



Kosovo KEDS Privatization

A CASE STUDY

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BACKGROUND

In the past, a lack of reliable access to electricity had frequently been cited as the largest single barrier to investment in Kosovo, limiting Kosovo's economic growth and the achievement of human development goals. Kosovo's ability to provide sustainable energy to its citizens was hampered by problems across the entire sector - Generation, Transmission, Supply and Distribution. Every aspect of the power sector was run by state owned companies, with the Energy Corporation of Kosovo (KEK) operating and overseeing power generation, distribution and supply, while transmission services were managed by the Kosovo Transmission System and Market Operator (KOSTT).

CHALLENGES IN THE STATE RUN SYSTEM

GENERATION — Kosovo's main energy sources come from two lignite mines, Bardh and Mirash, and two lignite-fired power plants, Kosovo A and B, with a joint generation capacity of 740-840 MW (with installed capacity of 1478 MW). Kosovo A and B were built in 1962 and 1983 respectively. However, due to degradation, underinvestment, and lack of maintenance

and rehabilitation, their production capacity had declined significantly over the years, impacting Kosovo's ability to generate enough power to meet its needs.

TRANSMISSION — KOSTT manages the country's transmission system, which is connected to a regional system that includes Serbia, Macedonia, Montenegro, and Albania. Insufficient investment over many years in its transmission infrastructure had led to significant

technical losses from its transmission lines as well as an inability to support peak loads required during the winter months.

DISTRIBUTION AND SUPPLY — Underinvestment in its distribution assets (e.g., distribution lines and substations) led to 17.19% in technical losses in the power system in 2007. On the supply side, commercial losses (theft and non-payment) were even higher at 30.31%. In 2007, of the gross consumption of 4,582 GWh of energy, only 2,452 GWh was billed (54%), and of that, only 1,843 GWh was collected (75%). This amounted to a revenue loss of €99 million for KEK for the year, the amount of which would have covered all of KEK's operating expenses and electricity imports, as well as part of the capital investment the company made in 2007.

SUBSIDIES — Due to its poor operational and financial performance, KEK required significant subsidies to support its operations. Between 1999 and 2008, KEK received about €1,052 million in subsidies (€459 million from the country's budget and €593 million from donors). During the 2006 to 2009 period, Kosovo allocated around €70 million annually from its budget to KEK (about 11% of Kosovo's total annual budget). KEK had, therefore, become a costly burden to Kosovo's budget as well as donor funds.

INCREASE IN ENERGY DEMAND AND IMPORTS — Due to low generation capacity and substantial technical and commercial losses in the transmission and distribution of the power they generated, KEK had to import additional power to meet the country's increasing demand, and by 2000, Kosovo had become a net importer of electricity. The price of electricity imports had also increased due to the energy deficit in the Balkans where most of the countries were electricity importers. This was a further financial burden on Kosovo's budget, and energy security became a priority for Europe's newest nation, as laid out in Kosovo's National Energy Strategy (2009-2018).

PRIVATIZATION OF KEDS

The privatization of Kosovo Electricity Distribution and Supply (KEDS)¹ was a major part of Kosovo's comprehensive Energy Strategy (2009-2018), which aimed to remedy the significant challenges the sector was facing, with the ultimate goal of igniting the country's economic and social development. The strategy also included exploring additional generation capacity (Kosovo C)², legal and regulatory reforms, modernizing transmission infrastructure, and regional energy integration.

The strategy was inextricably tied to the country's EU integration, further incentivizing Kosovo to bring

¹ KEDS is the product of unbundling KEK's distribution and supply division which was then privatized. Please see Key Players section for more information.

² Government of Kosovo is in the process of developing a new mine (Sibovc) which would be able to supply enough lignite to both Kosovo A and B until the end of their operational life in addition to a new associated power plant Kosovo C in order to increase its generation capacity. This was supported by World Bank's Lignite Power Technical Assistance Project (LPTAP).

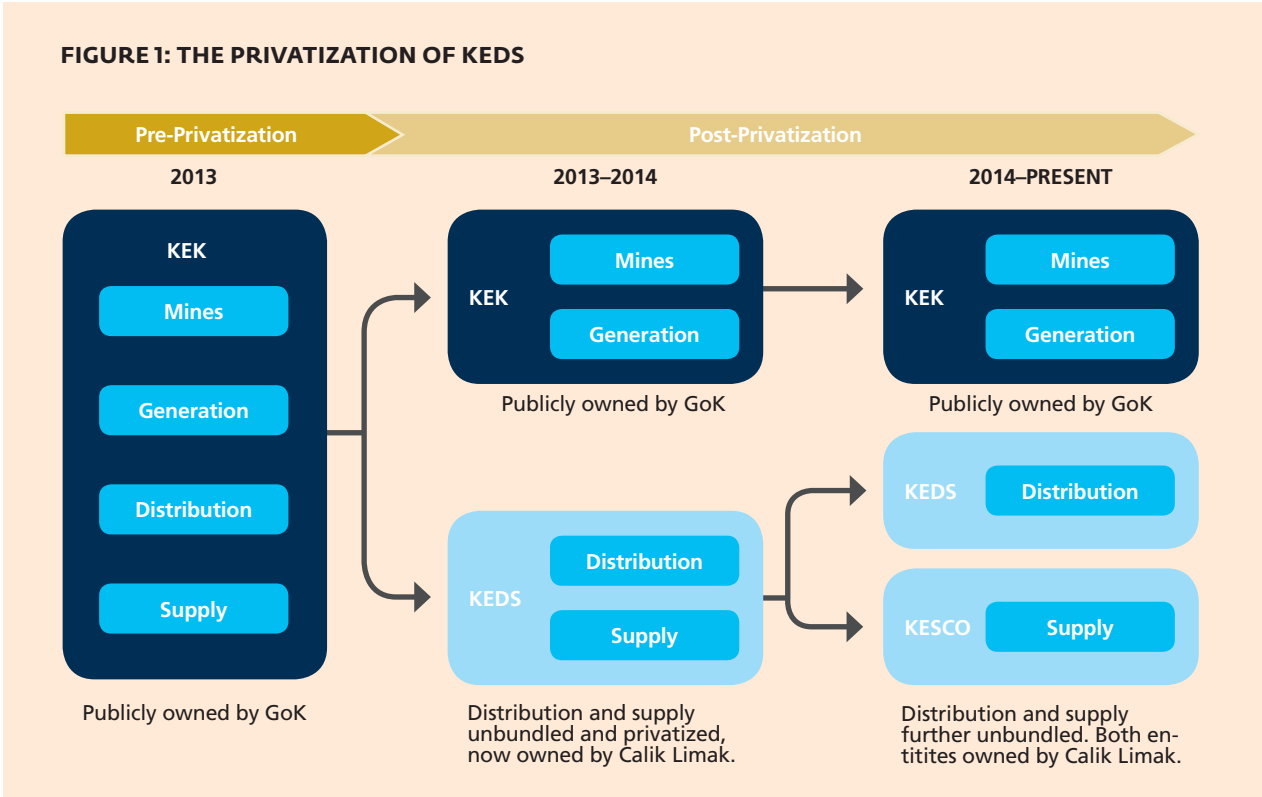
its energy sector into compliance with relevant EU directives. To do this, Kosovo looked to private sector.

Through privatization, Kosovo aimed to:

- 1. *Reduce the financial burden KEDS placed on the national budget*
- 2. *Improve the quality and reliability of power through greater investment and more effective maintenance and operations by reducing loss*

- 3. *Expand electricity coverage*
- 4. *Reduce high cost of imported energy*

The first step in privatizing KEDS was to unbundle the distribution and supply functions from KEK, as addressing these functions and their associated problems (technical and commercial loss) was seen as vital to reducing high subsidies and expensive energy imports, increasing energy efficiency, and bringing affordable and reliable energy to communities and businesses. The





unbundling was also required by the existing energy legislation in Kosovo as well as EU directives.

In 2009, IFC was brought in to advise the Government of Kosovo on structuring and tendering the privatization through a transparent and competitive bidding process. A Turkish consortium, Çalik-Limak, won the tender to purchase KEDS for €26.3 million and pledged to invest €300 million over the next 20 years. Figure 2 shows the timeline of the privatization.

To ensure the success and sustainability of the privatization, IFC remained as a post-privatization

advisor for an additional two years after the sale to help build contract management capacity and ensure a smooth transition to privatization. A Privatization Committee was set up and led by the Ministry of Economic Development (MoED), which is responsible for executing Kosovo's energy strategy and overseeing KEK (and KEDS). The Privatization Committee established an implementation unit within MoED called the KEDS Privatization Implementation Unit (KEDS PIU), which handled the day to day management of the privatization. The KEDS PIU was supported by 2 external consultants, funded by USAID, who served as resident advisors.

KEY HIGHLIGHTS

The Government of Kosovo (GoK) took the process of privatization seriously and followed best practices on privatization. Following are some of the key steps that GoK took that contributed to the successful privatization of KEDS.

- **Adequate financial and operational data for distribution and supply:** Unbundling of distribution and supply from a public power company ideally takes place up to 3 years before privatization, so there is a clear track record of the financial and operational health of both entities. However, for Kosovo, distribution and supply were unbundled just a day prior to the privatization agreements being signed. In this case, though, the required track records were available because KEK had organized the supply and distribution as separate cost-profit centers early in the process and was able to provide separate financial reports for distribution and supply to potential investors despite the time constraint.
- **Appropriate legal and regulatory framework:** Since its independence from Serbia in 2008, Kosovo has promoted reforms and passed legislation in

the energy sector as part of its efforts towards EU accession, and donors, such as USAID, contributed much to the reform efforts. Across the sector, the integration process focused on two fronts: participation in the Energy Community Treaty (EnCT) of South East Europe (2006)³ and involvement in the Stabilization and Association Tracking Mechanism⁴, both of which were critical parts of the EU acquis⁵ and in creating favorable a legislative and regulatory environment in Kosovo to attract foreign investors. Key legislation that enabled the privatization of KEDS, such as the Law on Energy Regulator (2004)⁶ and the Law on Public Enterprises (2008)⁷, were both in compliance with EU requirements. Additionally, for the privatization, the tariff methodology used in Kosovo needed to be adapted to ensure investments in the system as well as operational costs could be recovered through tariffs. IFC worked closely with the government, stakeholders, and regulators to get agreement on an appropriate, updated methodology. IFC also did its own analysis on how the regulatory framework and tariff structure should be amended and recommended actions for the GoK accordingly.

³ The key aim of the organization is to extend the EU's internal energy market to South East Europe and beyond on the basis of a legally binding framework. Energy Community website.

⁴ The European Union's policy towards the Western Balkans, established with the aim of eventual EU membership for countries in the region. Western Balkan countries are involved in a progressive partnership with a view of stabilizing the region and establishing a free-trade area. The SAP sets out common political and economic goals although progress evaluation is based on countries' own merits. European Commission website.

⁵ The acquis is the body of common rights and obligations that is binding on all the EU member states. European Commission website.

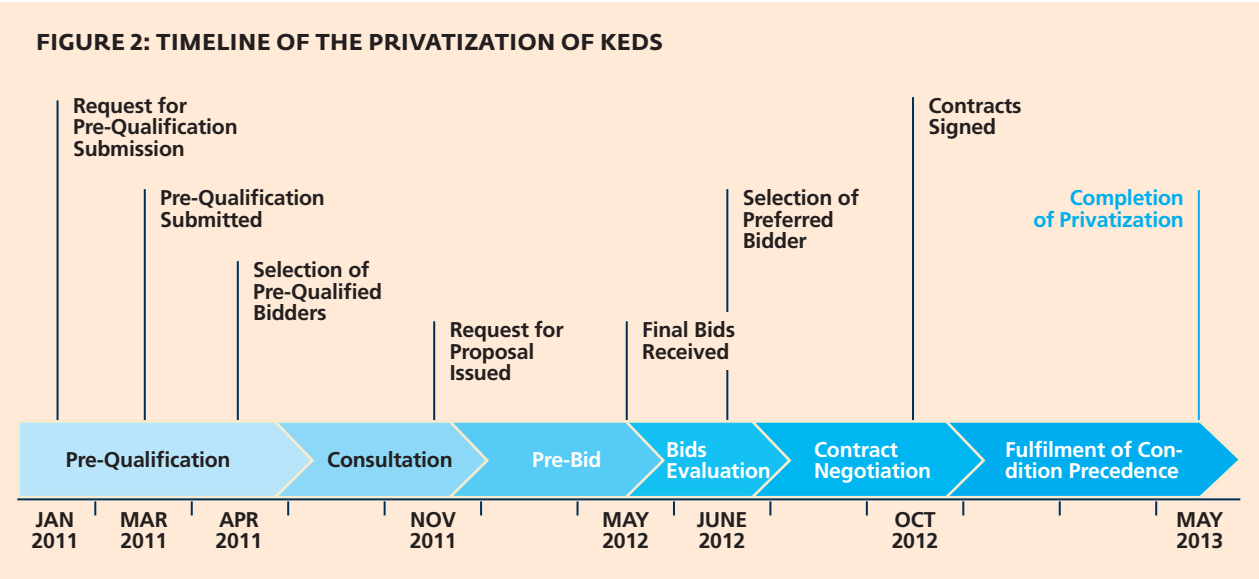
⁶ It established ERO as an independent regulatory agency.

⁷ It governed the privatization process.

- Clear Governance Structure for Implementation:**
 The Law on Public Enterprises (Law on PE) provides a clear governance structure for privatization that guided the process of approvals and the day to day management of privatization. It also included well-defined accountability and responsibility structures and roles: decision maker, project manager, and a lead advisor. The Privatization Committee was the decision-making body and it was comprised of 5 Ministries [Ministry of Economic Development (MoED), Ministry of Economy and Finance (MEF), Ministry of Labor and Social Welfare (MLSW), Ministry of Environment and Spatial Planning (MESP), and Deputy Prime Minister].
- Comprehensive Due Diligence:** Due diligence includes rigorous and detailed legal, technical and

financial research and analysis. In the case of the KEDS privatization, this information provided the foundation for structuring the privatization and ensured that both the public and private sectors had all the evidence required to make informed decisions regarding the sale. Issues were also flagged during this time so they could be resolved prior to the privatization. Transparency, competition and non-discrimination, optimal valuation, and minimized risks were important parts of the due diligence process for the KEDS privatization.

- Transparency, competition, non-discrimination:**
 GoK announced the privatization tender publically and well in advance, with very clear objectives and a pre-determined process. GoK also ensured maximum competition



while maintaining reasonable qualification requirements and ensured equal treatment of all prequalified companies.

- **Optimal Valuation and Minimized Risks:** Optimal valuation and minimized risks are critical in attracting good investors. Valuation entails multiple considerations such as return on capital, operating efficiency, bad debt, and risks (political, regulatory system, etc.). The valuation of a public entity is usually done by a regulator, and in Kosovo's case it was conducted by the Energy Regulatory Office (ERO). ERO was able to establish a reasonable Weighted Average Cost of Capital (WACC) that provided clear incentives for the investors. ERO was also able to minimize risks by having a clear governance structure under which ERO operated. ERO was, therefore, perceived by investors as credible and robust, and as a result, no risk insurance was required. This provided a positive purchase price.

POST PRIVATIZATION

Many issues can come up after a privatization that need to be managed. In the case of Kosovo, IFC advised the government to retain the KEDS PIU as a Post Privatization Unit (PPU) responsible for monitoring contractual obligations and performance, and reporting on and resolving any issues that could arise post privatization. IFC continued to support GoK for two



years following the privatization, providing advisory services and building contract management capacity.

KEY OUTCOMES

Privatization of KEDS produced many positive results for Kosovo. Looking specifically at the Government of Kosovo's four main objectives for the privatization, what have been the results?

OBJECTIVE: FISCAL SAVINGS

Outcome: Prior to privatization, distribution and supply services cost GoK an average of €47 million in subsidies per year. Subsidies were no longer required post privatization, saving GoK average of €47 million each year. Improved payment collection rates also helped provide the national budget with over €50 million annually in additional revenue from VAT and the coal royalty tax. This is almost a €100 million annual turnaround in public finances as a result of the privatization.

OBJECTIVE: IMPROVE QUALITY AND RELIABILITY OF ELECTRICITY

Outcome: Prior to the privatization, over 40% of electricity was lost annually due to technical and commercial losses. Privatization enabled significant reductions in both of these areas through better investments in electricity infrastructure. This meant that KEDS did not have to buy as much power as far less was being wasted. The reduction in losses and the increased savings from lower power imports (i.e. less power at a cheaper price – see below) also resulted in a reduction of electricity costs by €100 -150 million over the three years following privatization. In addition, through efficiency gains, the amount of energy load shed on average has fallen over 44% since privatization, and the quality of service has substantially improved. Out of the €300 million that the consortium has pledged, roughly €80 million has already been invested to improve services.

OBJECTIVE: INCREASE ACCESS

Outcome: Electricity coverage in Kosovo has always been quite high, but many communities remained cut off from the national grid or suffered from unreliable electricity due to poor management and a lack of investment. Since the privatization in 2013, KEDS has made over 100,000 new connections.

OBJECTIVE: REDUCE COST OF IMPORTS

Outcome: Energy imports were very expensive, prior privatization costing €77 per MWh. Within one or two months following the privatization, the cost of imports had been reduced by more than 30% and this average cost of imports remains around €53 per MWh since, providing substantial savings and helping keep tariffs in Kosovo among the lowest in the region.



Key Players

Ministry of Economic Development (MoED) — Ministry responsible for the energy policy and oversight of the public energy companies.

Energy Regulatory Office (ERO) — An independent energy regulator established in 2004, who sets the regulatory framework for Kosovo's energy sector. Its primary role is to approve tariffs, facilitate the development of new generation capacities, monitor energy markets, and prepare and adopt energy regulations.

Independent Commission of Mines and Minerals (ICMM) — Independent regulatory agency for the mining sector (generation) established in 2005. It is responsible for issuing and supervising exploration and exploitation licenses for minerals including lignite.

Energy Corporation of Kosovo (KEK) — Publicly owned company that owns and operates the power generation, distribution and supply (two lignite mines Bardh and Mirash, and two power plants, Kosovo A and B). KEK suffered from major technical, financial, and managerial problems. Through privatization, KEK unbundled distribution and supply divisions in 2013 establishing KEDS. KEDS is owned and operated by a private sector firm, Calik Limak consortium.

Kosovo Transmission System and Market Operator (KOSTT) — Publically owned company established in 2006 to operate, maintain and develop transmission network and interconnections with neighboring power systems.

Kosovo Electricity Distribution and Supply Company (KEDS) — Privately owned company managing both distribution and supply. It was established when KEK's distribution and supply were unbundled in 2013. Owned and operated by CL.

Kosovo Company for Supply of Energy (KESCO) — Privately owned supply company which was established through the further unbundling of KEDS in late 2014. The supply entity became KESCO while the distribution wing remained KEDS. Owned and operated by CL.

Calik Limak Consortium (CL) — A Turkish consortium who won the bid to privatize KEDS. CL owns both KEDS (distribution) and KESCO (supply).

Government Privatization Committee (PC) — Government entity entrusted by the assembly to manage privatization of public entities.

KEDS Privatization Unit (KEDS PIU) — A unit within Kosovo government established to handle the day to day management of privatization.

Post Privatization Unit (PPU) — KEDS PIU was turned into PPU to manage post privatization issues.

IFC — Lead Advisor to the privatization and post privatization.

USAID — Contributed to GoK's energy sector reform. USAID also provided funding for two external consultants who served as resident advisors to the KEDS Privatization Unit.



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