin has been issued, provided that the cost of such electricity does not increase the price of electricity to an unsustainable level in Kosovo." Unsustainable is vague and not adequately defined anywhere. This can lead to real problems down the road in both investment and system operation. More thought needs to be given to how to open the market to renewables.

4. The intent of the law is to establish a single public supplier and everywhere with one exception the work public supplier is used. In one instance the word is used in the plural form and this can give misleading results later. It is crucial for the concessioning effort that public supply remain a regulated industry in sole supplier status. Correct the Law to read only Public Supplier.