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The Prospects for an Energy Market in Kosovo: The Case of Electricity

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Abbreviations

KEK	Kosovo Energetic Corporation
KOSTT	Kosovo Electricity Transmission and System Operator
KEDS	Kosovo Electricity Distribution System
KESCO	Kosovo Electricity Supply Company
ERO	Energy Regulatory Office
EU	European Union
UNMIK	United Nations Mission in Kosovo
VIU	Vertically Integrated Utility
KOSID	Kosovo Civil Society Consortium for Sustainable Development
OECD	Organisation for Economic Co-operation and Development
IEA	International Energy Agency
Ofgem	Office of Gas and Electricity Markets
OU	Ownership Unbundling
ITO	Independent Transmission Operator
ISO	Independent System Operator

Tables and Figures

1. Executive Summary

The energy[1] sector represents the backbone of economic development and is a key political tool towards regional integration. The energy discourse in Kosovo is primarily focused on the issue of electricity; its production, transmission, distribution, and supply. This is because how the electricity sector functions also radiates into the way we consume it, the price we pay for it, and the goods and services offered. It also indirectly affects our disposable income for other goods and services. Namely, the more money a household spends on electricity the less it can afford to spend on other things.

The *sui generis* nature of Kosovo, not only in regard to its disputed status as a country and the implications which follow from it, but also its general legal and political infrastructure, warrants a deeper understanding of its electricity sector; how it functions, what are its drivers, who are the key stakeholders, what is their role.

Reforming Kosovo's electricity sector in line with the European model is a convoluted task.[2] It requires a synergy of capable and willing technocrats, government's political backing, and civil society and stakeholder participation to spearhead the process from theory into practice. There is a purported exigency assigned to this task by the European Community Treaty, signed by UNMIK on behalf of Kosovo in 2005. Indeed, while not completely bound by it[3], Kosovo has sought to implement the Treaty by liberalising the electricity market and opening competition to all segments, including households.

With a single electricity supplier, Kosovo's consumers cannot take advantage of their legal right to choose the entity they wish to buy from.[4] To this end, the Energy Regulatory Office (ERO), an independent state institution that regulates the energy market, has failed to facilitate a competitive regulatory framework that would create incentives for new investors, particularly on the supply side. Most worryingly, ERO has maintained its regulatory role with only three out of five board members.[5] Due to political clashes, authorities were unable to refill the vacant positions in ERO's five-member board for over a year. Two of the three members have had previous links to energy enterprises, which in our view constitutes a conflict of interest. These issues cast a serious doubt on ERO's monitoring capabilities, especially as there have been questions with regard to the professionalism, expertise, and transparency, of the board members and their decision-making.

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[1] Energy in Kosovo is operationalised mainly to mean electricity. This is due to the fact that Kosovo's energy is based almost entirely on electricity, and not gas (0%) or oil (0.9%). It is for this reason that, throughout this policy paper we use energy and electricity interchangeably when we are discussing the case of Kosovo. This, of course, does not preclude that the legislation is based purely on regulating only the electricity sector, it simply refers to the fact that Kosovo's energy sector is primarily characterised by electricity.

[2] Energy Community Secretariat, (2014), 'Annual Implementation Report 2013/2014', [Online] Available at: www.energy-community.org

[3] Kosovo is considered an underdeveloped country and is exempt from key treaty guidelines in order for it to develop an industrial base and become a developed country before it can adhere to the guidelines.

[4] From 1 January 2015, household's customers in Kosovo should have had the legal right to switch their electricity supplier. Yet, there is no standardised method of doing so nor an alternative supplier to turn to, meaning that this practice has remained theoretical.

[5] While three out of five board members is sufficient to cast a vote and make a decision, it invariably affirms the inadequate capability of ERO, and particularly the parliaments capacity to elect the additional to members, to oversee the entirety of Kosovo's energy sector.

Efforts[6] to liberalise the electricity system and market throughout the world must not be taken as rigid steps that are a prerequisite for newcomers but rather as useful guidelines.[7] As Kosovo is a young country, there are plenty of lessons to be learned from our European neighbours; one among many is the fact that there are components within the electricity system that are natural monopolies (Distribution, Transmission) and those which are potentially competitive (Generation, Supply).[8] These components should be adequately separated in order for competition to flourish. In Kosovo's case, distribution and supply are – while legally unbundled, opaquely at that – still under the same ownership. While this is acceptable with the presence of a vertically integrated utility (hereafter VIUs)[9] service, it represents a daunting hindrance to the free market principle of competition, creates room for discrimination against new entrants, and supports the creation of a stronghold by KEDS and its affiliate supplier KESCO.

There is no single remedy when it comes to designing a free electricity market however. The market design should reflect the country's contextual contours and not some distant prescription that may or may not be applicable to the situation on the ground.

The legal framework, which regulates the energy sector in Kosovo, is codified in three main laws: 1) the Law on Energy[10]; 2) the Law on Electricity[11]; and 3) the Law on the Energy Regulator[12]. The energy market is characterised by three main behemoth companies[13]:

1. *KEK* – the public generation utility
2. *KOSTT* – the public transmission system and market operator
3. *KEDS/KESCO* – the privatised distribution operator and supplier

The aim of this policy paper is twofold: 1) to explore whether the Energy Community Treaty guidelines and electricity market model is appropriate in Kosovo at this stage; 2) to investigate, through a comparative framework, Kosovo's implementation strategy and contemporary electricity market. The purpose is to highlight present barriers towards a free electricity market and come up with practical policy recommendations to overcome them.

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[6] We conceptualise it as "efforts" because liberalising electricity markets is an on-going process and not an event. Also, while there has been a spur of liberalisation processes throughout the world, a majority of countries are still in the initial stages and are struggling with flawed market designs and complex deficiencies that have yet to be fixed.

[7] Joode de, J., van der Welle, A., and Jansen, J., (2009), 'Distributed Generation and the Regulation of Distributed Networks', *Energy Research Centre of the Netherlands; Faculty of Technology, Policy and Management*.

[8] Joskow, P. L., (2005), 'Regulation of Natural Monopolies', *Massachusetts Institute of Technology, Centre For Energy and Environmental Policy Research*, Working Paper 0508.

[9] Countries that have production, transmission, distribution, and optionally supply, under the same ownership are considered to have a vertically integrated system of energy or electricity.

[10] *The Law on Energy., (Law No. 03/L-184)*, The Republic of Kosovo [Online] [Accessed on 15/03/2015] Available at: http://www.kuvendikosoves.org/common/docs/ligjet/2010-184-eng.pdf.

[11] *Law on Electricity., (Law No. 03/L-201)*, The Republic of Kosovo [Online] [Accessed on 15/03/2015] Available at: http://www.kuvendikosoves.org/common/docs/ligjet/2010-201-eng.pdf.

[12] *The Law on the Energy Regulator., (Law No. 03/L-185),* The Republic of Kosovo [Online] [Accessed on 15/03/2015] Available at: http://www.kuvendikosoves.org/common/docs/ligjet/2010-185-eng.pdf.

[13] Energy Community Secretariat, (2014), 'Annual Implementation Report 2013/2014', [Online] Available at: www.energy-community.org.

2. Methodology

This paper will exclusively focus on the electricity sector. All the figures, statistics, tables, and comparative discussions, are based on empirical evidence from the electricity sectors of relevant case studies. For instance, the United Kingdom serves as an ideal type of a liberalised energy market, albeit it is not the only example. Montenegro, Serbia, and Albania are taken as comparative examples as they are Kosovo's immediate neighbours. Other relevant examples, including Germany, Poland, Estonia, Croatia, Lithuania, Romania, among others, are only discussed in relation to specific issues or as exemplary niche cases (e.g. Germany's industrial players and their role in specifying the importance of free market principles during the liberalisation of the energy market – essentially outlining the importance of key stakeholders in the process).

The aim is to explore and evaluate Kosovo's path towards a free electricity market. The objectives include an understanding of the contextual situation, domestic and regional, and previous implementation methods and their applicability in the case of Kosovo. Repeatedly, relevant questions directed the pace and depth of this study. These were:

1. What does liberalising the electricity market constitute?
2. How have other countries fared with the process?
3. Why have these efforts been a success for some and a failure for others?
4. What lessons can be learned from neighbouring countries?
5. To what extent has Kosovo's liberalising efforts been a success?

In this policy paper, INDEP has applied a largely qualitative method of inquiry, presented in a comparative perspective. Overall, the paper presents a juxtaposition of Kosovo's electricity market with that of the neighbouring countries as well as other countries beyond the region. In particular, Western nations are regarded as ideal guidelines, especially the United Kingdom and Germany, while neighbouring countries are considered as possible routes to a liberalised electricity market.

This comparison was based on a number of factors that are relevant to the process of electricity market liberalisation, namely, the pace and feasibility of such a process, and governance and infrastructural prerequisites. Beyond this, legislative frameworks and regulatory strengths are also discussed and contrasted.

In addition to analysing publicly available data gathered through primary and secondary sources, INDEP also conducted in-depth interviews[14], both in person and electronically, with relevant stakeholders and office holders in the energy sector[15]. These efforts resulted in a clearer understanding of the structural barriers surrounding the implementation of a free electricity market in Kosovo. We have also developed an info-graph that succinctly highlights the structure of the electricity market in Kosovo and outlines relevant information that may be of interest to the general population.

[14] Two interviews were conducted, one with a KOSTT Official and the other with a KEDS official.
[15] These included KEDS, KESCO, KOSTT, and KEK.

3. The Treaty: Facts, Theory, and Practice

Today, Kosovo is overly dependent on lignite-coal as a source of energy[16], and despite having an abundance of it, lignite-coal, especially the type found in Kosovo, represents one of the most polluting and least efficient sources of energy. While not tailored specifically to the case of Kosovo, the Energy Community Treaty seeks to alleviate this problem by not only diversifying electricity production[17] but also building a legislative framework, which unifies the region towards its goal of an integrated energy market.

On 25 October 2005, the Energy Community, with the aim of creating a Regional Electricity Market in South East Europe and eventual integration into the European Union (hereafter EU) Internal Electricity Market, was established. It represents a legal agreement between the EU and signatory states on issues surrounding energy, particularly the establishment of key institutions that support integration through regional legal alignment. The Treaty[18], signed in Athens, calls for the creation of an integrated legal framework amongst the regional signatories[19] with the goal eventually being a single regulatory space for trade in energy between the South East European partners and the EU.

European Community Treaty	Kosovo
To create a stable legal and market framework capable of attracting investment in order to ensure a stable and continuous energy supply	Partially Completed[20]
To create a single regulatory space for trade in network energy	Completed[21]
To enhance security of supply in this space and develop cross-border relations	Partially Completed[22]
To improve energy efficiency and the environmental situation related to network energy and develop renewable energy sources	Incomplete[23]
To develop network energy market competition	Incomplete[24]

Table 1. Treaty Commitments and their Achievement[25]

[16] Approximately 97.8% of energy production comes from Coal; 0.4% comes for Oil; and 1.8% from Hydropower. World Bank, (2014), 'World Development Indicators: Electricity Production, Sources, and Access', *Environment*, [Online] Available at: http://wdi.worldbank.org/table/3.7 [Accessed 27/02/2015]

[17] BBC Monitoring Europe, (2014), 'Estonia's Energy Monopoly Executive says firm's becoming International Player', *BBC Worldwide Monitoring.*

[18] Deitz, L., Stirton, L., and Wight, K., (2007), 'The Energy Community of South East Europe: Challenges of, and Obstacles to, Europeanisation', *CCP Working Paper 08-04*, pp. 1-20.

[19] Albanian, Bosnia and Herzegovina, Bulgaria, Croatia, Serbia, Montenegro, The Former Yugoslav Republic of Macedonia, Romania and UNMIK on behalf of Kosovo.

[20] The legislation has stalled at the theoretical stages, as these are not being implemented in practice. Precisely due to their precarious nature, investment has not been forthcoming.

[21] ERO represents this single regulatory space. Yet, there are questions being raised as to whether ERO is capable of overseeing this process with only three board members, 22 employees, and a budget of 665,415 euro.

[22] With regard to cross-border relations, there is progress being made, especially with Albania. However, in terms of security of supply, lack of efficiency and continuous network losses have meant that supply has not been secure or continuous.

[23] While there is a law on Environment as well as Energy Efficiency, these are inadequate and remain mostly theoretical.

[24] From the 1st of January 2015, customers in Kosovo were supposed to be eligible to switch their suppliers. Yet, not only has this not be possible and deemed not viable by ERO, due to the fact that there is only one supplier and no form of competition. Indeed, market liberalisation in Kosovo seems to be a reality only on paper and theory rather than in practice.

Specifically, the Treaty guidelines seek to develop and incentivise (as a possible stepping-stone towards EU accession)[26] signatories to promote and implement an integrated free energy market design, which allows for a competitive environment in the electricity and gas sector. Indeed, market liberalisation is foreseen to enhance supply security, improve the environmental situation, and create regional integration by absolving national market frontiers so that all citizens can benefit.[27]

To begin with, the purpose of the Treaty seems to be twofold. First, it seeks to promote regional integration through economic cooperation, a strategy reminiscent of the Coal and Steel Community that was the genesis of the European Union[28]. For Kosovo, regional integration – by promoting a free electricity market – may also serve the purpose of wider state recognition and possible reconciliation with old regional foes. Second, by cooperating with the Energy Community, Kosovo would signal to potential investors and international donor programs that it is pursuing, in coordination with its European partners, a variety of key political and economic reforms and is a suitable destination for foreign investment.[29]

The establishment of a free electricity market not only will create an impetus for diversification but may also have a "spill-over"[30] effect – due to coordination on technical issues – into other sectors of the economy. For instance, potential competition between supply and generation may create an impetus to train and equip employees with specific sets of skills that can later be used in other technical sectors. Likewise, a stable electricity market, particularly in terms of supply, invites industrial growth by creating a safe environment for outside investors. In the case of Kosovo, energy diversification is a prerequisite for a functioning economy, particularly as heavy industry and large consumers depend on a stable and secure supply of electricity.

In terms of benefits, the Treaty has played a major role in facilitating and aiding Bulgaria and Romania's EU accession.[31] And while according to the EU 2008 Energy Security and Solidarity Action Plan, its role is to "build the internal market and security of supply legislation for electricity and gas", it has become an essential springboard for countries aiming to join the EU[32]. Correspondingly, Kosovo should adhere to the guidelines and guidelines of this Treaty while duly noting economic and political feasibility. The former pertains to an evaluation of the type of market model and a strategy to move away from a single source of energy production. The latter considers know-how and previous experiences of free energy market implementation in the region and beyond. The implementation of Community guidelines should be contextually sensitive with an appropriate transition phase in place to absorb the changes in structure and legislative framework.

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[25] The Energy Community Treaty., (2006), *Council Decision 2006/500/EC*, [Online] [Accessed on 24/03/2015] Available at: http://eurlex.europa.eu/legalcontent/EN/TXT/?qid=1428414223439&uri=URISERV:l27074.

[26] Deitz, L., Stirton, L., and Wight, K., (2007) 'The Energy Community of South East Europe: Challenges of, and Obstacles to, Europeanisation', *CCP Working Paper 08-04*, pp. 1-20.

[27] CSIS-EKEM Policy Report., (2010), *Re-Linking the Western Balkans: The Energy Dimension*, pp. 1-9

[28] Deitz, L., Stirton, L., and Wight, K., (2007) 'The Energy Community of South East Europe: Challenges of, and Obstacles to, Europeanisation', *CCP Working Paper 08-04*, pp. 1-20.

[29] Ibid.

[30] A neofunctionalist term, a "spill-over" effect assumes that once integration happens in one sector it has the potential to affect other sectors. For example, reform in energy efficiency sector may stipulate reform in the building sector because of the intimacy between these two entities.

[31] CSIS-EKEM Policy Report., (2010), *Re-Linking the Western Balkans: The Energy Dimension*, pp. 1-9

[32] Ibid.

4. The Rocky Road towards a Free Electricity Market

Theoretically, a free electricity market should create a platform for fierce competition, provide the consumer with options from whom to buy and how to buy, guarantee that electricity is available at the best possible price[33], promote innovation, establish a reliable stream of electricity supply, and promote a cleaner environment[34]. Competition should incentivise market players to be more efficient, whether that is by being timely with decision-making or their choice in technology.[35] By being more efficient, electricity utilities decrease technical losses, which are than translated into lower electricity prices for end-consumers.[36]

A liberalised electricity market creates a mechanism for energy diversification, which in turn facilitates greater supply security. Based on a 2012 energy market evaluation, global electricity generation is still overwhelmingly based on coal (see Figure 1). More worryingly, however, is the fact that the Western Balkans[37] remains the only region in the European continent where coal still occupies a higher share of production than other sources of electricity generation.

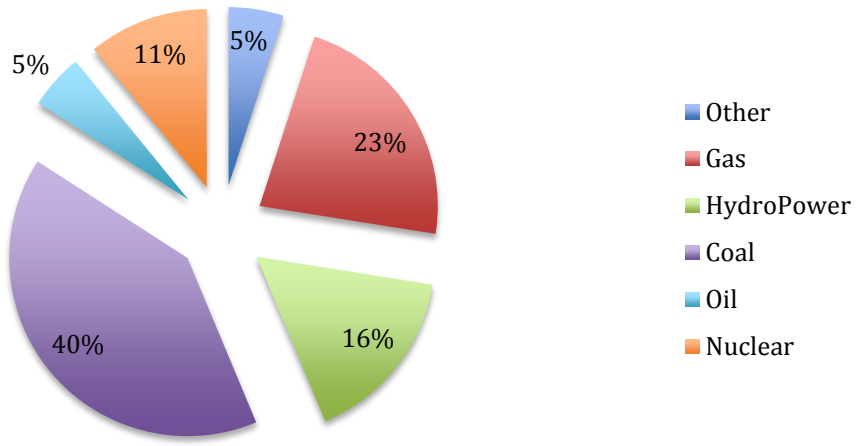

Fig 1. Global Electricity Generation by Energy Source, 2012

Source: Based on IEA data from Key World Energy Statistics, 2014

With that in mind, opening the electricity market to external investors has the potential to diversify Kosovo's production capabilities as well as provide an opportunity to create new supply routes connecting it with the region and beyond. Likewise, investment in

[33] BBC Monitoring Europe, (2014), 'Estonia's Energy Monopoly Executive says firm's becoming International Player', *BBC Worldwide Monitoring.*
[34] US Official News, (2014), 'Washington: Free Markets Supply Affordable Energy and a Clean Environment'.
[35] International Energy Agency., (2005), *Lessons From Liberalised Electricity Markets*, Energy Market Experience.
[36] Nonetheless, it should be noted that there are studies, which suggest that there are possible price hikes once a market opens to full competition, especially in the case where the prices have been subsidised by the state and do not reflect the real value of the commodity.
[37] Along with Bulgaria, Estonia, Poland, Czech Republic.

renewable sources of electricity generation, especially in an open market, could be stipulated through investment subsidies and tax deductions for potential investors. This, in turn, would allow Kosovo to move beyond its coal-dependency towards alternative means of electricity generation.

Practically, however, and especially in the case of underdeveloped countries, policy-makers largely underestimate the role and importance of the institutional and legislative framework required for a well-functioning free electricity market.[38] The issue is not exclusively sectorial, but rather involves a whole range of elements that are necessary, namely, the government and its institutions, professionals and experts, civil society, and outside investors, among others. The lack of a strong bureaucracy[39] and transparent governance inhibits an implementation process that is cognizant to the requirements[40] of a liberalised electricity market. Overwhelmingly, the problem found in Kosovo is a lack of know-how and the subsequently hastened privatisation process, which ensued without a clear understanding of the inherent domestic barriers.

Indeed, there is set of "hard" contextual barriers that constrain these underdeveloped countries, amongst them Kosovo, in their path towards a free electricity market. The physical situation, specifically the presence of indigenous electricity generating resources, or a dependence upon other countries for supply, represents the contours by which a country is bound to.[41] Likewise, market size and the degree of isolation also matter. Kosovo is landlocked and has a relatively poor population, especially in terms of purchasing power. This does not fare well with potential investors that expect return profits and larger margins of revenue for their lump sum investments.

Cultural elements and the history of a people's, albeit intangible at times, must not be ignored. They are the cementing factors that shape the delineations of institutions, most significantly, whether their role is that of a transmission-belt or a barrier towards a free electricity market. With regard to Kosovo, its lack of experience and crippling corruption represent barriers to the process of liberalisation, while its abundance of lignite coal and other potential sources of electricity generation as well as its geostrategic location are potentially a transmission-belt.

The Kosovo government should pay attention to the consequences associated with a hastened privatisation approach, where the process itself is a priority and not the establishment of a legal-institutional framework to support it.[42] A number of studies have highlighted how informal institutions – culture, values, and norms – may impede such a process and limit the development of formal institutions based on legitimately drafted legislation.[43] Russia is a case in point; competition authorities were impeded by a lack of

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[38] Deitz, L., Stirton, L., and Wight, K., (2007), 'The Energy Community of South East Europe: Challenges of, and Obstacles to, Europeanisation', *CCP Working Paper 08-04*, pp. 1-20.

[39] By this we mean impartiality and clear guidelines for procedures related to government and institutional business. A bureaucracy that is ridden by patrimonial tendencies represents a weak bureaucracy – in terms of transparency and accountability towards the population as a whole.

[40] These may vary from case to case. However, there are sets of "loose" requirements such as: good governance, accountability, timely implementation, technocratic expertise, strategic planning, evaluative and feasibility studies, infrastructure, etc.

[41] Sionshansi, P. F., (Ed.) (2008), *Competitive Electricity Markets: Design, Implementation, Performance*, Oxford: Elsevier.

[42] Ibid.

[43] Finon, D., (2003), *Introducing competition in French electricity supply industry: The destabilising of a public hierarchy in an open institutional environment*, Working Paper. Cambridge: the Cambridge-MIT Institute; North, D., (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge

clear regulations, independence, too-widely defined tasks, and an absence of a legal culture.[44] In this respect, one study astutely notes:

> Experts attribute this yawning gap between theory and practice to 'politics,' poor 'rule of law' and other 'weak institutions' that are needed to put the state on the sideline and to give the space for markets to operate… The lack of rigorous attention to these factors is particularly strange since political, legal, and institutional forces are hardly transient. Indeed, these factors appear to be the dominant ones in explaining the actual pace and character of market reforms in the electric power system in developing countries.[45]

Introducing competitiveness and efficiency to the electricity market in a climate of corruption and frequent misappropriation of funds, remains the largest challenge for Kosovo's government. Vertically integrated utilities[46] (hereafter VIU) are not easily disintegrated due to two reasons. First, because of the large windfalls gained from these public enterprises, coteries have been formed with a vested interest in maintaining the *status quo*. Second, and a corollary of the first, the liberalisation process signifies a shift from the *status quo* and thus a direct threat to the wherewithal of powerful groups. The result may be an impasse between key groups or a possible trade-off at the expense of the wider population.[47]

Retrospectively, the root cause of this problem is a legacy of centrally planned economic activity during the Yugoslav era. Of particular importance, then, is that the transition phase is as distinct as the Kosovar market economy itself, which necessitates a special and localized strategy and not an internationally imposed one.[48] The Energy Community guidelines are designed for nations with a higher overall quality of governance, and its implementation does not solely depend on sector-specific reform, or economic restructuring for that matter. To have a propitious chance of successfully implementing a free electricity market, a country must also improve its quality of governance.[49] In that sense, it is unreasonable for the Kosovo government to begin implementing a free electricity market without prior planning, clear guidelines, and a strategic evaluation of the domestic and regional electricity market.

Civil society organisations in Kosovo agree with the privatization process in principle, as they see it as the bedrock of economic development. In practice, however, there is an overall scepticism with regard to the privatisation process in Kosovo, particularly due to the lack of transparency and accountability of all the efforts so far.[50] KOSID[51], a civil

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University Press; Williamson, O. E., (1998), 'Transactions cost economics how it works; where it is headed', *De Economist*, Vol. 146, No. 1, pp. 23-58.

[44] Grusevaja, (2006), 'Do Institutions Matter? An Analysis of Russian competition policy in the period of transformation', *Universität Potsdam Working Paper No. 88,* 11th AISPE Conference.

[45] Victor, D. G., and Heller T.C., (2006), *The Political Economy of Power Sector: The Experiences of Five Major Developing Countries,* Cambridge: Cambridge University Press; Sionshansi, P. F., (Ed.) (2008), *Competitive Electricity Markets: Design, Implementation, Performance*, Oxford: Elsevier.

[46] Countries that have production, transmission, distribution, and optionally supply, under the same ownership are considered to have a vertically integrated system of energy or electricity.

[47] International Atomic Agency., (2005), *Lessons from Liberalised Electricity Markets*, Energy Market Experience.

[48] Fingleton, J., Fox, E., Neven, D., and Seabright, P., (1996), 'Competition Policy and the Transformation of Central Europe', *Centre for Economic Policy Research*.

[49] World Bank, (2006), *Governance Matters: A Decade of Measuring the Quality of Governance*, Washington DC: The World Bank.

[50] Sinani, N., and Demi, A., (2011), 'Energy Projects in Kosovo', *INDEP, FIQ, and GAP Institute*

[51] The members of KOSID are: Institute for Development Policy (INDEP), GAP Institute, Group for Legal and Political Studies (GLPS), Balkan Investigative Reporting Network (BIRN), Association of Pulmonologists of Kosovo, DokuFest, Forum for Civic Initiative (FIQ), IAZHL, Internews Kosova.

society consortium for sustainable development, finds that even after nine years of privatisation there is no example of a success story, a worrying result that directly challenges the prospect of a free electricity market implementation in Kosovo.[52] Congruently, intransigent incumbent utilities are partly to blame for the slow and haphazard pace of privatisation. The government's failure to effectively unbundle previously publicly owned utilities, in particular the distribution operator from the supplier[53], is an important barrier to development as well as the process of free electricity market implementation.[54]

All in all, over-dependence on a single source of electricity production, a low quality of governance, a fragile institutional structure, a facile legislative framework, coupled with several other electricity challenges such as severe lack of efficiency, and a lack of interconnectors with the wider region, serve as reminders of the precarious nature of Kosovo's electricity market. Nonetheless, the Kosovar government can learn from the region on how to strategise and implement effective and functional reform. The question that ought to be answered is: How have other countries faired with a free electricity market? What were the implementation procedures and the contextual factors? The past experiences of countries may serve as guidance for underdeveloped countries in their pursuit for electricity market liberalization. In particular, by juxtaposing implementation methods, lessons learned from reports, and development curves from several countries in Europe, a liberalised electricity market in Kosovo might become plausible. Thus, to overcome the barriers discussed above – coal dependency, infrastructural problems, lack of political commitments, corruption, institutional inadequacy – Kosovo needs to look to its European neighbours and their implementation methods.

Below is a table with a summary of prevalent limitations found in all countries discussed in this policy paper:

	Factors	Impact
Institutional	*Informal Institutions*	Depending on culture, values, traditions, and norms, a country may be receptive to a competitively driven electricity market or, on the contrary, towards a state-centred electricity market design. Kosovo's institutional clientelism and weak bureaucracy may impede the liberalisation process as it may threaten rent-seekers and their grip on key utility services. Unresponsive politicians, a lack of professional technocrats to spearhead the process, and rampant corruption all continue to dissolve the positive potentials of a free electricity market.
	Institutional Stability and Rule of Law	A strong governance structure creates a platform for investment and external funding. A lack of institutional stability represents volatile investment opportunity and greater risks for stakeholders. In Kosovo, the rule of law is based on facile principles and enforcement methods. Institutions are not stable and are subject to ideological swings and complete politicisation. Partisanship rests above

[52] Sinani, N., and Demi, A., (2011), 'Energy Projects in Kosovo', *INDEP, FIQ, and GAP Institute*

[53] At the moment, distribution and supply are legally unbundled in Kosovo, however, this form of unbundling does not sufficiently curtail discrimination and favorable terms between the two legally unbundled entities, especially when these are for-profit organisations and have remained under the same ownership. The quintessential example of this is the fact that if one visits KEDS's and/or KESCO's website, he/she will find that the contact number is the same for both entities.

[54] International Energy Agency., (2005), *Lessons from Liberalised Electricity Markets*, Energy Market Experience.

		legislative and institutional legitimacy. ERO is a case in point, where since 2013 there have been only three board members, with two seats remaining unfilled due to the parliament's inability and the government's incapacity to bring forward two additional names.
	Influence of Stakeholders	The power of stakeholders to guide the government's decision-making is a double-edged sword. On the one hand, if these stakeholders are receptive to the idea of a free electricity market, they create pressure and may facilitate its implementation. If, on the other hand, these are rent-seeking stakeholders that do not intend to change the *status quo*, they become barriers to the implementation process. A prerequisite to institutional instability and informal clientialism is the influence of rent-seeking stakeholders. As such, Kosovo suffers from a large number of political and economic elites that are preoccupied with self-empowerment but not the simultaneous development of the nation in general. Anything that impairs their prosperity is perceived as a direct threat.
Economical	*Level of Development*	Signifies the potential for development, the degree of institutional stability, and the rate of demand growth. Kosovo's development has been largely a result of foreign aid instead of sound fiscal policy. It remains the country with the highest unemployment rate in the region and the least skilled population as well.
	Feasibility	Represents the confines of developing or transition countries; with weaker institutions and economic planning financing options may be confined. To date, there has not been any feasibility study in Kosovo pertaining to the opening of the electricity market. There have been no evaluations with regard to the issues or barriers surrounding this process.
Physical	*Natural Endowment with Energy Sources*	Presence or absence of a natural resource for electricity production guides the technical and economic characteristics of the sector; it also influences policy choices and market design. While Kosovo's lignite coal rich territory represents an opportunity to supply its population with electricity without depending on outside imports, it should not serve as a reason to not diversify its sources of electricity production. Indeed, the revenue not spent on imported energy should be allocated to subsidising the development of renewable sources of energy.
	Size of the Market	Larger markets are capable of accommodating a larger number of competitors while smaller markets are likelier to be more concentrated. Presently, there is only a single supplier in Kosovo's electricity market. It is effectively the supply arm of the distribution operator KEDS, which unambiguously represents a potential to discriminate against new entrants in the electricity market. There are around 470 thousand non-eligible household customers that were supposed to be able to switch suppliers by the 1st of January 2015 yet no supplier to switch to, nor a standardised procedure that outlines exactly how this is done. The small size of Kosovo's electricity market should not act as an excuse to allow only a single supplier of electricity to end-consumers.
	Geographic Isolation	May result in network congestion, limited competition, and market fragmentation.

	Kosovo is landlocked and has a relatively poor population, especially in terms of purchasing power. This does not fare well with potential investors that expect return profits and larger margins of revenue for their lump sum investments.

Table 2. Summary of Limitations[55]

4.1 Past Experiences in Europe

This section of the paper discusses a specific number of issues faced by European countries in their effort to implement a liberalised electricity market. Specifically, we discuss the relationship between distribution and supply in depth by taking the example of the United Kingdom and to a lesser extent Germany. Additionally, the role of the regulatory body is briefly discussed in relation to its market role as not only an overseer but also a competition driver; the example of Ofgem elucidates this point. Subsequently, the role of regulation itself is analysed, with specific attention paid to a regulated tariff and the suggested implications that follow.

We analysed five countries (Poland, Lithuania, Romania, Germany, and Estonia) and their domestic electricity markets. Specifically, we focused on customer switching rates, generation market share, and a number of electricity retailers, as potential measures of a "successful" liberalised electricity market. Furthermore, this was further extended to include six other countries (Belgium, Greece, Bulgaria, Denmark, Latvia, United Kingdom) in a more comprehensive table showing the structure of regulated prices as well as the regulatory authority of the selected countries, among other things.

It should be noted, however, that past experiences only highlight successive routes and how to avoid errors in the process of implementation and possible structural amendments to the legislative and institutional framework. They are not rigid guidelines/directives that are a prerequisite for a given country to have a functioning free electricity market.

4.1.1 Issues related to Distribution and Supply

Britain is regarded as the pioneer of free electricity market implementation. It is for this reason that we use the British case as an ideal-type for this sub-section. Under Margaret Thatcher's leadership, the government implemented the 1983 Energy Act that dissolved the monopoly on supply, until then the exclusive duty of Area Boards. Subsequently, private generators or suppliers could sell electricity and use the transmission and distribution system[56] without discrimination from the Area Boards.

It took seven years before the introduction of competition in the electricity market was deemed viable.[57] What's more, it took another nine years for the electricity market to be

[55] Partially adopted from Sionshansi, P. F., (Ed.) (2008), *Competitive Electricity Markets: Design, Implementation, Performance*, Oxford: Elsevier.
[56] Pond, R., (2006), 'Liberalisation, Privatisation and Regulation in the UK Electricity Sector', *Working Lives Research Institute*, London Metropolitan University.
[57] The 1986 Gas Act and the 1989 Electricity Act were the necessary legislative pillars in order for the UK to implement a free energy market across its territory. The government at the time prioritized legislation over hasty implementation.

opened to domestic and international competition. The process was divided into three tranches implemented between 1990 and 1999.[58]

Tranche 1	Tranche 2	Tranche 3
5,000 Large Customers	50,000 Medium Customers	26 Million Customers
Maximum demand of 1 MW and above	Maximum demand of 100 kW – 1 MW	Annual consumption of 12,000 kWh
Opened in April 1990	Opened in April 1994	Opened in September 1998 and May 1999

Table 3. UK Electricity Competition Phases[59]

Britain's institutional capacity, technocratic expertise, and technical know-how, regulated by an authoritative legislative framework, supported and made possible the introduction of a free electricity market. The engineers of the process acknowledged that transmission and distribution were natural monopolies while generation and supply had a potentially competitive function.[60] It became clear that a company that has distribution capacity while simultaneously performing the function of a supplier, effectively a competitor in the end-user market, might become potentially biased and discriminate against newcomers. Consequently, consumers may associate risks and difficulty when switching their electricity supplier. It can do this by setting unnecessary technical requirements (e.g. related to metering), cross subsidisation, procedural and implementation delays, all of which enfeeble the prospects of a competitive end-user supply market.[61]

OECD and IEA conducted an investigation into competition in liberalised electricity markets and found that incumbent suppliers, especially the ones supported by their distributive arm, have a significant competitive advantage over independent entrants. This is because from the onset they benefit from horizontal market power, an established reputation, and recognition "attached to the name and logo of the parent utility".[62]

Before 1997, companies could own generation, supply, and distribution capabilities at once in any given region in the UK. However, in 1997, The Office of Gas and Electricity Markets (hereafter Ofgem), after becoming aware that companies were using their effective regional monopolies to subsidise their activities, decided that these companies could not operate both distribution and supply in a single region, albeit they could still own both operations separately.[63] Ofgem recognised the consequential distortions – ranging from discriminatory access charges to "strategic" investments – that followed from grid monopolists also owning supply in the same region.[64] The authoritative and independent role of Ofgem in protecting consumers and regulating competition in the UK energy market[65], underscores a key point, namely, that for a free electricity market to function there has to be a clearly defined and operationalized regulatory body with sufficient capacity, both in manpower and funds, to oversee the activities of the domestic

[58] OECD., (2003), *The Power to Choose: Demand Response in Liberalised Electricity Markets,* Energy Market Reform, Paris, France: International Energy Agency.
[59] Ibid.
[60] Key Note., (2010), 'Energy Industry', *Market Review*, 8th Edition.
[61] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.
[62] Ibid: pp. 77.
[63] Pond, R., (2006), 'Liberalisation, Privatisation and Regulation in the UK Electricity Sector', *Working Lives Research Institute*, London Metropolitan University.
[64] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.
[65] Key Note., (2010), 'Energy Industry', *Market Review*, 8th Edition.

market.[66] A well-functioning competitive electricity market necessitates a strong regulator that supports competition, monitors the market, and dismantles emerging (or already emerged) cartels.[67]

Subsequently, within two years, around 11 million (38% of customers) had switched supplier at least once, highlighting a healthy competitive platform in the UK electricity market.[68] Furthermore, between 1998 and 2005 domestic consumers and industrial and commercial users saw prices fall by 17% and 30%, respectively. [69] Britain's implementation method highlights the importance of a reasonable transition phase coupled with a clear legislative framework. Germany's large industrial segments also repeatedly set forth a clear transition phase as a prerequisite for a liberalised electricity market. Indeed, a collection of large industrial stakeholders maintained that the privatisation process could only be tolerated if is based on free market principles, namely, transparent, competitively driven, and a lack of government intervention. The example of Germany reinforces this assertion and adds to it that the principles of free-market economy should not be tampered with.[70]

This, however, should not be misconstrued to mean a lack of government intervention – in terms of monitoring and regulation – when necessity calls for it but rather a move away from a centrally focused economy into the hands of private enterprises. For instance, Germany's distribution system operators are still legally allowed to obtain a supply arm within their respective region, but only in the case where they have below 100,000 customers.

4.1.2 Regulated Retail Tariffs

Interestingly, lessons derived from deregulated electricity markets highlight that regulated retail tariffs discourages customer switching. According to OECD and IEA, regulating the retail price is an imperfect substitute for competition "in providing incentives for efficiency"[71]. Figure 2. outlines the number of countries with and without regulated electricity prices:

[66] The European Commission., (2014), *EU Energy Markets in 2014*, Publication Office of the European Union: Luxembourg [Online] Available at: www.europa.eu [Accessed on 24/02/2015]
[67] Sioshansi, F. and Pfaffenberger, W. (2006). Electricity Market Reform: An International Perspective. Elsevier. (2)
[68] OECD., (2003), *The Power to Choose: Demand Response in Liberalised Electricity Markets,* Energy Market Reform, Paris, France: International Energy Agency.
[69] Pond, R., (2006), 'Liberalisation, Privatisation and Regulation in the UK Electricity Sector', *Working Lives Research Institute*, London Metropolitan University.
[70] Kemezis, P., (1997), 'Germany Deregulation: Will it spark – or fizzle – the European Union's free market?', *Electrical World International*, Vol. 211, No. 1, pp. 24.
[71] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.

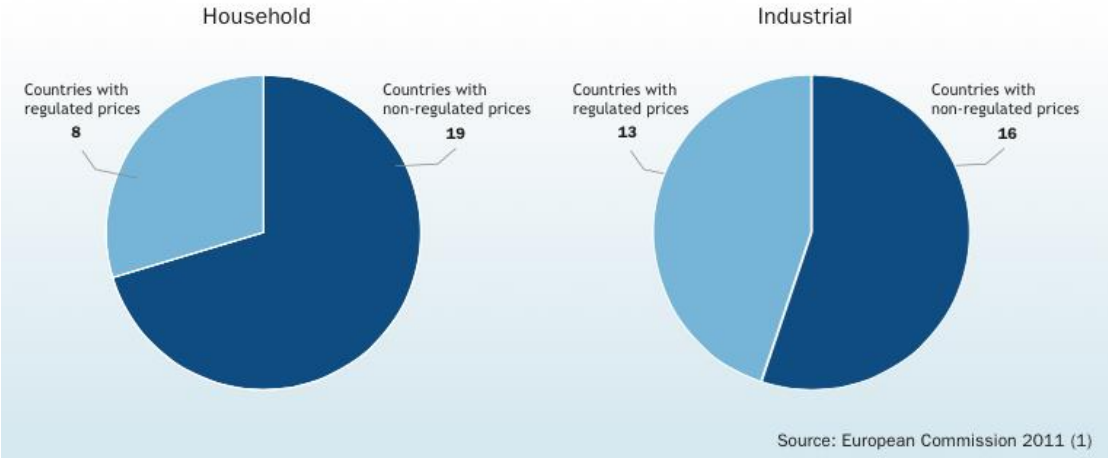


Fig 2. Number of Countries with Regulated Electricity Prices (2009) EU-27

Yet, there are worrying results from previous cases, referring specifically to Ontario, when deregulation resulted in retail market prices rising 30% in the first months.[72] Due to customer pressure, a consequence of their deep aversion to price volatility, Ontario, United States, cancelled its liberalisation process and began re-regulating retail electricity prices.

There are also concerns that consumers are simply reluctant to undertake the necessary and continual monitoring and control of their electricity usage, something that is advisable once electricity prices are based on market forces rather than government regulated prices. While efforts to deregulate tariffs should be a priority, it is necessary that the Kosovo government conducts a feasibility study and evaluates the impact this would have on electricity prices – known to be volatile.

Table 4. outlines key information for ten EU countries, and Kosovo, and their domestic electricity markets, including price regulation:

[72] Sioshansi, F. and Pfaffenberger, W. (2006). Electricity Market Reform: An International Perspective. Elsevier.

	National Regulatory Authority	Number of Companies representing at least 95% of net power generation	Number of Main Power Generation Companies	Market Share of the largest Power-Generation Company	Number of Electricity Retailers	Number of Main Electricity Retailers	Regulated House and Non-Household
Belgium	CREG[73]	46	2	65.9%	33	4	No (Both)
Greece	RAE[74]	3	1	65.5%	11	1	No (Both)
Estonia	ECA[75]	6	1	87%	>1000	42	Yes (Both)
Bulgaria	SWERC[76]	20	5	N/A	24	8	Yes (Both)
Denmark	DERA[77]	1300	2	37%	55	3	Partly (Both)
Germany	BNetzA[78]	>450	4	N/A	>1000	4	No (Both)
Latvia	PUC[79]	17	1	89%	6	2	Yes (Households) No (Non-Households)
Poland	URE[80]	32	2	39.3%	82	5	Yes (Households) No (Non-Households)
Romania	ANRE[81]	11	5	26.7%	54	5	Yes (Households) No (Non-Households)
UK	Ofgem[82]	17	7	25%	32	6	No (Both)
Kosovo	ERO[83]	1	1	98%	1	1	Yes (Both)

Table 4. Domestic Electricity Markets

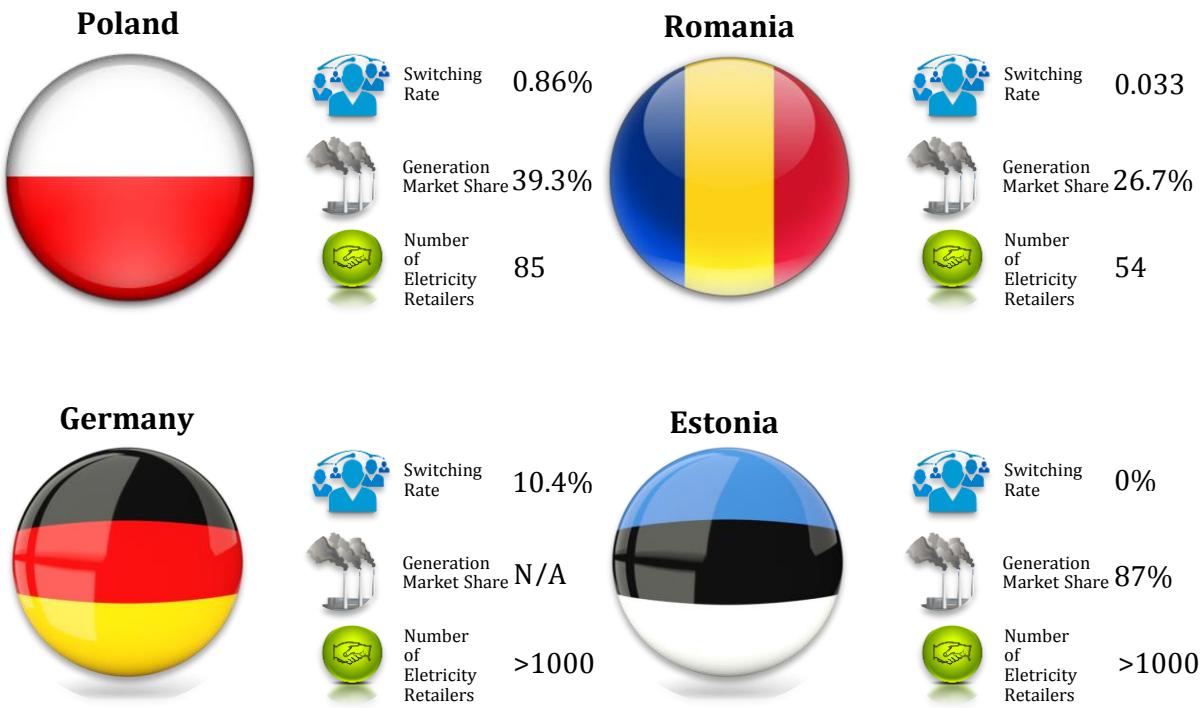
Source: European Commission Publication *EU Energy Markets in 2014*

[73] Employs 64 individuals and has an annual budget of EUR 14, 952, 254.
[74] Employs 7 individuals and has an annual budget of EUR 7, 300, 000.
[75] Employs 61 individuals and has an annual budget of EUR 1, 830, 000.
[76] Employs 128 individuals and has an annual budget of EUR 1, 860, 000.
[77] Employs 50 individuals and has an annual budget of EUR 5, 560, 000.
[78] Employs 2324 individuals and has an annual budget of EUR 181, 200, 000.
[79] Employs 120 individuals and has an annual budget of EUR 4, 700, 000.
[80] Employs 300 individuals and has an annual budget of EUR 23, 800, 000.
[81] Employs 300 individuals and has an annual budget of EUR 15, 800, 000.
[82] Employs 729 individuals and has an annual budget of EUR N/A.
[83] Employs 22 individuals and has an annual budget of EUR 665, 415.

From the figures above, it is clear that some states have emerged as more competitive than others. In particular, Estonia is a good example of supply but a bad one for production. This may be due to the legislative conditions put on transmission and distribution operators – similar to Germany's case – that have acquired 100,000 customers and beyond to not procure a capacity to sell or produce electricity.[84] Consequently, this puts an unnecessary limitation on the free-market principle and may create counter-incentives for production. Nonetheless, capping distribution and transmission operators serves the wider purpose of limiting their monopoly to their respective spheres of influence, which explains the large number of suppliers in Estonia.

In a similar fashion, but not included in the table, Croatia represents an example of an inadequate supply platform; with only ten licensed supply companies and Hep-Ops – one of the suppliers – in possession of 95% of the market share.[85] Likewise, the Polish electricity market suffers from apathetic consumers, partially due to long formal procedures related to changing ones electricity provider, and a lack of competition among electricity producers; the domestic market is controlled by four state-controlled holdings.[86]

What is also apparent is the correlation between regulated household prices and retail consumer switching (shown in fig. 3 below) in a number of countries.



[84] Republic of Estonia, (2003) Electricity Market Act [Online] Available at: http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=X60045K10&keel=en&pg=1&ptyyp=RT&tyyp=X&query=elektrituruseadus [Accessed 07/03/2015]
[85] CSIS-EKEM Policy Report., (2010), *Re-Linking the Western Balkans: The Energy Dimension*, pp. 1-9.
[86] Polska Grupa Energetyczna; Tauran Polska Energia; Enea; and Energa. Polish News Bulletin, (2007), 'Energy Industry Faces New Challenges and Threats', *Economic Review.*

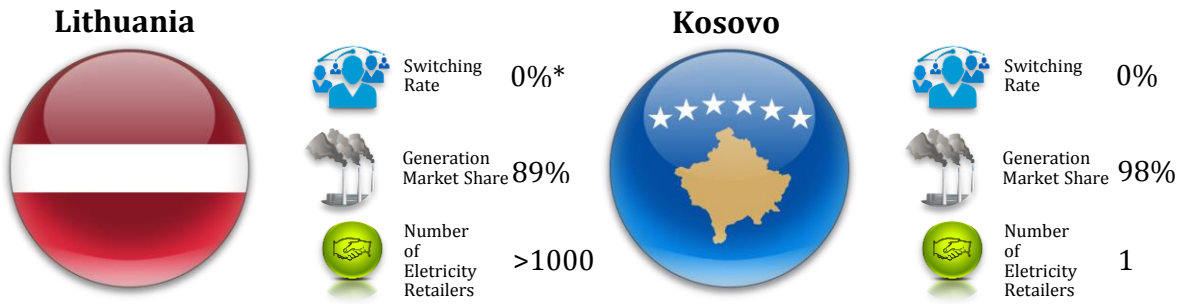


Fig 3. Electricity Market Information

*This applies to households. The figure for non-households is 15%.

There is no clear correlation, however, between lower generation market share and higher switching rates. Similarly, a higher number of electricity retailers also do not lead to higher switching rates. These findings may suggest that it is also a matter of regulated prices, governance capability, infrastructure, and, most significantly, a legitimate legislative framework that is contextually sensitive and feasible. Kosovo needs to promote a liberalisation process that is suited to its capabilities and surroundings. It must take into consideration the fact that it took the United Kingdom almost two decades and several market restructures later for it to functionalise the energy market it has today. More importantly, it must acknowledge the unambiguous differences in technocratic ability between it and the UK, meaning that if it took the former two decades, it will take the latter much longer.

The extent to which the UK in particular, and Western Europe in general, are comparable to Kosovo's case with regard to a free electricity market implementation is limited for two reasons. First, Kosovo lacks the institutional structure and legitimate technocracy to implement such reforms at the same pace and scale. Second, the contextual factors are significantly different, ranging from governance to the scale of corruption. The UK model may serve as an ideal type of free electricity market implementation, but not as a necessarily rigid route towards it. Today, Kosovo's energy legislative framework and institutional structure is a mimicked version of its more developed, wealthy, and capable, West European neighbours. While following guidelines is important, one cannot do it if the necessary tools and skills are not present. Thus, nations such as Montenegro, Serbia, and Albania, on the other hand, and their path towards a free electricity market are likelier candidates to serve as realistic and practical comparisons, if not guidelines, for the case of Kosovo.

5. Comparison with Immediate Neighbours

There is a common struggle amongst Kosovo's neighbours to reach an optimal wholesale and retail electricity market. Of particular importance to these states is stimulating competition between the potentially competitive segments of the market (generation, supply) while firmly regulating the natural monopolies (transmission, distribution). The issue is how to unbundle the four segments of the electricity market. We compare the unbundling structures of Albania, Montenegro, Serbia, and Kosovo, in order to illuminate possible problems associated with the different types of unbundling regimes.

Figure 4 represents a comparative perspective on the above-mentioned electricity markets:

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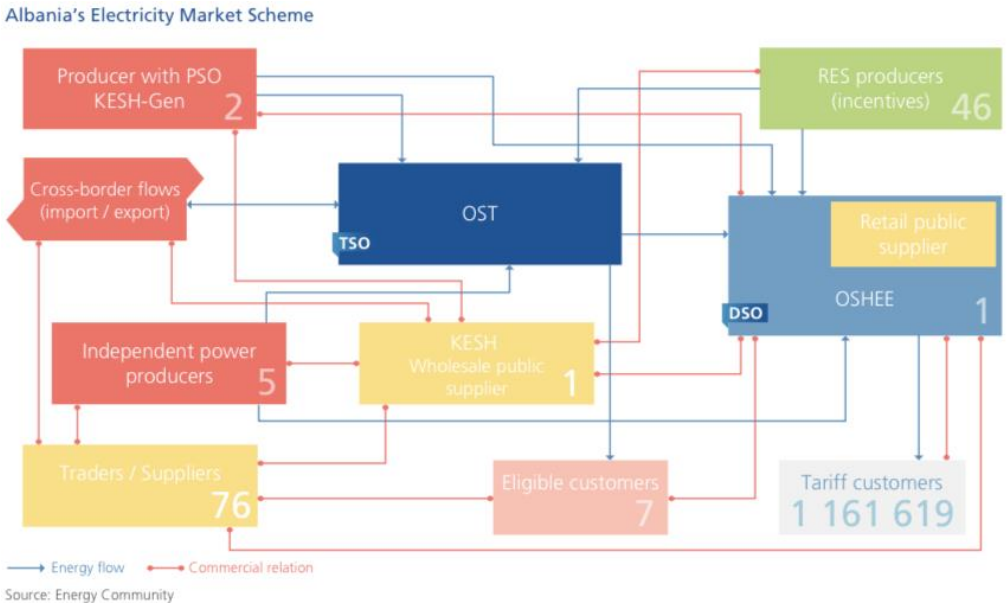

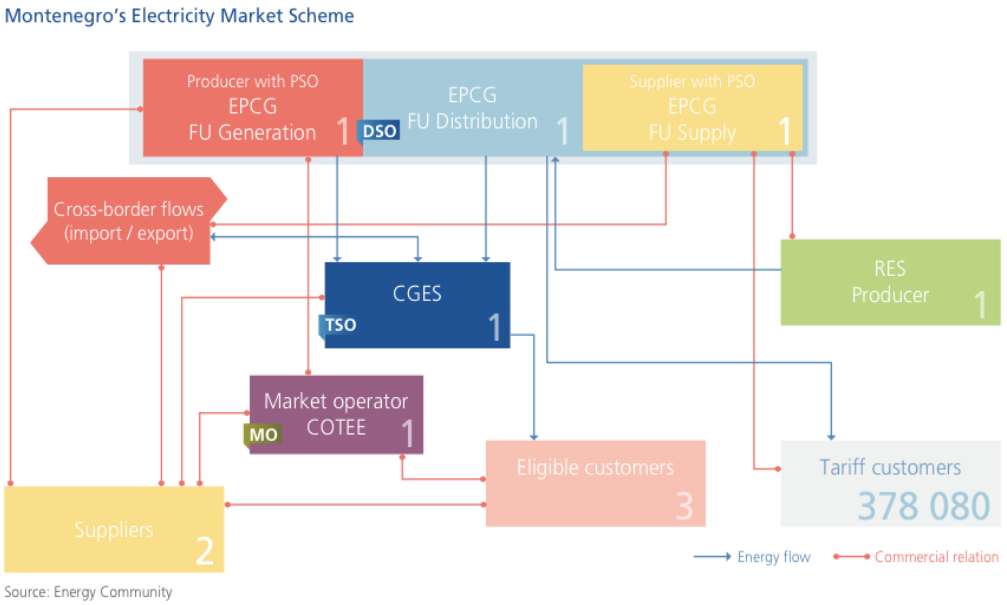

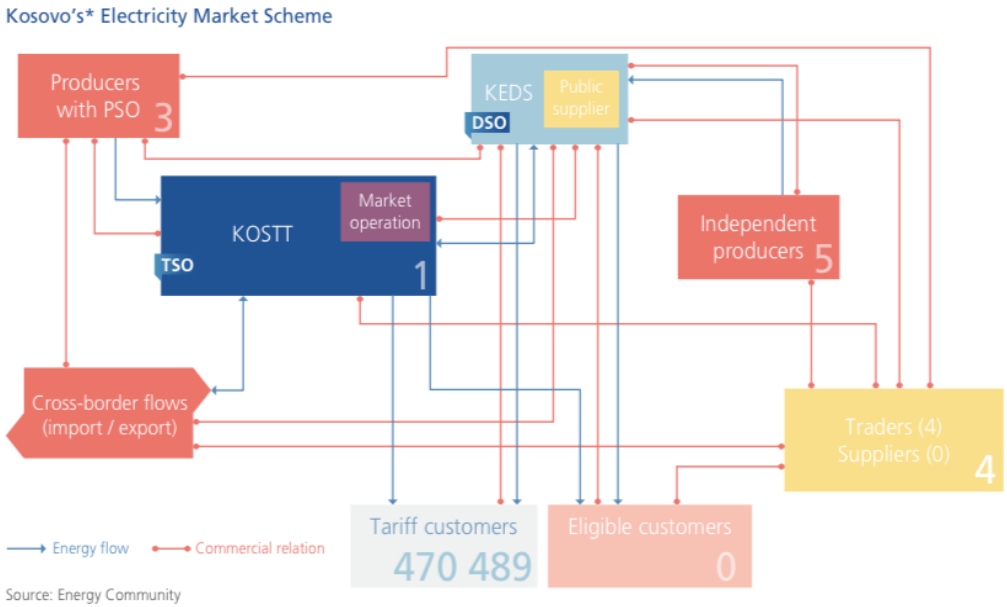

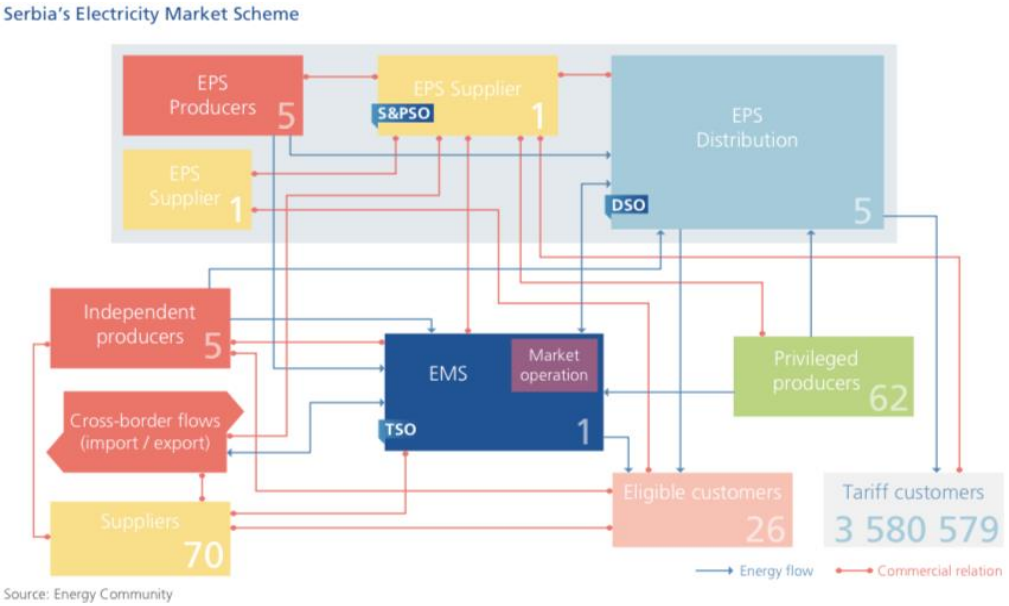

Fig 4. Comparison of Electricity Market Structures

Albania's wholesale market is monopolised by the incumbent state-owned generation company Albanian Power Corporation (*Korporata Elektroenergjitike Shqiptare* - KESh). It also serves as a "wholesale public supplier" as well as being the supplier of last resort. With regard to distribution system operator and retail supply, the Electricity Supply Operator (*Operatori i Shperndarjes se Energjise Elektrike* - OSHEE) dominates the market[87].

The Montenegro electricity sector is dominated by the vertically integrated utility *Elektroprivreda Crne Gore* (EPCG), which performs generation, distribution, and supply. It is to be noted, however, that apart from the state (55% of the shares), the Italian *A2A* Company owns 43.7% of the shares. In a similar fashion, the transmission system operator, Montenegrin Electrical Transmission System (*Crnogorski Elektroprenosni Sistem* - CGES), is owned partially by the state (55% of the shares) and the Italian *TERNA* firm (around 22% of the shares), among other investment funds.[88]

Similar to Montenegro, the electricity sector in Serbia is characterised by a vertically integrated undertaking *Elektroprivreda Srbije* (EPS). The public enterprise is responsible for generating, distributing, and supplying electricity. Transmission system operator, *Elektromreza Srbije* (EMS) is legally unbundled from EPS. Yet, both EMS and EPS are fully owned by the Serbian state and under the control of the Ministry of Economy.[89]

Similar patterns are apparent between the four market structures. First and foremost, all the above markets are based on regulated tariffs for retail customers. And while this may be necessary at the inchoate stages of market liberalisation, it represents an imperfect substitute for competition in the long term. Additionally, Kosovo and Serbia are characterised by a transmission system operator that also functions as a market operator. Albania and Kosovo have a distribution system operator that is also involved in supplying electricity to end-users. They differ however, on the fact that the distribution and supply in Kosovo are legally unbundled while in Albania it is not.

Serbia and Montenegro are still characterised by vertically integrated public enterprises that maintain a monopoly over the electricity market. This constitutes a breach of the European Union Directive that requires an unbundling of vertically integrated utilities and a feasible re-structuring of the electricity market to one that promotes competition, transparency, and accountability.

While Montenegro, Serbia, and Albania have eligible customers that may switch their supplier, respectively 3, 26, and 7, Kosovo is the only country where this eligibility remains theoretical.[90] Why is Kosovo still at the theoretical stage of implementation? Is there competition in Kosovo's electricity market? To understand further the underlying reason(s) and answer the above questions, it is important to investigate the relationship between generation, transmission, distribution, and supply. Figure 4 outlines the process of unbundling in each of the four electricity markets:

[87] Energy Community Secretariat, (2014), 'Annual Implementation Report 2013/2014', [Online] Available at: www.energy-community.org
[88] Ibid.
[89] Ibid.
[90] ibid.

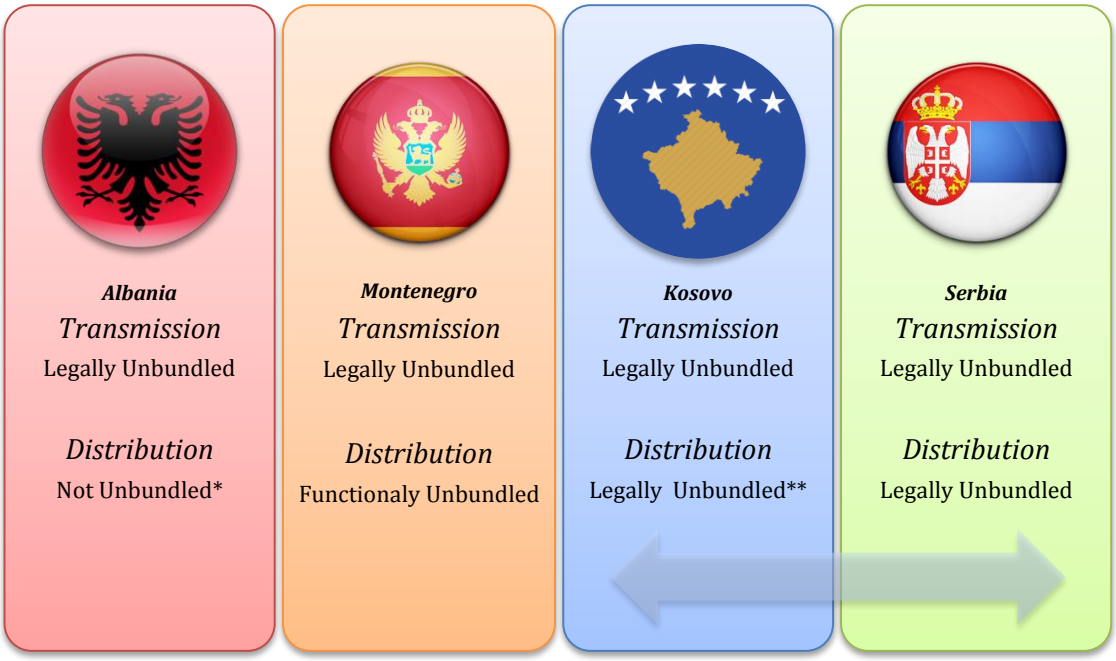

Fig 5. Comparison of Unbundling Regimes

* Distribution is not unbundled from supply legally, functionally, or in terms of ownership.
**This has been only a preparatory undertaking as both distribution and supply remain activities performed by a single company but split into two internal division.[91]

The European Union Directives permit signatory states to choose, based on an evaluation of feasibility and context, albeit also political climate, between legal (incomplete - ITO) and ownership (complete - OU) unbundling. There is also managerial unbundling (ISO), however this has limited application in relation to Kosovo's case.

It is for this reason that Albania, Montenegro, Serbia, and Kosovo, can have divergent unbundling regimes. Indeed, as table 5 highlights, this is also apparent in the EU. It is to be noted, however, that the table features randomly selected EU countries and serves the purpose of merely representing the divergent unbundling features of EU members.

Why Unbundle?

Empirical studies have found that incumbent utilities, also referred to as Vertically Integrated Utilities (hereafter VIUs), have, at times, increased profitability – at the expense of the welfare of the wider population – by curbing competition. They were able to do so by owning generation and transmission and/or distribution. Accordingly, EU law now requires that nations unbundle (separate) these features.

Types of Unbundling

- *Ownership Unbundling (OU):* complete separation between the operation of the transmission networks from supply and generation activities.

- *Independent System Operator (ISO):* requires the integrated transmission and supply companies to managerially separate and comply with additional rules in order to ensure that the two activities are operated-independently.

- *Independent Transmission Operator (ITO):* involves the legal separation but not ownership of vertically integrated companies. As such ISO unbundling maintains that the company cannot hold any interest in a supply or generation undertaking.

[91] Sionshansi, P. F., (Ed.) (2008), *Competitive Electricity Markets: Design, Implementation, Performance*, Oxford: Elsevier.

	Transmission	Distribution
Estonia	Ownership	Exempt
Austria	Legal/Ownership	Legal
Poland	Ownership	Legal
United Kingdom	Ownership	Ownership

Table 5. Divergent Unbundling Regimes in Europe

Source: Haas et al. (2006)[92]; EFTA (2007)[93]; Mostly adopted from European Commission (2014)[94]

The choice of unbundling resonates with the market design as well as the market structure. Similarly, how a country unbundles its vertically integrated utility also determines the degree of competition and the key players in the electricity market. Essentially, the main objective of unbundling is to curb discriminatory behaviour in the market. Thus, some degree of separation between generation and transmission, transmission and distribution, and distribution with end-user supply, is necessary.[95] And while there is ownership separation between transmission and distribution in Kosovo, there is only legal unbundling, albeit weak, between distribution and supply. This presents, as mentioned beforehand, the possibility for the distribution operator to discriminate against potential new entrants to the market by using its monopoly to favour its supply arm.

5.1 Kosovo's Electricity Market: Limitations and Progress

Kosovo's electricity sector is – in legislative terms – possibly the closest to a harmonisation with the European Union Directives regarding the liberalisation of the electricity market. It has also made great progress by preliminarily solving its energy problem in the North. Despite this, there remain a number of barriers that put its implementation of a free electricity market on precarious grounds.

5.1.1 Kosovo-Serbia Energy Agreement

The agreement[96] reached on September 8, 2013 between the governments of Kosovo and Serbia, backed and guaranteed by the European Community, in a sense was a step forward for both nations in their pursuit of a free energy market. It made the issue of opening up the market much easier and less contentious between Kosovo's transmission system operator KOSTT and Serbia's utility service EMS. Indeed, Article 4 of the agreement underlines a commitment by both parties towards the implementation of the European Community Treaty with regard to liberalisation of the energy market, while also supporting the creation of a new electricity company in the region. The new company would be established under the contours of Kosovo's legal and regulatory framework. Article 5 of the Agreement outlines the general provisions applicable to the new electricity company. It highlights that the electricity company would be eligible to

[92] Haas, R., Glachant, J. M., Keseric, N., and Perez, Y., (2006), 'Competition in the Continental European Electricity Market: Despair of Work in Progress?', In *Electricity Market Reform: An International Perspective*, Sioshansi, F., and Pfaffenberger, W., (Eds.), Elsevier.

[93] EFTA (European Free Trade Association)(2007), *Energy Sector Inquiry: Concluding Report*, EFTA Surveillance Authority, 10th of January.

[94] European Commission, (2014), 'Single Market Progress Report', [Online] Available at: http://ec.europa.eu/energy/en/topics/markets-and-consumers/single-market-progress-report.

[95] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.

[96] Arrangements Regarding Energy, Office of the Prime Minister, (2013), [Online] Available at: http://www.kryeministri-ks.net/repository/docs/Arrangements_regarding_Energy_September_8_2013.pdf

perform distribution as well as supply services to all customers in the four northern Serb majority municipalities, by which it would have to sign agreements with KOSTT as well as, according to Article 5.1, enter into discussions with KEDS and KOSTT on any other issues of mutual interest.

This agreement signifies a clear step forward in the right direction. With the establishment of a new electricity company there would be a new entrant into the energy market, which would compete with the incumbent utility services and may slowly promote an environment of competition. It would also possibly entrench an entry format for new electricity companies that may come forward in the future. Indeed, if this venture is successful, specifically, if the new entrant to the market manages to carve out the market share of the already established utility companies, outside financiers may find themselves inclined to invest and create an electricity portfolio in Kosovo's energy market. Similarly, such an agreement between Serbia and Kosovo highlights their commitment towards a stable relation with regard to energy, if not other pending issues, which in turn also signals to external investors a safe environment to invest and not one riddled by disputes and uncertainty. Nonetheless, and while this still remains on paper, there are four prevalent issues that have to be addressed with regard to Kosovo's electricity market.

5.1.2 Corrupt Implementation

In practice, and as shown in figure 4 (page. 21), the transmission system operator, *KOSTT*, is fully unbundled in accordance with the directives of the *acquis,* also confirmed by a *KOSTT* procurement employee.[97] In a similar fashion, but to a lesser extent, the distribution system operator has also been legally unbundled from end-user supply, which has also been confirmed by the CEO of *KEDS* – Mr George Karagutoff.[98] While there is still a long road ahead, it is clear that Kosovo has begun deconstructing, with partial success, its past vertically integrated utility.

However, legal unbundling has meant that the transmission system and generation remain under the ownership of the Kosovar government, while the distribution system and end-user supply are both owned by the Turkish *LIMAK Holding* & *ÇALIK Holding* consortium. Consequently, INDEP believes that there is the potential for curbing competition by discouraging new entrants – either in generation or supply – through discriminatory actions by either entity.

An analysis conducted on the effects of corruption[99], and more recently one done on Europe's unbundling regimes and regulatory inefficiencies[100], reveals that in many European countries VIUs were opposed to ownership unbundling and instead opted for legal unbundling. As a result, the authors were concerned as to "whether VIUs were able to manipulate the legislative and regulatory process in favour of the weaker form of unbundling"[101]. This, of course, also puts into question the integrity and transparency of the legislative and regulatory process.

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97 Authors Interview. March 25, 2015.
98 Interview through email with the Author and Mr. Karagutoff. March 30, 2015.
99 Mauro, P., (1997), 'The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross-Country Analysis', In *Corruption in Global Economy,* Elliot, A. K., (Ed.), Washington: Institute for International Economics.
100 van Koten, S., and Ortmann, A., (2007), 'The Unbundling Regime for Electricity Utilities in EU: A Case of Legislative and Regulatory Capture?', *Working Paper Series,* CERGE-EI.
101 Ibid: pp. 5.

A cross-comparative study of 15 EU member states finds that there is a robust correlation between the rate of corruption and the choice of unbundling. Namely, the higher the rate of corruption the likelier a country will choose a weaker unbundling regime.[102] They concluded that due to less stringent unbundling measures adopted by politicians, VIUs are expected to attain higher profits and in the process remain less transparent. With the above in mind, there are a number of worrying aspects when considering Kosovo's route towards a liberalised electricity market. Past experiences have taught us that transparency "is a proven, strong instrument to ensure continuous development towards more effective markets".[103] Yet, Kosovo is no stranger to corrupt practices that span across the entire spectrum of economic, political, and institutional processes.

5.1.3 The Regulatory Body

ERO, the energy regulatory body, maintains its role despite major irregularities. To begin with, at present there are only three board members, and although the board requires only three votes to pass regulations, Article 4.1 of the Law on the Energy Regulator[104] maintains that there have to be five board members. Most unsettling is the fact that ERO has been functioning with three board members since December 2013. ERO maintains its oversight role with a budget of 665,415 euro. Currently, it has only 22 employees. As such, ERO is understaffed and underfunded. As it presently stands, it is unlikely to perform its duty to oversee the electricity market efficiently or even with clarity. The Chairman of the Board, Mr Enver Halimi, is in violation of two legislations. First, Mr Halimi is 67 years old, two years past the retirement age as prescribed by Chapter 8 Article 67 of the Law on Labour[105]. Also, Mr Halimi, apart from performing his duty as the Chairman of the Board, is also its Chief Administrative Officer. This is in direct violation of Article 5.3.5 of the Law on the Energy Regulator, which asserts that board members cannot hold any other position within ERO. Two of the three board members – Ms Merita Kostar and Mr Krenar Bujupi – have had positions in energy enterprises; Mr Bujupi was a consultant for the World Bank on matters directly related to energy, Ms Kostari was employed at *KOSTT*. A number of deputies and members of parliament have expressed their concern over their appointment, suggesting that there may be a conflict of interest.[106]

These issues cast a doubt on ERO's monitoring capability; especially as there have been questions raised with regard to the professionalism, expertise, and transparency, of the board members and their decision-making. [107] With a weak, underfunded, and understaffed regulatory body, the prospects for the implementation of a free electricity market in Kosovo are remote. And while regulatory reform is not sufficient for competition to emerge, it nonetheless is a necessary prerequisite.[108] With that in mind,

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[102] Ibid: pp. 17.
[103] International Energy Agency., (2005), *Lessons From Liberalised Electricity Markets*, Energy Market Experience.
[104] *The Law on the Energy Regulator., (Law No. 03/L-185),* The Republic of Kosovo [Online] [Accessed on 15/03/2015] Available at: http://www.kuvendikosoves.org/common/docs/ligjet/2010-185-eng.pdf
[105] *The Law on Labour*, (Law No. 03/L-212), The Republic of Kosovo [Online] [Accessed on 15/03/2015] Available at: http://www.assembly-kosova.org/common/docs/ligjet/2010-212-eng.pdf
[106] These were: Visar Ymeri (Vetëvendosje movement); Ardian Gjini (Aleanca për Ardhmërinë e Kosovës); Deputy Teuta Sahatqija.
[107] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.
[108] Ibid.

Kosovo's parliament should prioritise immediately the strengthening of ERO as a regulatory body. It should elect the remaining two members of the board as well as increase the body's funding, employee number, and promote skilled training and professional expertise for it to effectively monitor the energy market.

5.1.4 Competition and Consumer Switching

As shown in fig. 3 (page. 19), there are still no eligible customers that can switch supplier, partially because there is no standardised method that is applicable, and wholly due to the fact that there is only one supplier. Legally, customers should have been eligible to switch suppliers by the 1st of January 2015. However, the entire electricity market is still regulated. *KEK*, Kosovo's production company, is under public service obligation to deliver electricity to *KEDS/KESCO*, the public supplier, so that it can supply the general public under regulated prices.[109] Of particular significance is the fact that there is an excessive public service obligation and regulated tariffs in the production and supply of electricity; both of which are the only potentially competitive segments of the electricity market.[110] The problem of competition with early reformers directly stems from the choice of unbundling and the opaque privatisation process. Lifting barriers to entry, albeit inchoate and based on theory, and restructuring the rules of the market is not enough: competition necessitates a sufficient number of competitors.[111] If supply is concentrated in a single unit, as is the case in Kosovo, competition cannot develop.

Similarly, empirical evidence suggests that without reasonable competition in generation, non-integrated retail suppliers "have little chance of success at any reasonable scale".[112] The suggested remedy is a sufficient divestiture of the incumbent generation company to no less that three market players. The basis of this argument is that new entrants to the market alone are not enough to ensure "the reduction of market power of incumbents".[113] There is an exigency to perform this divestiture at the beginning of the process when commencing the liberalisation of the electricity market, particularly because past experiences highlight the uphill struggle faced to reduce market concentration if left till afterwards.[114]

The Kosovo electricity market has little incentives to offer new entrants. If anything, Kosovo's electricity market is riddled by convoluted bilateral agreements between the key players, inadequately unbundled network operators, especially the distribution system operator, and no standardised entry format for new suppliers. Distribution losses are still paid for by retail consumers.[115] There are no fines or penalties regarding the non-delivery of minimum standards, either for the distribution system operator or supplier. As a result, there isn't any incentive as the burden and risk associated rests with the end-user.[116] The United Kingdom provides an important lesson in this regard. For over a decade in the UK, distribution losses did no change much, however, with the

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[109] Energy Community Secretariat, (2014), 'Annual Implementation Report 2013/2014', [Online] Available at: www.energy-community.org
[110] ibid.
[111] International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.
[112] Pollitt, M., (2007), 'Liberalisation and Regulation in Electricity Systems: How can we get the balance right?', *3rd Annual Regulation Seminar*, SBGI., pp. 6.
[113] Ibid: pp. 14.
[114] Ibid.
[115] Energy Community Secretariat, (2014), 'Annual Implementation Report 2013/2014', [Online] Available at: www.energy-community.org
[116] Ibid.

introduction of tougher financial sentences by Ofgem, distribution losses decreased immediately after.[117]

5.1.5 Further Unbundling

Lastly but most importantly, for competition to thrive, especially with regard to the retail electricity market, the distribution system operator and supply have to be further unbundled[118]. A report prepared by the Directorate General on Competition in Brussels casted suspicion on network operators that also own affiliates in the supply of end-users. Specifically, it found that some network operators were favouring their own affiliates "and thereby discriminating against other market participants"[119]. In hindsight, this was also the case in the United Kingdom until Ofgem, the British energy regulator, made it illegal for distribution system operators to own a supply company within their respective region of operation, albeit not outside it. Does this pessimistic evaluation apply to the case of Kosovo's distribution and supply? To begin with, the rate and possibility of costumer switching is dependent upon the actual switching mechanism. If a distribution system operator has its own retail arm it "will not have incentives to make consumer switching easier".[120]

One does not have to look far or deep to understand that there is a lack of transparency when it comes to customer switching as well as new supply entrants. For instance, the contact number for *KEDS* is the same as for *KESCO.*[121] Similarly, INDEP has emailed *KEDS* inquiring about the procedures for new entrants and received an email back from *KESCO.*[122] Additionally, notifications[123] sent to end-users have both *KESCO and KEDS's* logo.

A simple example would be if a customer wishes to switch suppliers, he/she has to contact *KEDS*, which has the same number as *KESCO*. It is hard not to imagine the potential discriminatory behaviours that can arise through this coupled *KEDS-KESCO* consortium. It is even harder to imagine how ERO could regulate or even prove such discrete behaviour. As a consequence, consumers may associate risks and potential costs with switching suppliers. This is due to the fact that they may perceive *KESCO* as more reliable because of its coupled reputation with its parent firm *KEDS.*[124] Effectively, consumers are hindered from having a genuine choice – practically captive – while new entrants are disadvantaged from the onset.

Kosovo has remained in the theoretical stages of the implementation of the Energy Community requirements. The reasons for this have been numerous; one among many is the facile unbundling of network operators and the precarious regulating body – which

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117 Jamasb, T., and Pollitt, M., (2007), *Incentive Regulation of Electricity Distribution Networks: Lessons of Experience from Britain*, EPRG Working Paper 07/01.
118 Group for Legal and Political Studies., KOISD,(2012), 'Between privatization, deregulation, and liberalization: The failures of the energy market strategy in Kosovo and European Union benchmarks', *Policy Report*, No. 4.
119 Directorate General on Competition., (2007), 'Report on Energy Sector Inquiry', *SEC (2006) 1724*, pp. 22
120 International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.
121 http://keds-energy.com; http://www.kesco-energy.com; The contact number for both is: 038 501 701 1000 or 038 791 000.
122 Email correspondents with the Author and *KEDS/KESCO*.
123 For instance, this may include the time a consumer has to pay their energy bill before the energy utility cuts of their electricity directly.
124 International Energy Agency., and OECD., (2001), 'Competition in Electricity Markets', *Energy Market Reform*, Paris; France.

currently has only three board members. What is required is a strengthening of governance practices in order for the institutional structure to carry forward the implementation process. Implementing a liberalised electricity market is not only dependent on sector specific factors. Indeed, it is a matter that concerns the entirety of the government machinery and requires a strong political will, a regulatory body acting as its bastion, and enough competitors to compete in the market. Kosovo's implementation of the European Community guidelines should be carried out based on the feasible evaluation of its contextual basis, not on a hastened approach that has as its priority the absolute harmonisation of Kosovo's legal basis with that of the *acquis*.

6. Conclusion

This paper has discussed a number of topics related to the prospect of a free electricity market in Kosovo. One of its main findings, similar to that of IEAs[125] conclusion, is that liberalisation is not an event but rather an on-going process. The empirical evidence suggests that there is no such thing as a completely liberalised electricity market; it remains only an ideal that most nation-states strive towards.

Previous examples of the approach to liberalisation, whether that is from studies conducted by the IEA[126] or nation-states implementing their unique version of a free energy market, has taught us that the process requires strong government involvement. This is because as long as there is a strong political commitment, extensive and detailed preparation, a timely transition phase, and cooperation between key stakeholders, including civil society organisation, the implementation procedure is supported by a germane approach that is contextually apt. With the support of the government, and of course a wide spectrum of organisations and institutions, a liberalised electricity market in Kosovo – while arduous – is feasible.

Accordingly, every country has a different understanding of what constitutes – based on what is feasible at that time – a liberalised electricity market. In other words, there is no liberalised electricity market design that serves as a panacea for all to follow. Due to the unstandardised nature of this process, Kosovo, similar to most developing countries seeking to implement the European Community guidelines, has faced barriers and struggles. Kosovo's energy strategy needs to be sensitive to the requirements of its people and the principles of sustainable development. The implementation procedure should be timely – by undergoing a number of stages including feasibility and evaluative studies – and contextually perceptive.

Excessive regulation, the strategy presently plaguing the electricity sector, hinders the emergence of competitive segments within the market. Consumers are still burdened by a regulated tariff, which includes distribution losses they are not responsible for, but ultimately pay for. This format cannot facilitate initiatives for network operators to invest in higher maintenance. Indeed, there is no risk of financial penalties for network operators, or for that matter generation and supply companies, with regard to achieving a minimal standard of operation.

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[125] International Energy Agency., (2005), *Lessons From Liberalised Electricity Markets,* Energy Market Experience.
[126] Ibid.

These potential barriers and factors were discussed generally, as well as in particular. These included, but are not limited to, EROs discrepancies regarding its role as the overseer of the energy market; insufficient unbundling of the distribution system operator with supply; overbearing tariff regulation which represents an incomplete substitute for actual competition; consumer switching remains theoretical. There is a long path ahead before Kosovo's electricity sector can enter into a liberalised state. In theory, there has been some progress in terms of the legislative framework governing the structure and rules of the electricity market, this is especially seen with the deal struck between Kosovo's KOSTT and Serbia's EMS over the Northern energy dispute. In practice, however, there is little to show for.

7. Recommendations

Based on the findings and anecdotes discussed in this policy paper, INDEP strongly recommends the following policy steps:

1. There should be an unbundling of retail tariffs. On the one hand, there should be tariffs that include only the "delivery" charges for using the distribution and/or transmission network(s), which would continue to be regulated by the network operators. On the other hand, there would be retail power supplies, which would be based on competitive prices. This is the duty of ERO and could be done in collaboration with the main stakeholders in the electricity market. ERO should conduct a feasibility study in order to evaluate the possible impact this would have on the end-consumer. The government should not be involved, as it is a matter of market forces rather than state intervention.

2. ERO should establish minimum standards of operation for the transmission and distribution operator. This should be done in an effort to promote accountability by these utilities and cut down on technical losses incurred by a lack of structured investments. It will invariably lead to less costly electricity bills for end-consumers due to lower technical losses and safe security of supply. The example of Ofgem represents a possible lesson and may be applied contextually to the case of Kosovo's electricity market.

3. There is a need to horizontally restructure the generation capacity, so that an adequate number of competing generators mitigate market power and create reasonable competitiveness. The divestiture of generation, to say five players, would instigate competition at the wholesale market and potentially liven up the retail market. While not favoured by market liberalists, the state could still own a majority share in each generation unit, or potentially golden shares[127] to maintain a majority, and assure some form of competition between the generation segments. As the generation utility is publicly owned, this is the responsibility of the Kosovo government. Thus, a government-mandated split of the generation utility into smaller generation units owned by different companies would instigate a wholesale market and increase the potential for competition in the retail arena.

4. Customer switching should be formalised by a standardised process instead of being based on bilateral agreements between the key players and the consumer. There is no

[127] These serve the purpose of maintaining some form of control of the direction of a company/organisation, especially if this company/organisation is important to the government or is a crucial public good. It can also serve as a buffer before complete privatisation or divestiture.

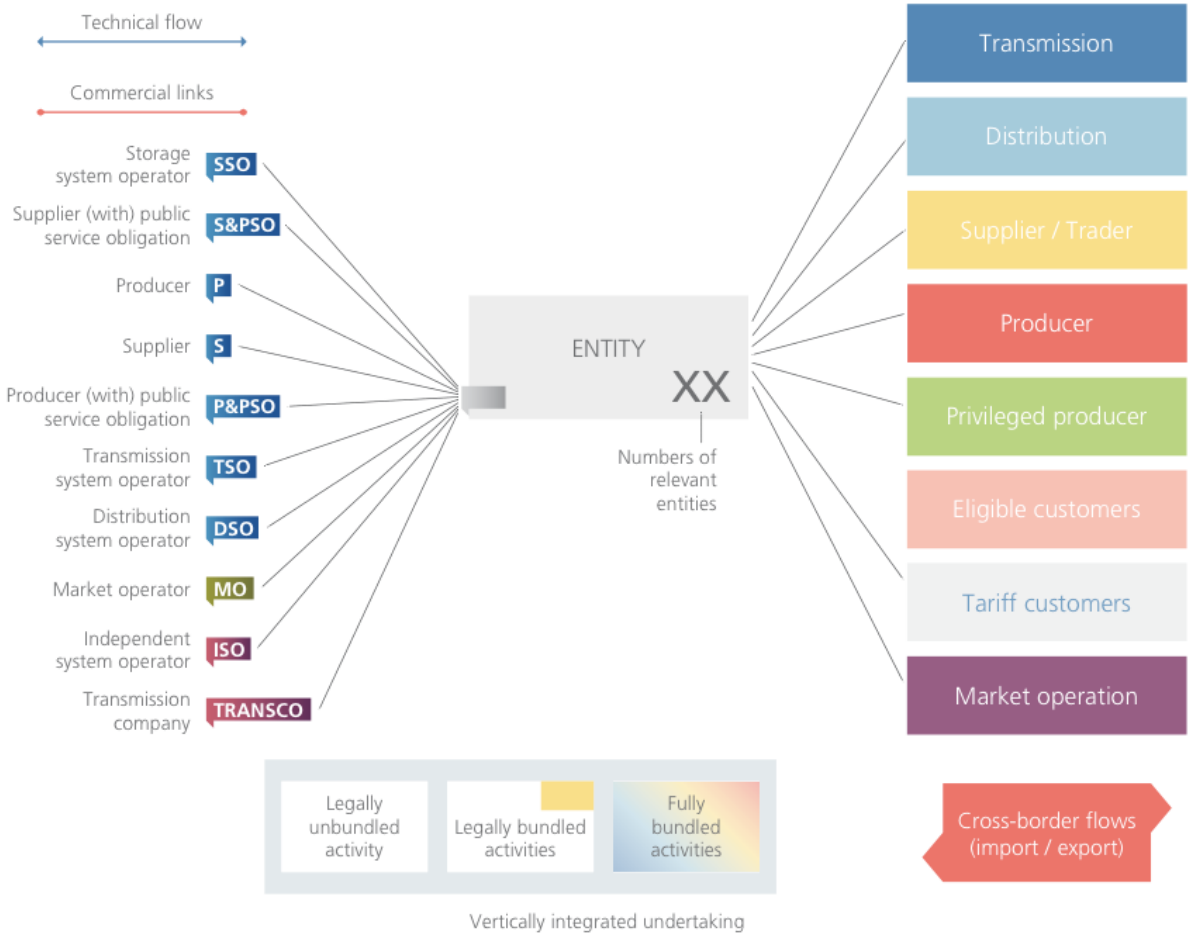
outlined process and very little information regarding how a consumer can switch suppliers. The fact that a single supplier exists at the moment is no excuse. Article 19.2 of the Law on Energy establishes the right of consumers to switch; it goes no further in establishing how this is done and/or in what way consumers are protected from predatory action by their current supplier. ERO should develop a draft proposal on a possible standardised form of retailer consumer switching that does not leave room for discrimination by the distribution operator or the current supplier, and which outlines end-consumer rights and clear information.

5. Further unbundling of distribution and supply should commence immediately. This is the duty of the government, which should initiate the procedure by decoupling completely KEDS from KESCO in terms of ownership or obligate KEDS to divestiture further its affiliate supplier, so that there may be two or three electricity suppliers. This, in turn, would at least create internal competition for the time being, till a clearer strategy is in place. Indeed, there are too many potentialities for discriminatory behaviour when a distribution system operator also has an affiliate supply arm. Thus, there should be ownership unbundling. This is because it is the most effective form of unbundling as it completely eliminates the incentive as well as ability to discriminate, at least in the aforementioned sense. Unsurprisingly, the problem is exacerbated by the fact that KEDS is privately owned, hardly an easy procedure, as opposed to, for example, KEK which is publicly owned, making it easier to unbundle by the government.

6. Kosovo's parliament should immediately fill the positions of the two remaining ERO board members and should give sufficient funds to ERO in order for it to undertake effectively its role as the electricity market overseer. Indeed, ERO is understaffed, underfunded, and lacks two board members. Put another way, the electricity market is presently being monitored by three board members and their 22 staff members. The parliament should afford priority and increasing exigency to these matters.

Appendix A

Energy Market Comparison Scheme Legends for Fig 3.



Electricity Market Structure Map

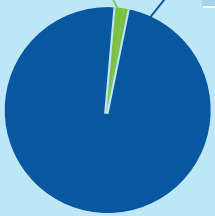
The energy sector represents the backbone of economic development and is a key political tool towards regional integration.
Indeed, how the electricity sector functions also radiates into the way we consume it, the price we pay for it, and the goods and services offered.
It also indirectly affects our disposable income for other goods and services. Namely, the more money a household spends on electricity the less it can afford to spend on other things.

Generation (KEK)

Public Service Obligation

3,09% comes from Hydropower

96,9% of all Electricity Generation comes from Lignite Coal



Lignite Coal represents one of the most polluting and least efficient sources of energy.

Electricity Production GWh

2011	2012
5,696,4	5,847,2
2013	**2014**
6,248,3	5,324,0

Transmission (KOSTT)

Market Operator

121-150 DAYS takes for a potential applicant to gain access and use the Transmission Line.

Transmission Losses in 2014: **2,02%**

The Connection Tariff is: **2.5%**

ZYRA E RREGULLATORIT PËR ENERGJI
REGULATORNI URED ZA ENERGIJU
ENERGY REGULATORY OFFICE

ZRRE (ERO in English) is the National Regulator for the Energy Sector in Kosovo.

Laws Governing the Electricity Market:

- Law on Electricity (2010)
- Law on Energy (2010)
- Law on the Energy Regulator (2010)
- ERO Secondary Rules

Distribution (KEDS)

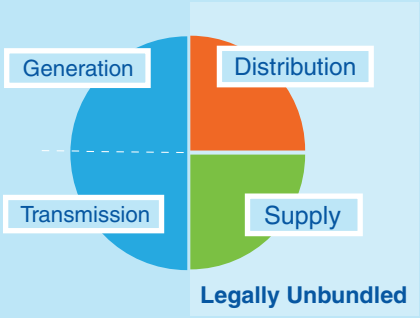
Distribution System Operator

Losses

2011		2012	
Technical	16,76%	Technical	16,32%
Commercial	21,37%	Commercial	20,37%
2013		**2014**	
Technical	16,04%	Technical	15,54%
Commercial	19,50%	Commercial	17,94%

2014 **5,177,710 MWh** is the total billed consumption of which **95,6%** has been **paid**

Ownership Unbundled from Generation and Transmission and **Legally Unbundled** from Supply



Legally Unbundled

Supply (KESCO)

Prices are regulated for end-consumers

470,489 ***non-eligible*** **Household Consumers** under Regulated Tariffs.

100% of Consumers have access to Electricity

70,793 ***eligible*** **Non-Household Consumers**, of which there are **0** active *due to a lack of other suppliers.*

Independent Producers

2014 Total Electricity Production ***151,4 GWh***

Hydro-Energy Power Plants:

"Ujmani"
"Lumbardhi"
"Radavci"

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