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Report No: 47748-AL

PROJECT APPRAISAL DOCUMENT

ON A PROPOSED

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PARTIAL RISK GUARANTEE

IN THE AMOUNT OF EURO 60 MILLION
(USD 78 MILLION EQUIVALENT)

FOR THE

PRIVATIZATION OF THE POWER DISTRIBUTION SYSTEM OPERATOR

OPERATORI I SISTEMIT TE SHPERNDARJES SHA (OSSH)

IN

ALBANIA

April 14, 2009

Sustainable Development Department
South East Europe Country Management Unit
Europe and Central Asia Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective February 2009)

Currency Unit	=	Lek
Lek 102	=	US$1
US$1.3	=	€1
CZK 1	=	US$0.04

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AMM	Albanian Market Model
APL	Adaptable Program Loan
CAS	Country Assistance Strategy
COOPI	Cooperazione Internazionale – Italian Bilateral Aid Agency
DSO	Distribution System Operator
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECSEE	Energy Community of South East Europe
EIB	European Investment Bank
EIRR	Economic Internal Rate of Return
EMP	Environmental Management Plan
ERE	Electricity Regulatory Entity
ETSO	European Transmission System Operators
EU	European Union
FDI	Foreign Direct Investment
GoA	Government of Albania
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
KfW	Kreditanstalt fur Wiederaufbau
KESH	Albanian Electricity Corporation
METE	Ministry of Economy, Trade and Energy
OSSH	The company that carries out the separately licensed functions of the DSO and RPS
PSGRP	Power Sector Generation and Restructuring Project
RPS	Retail Public Supplier
SEE	South East Europe
SPA	Share Purchase Agreement
TSO	Transmission System Operator
USAID	United States Agency for International Development
VAT	Value Added Tax
WPS	Wholesale Public Supplier

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ALBANIA
Privatization of the Power Distribution System Operator

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PRIVATIZATION OF THE DISTRIBUTION SYSTEM OPERATOR

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

ECSSD

Date: April 14, 2009	Team Leader: Demetrios Papathanasiou
Country Director: Jane Armitage	Sectors: Power (100%)
Sector Director: Peter D. Thomson	Themes: Regulation and Competition Policy (P) State enterprise /bank restructuring and privatization (P)
Sector Manager: Ranjit Lamech	
Project ID: P112242	Environmental screening category: C
Lending Instrument: Partial Risk Guarantee	

Project Financing Data

[ ] Loan [] Credit [ ] Grant [X] Guarantee [ ] Other:

Amount of guarantee: €60 million (US$78 million equivalent)

Proposed terms: PRG of up to a maximum term of eight years

Proposed Risk Coverage: The PRG will backstop the Government of Albania's debt obligation to a commercial bank, the L/C Issuing Bank, to compensate the privatized Distribution System Operator (OSSH) for loss of revenues resulting from a change or repeal of, or non-compliance by, the Albania Electricity Regulatory Entity (ERE) or the Government of Albania of certain provisions of the pre-agreed regulatory framework.

Financing Plan (US$m)

Source	Local	Foreign	Total
BORROWER/RECIPIENT	0	0.00	0
CEZ Equity	0.00	132	132
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (PRG)	0.00	(78)	(78)
Total:		132	132

Borrower:
Ministry of Finance
Blv. Deshmoret e Kombit Nr. 1, Tirana
Albania
Responsible Agency:
CEZ, ČEZ a. s.
Duhova 1444/2, 140 53 Praha 4
Czech Republic

Project implementation period: Start May 2009 End December 2016 Expected effectiveness date: May 2009 Expected closing date: December 31, 2016

Does the project depart from the CAS in content or other significant respects? ***Ref. PAD I.C.***	[ ]Yes [X] No
Does the project require any exceptions from Bank policies? ***Ref. PAD IV.G.*** Have these been approved by Bank management? Is approval for any policy exception sought from the Board?	 [ ]Yes [X] No [ ]Yes [ ] No [ ]Yes [X] No
Does the project include any critical risks rated "substantial" or "high"? ***Ref. PAD III.E.***	[X]Yes [ ] No
Does the project meet the Regional criteria for readiness for implementation? ***Ref. PAD IV.G.***	[X]Yes [ ] No

Project Development Objective:

The objective of the proposed PRG operation is to facilitate the privatization of OSSH in the context of a new Regulatory Framework. It will be achieved through enabling the Government of Albania (GoA) and CEZ of the Czech Republic to implement the Privatization Agreements for OSSH under the new regulatory framework.

Project Description:

The proposed PRG will backstop the GoA's debt obligation to a commercial bank (the L/C Issuing Bank) that has, on behalf of GoA, paid under a Letter of Credit (L/C) that may be drawn by the privatized OSSH upon the occurrence of a Guaranteed Event to compensate OSSH for a resulting loss of revenue. The Guaranteed Events would be a change, or a repeal, by GoA or the Energy Regulatory Authority ERE of, or a non-compliance by ERE with the provisions of the pre-agreed regulatory framework relating to the: (i) Distribution System Operator tariff service formula ; (ii) the Retail Public Supply service tariff formula; and (iii) timely tariff approvals.

The policy on environmental assessment is not triggered by the proposed PRG. No physical works (either rehabilitation or new investments) will be supported by the PRG and therefore the Environmental Assessment Category is C.

Guarantee Effectiveness:

Execution, delivery, and effectiveness of all privatization agreements, each in a form and substance satisfactory to IBRD including the conclusion of a Guarantee Agreement between the L/C Issuer and IBRD, a Project Agreement between the privatized OSSH and IBRD and an Indemnity Agreement between IBRD and Albania.

Covenants applicable to project implementation:

The privatized OSSH will provide reports (including audit reports) and other Project information, and make warranties and representations and covenanted undertakings, including in respect of compliance with applicable environmental laws and relevant Bank Guidelines and requirements relating to corrupt practices.

ALBANIA
Privatization of the Power Distribution System Operator

STRATEGIC CONTEXT AND RATIONALE

A. Country and sector issues

1. Albania has successfully maintained macroeconomic stability over the last 10 years with steady growth and low inflation. Growth has been above 5 percent annually in all but one of the last ten years, and inflation below 5 percent in all years. Such sustained growth resulted in upgrading Albania to the group of middle income countries in 2007. Despite the global financial challenges, 2008 growth remained at around 6 percent. However, sustaining high growth rates and maintaining macroeconomic stability will prove more challenging in the future amid the global economic crisis and deterioration in the productive capacity and financial position of the electricity sector. The first signs of adverse trends come from declining remittances and a decrease in bank deposits since October 2008. The growth rate therefore, is likely to fall below 2 percent in 2009.

2. In recent years there has been a gradual improvement in the fiscal deficit from 6.6 percent of GDP in 2002 to 3.2 percent in 2006, although it jumped to 5.6 percent in 2008. The gradual fiscal consolidation has resulted from a combination of improving revenue administration and reduced interest payments and has contributed to a sustained decline in public debt from 62 percent at end 2003 to 55 percent in 2007. The increases in the deficit in 2007 (to 3.8 percent, from 3.2 percent in 2006) and 2008 are largely due to increased public investment, and can therefore potentially be reduced in later years. The government has proposed a 2009 budget deficit of 4.2 percent of GDP, based on an optimistic GDP growth scenario of 6 percent, and aiming to complete most of the Durres-Kukes-Morine road works while pursuing another round of wage and pension increases. However, more conservative calculations and factoring in likely slower growth, show that the spending commitments in the draft budget are likely to imply a deficit of closer to 5 percent of GDP. Potential difficulties in financing such a deficit, and given the government's stated commitment to contain it at around 4 percent of GDP, imply potential budget adjustments during the year.

3. High and rising current account deficits in 2007 and 2008 arose mainly from the acceleration of public investment and high electricity imports, and food and commodity prices. These trends, combined with a slowdown in remittances, led to an estimated 2008 current account deficit of 13 percent of GDP. In 2009, this trend is expected to reverse, following the drop of food and oil prices, and the decline in imports as aggregate demand (consumption and public investment) falls, which should more than offset the impact on exports of a less favorable external environment. Part of the increase in the current account deficit in 2008 has been financed by a rise in Foreign Direct Investment (FDI), and ongoing privatizations may help to maintain a reasonable flow of FDI even in 2009. However, medium-term FDI flows will depend on a strong reform agenda. In this respect, the privatization of Albania's electricity Distribution System Operator (OSSH) is a key development for the country.

4. The most significant risks to growth and macroeconomic stability arise from the ongoing recession in large parts of the world economy and the financial position and electricity supply capacity of the state owned electricity producer (KESH). Albania's internal electricity generation capacity is today about 95 percent dependent on hydropower. During years with low rainfall, the combination of dry weather, below-cost retail tariffs, high network losses (technical and non-

technical), poor collection rates, and growing demand, means that KESH can maintain electricity supply at a loss, or implement extensive load shedding. An extraordinary dry period in 2007 resulted in both supply shortages and financial losses. In 2008, when only relatively dry weather continued until December, KESH improved the supply situation, but continued to accumulate losses and debt. At the same time, in preparation for privatization reform, KESH was unbundled and a new distribution company was established to handle the network operations of electricity distribution and the retail public supply service.

5. At the root of the problems of the electricity sector in Albania has been the distribution division of KESH, recently incorporated as a separate company: the Distribution System Operator (OSSH). The distribution side of electricity systems not only provides the physical interface between electricity supply and end-users, but also the commercial part of the financial transactions with electricity users. Electricity consumption is billed and cash collected from customers at the distribution level, and then allocated and transferred to the transmission and supply sides of the system. The distribution operator is, therefore, the channel that irrigates financially the whole power sector. However, high losses in distribution combined with low collections of billed electricity, have resulted in KESH being paid, over a number of years, for only about 50 percent, or less, of the electricity supplied through its network (see also Annex 1).

6. The electricity distribution system's poor performance has left KESH with insufficient money to invest in proper maintenance, operation, and expansion of its system, and, more seriously, prevented it from being able to pay for all of the imported electricity needed to make up for shortfalls in domestic hydropower production. The company required considerable direct transfers from the state's central budget in 2000-2004, 2007 and 2008, but even with such subsidies load shedding has continued. Moreover, KESH resorted to commercial lending to cover its operational losses. As of February 2008, KESH had commercial short-term debt of €112 million. In addition to its commercial debt, KESH is exposed to short-term debt issued through various agreements with the Ministry of Finance of about €45 million implying a total of €157 million (or 1.8 percent of GDP).

7. The Government, recognizing the importance of improving the performance of power distribution and the long-standing inability of a state-owned structure to make significant progress, has decided to privatize it. In early 2007, it contracted the International Finance Corporation's Advisory Services in Southern Europe (IFC-PEPSE) as the transaction advisor for the privatization. It adopted a new market model for the power sector in conformity with its commitments as a member of the Energy Community[1], and separated the distribution system operator from KESH, making it a new joint stock company (OSSH), 100 percent owned by KESH on June 19, 2007. In June 2008, in preparation for privatization, ownership of the company was transferred to the Ministry of Economy Trade and Energy (also the owner of KESH). In parallel, the Electricity Regulatory Entity (ERE) prepared new regulations, licenses and tariff methodologies, for the various participants in the reformed power sector.

[1]The Energy Community international treaty is an important element of a strategy developed by the member states of South East Europe and the EU to ensure access to a stable and continuous energy supply. The creation of an area without internal frontiers for energy contributes to economic and social progress and a higher level of employment as well as balanced and sustainable development. All of the Energy Community member countries have the prospect of EU membership, and the Energy Community Treaty requires members to implement the EC Directive 2003/54/EC (electricity).

The Government of Albania has developed a strong record of sector reforms and successful privatizations, despite government changes and notwithstanding delays. After concluding the privatization of most state-owned small and medium enterprises in 1999, the Government concentrated on larger enterprises and utilities. The privatization of five non-strategic state owned companies (a brewery, winery, dairy factory, pharmaceutical factory and cement factory) was successfully concluded in the first half of 2001 through tender sales, mostly to foreign investors. The privatization of strategic sectors however, proved more challenging for Albania. A summary of key privatizations include:

- The sale of the Savings Bank – the country's largest bank – to the Raiffeisen Group in the first half of 2003. Subsequently, the entire banking sector came under private management.
- In June 2005, the Government approved the sale of the state-owned fixed-line telecommunications operator Albtelecom. Calik Energy Telecommunication won the right to acquire a 76 per cent stake in the company for about €120 million, with the state retaining 24 per cent. Although the privatization contract had been signed in June 2005, the new parliament elected in July that year did not immediately ratify it. In August 2006 a review instigated by the Government led to limited re-negotiation and the contract was ratified a year later with few amendments.
- As part of the privatization process, the state oil company Albpetrol was split into three companies in 2003: Albanian Petroleum Company (oil and natural gas extraction), Albanian Refining and Marketing Oil (ARMO, refining) and Servcom (petroleum distribution). The private sector has been involved successfully in upstream oil exploration and development. However, the privatization of the country's outdated refinery has been rescheduled several times due to lack of interest by investors, but in 2008 the government succeeded in selling 85% of its stake in the oil refining and marketing company ARMO to a foreign investor (Refinery Associates of Texas, Anica Enterprises & Mercuria Energy Group) for about €125 million.

8. Based on discussions with potential investors that expressed concerns on regulatory risks associated with the OSSH privatization, IFC-PEPSE recommended to the Government that they should request the World Bank's Partial Risk Guarantee (PRG) instrument to help facilitate the transaction. Main concerns of investors were the lack of experience of the Albania's Energy Regulatory Entity with private sector operators and the projected requirements for tariff adjustments, as well as the upcoming elections in June 2009.

9. Four companies were pre-qualified in the bidding process for the sale of a controlling stake of 76 percent of the shares of OSSH: ENEL of Italy, EVN and Energie-Steiermark of Austria, and CEZ of the Czech Republic. Only ENEL and CEZ subsequently submitted a final bid. During the bid evaluation, ENEL's proposal was found not to comply with the technical requirements and was disqualified, while CEZ was declared the preferred bidder in November 2008. The Government and CEZ have since successfully concluded negotiations and signed the Share Purchase Agreement (SPA) on March 11 2009, whereby CEZ will pay €102 million for 76 percent of OSSH shares. The PRG is a condition precedent to the closing of the SPA.

B. Rationale for Bank involvement

10. The Bank has been engaged in the Albanian power sector since 1992 through investment projects, donors' coordination, and policy dialogue including on regulatory matters. The Bank's Power Transmission and Distribution Project contributed to the creation of ERE in 1995, whereas the Power Sector Rehabilitation and Restructuring Project contributed to strengthening ERE through the Law on Regulation of the Electricity Sector enacted in 2003, especially by removing the right of the Government to fix a price cap. Because of the Bank's continuing involvement in the sector, CEZ requested the PRG in its bid to help mitigate the perceived risks of a new regulatory framework and the limited track record of ERE.

11. The proposed PRG would guarantee the obligation of the Government of Albania (GoA) to compensate the privatized OSSH, should ERE or GoA fail to implement the regulatory framework agreed as part of the SPA, which will be ratified by the Albanian Parliament. The

Bank has had a successful experience with a similar PRG operation in Romania, where the PRG to date has been instrumental in ensuring that the pre-agreed regulatory framework remained on track in spite of changes in Governments and Governmental policies in the Energy Sector. CEZ was prompted to request the PRG also because of this positive experience in Romania, where the company owns a distribution utility.

12. The Bank is well placed to provide the proposed PRG because of its sector involvement through sector loans, its ongoing policy dialogue with the Government, and its experience with a similar PRG in Romania as noted above. CEZ may, upon completion of the privatization, request debt or equity financing from IFC. At this stage, MIGA support is not anticipated as CEZ does not intend to seek equity insurance.

13. This PRG operation, while not included in the Country Assistance Strategy, is fully aligned with the CAS objectives of economic growth through support to private sector development and improvement in public services. The PRG would contribute to the CAS outcome of achieving more reliable power supply, and reduced vulnerability and fiscal risks imposed by the electricity sector. In the absence of the proposed PRG the privatization would not conclude. As a result, electricity distribution in Albania would remain state-owned, with its unsatisfactory performance continuing to undermine not only the power sector's financial condition, but potentially also the country's fiscal stability.

C. Higher level objectives to which the project contributes

14. The privatization of OSSH is expected to reduce the fiscal burden imposed by the power sector. During the recent years of adverse hydrology, the operational weaknesses of OSSH increased the need for expensive power imports, brought about increased load shedding, and obliged the Government to reintroduce subsidies to KESH. Subsidies had been provided from 2000 through 2003 in response to an earlier period of adverse hydrology, but were not granted from early 2004 until mid-2007. The drought together with a doubling of the price of imported electricity and inadequate tariff increases after 2005 (see Annex 1) caused considerable financial losses that required budget transfers to KESH and increased public sector indebtedness through KESH (see also paragraph 6 above). In contrast, OSSH's performance after privatization will need to comply with: (i) a concrete schedule for operational improvements (progressive loss reductions and revenue collection increases); and (ii) a gradual adjustment of tariffs to cost-recovery levels. These measures should in the medium-term reduce the need for government subsidies and increase tax revenue. Achievement of a satisfactory financial performance of the privatized OSSH may not on its own eliminate the potential need for subsidies to KESH during future periods of adverse hydrology, but the loss reduction and collection improvement targets would improve the overall sector's revenues and thereby provide the funds needed to allow KESH to get through future dry periods without further significant government assistance.

15. The privatization of OSSH would also improve the overall electricity supply situation over time. Since 1997 electricity shortages have been affecting adversely the life and work of the Albanian people; rural and poor areas suffer disproportionately from supply disruptions. In Albania's most recent Investment Climate Assessment survey of 2008, electricity problems were highlighted as one of the two top concerns by businesses of all sizes and types[2]. Widespread electricity supply disruptions over a number of years have prompted businesses and households to invest in power generators that are expensive to operate and maintain, while their extensive use during blackouts contributes heavily to local air pollution and noise. To address the supply

[2] *Building Competitiveness in Albania* World Bank Report No. 47866-AL, forthcoming

issue, Albania has been trying for a number of years to attract FDI in electricity generation. Albania is a member of the Energy Community and enacted in late 2006 a new concession law to take advantage of its undeveloped potential for hydropower. The country's legal and regulatory framework is conducive to encouraging investments in power generation, while regional price trends could make such projects attractive. However, significant investments in new power generation have not materialized because of investor concerns about the credit-worthiness of the public electricity entities. The privatization of OSSH, on the other hand, should attract investments in electricity supply because it will: (i) bring a new credit-worthy entity in the sector that will procure considerable quantities of power at market prices, and (ii) establish, over time, a financially sustainable sector.

16. This PRG operation would also contribute to the success of the Albanian power market and its further integration into the Energy Community market. Albania is a member of the Energy Community in South East Europe, a market supported by the EU and other countries outside the region. Establishment and maintenance of an independent electricity regulatory authority is a requirement for membership in the Energy Community. The presence of the PRG would help to buttress ERE's independence and ensure that the regulatory authority performs in accordance with the pre-agreed Regulatory Framework.

PROJECT DESCRIPTION

D. Privatization of OSSH

17. OSSH owns 69,000 km of network and serves about 1 million customers. Collected annual revenue of OSSH for 2008 (including arrears) was Lek 32.5 billion, whereas the billed consumption for 2008 reached Lek 39 billion[3]. In 2008, KESH reported net domestic power generation of 3,833 GWh, all hydroelectric and all of which was produced by KESH except for 62 GWh supplied by small privately operated hydropower plants. Net imports and exchanges were 2,465 GWh and total available electricity was 6,298 GWh; load shedding is estimated at 561 GWh (Annex 1 contains a detailed electricity balance).

18. The Government decided to sell 76 percent of the share capital of OSSH to a strategic investor. Part of the remaining state-owned shares (24 percent) are to be offered to: (i) the employees of OSSH in exchange for privatization bonuses and/or vouchers held by these employees, including their parents, spouses and children; and (ii) the former owners of land that was nationalized during the communist period. The strategic investor will have the right to acquire any shares not taken up by these two groups.

19. The privatized OSSH will operate under two licenses: (a) a Distribution System Operator (DSO) License for 30 years with exclusive right to serve all of Albania; and (b) a Retail Public Supply (RPS) License for 30 years with exclusive right to supply electricity to tariff customers. The DSO license applies to network operation (covering all voltage levels within Albania from 0.4 kV up to and including 110 kV) and to connections of consumers, including eligible customers who will not be buying their electricity from the Retail Public Supplier (RPS), independent generators, and installation and servicing of meters and meter readings. The Albanian Market Model (AMM) requires market purchases of electricity to cover all distribution losses; this mechanism provides a strong incentive to reduce distribution losses quickly.

20. The Retail Public Supplier (RPS) License provides for the purchase of electricity destined for final tariff customers from the Wholesale Public Supplier (WPS), which will remain state-

[3] These figures include Value Added Tax (VAT) at 20 percent

owned, at a regulated tariff and sale to final tariff customers also at a regulated tariff. Billing and collections come under the RPS license as well. The WPS will buy at a regulated price all of the electricity produced by KESH Generation (KESH Gen) to the extent needed to serve tariff customers except for what is needed by the TSO for ancillary services. WPS will buy any additional electricity, as needed, to meet the demands of final tariff customers on the market. The WPS as the "supplier of last resort" is responsible for overall security of supply within Albania. Over the next few years, purchases on the market will consist mostly of purchases of imported electricity, and the bulk of the purchased imports will be for distribution losses.

21. Based on the agreed Regulatory Framework, the privatized OSSH will be required to: (i) reduce total losses from 32 percent in 2009 to 15 percent by 2014; (ii) increase the collection rate from 86 percent in 2009 to 91 percent by 2014; (iii) improve operational efficiency;[4] and (iv) improve the quality of electricity supply. Further improvements will be agreed in 2014 for subsequent regulatory periods (not guaranteed by the PRG). In order to effect these improvements, CEZ expects that OSSH will invest around €240 million in the first five years of operation after privatization. While OSSH will operate during 2009 with a tariff that is below cost recovery, the new Regulatory Framework contains specific provisions for reimbursing OSSH for the resulting financial losses in subsequent years. ERE has committed to gradually raise the weighted average end-user tariff by 15% in real terms from January 1, 2010 until the tariff reaches cost recovery levels. OSSH will be reimbursed for any financial losses until the end of 2012 while tariffs remain below cost recovery. Tariffs in subsequent years are projected to decline as the company meets its progressively ambitious distribution loss and revenue collection targets set out in the Regulatory Framework.

E. Project development objective and key indicators

22. The objective of the proposed PRG operation is to facilitate the privatization of OSSH in the context of a new Regulatory Framework. The project would be considered successful if: (i) the transaction is closed and the strategic investor takes over OSSH; and (ii) if the new Regulatory Framework is implemented as agreed for the period of the PRG coverage. A steady improvement in OSSH's performance is a key requirement of the Regulatory Framework (see paragraph 21). Once these improvements are accomplished, the sector should become viable and further investments in transmission and generation will likely follow.

23. The key performance indicators that would be used to assess the fulfillment of the project's development objectives in terms of outcomes and outputs are: (i) transaction closed by the target date of May 2009; and (ii) timely tariff adjustments approved for the DSO and RPS in conformity with the agreed Regulatory Framework.

24. The project's intermediate outcome indicators are: (i) the initial equity investments are made by the investor for the purchase of shares from GoA; (ii) the operation of OSSH in accordance with its license obligations and the implementation of the investment programs approved by ERE. Key outcome indicators are: (i) reduction in electricity distribution losses; and (ii) improvement in collections in accordance with targets set out in the Regulatory Framework. While the regulatory provisions supported by the PRG will provide incentives for OSSH to achieve these important goals, the degree of success will also depend on the actual performance of OSSH under its new ownership. Losses and collections indicators will be included among the

[4] For instance, the number of customers per employee in Albania is only about 150, compared to more than 400 in some Central Europe utilities. Efficiency improvements are to be encouraged through the use of price cap regulation of the DSO tariff.

high level outcome indicators that will be used to evaluate the project, because the PRG is only one contributing factor among several in meeting these objectives.

F. The Partial Risk Guarantee

25. The proposed PRG would backstop the Government's debt obligation to a commercial bank (the L/C Issuing Bank) that has, on behalf of the Government, paid under a Letter of Credit (L/C) that may be drawn by the privatized OSSH in specified circumstances. This would be the second PRG to be provided in support of a power distribution privatization transaction and this use of the PRG was developed specifically to enhance and facilitate the privatization and concessioning of infrastructure and public service utilities.

26. The PRG would guarantee debt arising from a drawing of the L/C which would be issued by a commercial bank in favor of the OSSH as beneficiary. OSSH would be entitled to draw on the L/C upon the occurrence of a Guaranteed Event to compensate for a resulting loss of revenues. The Guaranteed Events would be a change or a repeal by the Government or ERE of, or a non-compliance by ERE with, the provisions of the pre-agreed regulatory framework relating to: (i) the DSO tariff formula and its related inputs, and the RPS tariff formula and its related inputs, including the compensation mechanism, and (ii) the timely approval of tariffs, which result in a loss of revenue to OSSH (Annex 5 contains a detailed description). These Guaranteed Events will cover a transitory period in year 2009 and then the first three Regulatory periods up to the end of year 2014 and will be set forth in the Government Support Agreement (GSA) to be concluded between OSSH, the Ministry of Finance (MOF), and the Ministry of Economy Trade and Energy (METE). Following a drawing, the GoA would be obligated to repay the L/C Issuing Bank for the amount drawn with interest, within 12 months. GoA's obligation to repay the L/C Issuing Bank for the amount drawn and not repaid at the end of the 12 month period, would be guaranteed by the Bank under the PRG together with accrued interest. The L/C would be for a maximum amount of €60 million, and would be valid for a term of a maximum of six years from the transfer date of OSSH. The L/C amount of €60 million was the minimum level of risk mitigation negotiated by GoA with CEZ (estimates of OSSH revenue requirements and potential exposure of OSSH to non-adjustment of tariffs are provided in Annex 7). Thus the PRG would backstop well-defined risks relating to the Regulatory Framework, which would be under GoA and ERE's control, while OSSH will assume all the commercial risks associated with operating a regulated distribution company (operational, collections, and investments). The PRG term sheet and contractual structure are attached as Annex 4.

27. Upon the occurrence of a Guaranteed Event, OSSH would notify GoA and the Bank of a claimed Event of Default. If the Event of Default is not remedied within the review/cure periods provided for in the GSA and provided the claim is undisputed, OSSH would be entitled to draw under the L/C upon the presentation of the relevant documentation to the L/C Issuing Bank, and the L/C amount would be reduced by the amount of the drawing. In the event that a claim under the GSA is disputed by the Government, the claim would be referred to international arbitration. Pending adjudication of the claim, OSSH would be entitled to draw provisional payments under the L/C by posting appropriate security issued in favor of the Government. Following the resolution of the dispute, if an award is made against OSSH, the Government would be entitled to claw back the advance payment made to OSSH by calling its security.

28. Following a drawing, GoA will be obligated to reimburse the L/C Issuing Bank, under the terms of an agreement to be entered into between the L/C Issuing Bank and the GoA, for the amounts drawn (plus accrued interest) within a repayment period of 12 months. If the GoA fails to make the required repayment by the end of that period, the L/C Issuing Bank would have the

right to call on the PRG for the overdue principal amounts plus accrued interest and the amount of the PRG would be reduced by the amount of such payments. Although the validity period of the L/C would be approximately six years from the effectiveness of the privatization transaction, the PRG term would be up to a maximum term of eight years to accommodate the pre-agreed periods for making claims (cure periods) under the GSA, the one-year repayment period following a drawing in the last year of the L/C availability period, and the 60-day payment period within which the Bank would be obligated to pay the L/C Issuing Bank following a call on the PRG. As with all guarantee operations, the Republic of Albania will undertake to indemnify the Bank, on demand or as the Bank may otherwise determine, for any payments made by the Bank under the PRG, pursuant to the Indemnity Agreement to be entered into between the Bank and GoA.

29. Under the PRG, the Bank will have the right to limit its liability to outstanding draws under the L/C in the circumstances set forth in the Guarantee Agreement, including if there is a material breach by OSSH of its obligations under the Project Agreement to be entered into between the Bank and the OSSH.

30. The PRG would be priced at 30 basis points per annum on the guaranteed amount payable every six months in advance. In addition, there would be a Front-end Fee of 25 basis points, an Initiation Fee of 15 basis points and a Processing Fee of up to 50 basis points (for reimbursable expenses) on the guaranteed amount. All PRG-related charges would be payable by OSSH. The above is consistent with the pricing policy for IBRD Guarantees.

31. The issuance of the PRG will be conditional upon the receipt by the Bank of the relevant Government to the provision of the guarantee of a loan provided by a private bank as required under Section 1(b) of Article IV of the Bank's Articles of Agreement.

32. **Value Added of the PRG.** GoA had formally requested the Bank to provide a PRG following requests from the pre-qualified bidders. The agreement of GoA to condition the effectiveness of the privatization upon the issuance by the Bank of the PRG facilitated the signing of the SPA and helped to secure the interest of CEZ, a major regional player in the power sector, in the acquisition of OSSH. The PRG is also believed to have enhanced the price offered by CEZ. Furthermore, the PRG will help to catalyze around €240 million of expected investments in the distribution network by OSSH over a period of five years. With the proposed investments and improvements in management and operations in the form of reductions in technical and non-technical losses stipulated in the pre-agreed Regulatory Framework, the distribution sector should be put on a sustainable path to cost recovery tariffs, with the PRG affording protection to CEZ during the transitional period. In the absence of the PRG, there could well have been a bid failure which would have meant that OSSH would have continued to be a major budgetary drain on the GoA with consumers facing deteriorating electricity services.

G. Lessons learned and reflected in the project design

33. Access to reliable electricity is a key driver of economic growth and a direct means of reducing poverty because it improves the productivity of households and enhances the delivery of social services. The successful privatization of electricity utilities, a key component of reforming energy markets, is therefore a priority for the governments of many developing countries and transition economies, as they seek to improve efficiency and reliability, and attract private investment in the sector. In the Bank's experience, a satisfactory privatization of power distribution utilities should precede efforts to attract private investment to other parts of the sector; as cash flows arise mostly from distribution.

34. Because of the mixed post-privatization experience of investors in distribution utilities, primarily due to tariffs not being adjusted towards cost-recovery in a timely manner, there has been heightened investor sensitivity to the regulation of the sector, which is perceived as a critical risk. In response to these global lessons, the Bank adapted the PRG to specifically support distribution privatization by backstopping regulatory risk. The conceptual design work of this PRG structure was completed in late 2002[5] and since then the Romania transaction has been successfully completed and is currently operational.[6]

35. Utility privatizations elsewhere have also shown that tariff adjustments should be gradual and accompanied with improvements in service. The agreed regulatory framework for this privatization establishes a clear and sustainable pathway for operational improvements. It also includes a compensation mechanism that allows some flexibility to the regulatory authority to partially defer tariff increases over time, so that adjustments can take place gradually as sector performance recovers. As OSSH's performance improves, its tariffs are expected to come down while still provide adequate returns (see paragraph 21 and Annex 7).

36. Tariff adjustments should also be accompanied by better provision of social assistance. Currently, electricity tariffs in Albania establish a first block of consumption for households (up to 300 kWh/month) at a low rate of Lek 7/kWh, while for higher consumption the tariff is Lek 12/kWh. The tariff-blocks system is a second-best way to deliver subsidies to needy households because of its poor targeting (all households receive it regardless of their economic situation). ERE has begun a study to evaluate minimum consumption requirements, and the results of this study will be used to change the width of the first block in the tariffs of January 1, 2010. In addition, the Bank has ongoing technical assistance programs to assist the Government with its overall social assistance provision[7] (see also paragraphs 63 below).

H. Alternatives considered and reasons for rejection

37. The Government decided in 2006 to privatize power distribution because of persistent failure by KESH to achieve success in reducing power distribution losses and improving collections. Its decision also took account of the considerable progress made up to that time in restructuring the power sector and strengthening the regulatory authority. The Government initially was expecting to achieve the privatization without the PRG. However, following strong feedback from potential investors for the need of risk mitigation, GoA requested the Bank for the PRG in support of the privatization. As noted above, the Bank's involvement to date has helped to advance the process to a stage where the SPA was signed on March 11, 2009.

38. With respect to the manner of privatization, one alternative would have been not to have a PRG, given its associated costs and the resulting contingent liability for GoA. However given the fact that CEZ made its bid conditional to the PRG, this has proved not to be an option for GoA and both CEZ and GoA agree that the value of the PRG will significantly exceed its costs.

IMPLEMENTATION

I. Partnership arrangements

39. IFC's Private Enterprise Partnership–Southeast Europe Infrastructure has acted as the Privatization Advisor for OSSH's privatization. USAID has been providing technical assistance

[5] See Mitigating Regulatory Risk for Distribution Privatization—The World Bank Partial Risk Guarantee, Energy and Mining Sector Board Discussion Paper No. 5, November 2002.
[6] This transaction received a 'best practice' rating from QAG.
[7] For instance the "Regional Safety Nets", ESW/TA, P113286 and "Albania Social Protection" TA, P111798.

to ERE for preparation of regulations and licenses. Albania is an active member of the Energy Community. Many donors and financiers have sustained a coordinated support to Albania's energy sector with the Bank for more than a decade (see Annex 2).

J. Institutional and implementation arrangements

40. GoA will transfer a controlling stake of 76 percent of OSSH's shares to ČEZ a.s. (CEZ), an integrated electricity conglomerate based in the Czech Republic[8] and majority owned by the Government. CEZ's principal businesses encompass electricity generation and distribution, sales of electricity and heat, as well as coal mining. In 2007, CEZ owned about 14.3 GW of electricity generation capacity, sold 73,793 GWh of electricity and had more than 70,000 employees in its operations in the Czech Republic, Poland, Hungary, Romania, Bulgaria and other countries. In November 2008, CEZ was among the top ten European power utilities with about 6.8 million customers and a market capitalization of about €16.3 billion. The company serves about 3.5 million electricity customers in the Czech Republic and owns controlling stakes at electricity distribution companies in South East Europe (1.67 million customers in Romania and about 2 million customers in Bulgaria). CEZ reported net income of CZK 42.8 billion in 2007 and estimates a net income of CZK 48.6 billion (about US$ 2 billion) in 2008, while it maintained the lowest debt leverage ratio among European power utilities and a rating of A-/A2[9]. CEZ is a key member of the CEZ Group with its primary focus on pursuing investment opportunities in Central and South Eastern Europe. Entry into the Albanian electricity distribution will provide CEZ with a unique opportunity to further expand its operations in the Balkans following its acquisitions of distribution in Romania and Bulgaria, and generation in Poland and Bulgaria.

41. Initially the RPS will be part of OSSH, but it will be organized under a separate management structure (with separate accounts) and later as a separate legal entity in order to conform to the EC's Electricity Directive. Whether combined or separate, the RPS and OSSH will need to coordinate their activities to reduce distribution losses and improve collections. The RPS is responsible for billing and collection, with the bills of final customers including a charge for use of the DSO's network as well as purchase of energy. The DSO is responsible for meter reading and maintenance and for consumer connections. Therefore the RPS will have to request the DSO to disconnect consumers who have connected illegally or are in default, but operational control for both entities can be effectively coordinated as they are both owned by OSSH.

42. The DSO will operate under a tariff designed to cover the costs of operating the distribution system, including the costs of purchasing electricity on the market to cover distribution losses plus an allowed rate of return on the approved rate base. The tariff will be based on specified distribution loss reduction levels to be achieved (see paragraph 21 above, subject to qualifications set out in Annex 5). The DSO can make additional profits by over achieving the targets, but must absorb any financial losses from failing to meet the targets; powerful incentives to improve performance are therefore in place.

43. The RPS will operate under a retail tariff that passes through the cost of buying electricity at a regulated price from the WPS plus the transmission tariff plus the distribution tariff plus a margin to cover operating costs, and a designated fee of 2.2 percent of purchases from the WPS for performing the retail supply activity. The tariff is based on the assumption of a bad debt

[8] CEZ group is owned by ČEZ a.s. a joint-stock company incorporated in May 1992 and listed in the stock markets of Prague and Warsaw; the Czech Republic continues to be the company's largest shareholder with a almost 70% stake as of 31 December 2007.

[9] *Sources*: CEZ Annual Report 2007; CEZ Quarterly Presentation to Investors, November 2008.

allowance that will be reduced from 14 percent of billed revenue in 2009, by one percentage point each year (subject to qualifications set out in Annex 5).

44. The PRG will guarantee adherence by ERE to the detailed tariff methodologies for the DSO and RPS tariffs. Further details are given in Annex 5.

K. Monitoring and evaluation of outcomes/results

45. The proposal to provide the PRG has already achieved one of its key objectives. The Government and CEZ have concluded their negotiations and signed the Share Purchase Agreement (SPA). CEZ will take ownership of OSSH, once the SPA is ratified by parliament and the PRG has been issued, which is expected to take place in May 2009. The first key outcome therefore will be effectiveness of the privatization transaction.

46. During the PRG validity period, the key events that will be closely monitored are ERE's regulatory decisions. The Bank is closely involved in the power sector through its previous and three ongoing projects and its continuous review of sector performance with respect to the Power Sector Action Plan. It is therefore, well positioned to monitor the guarantee operation until 2014 through periodic supervisions. The Bank will also review and comment on the regulatory framework to be agreed in 2014. Key indicators to be monitored and to be used in the evaluation of outcomes and results are discussed in Section II (B).

L. Sustainability

47. The Albanian power sector is sensitive to hydrology. In 2007 a severe drought cut domestic production (all from hydropower plants) from a normal level of well over 4,000 GWh to 2,900 GWh, while electricity import prices more than doubled between 2005 and 2008. Although hydrological conditions improved in late 2008, it has not been possible to raise tariffs enough to cover the incurred costs of imports, forcing KESH to make large short-term borrowings and to request assistance from the Government. Future hydrological variations will affect the state-owned WPS rather than OSSH, while OSSH may pass through to their tariffs future variations in the import price and the regulated price of the WPS.

48. Financial sustainability of the sector will be strongly dependent on OSSH's performance. OSSH's pre-privatization performance has moderately improved (losses decreased from 39.4 percent in 2006 to 32.7 percent in 2008, and collection rate increased from 81.9 percent in 2006 to 83.3 percent in 2008). However, ERE's decision to maintain tariffs at the level that came into effect on March 1, 2008 until January 1, 2010 (transition period for privatization) made it necessary to reach agreement with CEZ on the handling of the losses of OSSH incurred during 2008 and those expected to be incurred during 2009. Financial losses of 2009, as well as losses incurred in subsequent years as a result of phased tariff increases, are to be handled by means of an agreed compensation mechanism. Under this mechanism, increases in end-user tariffs are to be at least 15 percent per year in real terms as long as there are amounts to be compensated. The Government, ERE and CEZ have agreed to these arrangements. The above arrangements provide for a balanced and reasonable path forward to reach financial sustainability in the medium-term.

49. Overall sector performance will depend on the realism of the agreed targets for loss reduction and collection improvement. Such risks will be borne by the privatized OSSH. The prospects of sustainability are supported by CEZ's technical and financial credentials and its demonstrated ability to improve distribution performance in other South East Europe countries. Sustainability will be self-reinforcing to the extent that the targets are achieved. The current levels of the critical loss and collection rate variables, despite recent improvements, are so far

below potential that the opportunities for improvement are large, and large improvements would increase overall sector revenues and reduce the required level of future tariff increases.

50. Sustainability will also depend on ERE honoring the agreed provisions of the regulatory framework both during and after project implementation. It will be particularly important to ensure that the RPS and DSO tariffs cover their costs, and that overall tariffs for the power sector rise reasonably quickly to cost-covering levels. While the current regulatory framework is new, the prospects for satisfactory performance by ERE are helped by the enactment of a sound legislative foundation designed to protect ERE's independence and by the adoption of comprehensive secondary legislations and regulations that lay out a clear path to sustainability. The current framework for the electricity sector in Albania conforms with EU Directives and is more advanced compared to other countries in the region and is considered satisfactory.

51. Sustainability of the privatization will also require Government support to: (i) ensure that electricity bills of budgetary and state-owned entities are paid fully and promptly; (ii) enforce through courts OSSH's efforts to reduce illegal use of electricity and payment delinquencies; (iii) maintain adequate social safety net coverage for vulnerable electricity consumers; and (iv) avoid inappropriate interference in the regulatory process.

M. Critical risks and possible controversial aspects

52. Given KESH's past underperformance and ERE's mixed record in sufficiently adjusting tariffs to cover cost increases, this is considered a substantial risk operation. The project has an overall substantial risk rating as its outcome is contingent on considerable risks external to the Project as well Project-specific risks. The main risks are summarized in the table below:

Risks	Risk Mitigation Measures	Risk Rating	
		Before Mitigation	After Mitigation
Political Risks			
(i) The Government of Albania may interfere with the tariff setting process. ERE has a mixed record of adjusting tariffs to cover costs and has limited experience of regulating private sector entities.	A Regulatory Statement has been negotiated between ERE, METE, and CEZ, outlining key parameters of performance and required revenues for OSSH for the first three Regulatory periods until 2014 covered by the PRG. In addition, there is an undertaking by ERE that similar parameters would be developed for the fourth Regulatory period. The Regulatory Statement is annexed to the Share Purchase Agreement and will be ratified by the Albanian Parliament. The GSA provides for an independent panel of experts during an appeal process, if a dispute between OSSH and ERE arises on tariff matters. The Bank's counter-guarantee should prove a strong disincentive for both the Government and ERE to deviate from the pre-agreed regulatory framework and from breaching the GSA. Furthermore, the Bank will closely monitor the situation through supervision and would have a 12 month period from the time of a claim on the L/C to work with the Government and resolve issues before the PRG can be triggered. USAID is planning continued technical assistance to improve ERE's decision making capabilities.	H	S
(ii) Future governments may challenge the privatization of OSSH.	Albania has a track record of honoring privatization transactions, even when governments change. The process followed for the privatization of OSSH was conducted, with IFC-PEPSE's involvement, in a transparent and competitive manner. IFC and the Bank have been engaged in consultations with the current opposition parties to explain the process and benefits of this privatization for the country. As noted above, the counter-guarantee relating to the PRG would also be a strong disincentive for any new Government to interfere with the agreed regulatory process.	S	M
(iii) The Government may not provide sufficient support to OSSH (enforcement of law regarding illegal connections and non-payment of bills). Lack of such support may cause difficulties in meeting the privatization objectives of reducing overall losses and increasing collection rates.	OSSH's performance has been unsatisfactory in the past, mainly because under state-ownership the quality of electricity provision --and its associated costs-- have been politicized, resulting in inadequate investment and management practices, as well as inadequate enforcement of provisions regarding illegal use of electricity and non-payments. The privatized OSSH should serve as a means to de-politicize the sector, while the private investor's incentives to improve performance are strong. CEZ has presented preliminary business plans to centralize the billing and monitoring of electricity invoices, which combined with advanced metering, network controls and personnel training, should enhance the company's performance in the short- to medium-term. However, without sufficient support from governmental institutions to address the issues of electricity theft and non-payment of electricity (for instance: the courts and bailiffs acting on illegal connections and non-payment; the Ministry of Finance aiding non-budgetary state owned companies when lacking funds for electricity), OSSH's performance may still suffer, placing at risk the performance of the sector.	H	S
Macro-economic Risks			
Even with the OSSH privatization, the state-owned KESH may continue to carry losses during 2009. Hence, there is a risk that unless there is a swift restructuring of KESH's debt, and adequate, explicit and transparent contingent provisions made for budget transfers to KESH during 2009, there could either be a fiscal shock or an impact on electricity supplies.	The government has begun to address this problem through the issue in December 2008 of a guarantee of €50 million for KESH's commercial debt and an additional loan from the Ministry of Finance of €25 million. In addition, it is enforcing the payment of electricity bills from government agencies (also a prior action for the January 2009 IMF review). Finally, it is including in the budget a contingency of 0.3 percent of GDP for KESH, with a commitment that any additional support to KESH will be within its fiscal deficit target of 4.2 percent. The government recognizes that these are ad-hoc and short-term measures, and success of the privatization is necessary (while not sufficient) for the integrity and predictability of the budget. Furthermore, to immediately improve the financial situation of KESH and its ability to supply electricity at the wholesale level, the Government has agreed that part of the privatization proceeds will be used to reduce KESH's commercial short-term debt.	H	M

Risks	Risk Mitigation Measures	Risk Rating	
		Before Mitigation	After Mitigation
Social Risks			
Depending on hydrology and regional electricity prices, the tariff increase, necessary in the short-term, to bring financial viability to the sector (before OSSH's performance improves under new ownership after the first three years) may affect vulnerable parts of the population in Albania.	In past years, extensive supply disruptions affected rural and poor areas of Albania disproportionately, but as OSSH's performance improves the overall supply situation should improve. The country's social assistance program (Ndihma Ekonomike) is well targeted but reaches only one third of the poor. In this context, the Government has resorted to the sub-optimal approach of pricing electricity in consumption blocks with the lowest-priced block set at 300 kWh/month (see also paragraph 63). More than half of electricity household consumers use less than this amount, which is therefore set too generously to protect only the poor. By July 2009 ERE will redefine the pricing structure to improve targeting. While some consumers will be affected by this re-structuring, the poor are expected to fall within the re-defined first consumption block. More generally, the ability of the government to administer social assistance needs to improve, but also efforts to educate electricity consumers on energy efficiency and electricity use have to take place. The Bank has on-going technical assistance projects to improve the overall social assistance capacity of the Government, while the project team aims to continue working with donors on improving awareness regarding energy efficiency measures during implementation.	S	M
Regulatory Framework Risks			
OSSH's unbundling and independent operation have only recently been implemented and the current regulatory framework has only been used and tested in practice for a brief period. Future implementation might still present unforeseen challenges.	Secondary legislation and regulatory decisions have been developed in earnest by the Government and ERE over 2007 and 2008 with technical assistance from the USAID and extended commenting and involvement by the Bank and IFC. The overall electricity market model design and accompanying secondary regulations have been reviewed by the Bank and found to be modern and adapted to the Albanian realities. The electricity market is in line with European Union guidelines and directives on electricity, including proper allocation of risks and incentives to bring sector sustainability in the medium-term. The Regulatory Framework contains an overall balanced approach, where the new OSSH operator undertakes significant commitments to improve performance, while the Government and the Regulatory Entity agree to provide reasonable returns if that performance is reached.	S	M
Electricity Supply Risks			
The region remains under supply constraints, which could result in either high electricity prices or persistent disruptions in the first couple of years of the privatization, putting at risk the performance of OSSH.	By mid-2009 the 100 MW Vlora thermal power plant is expected to come online adding 15-20 percent to internal electricity generation. Transmission constraints should be alleviated by mid-2010, as donor-financed projects will be completed. Recent rainfalls in 2009 have improved hydroelectric reserves in the region, while the global financial crisis has constrained electricity demand growth, resulting in temporary reductions in regional prices. This should help in keeping costs under control in 2009 and potentially 2010.	S	M
Overall risk rating		**H**	**S**

Risk rating: H (High risk), S (Substantial risk), M (Moderate risk), N (Negligible, or low, risk)

53. ***PRG Risk Coverage.*** As indicated above, there are a number of potential risks related to the OSSH privatization, but the PRG will cover only limited and pre-defined risks. The main reason for regulatory uncertainty from CEZ's perspective are that: (a) the regulatory framework is new and largely untested, and (b) ERE has limited track record of regulating private companies. The Bank, with its extensive involvement and ongoing electricity sector support to the Government, is well positioned to bridge the regulatory credibility gap for the investor through the PRG. The Bank has been working closely with ERE and its technical advisers USAID, and the Government, in the development of the Regulatory Framework, which will be ratified by Parliament as part of the Share Purchase Agreement. Because ERE has been intensively involved in the negotiations of the Regulatory Statement, which would become law once ratified by Parliament, the probability of a change or repeal by ERE of the framework should not be a major risk. Similarly, the Government has led the negotiations with CEZ and will be concluding a GSA in which it will undertake to compensate CEZ for any non-compliance of the regulatory framework, which will be backed by the PRG and counter-guaranteed by Albania in the form of an Indemnity Agreement to be concluded with the Bank. This is likely to prove a strong disincentive for either the existing Government, or any new Government, to breach the Agreements or the law by interfering with the regulatory process, as a call on the PRG could jeopardize not only this operation but the country's entire lending program with the Bank. This aspect of the Bank's leverage through its counter-guarantee has been tested in Romania where the regulatory framework backstopped by the PRG remained on track even when a new Government radically changed the energy privatization policy.

54. Furthermore, the proposed PRG structure is designed to provide the right incentives for the Government to comply with its privatization Agreements. In the event of a breach, the GoA would be at risk first and the Bank's Guarantee would not be exposed for a subsequent period of 12 months, given the 12 month repayment period afforded to GoA under the L/C structure. This would allow the Bank sufficient time to work with GoA and ERE to help remedy any default and prevent a call on the Bank's PRG. Thus the PRG poses manageable risks for the Bank.

N. Loan/credit conditions and covenants

55. The PRG would be subject to the Conditions Precedent in the Term Sheet in Annex 4.

APPRAISAL SUMMARY

O. Economic and financial analyses

56. The main benefits of the privatization of OSSH include: (i) reduced technical and non-technical distribution losses; (ii) improved bill collection; (iii) improved quality of electricity supply in the form of avoided distribution outages and reduced voltage levels and fluctuations; (iv) improved operational efficiency through better management; (v) reduction in uneconomic consumption of electricity through obliging consumers to pay for all of the electricity they consume; and (vi) revenue to the Government from its shares of OSSH.

57. The strictly economic benefits include reduced technical distribution losses, improved quality of supply, improved efficiency and reduction in uneconomic consumption. The financial benefits include all of the items in paragraph 56 except reduction in uneconomic consumption of electricity. The main economic and financial costs consist only of the additional rate of return needed to cover the private buyer's risks relative to the rate of return needed if the OSSH remained under government ownership. The PRG provided a benefit in terms of a higher bid

price for OSSH shares submitted by CEZ, as a result of its role in reducing the regulatory risks to which the OSSH would be exposed. The costs of the PRG would be borne initially by the OSSH, but will be reflected in the tariffs. From the point of view of the Government, the benefits of the PRG would consist of lower electricity tariffs due to the reduced required rate of return. The PRG amount, however, would take the form of a contingent liability for the Government during the guarantee period.

58. Given the narrow focus of the proposed PRG operation it would be inappropriate to do full economic and financial benefit-cost analysis of the privatization.

P. Technical

59. The detailed arrangements for the operation of the PRG are described in Section II(C).

Q. Fiduciary

60. There are no fiduciary issues as there will be no procurement, or procurement-related, disbursements under the project. Should the Bank guarantee be called, the Bank would disburse to the L/C bank and Albania would then be obligated to repay the Bank in accordance with the terms of the Indemnity Agreement between Albania and the Bank.

61. It should be noted that IFC's involvement as a transaction advisor throughout the bidding process has created broad confidence in Albania that a fair, transparent, and competitive procedure was followed for the sale of this strategic asset of the Albanian state.

R. Social

62. No land acquisition or resettlement is required due to privatization. The new DSO owner may reduce the number of employees and will provide the legal compensation if it does so.

63. In past years, extensive supply disruptions affected rural and poor areas of Albania disproportionately, but as OSSH's performance improves the overall supply situation should improve. The country's social assistance program (Ndihma Ekonomike) is well targeted but reaches only one third of the poor. In this context, the Government has resorted to pricing electricity in consumption blocks. Currently, low-income consumers benefit from two protection mechanisms: (i) a social subsidy scheme for electricity and (ii) a tariff block system. The electricity social subsidy scheme was established in 2006 to compensate targeted socially vulnerable groups for the increase in the price of electricity for monthly consumption below 210 kWh[10]. But, the system is not functioning well since the procedures are burdensome and the payments are small. The block-tariff system provides a subsidized price for consumption below 300 kWh/month. This level is considerably larger than the estimated minimum required consumption for an acceptable standard of living of about 200 kWh per month. It could, therefore, be reduced over time to improve targeting so that vulnerable consumers with low consumption would remain protected, while other consumers would receive slightly larger bills (see also Annex 8).

64. In accordance with ERE requirements, the DSO will be obliged to connect new customers and furnish all customers with meters. This would lead to faster regularization of connections than has occurred in the past, resulting in much improved quality of supply to those consumers. This regularization would be accompanied by reductions in distribution losses and improvement in collections from formalized customers, but would of course impose additional

[10] A uniform tariff for all consumers came in force in 2007 until 2008, which increased the first block of tariffs from Lek 4.5/kWh to Lek 7/kWh. The first block of consumption was set at 210 kWh/month in 2006.

expenses on users that have intentionally avoided regularization and hence payments up to now. With respect to consumer protection, the DSO will handle consumer complaints in accordance with satisfactory procedures enforced by ERE.

S. Environment

65. The potential environmental impacts concerning electricity distribution systems activities are relatively low, rather reversible, and of low significance. A general environmental concern in distribution systems are PCBs[11]. The Bank financed a study to investigate PCBs were present in power sector in the 1990s under the Power Transmission and Distribution Project. The consultants that reviewed it did not find any indication that PCBs were present.

66. IFC's consultants have reviewed OSSH's standards and found satisfactory health and safety standards performed in most OSSH substations.

67. OSSH is required to comply with the environmental laws and regulations of Albania.

68. No physical works would be supported by the PRG. The Environmental Assessment category is C.

T. Safeguard policies

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment (OP/BP 4.01)	[ ]	[X]
Natural Habitats (OP/BP 4.04)	[ ]	[X]
Pest Management (OP 4.09)	[ ]	[X]
Physical Cultural Resources (OP/BP 4.11)	[ ]	[X]
Involuntary Resettlement (OP/BP 4.12)	[ ]	[X]
Indigenous Peoples (OP/BP 4.10)	[ ]	[X]
Forests (OP/BP 4.36)	[ ]	[X]
Safety of Dams (OP/BP 4.37)	[ ]	[X]
Projects in Disputed Areas (OP/BP 7.60)	[ ]	[X]
Projects on International Waterways (OP/BP 7.50)	[ ]	[X]

G. Policy Exceptions and Readiness

69. No exceptions to Bank policies are sought.

70. The project is expected to be ready for Board presentation on May 5, 2009. It should be noted however, that, while the structure of the guarantee is well-defined, the Guarantee Agreement, the Indemnity Agreement and the Project Agreement between the Bank and OSSH are being negotiated. These agreements are expected to be substantially negotiated by the date of Board presentation. If they are not, and should the negotiated agreements result in any substantial changes in the terms of the guarantee form those approved by the Board, the guarantee would be resubmitted to the Board for approval. Such approach is consistent with the procedure set forth in BP 14.25 on Guarantees.

[11] Polychlorinated biphenyls (PCBs) and polychlorinated terphenyls (PCTs) are halogenated aromatic hydrocarbons, which belong to the group of persistent organic pollutants (POPs), which are virtually not soluble in water. Because of their physical properties and high ignition temperatures, PCBs are used in electrical transformers, capacitors and condensers. They were manufactured until the mid-1980s, after which they were banned due to their toxicity and persistence.

ALBANIA

Privatization of the Power Distribution System Operator

Annex 1: Country and Sector Background

Country Background

1. Albania has successfully maintained macroeconomic stability over the last 10 years with steady growth and low inflation. Growth has been above five percent annually in all but one of the last ten years, and inflation below five percent in all years. Despite the global financial challenges, 2008 growth remained strong at around 6 percent. Such sustained growth resulted in an estimated GNI per capita of US$3,290 in 2007, upgrading Albania to the group of middle income countries. However, sustaining high growth rates and maintaining macroeconomic stability will prove more challenging in the future amid the global economic crisis and deterioration in the productive capacity and financial position of the electricity sector. The first signs of adverse trends come from declining remittances (16 percent estimated reduction in 2008) and a 9 percent decrease in bank deposits between September and January 2008. Given the strong links between remittances, consumption and imports, the latter are also showing signs of slowing down. This slowdown will almost inevitably be accompanied by a reduction in growth which is likely to fall below 2 percent in 2009.

2. In recent years there has been a gradual improvement in the fiscal deficit from 6.6 percent of GDP in 2002 to 3.2 percent in 2006, although it jumped to 5.6 percent in 2008. The gradual fiscal consolidation has resulted from a combination of improving revenue administration and reduced interest payments and has contributed to a sustained decline in public debt from 62 percent at end 2003 to 55 percent in 2007. The increases in the deficit in 2007 (to 3.8 percent, from 3.2 percent in 2006) and 2008 are largely due to increased public investment, and can therefore potentially be reduced in later years. Given adverse international developments, the availability of financing could become a constraint, at least during 2009. The government has proposed a 2009 budget deficit of 4.2 percent of GDP, based on an optimistic GDP growth scenario of 6 percent, and aiming to complete most of the Durres-Kukes-Morine road works while pursuing another round of wage and pension increases. However, more conservative calculations and factoring in likely slower growth, show that the spending commitments in the draft budget are likely to imply a deficit of closer to 5 percent of GDP.[1] Potential difficulties in financing such a deficit, and given the government's stated commitment to contain the deficit at around 4 percent of GDP, might imply the need for significant budget adjustments during the year.

3. High and rising current account deficits in 2007 and 2008 arose mainly from the acceleration of public investment as well as higher electricity imports, and food and commodity prices. These trends, combined with a slowdown in remittances, lead to an estimated 2008 current account deficit of 13 percent of GDP. In 2009, this trend is expected to reverse, following the drop of food and oil prices, and the decline in imports as aggregate demand (particularly consumption and public investment) falls, which should more than offset the impact on exports of a less favorable external environment. Part of the increase in the current account deficit in

[1] The IMF forecast for the 2009 deficit is 3.8 percent, slightly lower than the government budget, and assumes that as in past years actual spending will be lower than budgeted due to limits in procurement capacity.

2008 has been financed by a rise in Foreign Direct Investment (FDI), and ongoing privatizations may help to maintain a reasonable flow of FDI even in 2009. However, medium-term FDI flows will depend on a strong reform agenda. In this respect, the privatization of Albania's electricity Distribution System Operator (OSSH) is a key development for the country.

4. The most significant risks to growth and macroeconomic stability arise from the ongoing recession in large parts of the world economy and the financial position and electricity supply capacity of the state owned electricity producer (KESH). Albania's internal electricity generation capacity is today about 95 percent dependent on hydropower. During years with low rainfalls, the combination of: dry weather; below-cost retail tariffs; high network losses (technical and commercial); poor collection rates; and increasing demand for electricity, means that KESH can accumulate debt and maintain electricity supply[2], or practice extensive load-shedding. An extraordinary dry period in 2007 resulted in both supply shortages and financial losses. In 2008, when relatively dry weather continued until December, KESH improved the supply situation, but continued to accumulate losses and debt. At the same time, in preparation for privatization reform, KESH was unbundled and a new distribution company (OSSH) was established to handle the network operations of electricity distribution and the retail public supply service.

5. Albania still faces key challenges to sustain the positive developments seen in the past. Weak public institutions, corruption, inadequacies in contract enforcement and property rights, infrastructure and electricity deficiencies remain critical constraints for business environment and investment in Albania. Complementing the IMF dialogue on macro-economic stability and its technical and advisory assistance to strengthening tax administration, the Bank is using a combination of instruments, namely the Business Environment Reform and Institutional Strengthening Project and the Land Management and Urban Development project in conjunction with the DPO to support improvements in the business climate, through (i) the adoption and implementation of regulatory governance tools aimed at improving the quality of business-sector related regulations, (ii) establishment and operations of a Secretariat for Regulatory Reforms for the removal of administrative barriers to investment; and, (iii) adoption and implementation of a transparent land registration system.

6. After concluding the privatization or liquidation of most state-owned small and medium enterprises in 1999, the Government concentrated on larger enterprises and utilities. The privatization of five non-strategic state owned companies (a brewery, winery, dairy factory, pharmaceutical factory and cement factory) was successfully concluded in the first half of 2001 through tender sales, mostly to foreign investors. The privatization of strategic sectors however proved more challenging for Albania.

- In 2001, the government granted two 30-year concessions for chromium mining to the Italian company DARFO, as well as providing concessions to the Turkish copper mining company Ber Oner.
- Following the sale of the Savings Bank – the country's largest bank – to the Raiffeisen Group in the first half of 2003, the entire banking sector came under private management. The privatization could have taken place much earlier, had the pyramid scheme events not complicated the overall financial sector situation in the mid 1990s.
- As part of the privatization process, the state oil company Albpetrol was split into three companies in 2003: Albanian Petroleum Company (oil and natural gas extraction), Albanian Refining and Marketing Oil (ARMO, refining) and Servcom (petroleum

[2] Because of the hydro dependence, shortfalls in supply can only be covered with imports of expensive electricity.

distribution). Since the privatization has been rescheduled several times due to lack of interest by investors. Only this year the government succeeded in selling 85 percent of its stake in the oil refining and marketing company ARMO to a strategic foreign investor (Refinery Associates of Texas, Anica Enterprises & Mercuria Energy Group) for €128.75 million. ARMO is the country's only refinery and holds a 20 per cent share in the retail market.

- In June 2005 the government approved the sale of the state-owned fixed-line telecommunications operator Albtelecom. However, by September 2005 the privatization had yet to be approved by the new parliament. Calik Energy Telecommunication won the right to acquire a 76 per cent stake in the company for €120 million, with the state retaining 24 per cent. In August 2006 a review instigated by the Government ruled that the sale had a number of important shortcomings. Although the privatization contract had been signed in June 2005, the new parliament elected in July that year did not immediately ratify it. The contract was ratified a year later with few amendments.

Power Sector Background

7. Power Sector Infrastructure. The three hydropower plants on the Drin River Cascade (Fierza, Koman and Vau i Dejes) and the two hydropower plants on the Mat River Cascade (Ulza, Shkopeti) account for over 90 percent of electricity production in Albania. Fierza, constructed from 1971 to 1978 at the top of the Drin Cascade, has active storage of 2,300 million m3, four units with total plant power of 500 MW and annual production of about 1,800 GWh. Koman, constructed from 1980 to 1985 in the middle of the Drin Cascade, has active storage of 200 million m^3, four units with total plant power of 600 MW and annual production of about 2,000 GWh. Vau i Dejes, constructed from 1967 to 1971 at the lower end of the Drin Cascade, has active storage of about 250 million m3, five units with total plant power of 250 MW and annual production of about 1,000 GWh. Ulza, constructed from 1952 to 1958 at the high end of the Mat Cascade, has active storage of about 240 million m^3, four units with total plant power of 25 MW and annual production of about 120 GWh. Shkopeti, constructed at the lower end of the Mat Cascade from 1958 to 1963, has active storage of 40 million m^3, two units with total plant power of 25 MW and annual production of about 94 GWh.

8. The only thermal power plant still operating occasionally in Albania is at Fier. The plant operates on heavy fuel oil produced by the Ballsh oil refinery and available capacity is only about 20 MW. The plant was not used in 2008. The GoA advanced a concession for its rehabilitation and selected a preferred bidder in February 2008, but no agreement has been concluded to date.

9. The transmission system consists of 120 km of 400 kV, 1,100 km of 220 kV, and 50 km of 150 kV. There is a 400 kV interconnection to Greece (Elbasan – Kardia), a 220 kV interconnection to Montenegro (Vau i Dejes – Podgorica) and a 220 kV interconnection to Kosovo (Fierze – Prizren). There is also a 150 kV interconnection with Greece (Bistrice 1 – Igumenice). The 220 kV transmission network serves to interconnect the three large hydropower plants on the Drin River Cascade that normally account for over 90 percent of total electricity generation in Albania (Vau I Dejes – 5x50 MW, Koman - 4x150 MW, and Fierza – 4x125 MW) and the thermal power plant of Fier with the major load centers of Tirana-Durres, Elbasan, Burreli and Fier. There are 11 existing transmission substations with a total installed capacity of 2,400 MVA. Two new substations (Durres Rrashbull and Zemblak) have been financed with loans from co-financiers of IDA under the Power Transmission and Distribution Project.

10. The distribution system consists of 325 110/35 and 50 110/20kV substations, of which 40 have been recently rehabilitated with donor assistance, including by the Bank, 1,200 km of 110 kV lines, about 25,000km of 35 kV distribution network, 5,000 km of 20 kV distribution network, which is being introduced in large cities to replace the 35 kV, 10 kV and 6 kV networks, 20,000 km of 10 kV network, 10,000 km of 6 kV network and 9,000 kV of 0.4 network. The 35 kV, 10 kV, 6 kV and 0.4 kV network is mostly old and in need of replacement. KESH has had difficulty in providing meters to cover the needs of all consumers, and, in mid-2007, about 70,000 consumers were without meters. The number of consumers increased by about 200,000 from 2003 to 2006 to a total of more than 900,000, largely as a result of large migration to Tirana and other cities and the desire of subunits of extended families living in the same dwellings to have their own meters. Since the mid-1990s, KESH, in an attempt to reduce meter tampering and illegal use of electricity, has been purchasing mechanical meters to be kept together in groups of about 16 in locked heavy metal cabinets and installed at the entrance of apartment buildings, and sealed meters with connections to the grid using tamper resistant co-axial cable for detached dwelling units.

11. Power Sector History At the beginning of Albania's economic transition in the early 1990s, the country was virtually 100 percent electrified and was a net electricity exporter. However, while the three hydropower plants on the Drin River Cascade, and smaller plants on other rivers, which produced over 90 percent of total electricity supply, were in reasonably good condition, the Fier thermal power plant and the transmission and distribution systems were badly run down because of previous neglect of maintenance, and there were frequent power outages due to overloading of facilities. Electricity demand within Albania fell initially to 79 percent of the 1989 level by 1992 because of declines in industrial production. Thereafter it rose by 10.4 percent per year to 6,160 GWh in 2000. This increase was due mainly to a sustained surge in consumption, much of which was not paid for, by households and small commercial establishments. The quality of electricity supply was improved temporarily by emergency repairs financed by donors, including the International Development Association (IDA). In 1995 KESH was incorporated as a separate company.

12. By 1998, Albania had become a net electricity importer. From the second half of 2000, the need for imports increased greatly as a result of a fall in hydropower production caused by reduced rainfall. The country was unable to get all the imported electricity it needed because of transmission and financial constraints. The result was large load shedding, which had serious adverse macroeconomic effects. The fall in hydropower production between 2000 and 2002 had an unavoidable direct and significant adverse impact on national economic output, and the load shedding (which could have been avoided in the absence of financial and transmission constraints) caused cuts in production by industry and obliged other businesses to purchase and use costly back-up diesel generators. Households unable to afford back-up generators had to suffer without electricity for many hours of each day.

13. The Albanian Power Corporation (KESH) was unable to pay for more than a small proportion of the imports needed out of its own resources because of financial difficulties caused by widespread illegal use of electricity, poor payment of bills and retail prices which were below the cost of imported electricity. Faced with these difficulties, the Government started providing a subsidy, but its large level (US$31.5 million) in 2001 diverted funds from other critical needs including poverty reduction measures. KESH also began implementation at the start of 2001of a rolling multi-year Power Sector Action Plan to tackle the critical issues of the sector, with detailed quarterly and annual targets for key variables such as network losses and bill collection. It managed to reduce total transmission and distribution losses from 44.8 percent of net

transmitted energy (equal to net generation, except from distribution hydropower plants, plus net imports and exchanges) in 2001 to 39.7 percent in 2004, and improved collections from 76.3 percent in 2001 to 83.8 percent in 2004, largely through reductions in receivables from Government budgetary and non-budgetary entities (See the table below). Non-collection from other consumers (about 90 percent due to households) remained almost constant over this period at just under 20 percent of the total amount billed. In addition, the Electricity Regulatory Entity (ERE) raised the average tariff from Lek 4.41/kWh (excluding VAT) in 2001 to Lek 6.70/kWh in 2004. As a result of these measures, collected revenue increased from Lek 12.50 billion in 2001 to Lek 23.84 billion in 2004. These improvements and greatly improved hydrology after 2002 enabled KESH to achieve satisfactory financial performance and allowed the import subsidy to be phased out by the end of 2004. However, load shedding continued throughout this period.

14. Power sector improvements were partly reversed in 2005 and 2006 because of disruption caused by Parliamentary elections, the coming into power of a new Government and the replacement of KESH's management and many distribution employees. Total losses rose to 41.9 percent in 2006, and the collection rate fell to 81.9 percent, but the tariff was raised to Lek 7.26/kWh. Collected revenue reached only Lek 24.86 billion in 2006. A turnaround began in March 2007 with the appointment of a new manager in KESH. The new management has been giving high and widely publicized priority to reducing non-technical losses and improving collections. As a result, total losses fell to 37.1 percent in 2007, the collection rate increased to 89.5 percent, and KESH's collected revenue for 2007 reached Lek 27.25 billion. Nevertheless, the return of below average hydrology in late 2006 and a simultaneous large increase in electricity import prices created severe cash-flow difficulties for KESH in 2007. The Government provided some relief by paying off outstanding arrears on bills to government budgetary and non-budgetary entities and by providing loans. KESH also obtained large overdraft facilities from Albanian commercial banks to help pay for imported electricity. Despite these contributions from the Government and banks, KESH was obliged to increase load shedding to a record-high 927 GWh. ERE approved a tariff increase to a level of Lek 8.15/kWh (US$0.08/kWh) in February 2008 (Lek 7.92/kWh average for 2008), but KESH continued to have cash-flow difficulties in 2008 despite a reduction in distribution losses to 32.7 percent and a collection level of 83.3 percent. Load shedding was 561 GWh in 2008.

15. As of September 2008, KESH had a total short-term debt of Lek 22 billion (€180 million). In addition, after OSSH was fully separated from KESH and took over the function of importing power in July 2008 it incurred a short-term debt of €10 million. This debt is expected to be transferred to KESH after OSSH is privatized. In order to help alleviate KESH's financial difficulties, the Government provided in 2008 a guarantee of €50 million for loans made by Albanian banks to KESH. The Government also provided a soft loan of €25 million to KESH, with a provision for it to be renewed in 2009. In addition it provided a subsidy of €6 million to the water companies to be used to pay their unpaid bills to KESH. The Government has agreed with IMF on further measures to help KESH. These include: (i) extending the validity period of the €50 million guarantee to five years; (ii) providing direct loans or other measures to restructure KESH's existing short-term debt; and (iii) increasing the contingencies in the 2009 budget to 2 percent of GDP, out of which 0.03 percent (about Lek 3 billion, equivalent to €30 million) are reserved for providing a direct subsidy to KESH. In addition, the Government is planning to use part of the proceeds from the sale of OSSH shares to CEZ to pay off part of KESH's outstanding short-term debt.

16. The table below shows that demand rose by about 1.3 percent per year from 2001 to 2008 compared to 10.4 percent per year from 1992 to 2000. The reduction in rate of growth is probably partly due to the increase in electricity prices, reductions in network losses and improvements in collections. Poor quality supply (voltage variations large enough to damage appliances as well as load shedding) may also have led some consumers to switch permanently to alternative sources of energy. However, total current demand, which includes estimated load shedding, may have been underestimated because of the difficulty of measuring the load shedding. If so, the load shedding may be even larger than the amounts shown for the years 2000 to 2008.

17. The expected commissioning of the Vlore Thermal Power Plant, financed by EBRD, EIB and the Bank, in 2009 will add about 760 GWh/year of domestic production. The completion at about the same time of a 400 kV transmission interconnection to Podgorica (financed by KfW, to be connected with a new Tirana-Elbasan section financed by COOPI) and a subsequent 400 kV transmission interconnection to Kosovo will relieve the transmission constraint on importing electricity. In 2008, the Government entered into a public-private partnership with EVN (Austria) for development of the Ashta Hydropower Plant below Vau i Dejes on the Drin River. This plant will produce about 260 GWh of electricity on average per year after it comes into operation in 2012. A concession was granted in 1997 for a hydropower plant on the Vjosa River, but up to now no significant construction had taken place. A concession is being planned for the Fier Thermal Power Station. However, it will be several years before these last two options will start producing power. As a result, Albania will remain a large net electricity importer for some years. Since hydropower production ranges from below 2,900 GWh in very dry years to as much as 5,800 GWh in abnormally wet years import requirements will continue to be subject to large variations. Because of a worsening electricity shortage in South East Europe import prices rose unusually high levels in 2007 and 2008, and KESH has occasionally been unable to contract imports even when it has secured the funds to pay for them. The main actions that KESH should implement until new power stations are built are to strengthen its financial performance so as to improve its ability to pay for enough imported electricity to cover the supply deficit and to finance needed reinforcement and expansion of the transmission system to improve quality of electricity supply (see table).

18. *Power Sector Reform.* The power sector is undergoing reform. The Law on Regulation of the Electricity Sector, enacted in August 2003, provided for strengthening of ERE, and removed the authority of the Government to fix a price cap. The Transmission System Operator (OST), created from the separation of transmission from KESH, was registered as a joint-stock company on July 14, 2004 with KESH as the holding company. The Transitional Market Model was approved in August 2004. All non-household customers have been granted the right to become eligible consumers and choose their own suppliers in conformity with the Energy Treaty 2008 deadline. However, all but one customer had chosen to remain as tariff customers as of 2008. The strengthening of ERE's independence and the creation of OST enabled Albania to meet the initial conditions of membership in the Energy Community. A second phase of the reform process leading to privatization and further implementation of the market model commenced with the Government's decision in 2006 to privatize power distribution. IFC has been providing assistance to the Government for this purpose. A revised market model, the Albanian Market Model (AMM) was approved by the Government in 2008. The AMM distinguishes between a Wholesale Public Supplier (WPS), which is for now a part of KESH, and a Retail Public Supplier (RPS), which is being privatized with the Distribution System Operator (DSO). The WPS is responsible for security of supply to all tariff customers. It sells

its electricity to the Retail Public Supplier at a price regulated by ERE. The DSO is responsible for owning and operating the distribution system, and buys electricity to cover its technical and non-technical distribution losses from the market. Since distribution losses were 1,927 GWh in 2008 the DSO is currently the main buyer in the unregulated market, The distribution margin of the DSO and the allowed supply fee of the RPS as well as the retail prices for tariff customers are fixed by regulation by ERE.

19. The AMM also stipulates that a power generation company, KESH Gen, is to be separated from KESH and incorporated. Its shares will be held initially by KESH, but the company may be privatized subsequently. KESH Gen will be responsible for the three hydropower plants on the Drin River and the two hydropower plants on the Mat River. The AMM stipulates that KESH Gen will provide ancillary services to the TSO and offer its remaining electricity to the WPS at a regulated tariff. Any electricity not taken by the WPS may be sold on the market. Any profits are to be provided to tariff consumers through later adjustments in KESH Gen's regulated tariff.

20. OSSH owns 69,000 km of network and serves over 900,000 customers. The relationships among the various market participants may be clarified by making use of KESH's electricity production and consumption figures for 2008.. KESH reported net domestic power generation of 3,833 GWh, all hydroelectric and all of which was produced by KESH except for 62 GWh supplied by small and medium privately operated hydropower plants. Net imports and exchanges were 2,465 GWh, of which 49 GWh were for an "eligible" customer served off the distribution network3. Total available electricity was 6,298 GWh, which was less than total demand of 6,859 GWh by an amount equal to load shedding of 561 GWh. Electricity entering the distribution network was 5,886 GWh, of which 5,817 came through the transmission system and 69 GWh were injected directly into distribution by small hydropower plants owned by KESH. The difference between the estimate of electricity entering the distribution network and the figure for total available electricity is equal to transmission own consumption and losses of 214 GWh plus sales by OSSH to a high-voltage consumer of 197 GWh. Sales to tariff customers served by the distribution network were 3,912 GWh. Under the current market model, the Wholesale Public Supplier (WPS) is responsible for purchasing this amount of power plus the electricity to be sold at high-voltage level and selling it to the Retail Public Supplier (RPS). WPS bought all the domestic hydroelectric power production of 3,833 GWh less 214 GWh needed by the TSO to cover transmission losses. It would have had to purchase 489 GWh of imported electricity to cover the gap between its sales to the RPS and its purchases of hydroelectric power. The eligible consumer imported 49 GWh and received 47 GWh from the distribution network. Distribution losses were 1,927 GWh (32.7 percent of electricity entering distribution). OSSH was responsible from June 2008 for purchasing electricity to cover such losses in the market (mainly through imports). Thus, until distribution losses are significantly reduced, the OSSH will be purchasing much more electricity on the market than the WPS. The RPS would have billed final consumers for sales of 4,109 GWh. The DSO was entitled to charge a distribution fee for 3,959 GWh of electricity exiting the distribution system, which included 47 GWh for the eligible customer, but excluded the 197 GWh sold by the RPS at the high-voltage level.

21. Electricity Tariff. The tariff structure in 2008 for final consumers is shown in the following table. This structure is expected to remain in place until January 1, 2010, when ERE

[3] Eligible customers, according to the Albanian Market Model, are electricity consumers that can purchase their electricity freely in the market. Such purchases are not subject to regulated tariffs for electricity supply.

plans to introduce the first regulatory period with the privatized OSSH. A new tariff structure and level are expected to be introduced at the same time.

Distribution Tariffs (in Euro cent/kWh equivalent)	
Clients of the 35 kV lines	1.64
Clients of the 20/10/6 kV lines	2.13
Clients of the 0.4 kV lines	5.12
Retail Tariffs (in Euro cent/kWh equivalent)	
Budgetary	9.32
Non-budgetary	7.2
Private	6.93
Households	
First block < 300 kwh	5.73
Second block > 300 kwh	9.84

22. Hydropower Issues. The Albanian power sector faces a key issue: (i) because of a large variability in annual hydropower production from below 3,000 GWh to nearly 6,000 GWh as a result of hydrological variations; and (ii) because the electricity tariffs have been based on the weighted average cost of domestic hydropower production (less than Lek 1/kWh) and the import price (more than Lek 10/kWh in 2008). The most damaging consequence of these two factors is an enormous variation from year to year in the costs of meeting electricity demand, with the costs being particularly high in poor hydrological years when additional imports need to be purchased to offset reductions in domestic hydropower production. As mentioned above, KESH's inability to pay the increased costs during the two dry periods that the power sector has experienced since Albania became a net electricity importer, 2000-2002 and late 2006-2007 resulted in massive load shedding with major adverse consequences on the economy and consumer well-being.

23. The new regulatory system contains the following features for addressing this issue. (i) ERE has agreed in the Regulatory Statement to set the notional level of hydropower production for sale to the TSO and the WPS at the regulated hydropower price at 4,200 GWh per year, which is below the average level of 4,400 GWh over the ten years 1999 -2008. KESH Gen. is expected to sell any surplus production at the international price. Since the probability of producing 4,200 GWh or more per year exceeds 50 percent this provision reduces the amount of variation in costs of supply to the WPS compared to the case in which the notional level of production is set at 4,400 GWh. (ii) ERE is to adjust the WPS tariff to cover interest costs for maintaining a line of credit to pay for the additional imports needed in poor hydro years. (iii) ERE can decide to adjust the WPS tariff annually for differences in expenses due to any previous year over or under production of hydropower. (iv) The Council of Ministers decided on October 3, 2007 to assume responsibility for hydrological risk mitigation in order to provide electricity to all consumers at unchanged prices. If this decision is fully implemented the above provisions (ii) and (iii) would not need to be put into effect.

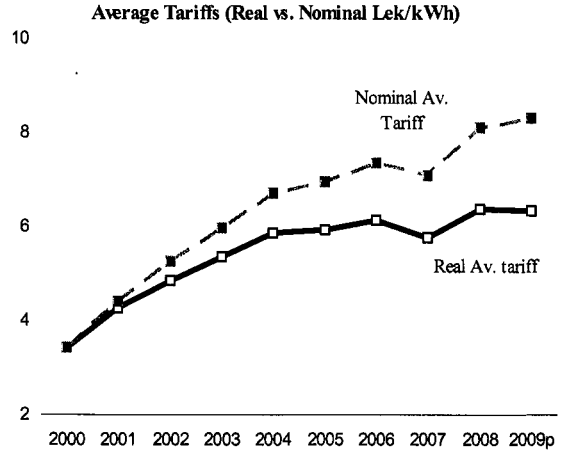
24. The AMM's stipulation that the "hydro benefit" will all be reserved for the tariff customers creates a further set of problems that will impede the operation of the competitive power market unless offsetting remedies are found. First, it implies that any profits KESH Gen

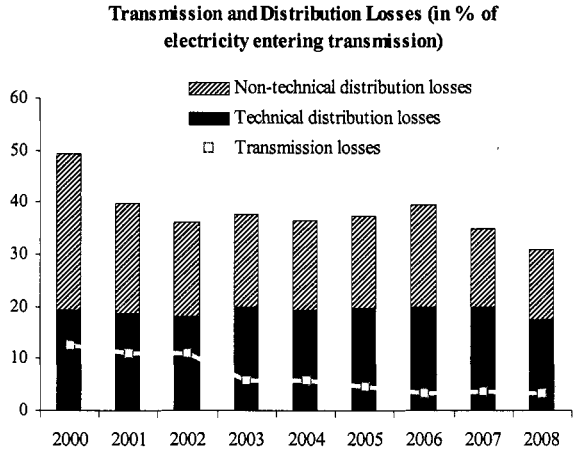
will make from selling surplus power above 4,200 GWh will have to be returned to tariff customers. This is expected to occur through lower approved tariffs for KESH Gen sales to the WPS and for the WPS's sales to the RPS. Second, it prevents KESH Gen from acting as a competitor in the Albanian or regional market except when it has surplus power. It also removes the possibility of introducing competition between individual power plants. It even removes KESH Gen's incentive to profit from the opportunity of making power exchanges with neighboring countries by sending out power during peak periods in return for receiving larger quantities in off-peak periods. As a publicly owned company KESH Gen could try to optimize exchanges anyway, realizing that the benefits would go to Albanian tariff customers through a lower KESH Gen tariff. However, these considerations would reduce the attractiveness of KESH Gen to a possible future private buyer.

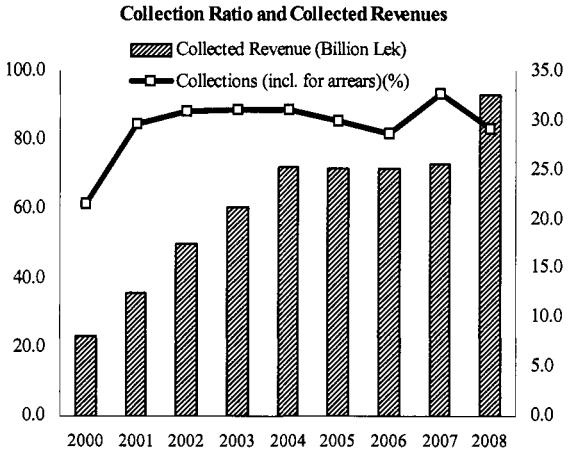
25. A second adverse result is to increase the likelihood of load shedding by the WPS, which is responsible for security of power supply to tariff customers. This is due to the per unit cost of electricity imported by the WPS being greater than the sales price, which is based on the weighted average of low-cost domestic hydropower and high cost imports. As a publicly owned entity, the WPS may try to meet total demand, but if it runs into financial difficulties (because its tariff is too low or for any other reason) it may be unable to buy all the imports it needs not just because it would have to wait to receive payment from the RPS, but mainly because that payment would cover only a portion of the import cost. However, if the above-mentioned provisions for dealing with hydrological variations are fully implemented, this load shedding is less likely to occur.

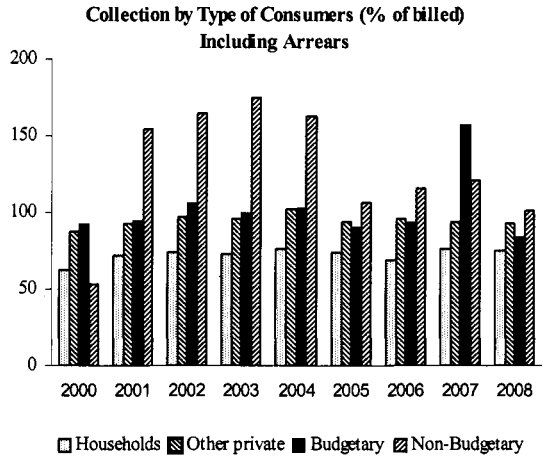
26. A third result of giving the hydro benefit to tariff customers is to reduce the likelihood that more than a few eligible consumers will opt out of being tariff customers, since they would lose their share of the hydro benefit. The DSO would not be affected by whether eligible customers cease being tariff customers or not since it will continue to receive distribution fees from these consumers whether or not they cease being tariff customers, as long as they are served off the distribution network. The RPS would only be affected to the extent that the revenue base against which its 2.2 percent profit margin is calculated would be reduced if some eligible customers cease being tariff customers.

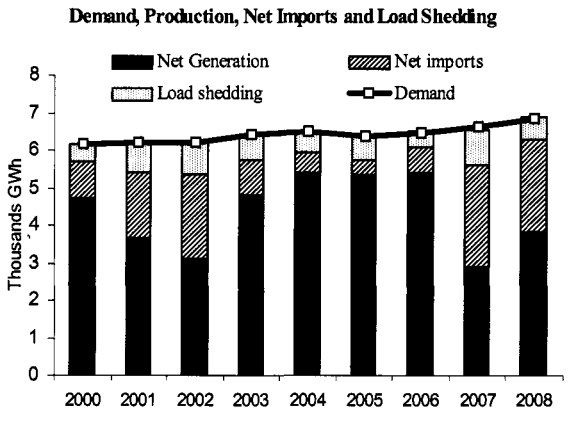
27. The design of the DSO tariff avoids another possible adverse result by providing for the DSO to buy the electricity needed to cover distribution losses on the market (i.e., through imports) rather than from the WPS at the WPS regulated tariff. This provision gives the DSO the incentive to reduce distribution losses as long as the cost of doing so is less than the marginal cost of electricity supply. Moreover, this provision means that the DSO will buy most of the imported electricity needed by Albania for as long as distribution losses remain high, thereby reducing both the risk and the magnitude of load shedding by the WPS. The risk of the private DSO not buying enough electricity to cover its losses is considered low since this would mean defaulting on its responsibilities under its license, which could lead to the license being cancelled.

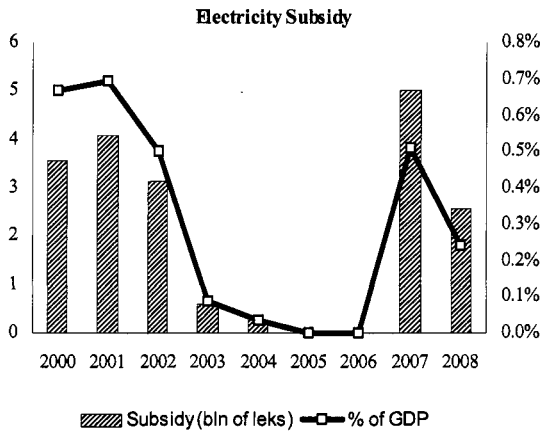












Summary of figures of the Albanian Power Sector
Sources: KESH, Bank staff estimates

Albania Power Sector Energy Balance and Selected Financial Data

Selected Data on the Power Sector

	2001	2002	2003	2004	2005	2006	2007	2008
Energy (GWh)								
Demand	**6,258**	**6,200**	**6,200**	**6,429**	**6,640**	**6,465**	**6,656**	**6,859**
Hydro Generation			4,737	5,325	5,274	5,331	2,875	3,788
Fier Thermal Power Station			81	76	77	93	72	0
Vlore Thermal Power Plant			0	0	0	0	0	0
Plant Consumption and Losses			91	97	95	99	46	17
Net Generation	3,690	3,123	4,811	5,395	5,256	5,325	2,901	3,703
KESH/OSSH Net Imports and Exchanges	1,750	2,269	916	478	504	545	2,828	2,418
Imports of Eligible Suppliers	0	-43	0	0	20	60	0	49
Transmitted Energy	5,440	5,349	5,727	5,873	5,780	5,930	5,729	6,170
Load Shedding	818	851	473	556	760	409	927	558
Net Generation in Distribution			85	90	101	126	0	131
Sales to HV Customers		14	14	68	146	90	219	200
Distribution to Distribution Zone Customers	4,839	4,751	5,195	5,557	5,471	5,743	5,297	5,886
Losses (GWh)								
Transmission	601	584	603	338	264	223	213	214
Technical Distribution	849	816	792	1,067	1,147	1,277	1,062	1,167
Non-Technical Distribution	985	830	974	925	994	983	812	760
Total Distribution	1,834	1,646	1,766	1,992	2,141	2,260	1,874	1,927
Percent Losses								
Transmission (% of Transmitted Energy)	11.0	10.9	10.5	5.8	4.6	3.8	3.7	3.5
Technical Distribution (% of Distribution)	17.5	17.2	15.2	19.2	21.0	22.2	20.0	19.8
Non-Technical Distribution (% of Distribution)	20.4	17.5	18.7	16.6	18.2	17.1	15.3	12.9
Total Distribution (% of Distribution)	37.9	34.6	34.0	35.8	39.1	39.4	35.4	32.7
Total Losses (% of Transmitted Energy)	44.8	41.7	41.4	39.7	41.6	41.9	36.4	34.7
Sales (GWh)								
Eligible Customers	0	0	0	0	18	58	1	47
HV		14	14	68	146	90	219	197
MV and Non-Domestic LV	1,111	1,066	892	1,188	1,243	1,242	1,343	1,619
Domestic	1,894	2,039	2,451	2,286	2,067	2,132	2,078	2,293
Total	3,005	3,119	3,357	3,542	3,474	3,522	3,641	4,156
Billed (incl. VAT) (Lek Million)	15,910	19,817	23,974	28,456	29,919	30,127	30,464	39,032
Collection	12,498	17,496	21,318	23,843	24,060	24,600	27,253	32,500
Percent Collection	76.3	88.3	88.9	83.8	80.4	81.7	89.5	83.3
Billed (excl. VAT)	13,258	16,389	19,978	23,713	24,933	25,106	25,387	32,527
Average Tariff (excl. VAT)(Lek/kWh)	4.41	5.25	5.95	6.69	7.21	7.25	6.97	7.92

Source: KESH

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Annex 2: Major Related Projects Financed by the Bank and/or other Agencies

1. **Support for the Albania Electricity Sector.** Donor assistance to the power sector began with IDA and Swiss financing of emergency repairs to the power system under the Critical Imports Project in 1992. At that time the power system was badly run down as a result of lack of maintenance and was partly damaged by vandalism. Although the country had a surplus of hydroelectricity there were frequent power cuts due to unscheduled outages in the transmission and distribution systems. Shortly thereafter, non-technical power losses began increasing rapidly. Since then, donor assistance has focused mainly on four areas: supply of meters and technical assistance aimed at reducing non-technical power losses and improving bill collection; rehabilitation of the hydropower stations on the Drin River; rehabilitation and strengthening of the power transmission and distribution systems; and the beginning of sector reforms aimed at improving efficiency, establishing competition and creating conditions conducive to eventual private sector participation in the power sector.

2. With respect to the IDA-financed projects, the Critical Imports Project was rated satisfactory by OED. The Power Loss Reduction Project was rated satisfactory with respect to implementation, but unsatisfactory with respect to achievement of the Development Objective since the numerical power loss reduction targets were not achieved. The same ratings were given for the Power Transmission and Distribution Project. While the original development objectives in terms of loss reduction, bill collection and sector reform were not achieved, the revised targets fixed as a condition for lifting the project's suspension were achieved (see Annex 1). The Implementation Completion Report for the Power Sector Rehabilitation and Restructuring Project (for sector reform and rehabilitation of transmission and distribution) rated the outcome as Moderately Satisfactory. The Power Sector Generation and Restructuring Project (for sector reform and the construction of a new combined-cycle power station at Vlore) is under implementation. The ECSEE APL2-Albania Project for transmission system strengthening is also under implementation and rated Moderately Satisfactory. The ECSEE APL5 Project for Albania Dam Safety was approved by the Bank's Executive Directors in June 2008, and became effective in December 2008.

3. EIB, Italy, Norway and Switzerland have supported efforts to reduce non-technical power losses and improve revenue collection through the financing of meters and technical assistance. EBRD and later Italy have provided management support to KESH that has focused largely on the same goals. EBRD, Austria, Italy, Japan and Switzerland financed rehabilitation of the hydropower stations on the Drin River through the Drin River Cascade Rehabilitation Project. EBRD, EIB, Italy, Japan and Switzerland co-financed (with IDA) power transmission and distribution system rehabilitation through the Power Transmission and Distribution Project. EBRD and EIB are co-financing the PSGRP with IDA. Germany, Italy and Norway have been providing separate assistance for power sector rehabilitation. South Korea is providing financing for the Babica 220/110 kV substation and the 220 kV Fier-Babica transmission line. Spain has been providing finance for power distribution. Italy has provided financing for imports of electricity. The United States (USAID and USTDA) and Canada (CIDA) have been providing technical assistance for power sector reforms and investment evaluation. A transmission line

from Elbasan through Tirana to Podgorica is being implemented with financing by Italy and KfW. The ECSEE APL5 Project for Albania Dam Safety was approved by the Bank's Executive Directors in June 2008, and became effective in December 2008.

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Annex 3: Results Framework and Monitoring

PDO	**Outcome Indicators**	**Use of Outcome Information**
Facilitate the privatization of OSSH in the context of a new regulatory framework.	(i) The transaction is closed by May 2009. (ii) Tariff adjustments are made in conformity with the regulatory framework	(i) The experience from this privatization will provide guidance for possible future privatization of power generation. (ii) The particular tariffs approved will provide an indication of likely future performance of ERE under the new regulatory framework
Higher Level Objective: A financially viable and well performing sector is established	(i) Distribution Losses (ii) Collections of Billed Electricity (iii) Sector Investments	See also (i) above. Losses, collections, and investments indicators are *high level outcome indicators* --the PRG is only one factor among several to meet these objectives.
Intermediate Results	**Results Indicators for Each Sub-Component**	**Use of Results Monitoring**
(i) A qualified strategic investor assumes ownership of the DSO.	(i) Initial purchase of shares of OSSH.	(i) The magnitude of the investments will indicate the attractiveness of the Albanian power sector to investors and thereby provide guidance for preparation of privatization of other parts of the sector. It also enables the Government to decide on how to use the revenue from sale of OSSH.
(ii) The new regulatory framework is implemented for the period of the guarantee coverage.	(ii) OSSH operates in accordance with its license obligations and implements the investment programs approved by ERE.	(ii) The extent of success will reveal how well the new regulatory framework is working and provide indications on whether and how to improve it.

Arrangements for results monitoring

Outcome Indicators	**Baseline**	**YR1 09**	**YR2 10**	**YR3 11**	**YR4 12**	**YR5 13**	**YR6 14**	**Frequency and Reports**	**Data Collection**	**Responsibility for Data Collection**
(i) Transaction is closed by May 2009	(i) Share Purchase Agreement signed.	(i) Share Purchase Agreement approved by Parliament						(i) Notice of approval by Parliament	(i) Notices from investor, OSSH, METE Parliament	(i) OSSH, METE
(ii) Timely tariff adjustments are made in conformity with the agreed regulatory framework.	(ii) 2008 tariff of old regulatory regime	(ii) 2008 tariff continues.	(ii) tariffs for first regulatory period	(ii) tariffs for second regulatory period	(ii) tariffs for third regulator y period	(ii) tariff adjustme nts for supply cost	(ii) tariff adjustme nts for supply cost	(ii) ERE tariff announceme nts at the times of the tariff changes	(ii) ERE tariff decision procedures	(ii) OSSH and ERE
(iii) Total losses in electricity distribution network	(iii) 32.7%	(iii) 32%	(iii) 28%	(iii) 24%	(iii) 21%	(iii) 18%	(iii) 15%	(iii) OSSH annual report	(iii) OSSH accounting system	(iii) OSSH
(iv) Total collection of bills	(iv) 86%	(iv) 86%	(iv) 87%	(iv) 88%	(iv) 89%	(iv) 90%	(iv) 91%	(iv) as above	(iv) as above	(iv) OSSH
Results Indicators for Each Sub-Component										
(i) Initial investments are made by the investor for the purchase of shares	(i) No private share ownership in OSSH	(i) € 102 million						(i) Once	(i) Share Purchase Agreement	(i) Notice from investor. Confirmation by OSSH and METE
(ii) OSSH operates in accordance with its license obligations and implements the investment programs approved by ERE.	(ii) OSSH holds DSO and RPS licenses	(ii) Lek 3.2 billion	(ii) Lek 4.2 billion	(ii) Lek 4.9 billion	(ii) Lek 6.0 billion	(ii) Lek 6.4 billion	Lek 6.6 billion	(ii) OSSH annual report.	(ii) Investor's projection. OSSH annual report	(ii) OSSH.

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Annex 4: The PRG Term Sheet and Contractual Structure

Summary of Terms and Conditions of the World Bank (IBRD) Partial Risk Guarantee (PRG) for the Privatization of OSSH in Albania

L/C Applicant	The Ministry of Finance (MoF)
IBRD Guaranteed L/C:	A revolving Standby Letter of Credit (L/C) Facility issued in favor of the L/C Beneficiary by the L/C Issuer. The MOF's obligations to repay the L/C Issuer for the amounts drawn under L/C will be guaranteed by IBRD. Upon repayment by the MOF to the L/C Issuer of amounts drawn by the L/C Beneficiary, the L/C shall be re-instatable for such amounts. If the MOF fails to reimburse the L/C Issuer for such amounts drawn by the L/C Beneficiary within twelve (12) months plus accrued interest, the L/C Issuer will have the right to request IBRD the repayment of such amounts under the IBRD guarantee. The L/C shall not be reinstated for any L/C amounts drawn by the L/C Beneficiary and paid by the IBRD to the L/C Issuer under the IBRD guarantee following the failure of the MOF to reimburse such amounts. The Letter of Credit issued by the L/C Issuer would be drawn by the L/C Beneficiary following a 'Guaranteed Event' (see below). If there is a dispute between MOF and the privatized company OSSH as to whether a Loss and/or a Guaranteed Event has occurred, the L/C can also be called for provisional payments pending the settlement of the dispute, provided that the L/C Beneficiary shall provide the L/C Issuer with appropriate security (acceptable to both the L/C Beneficiary and the MOF and to be reflected in the GSA (as defined below), in favor of the MOF guaranteeing such provisional payments in the event the final decision determines that the MOF had no liability or its liability was for less than the amount of the provisional payments.
L/C Beneficiary:	The privatized company OSSH, in its capacity as energy distribution system operator (DSO) and energy retail public supplier (RPS).
L/C Term:	Up to 6 years to cover the Transitory Period in 2009 and the First, Second, and Third Regulatory Periods, as such terms are defined in the Regulatory Framework (see below) and the additional period allowed for the filing of a claim under the GSA.
L/C Issuer:	A commercial bank acceptable to MOF, the IBRD and the L/C Beneficiary and that will be selected by the MOF in accordance with its applicable procedures.
L/C Form:	The L/C will be issued in a form satisfactory to the investor, MOF and IBRD.
PRG Purpose:	To provide a guarantee for the repayment to the L/C Issuer of the amounts drawn by the L/C Beneficiary under the L/C following the occurrence of a Guaranteed Event (as defined below) that results in a loss of annual

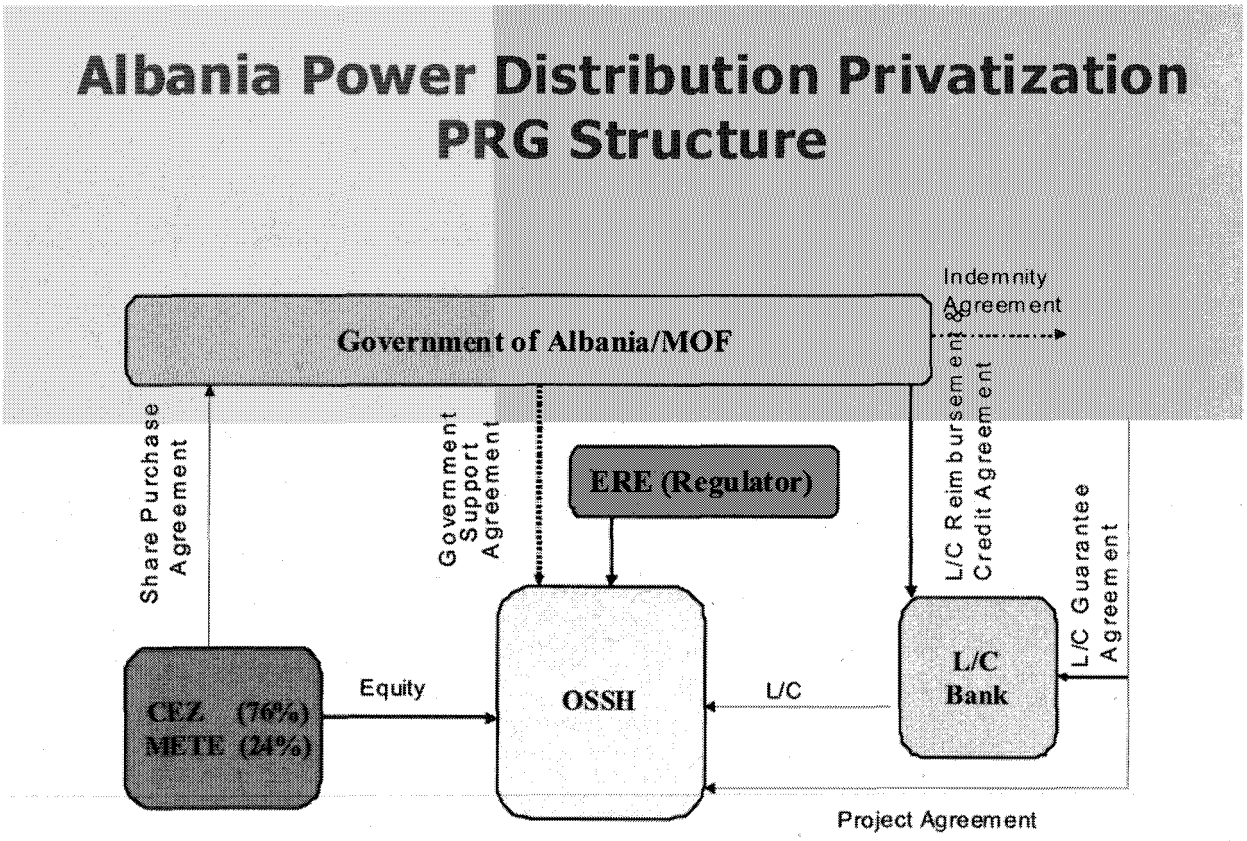
	regulated revenues (a Loss) to OSSH during the transitory period and the three regulatory periods identified in Section 1.2 of the Regulatory Statement (RS) approved by Decision No. 12 of the Board of Commissioners of the Albanian Electricity Regulatory Entity (ERE) on March 3, 2009.
Guaranteed Events:	**The Guaranteed Events will consist of:** A change, repeal or non-compliance by the ERE or the GOA of certain provisions of the Regulatory Framework (as defined below) governing: (i) the timely approval of the distribution system operator (DSO) and retail public supplier (RPS) tariffs applications as submitted by OSSH, pursuant to Clause 1.3 of the RS; and (ii) the DSO tariff formula and the RPS tariff formula and their related inputs including the compensation mechanism as reflected in Sections 5 and 6 of the RS but excluding any references to regulatory periods beyond December 31, 2014. **The inputs to the DSO and RPS formulae include:** ***For the DSO Formula*** • The determination of the regulatory asset base (RAB) for 2009 and subsequent years through 2014 as described in Section 6 of ERE's Board of Commissioners Decision No. 79, dated June 26, 2008 and in Section 4.1 of the RS. • The weighted average cost of capital (WACC) calculation methodology including the treatment of the pre-tax allowed return on equity (ARoE) until December 31, 2014, as described in Section 4.2 of the RS and ERE's Board of Commissioners Decision No. 79, dated June 26, 2008. • Recognition of the cost of equity of 16.44% pre-tax until 2014 as set out in Section 4.2 of the RS. • Full pass-through into the applicable tariff by way of the WACC calculation of the cost of new debt (including shareholder financing) acquired following the specified procedures set out in Section 4.2 of the RS. • Application of the 60% gearing ratio for the DSO as set out in Section 4.3. of the RS. • Determination of the costs of operation (OPEX) of the DSO in 2009 and subsequent years through 2014, as set out in Section 5 of ERE's Board of Commissioners Decision No. 79, dated June 26, 2008 and Section 4.4 of the RS. • Working Capital Requirement for the DSO as described in Section 4.4 of the RS. • The starting level and future targets for DSO distribution loss reduction and changes to these that may result from the Loss and Audit Studies as described in Section 4.5 of the RS. • Full pass through of the cost of power to cover distribution losses for power procured on the open market in accordance with tender

	procedures approved by ERE as set out in Section 4.5 of the RS. • Setting the X-factor equal to zero for the first three regulatory periods and recognition by ERE of any profit stemming from the reduction of operational costs (excluding losses), as set out in Section 4.6 of the RS. ***For the RPS Formula*** • Recognition of the bad debt allowance targets as may be revised as a result of the Bad Debt Study, as set out in Section 5.2 of the RS. • Recognition of RPS profit margin of 2.2% on annual electricity purchases from the wholesale public supplier (WPS) until 2014 as set out in Section 5.3 of the RS. • Full pass-through for the power procurement costs of the WPS as set out in Section 5.3 of the RS. • Adjustment to the tariff to final consumers to compensate for differences between forecast and actual revenue resulting from the circumstances specified in Section 5.3 of the RS. • Non claiming of any increased earnings, before interest and taxes of OSSH, relating to the period starting on 1st January 2009 and ending on the date of closing of the transaction relating to the privatization of OSSH according to the comfort letter issued by METE on March 9, 2009. The Guaranteed Events relate to the following documents (which are subject to further due diligence by the Bank) (the Regulatory Framework) to be attached to the Government Support Agreement (GSA): - ERE's Board of Commissioners Decision Nr. 18 concerning "Electricity Generation Tariff for KESH for the period from March 1, 2008 to February 29, 2009", dated February 14, 2008,; - ERE's Board of Commissioners Decision Nr. 19 concerning "Electricity Transmission Service Tariff for the period from March 1, 2008 to February 29, 2009", dated February 14, 2008,; - ERE's Board of Commissioners Decision Nr. 20 concerning "Electricity Distribution Service Tariff for the Users of the Distribution System, for the period March 1, 2008 to February 28, 2009", dated February 14, 2008, ; - ERE's Board of Commissioners Decision Nr. 21 concerning "Retail Electricity Prices for Tariff Customers for the period March 1, 2008-February 28, 2009", dated February 14, 2008; - ERE's Board of Commissioners Decision Nr. 75 concerning "Electricity Wholesale Tariff", dated June 26, 2008; - ERE's Board of Commissioners Decision No. 79 concerning "Electricity Distribution System Operator Tariff Calculation Methodology", dated June 26, 2008; - ERE's Board of Commissioners Decision No. 80 concerning "Retail Sales to Regulated Tariff Customers Tariff Calculation Methodology", dated June 26, 2008; - OSSH's tender procedures regarding selection of banks providing new debt to be approved by ERE by the closing date of privatization of

	OSSH; - OSSH's tender procedures regarding selection of supplier of electricity covering the losses to be approved by ERE by the closing date of privatization of OSSH; - Council of Ministers Decision from February, 2009 - Regulatory Statement (RS) approved by ERE on March 3, 2009 - Comfort letter issued by METE concerning government compensation to OSSH for financial losses in 2009 resulting from specified possible ERE decisions and dated March 9, 2009. In the event of any conflict between the RS and any other of the ERE decisions or regulations indicated above, the RS shall prevail.
L/C Amount:	An amount of up to Euro 60 million. The L/C shall be available for drawings by the L/C Beneficiary upon filing of a claim on the basis of drawdown mechanisms and the presentation of supporting documentation to be agreed between the parties in the GSA and the Standby L/C, and satisfactory to the IBRD. Upon the MOF repayment to the L/C Issuer of the amounts drawn by the L/C Beneficiary under the L/C, the drawn amounts shall be reinstated by the L/C Issuer.
IBRD Maximum Guaranteed Amount:	An aggregate amount equivalent to the L/C amount plus accrued interest
Guarantee Validity Period:	L/C term plus 14 months
L/C Reimbursement Period:	Following any L/C drawings, the MOF will be obligated to repay the drawings to the L/C Issuer within a period of twelve (12) months from the date of each drawing together with interest thereon to be reflected in a Reimbursement and Credit Agreement to be concluded between the MOF and the L/C Issuer. In the event of a non-payment by the MOF of the amounts drawn under the L/C at the expiration of the twelve (12) month period, the L/C Issuer would have the right to call on the IBRD guarantee for the amounts due plus accrued interest following which the L/C would not be reinstateable for the amounts repaid by the IBRD.
Interest Rate on Drawings during the Reimbursement Period charged by the L/C Issuer:	An appropriate spread acceptable to MOF and IBRD, and payable by the MOF.
IBRD Guarantee Fees:	30 bp per annum on IBRD guaranteed amounts outstanding, payable semi-annually in advance by the L/C Beneficiary.
IBRD Front-end Fees:	a) A Front-end Fee of 25 bp on the guaranteed amount. b) An Initiation Fee of 15 bp of the guaranteed amount (but not less than USD100,000) for internal Project preparation. c) Processing Fee of a maximum of 50 bp of the guaranteed amount to cover IBRD designated reimbursable expenses.

	All IBRD related fees to be payable by the L/C Beneficiary.
L/C Fees:	To be negotiated between MOF, the L/C Issuer, and the L/C Beneficiary, and payable by the L/C Beneficiary
Conditions Precedent to the effectiveness of the IBRD Guarantee:	Usual and customary conditions for financing of this type, including the following: a) Execution, delivery and effectiveness of all privatization and related agreements (including the GSA), each in form and substance satisfactory to IBRD; b) Provision of relevant satisfactory legal opinions from: (i) the Ministry of Justice of the Republic of Albania relating to the Share Purchase Agreement, the Indemnity Agreement, the Government Support Agreement, and the Reimbursement and Credit Agreement, (ii) counsel to OSSH relating to the Project Agreement; (iii) counsel to the L/C Issuing Bank relating to the L/C; and (iv) counsel to CEZ regarding the Share Purchase Agreement. c) Payment in full of the Initiation Fee and Processing Fee, and the first installment of the Guarantee Fee; and d) Conclusion of a Guarantee Agreement between the L/C Issuer and IBRD, a Project Agreement between the L/C Beneficiary and IBRD, and an Indemnity Agreement between IBRD and MOF.
Government Support Agreement:	The MOF will enter into a GSA with the L/C Beneficiary under which the Ministry would undertake to indemnify the L/C Beneficiary for the loss of revenues resulting from the occurrence of a Guaranteed Event on the basis of drawdown and dispute resolution mechanisms and supporting documentation to be agreed between the parties and satisfactory to IBRD.
Reimbursement & Credit Agreement:	The MOF will enter into a Reimbursement & Credit Agreement with the L/C issuer in which it will undertake to repay the L/C issuer the amounts drawn under the L/C within a period of twelve (12) months from the date of each drawing plus accrued interest.
Guarantee Agreement:	The terms and conditions of the IBRD Guarantee would be embodied in a Guarantee Agreement between the L/C Issuer and IBRD.
Indemnity Agreement:	Albania would enter into an Indemnity Agreement with IBRD. Under the Agreement, Albania would undertake to indemnify IBRD on demand, or as IBRD may otherwise determine, for any payment made by IBRD under the terms of the Guarantee. The Indemnity Agreement will follow the legal regime, and include dispute settlement provisions, which are customary in agreements between member countries and IBRD.
Project Agreement:	The L/C Beneficiary would enter into a Project Agreement with IBRD in respect of its Guarantee. Under such Agreement, the L/C Beneficiary will provide reports (including audit reports) and other Project information, and make warranties, representations and covenanted undertakings, including in respect of compliance with applicable environmental laws and applicable

	World Bank requirements relating to 'corrupt practices'.
Other Provisions:	As part of its appraisal process, IBRD would carry out a review of the financing and commercial structure of the Project and any related financing agreements, and the proposed risk coverage, as deemed relevant by IBRD. The Project Company would be expected to comply with all applicable Bank policies and requirements, relating to disclosure of information, and applicable fiduciary and anti-corruption safeguards.



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Annex 5: Electricity Regulation and Regulatory Framework Backstopped by the PRG

Privatization of the Power Distribution System Operator

1. *The Electricity Regulatory Entity (ERE).* The ERE was established in 1995 but remained weak until its authority was strengthened by the Power Sector Law enacted in 2003, which, among other provisions, removed the right of the Government to fix a cap on electricity prices. The Law provides for the appointment of the Chairman and the Commissioners by Parliament and these officials may not be removed except for particular reasons that would rarely be applicable. The ERE is financed by annual fees paid by the licensees and has a staff of 45. USAID has been providing technical assistance for training and preparation of the necessary regulations provided for under the Power Sector Law. Under the ERE, the average tariff level has risen from Lek 4.41/kWh in 2001 to Lek 8.15kWh (€0.063/kWh) in 2008 after February, but is still not at cost recovery level.

2. The ERE is, *inter alia,* competent to:

- set the rules and requirements for granting, modifying, transferring and revoking of licenses to generation, transmission, distribution and supply companies;
- set, regulate and review tariffs contracts and the terms and conditions of service of electric energy proposed by a licensee or reviews them according to circumstances;
- resolve disputes between licensees and consumers, and between or among licensees;
- monitor and control the operation of services by licensees, with powers of inspection, access, acquisition of documentation, and relevant information;
- control whether the licensee providing power services to customers is respecting the terms of the contract or is providing services consistently with standards established by the terms of the license or any regulation approved by the ERE; and
- publicize and make known the conditions under which the electric energy services are provided in order to ensure maximum transparency and the competitiveness of the supply (Article 8 of the Power Sector Law)

Regulatory and Competition Framework for Electricity Distribution and Retail Supply

3. The regulatory and competition framework is governed by the Power Sector Law, and by the Albanian Market Model (AMM) that was adopted by the Council of Ministers in January 2007 and amended in January 2008 to accommodate the Government's decision to have separate wholesale and retail public suppliers. The AMM is designed to meet Albania's commitments under the Energy Community Treaty, which requires conformity with the EC Directive 2003/54 (electricity), which requires liberalization of the power systems of the European Union countries.

4. The power sector has been restructured by creating separate generation, transmission, distribution and supply entities. Each has a license from ERE, and those intended to operate under regulated tariffs have such tariffs. However, all of these entities are currently publicly owned (apart from private Qualified Suppliers), with the DSO being the first to be offered for sale to a private investor.

5. A competitive market has yet to be established and it will be some years before it will be possible to have much competition. Since all domestic power production, except for a small amount from small hydropower plants, comes from one entity, KESH Gen, and is sold at regulated prices either to the TSO or the WPS, there is no possibility of competition between generation companies within Albania at the present time. The only new power station that will come into operation in the next few years is the Vlore Thermal Power Plant. It will be operated by a separate company, initially fully owned by KESH and will have a Power Purchase Agreement (PPA) with the WPS. Therefore it will be some years before competition between domestic generators within Albania is likely to take place. In the meantime, the main way that competition can occur in Albania is through the possibility for Eligible Consumers to choose between alternative Qualified Suppliers who would purchase on the import market. Although the ERE has authorized all non-household electricity consumers to be Eligible Consumers, only one large consumer has so far opted to cease being tariff customers. Others may be reluctant to do so in the near future since they would lose the hydro benefit.

Regulation of the DSO and the RPs

6. OSSH will operate under two licenses: (a) a Distribution System Operator License for 30 years with exclusive right to serve all of Albania; and (b) a Retail Public Supply License for 30 years with exclusive right to supply electricity to final tariff customers. The Distribution System Operator License applies to network operation (covering all voltage levels within Albania from 0.4 kV up to and including 110 kV) and to connections of consumers (including Eligible Consumers, who will not be buying their electricity from the RPS) and independent generators, installation and servicing of meters and meter readings. The Retail Public Supply License provides for the purchase of the electricity destined for final tariff customers from the WPS at a regulated tariff and sale to final tariff customers at a regulated tariff. The RPS will also pay the Transmission Systems Operator (TSO) a regulated fee for transmission services. Billing and collections come under the RPS license as well. There will be a detailed contract between the RPS and the WPS, and this contract will require the approval of ERE.

7. The DSO and RPS tariffs will be regulated in accordance with the "Electricity Distribution System Operator Tariff Calculation Methodology" and the "Retail Sales to Regulated Tariff Customers Tariff Calculation Methodology", both approved by ERE on June 26, 2008. Certain provisions of these Methodologies have since been amended and supplemented by a Regulatory Statement that was negotiated with CEZ and approved by ERE on March 3, 2009. Consequently, the Regulatory Framework will consist of the two methodologies mentioned above as well as the Regulatory Statement, which will prevail in the case of any inconsistencies with the two Methodologies.

Distribution System Operator (DSO)Tariff Methodology

8. This document, together with the Regulatory Statement, establishes the methodology for the calculation of the distribution access and use-of-network tariffs for the distribution system users of Albania that is consistent with the Energy Community Treaty. The year 2009 is to be a transitory regulatory period during which the existing regulatory parameters will be preserved and the tariff approved in February 2008 will apply to year 2009. By September 30, 2009 the DSO is to apply for a new distribution tariff, which is to become effective on January 1, 2010. The year 2010 will be considered as the first regulatory period for the DSO, with the year 2011

as the second regulatory period and years 2012, 2013 and 2014 as the third regulatory period. The subsequent regulatory period will be of 3-5 year term.

9. Tariff submissions are required to be submitted by OSSH before each regulatory period for the DSO from Year 2010. Tariff submissions are required to be made no later than September 1 and to be approved by ERE by December 7 of the same year. The tariffs for 2010 and the subsequent regulatory periods are intended to cover the revenue requirements as follows:

RR = C + (RAB* WACC), where:

RR = the annual revenue requirements;
C = the allowed annual cost of operation for the licensed activity (OPEX);
RAB = the Regulatory Asset Base;
WACC = pre- tax Weighted Average Cost of Capital

10. Allowed Annual Operating Costs (OPEX) will include the operations and management costs of OSSH for distribution services *plus* the cost of imports of power required to cover target levels of technical and non-technical distribution losses plus the cost of transmission of the imported electricity plus depreciation. For purposes of determining allowed import costs to cover distribution losses, ERE will assume that total distribution losses as a percentage of electricity entering the distribution network are reduced from an assumed level of 32 percent in 2009 by four percentage points in 2010, 4 percentage points in 2011 and 9 percentage points in 2012-2014 (three percentage points per year) to reach 15 percent in 2014. The imported electricity will be purchased on the basis of fair, transparent and lawful tender procedures proposed by the DSO and approved by ERE no later than the closing of the privatization of OSSH. The weighted average price determined from these approved procedures for the year ahead multiplied by the quantity of electricity needed to cover the approved distribution losses will determine the import costs to be recognized by ERE for determination of the DSO's tariff for the year ahead. Any differences between the forecast and actual cost of power purchased to cover the target losses in each year will be fully passed through in the tariff for the next year in such a way that the DSO will bear no risk arising out of power procurement on the open market. The differences allowed for pass-through could arise from the actual weighted average price being different from the forecast average or from the quantity of imports being different because the demand by final consumers is different from the forecast demand. The DSO will be allowed to keep any profits earned as a result of reducing distribution losses to a percentage below that approved by ERE. Conversely it will have to absorb any possible loss resulting from the distribution loss percentage being higher than the target rate.

11. No later than July 31, 2009, the DSO shall have a Loss Audit carried out by an independent technical expert to determine the methodology of calculation of total losses and verify the actual 2008 distribution losses. No later than July 31, 2010 the DSO shall have a Loss Study carried out by the technical expert to determine the distribution losses incurred in 2009. The Loss Study will be approved by ERE within two months of submission and the Loss Audit within one month. After they are approved by ERE the results of these studies will be used to amend the loss reduction schedule (by 4 percent each year for 2010 and 2011 and by an additional 9 percent by the end of 2014). The costs of the Loss Audit, Loss Study, Bad Debt Study, as well as the PRG-related costs will be a pass-through in the OPEX.

12. Annual Adjustments of OPEX: The methodology provides for the annual adjustment of operating costs excluding import costs and depreciation in accordance with a price cap formula based on rate of price increase less efficiency improvement (RPI –X). RPI is set equal to the increase in the Albanian Consumer Price Index. X is set equal to zero for the first three regulatory periods, allowing OSSH to keep any profit resulting from a reduction of OPE, but will be subject of review for the subsequent regulatory period. The DSO will be allowed to request adjustments in its allowed operating costs at the beginning of regulatory periods for justifiable expenses.

13. Regulatory Asset Base (RAB) will be determined according to the following formula:

RAB = A-CG-D+WC+INV where :

A = the recognized values of used and useful fixed assets:
CG = the value of assets acquired through gratuitous transfer or constructed with financial resources of electricity consumers;
D = The accumulated depreciation for the past period of assets used to perform the licensed activity;
WC = the working capital requirement, which shall be equal to 1/12 of OPEX excluding depreciation and financial expenses.;
INV = the forecast average cumulative nominal amount of investments approved by the ERE and invested during the regulatory period.(OSSH is required to submit an investment plan for 2009 and 2010 no later than 2 months after the closing of the Privatization).

14. The starting value of the Regulatory Asset Base for the DSO for 2009 will be equal to the book value of fixed assets of the audited IFRS balance sheet of the DSO as of December 31, 2007, plus the value of investment of the company for 2008, plus projected investment by the company for 2009 approved by the ERE, less accumulated depreciation for 2008 and 2009. The ERE will exclude from the RAB those fixed tangible and intangible assets financed through grants. These assets were valued at Lek 770 million for 2008.

15. WACC will be determined in accordance with the following formula:

WACC = 40%*ARoE + 60%*(Y1% +Y2%) where:

ARoE = allowed return on equity before tax pre-agreed to be 16.44% for the first three regulatory periods.
Y1% = the interest rate on old long-term debt multiplied by the share of old long-term debt in total long-term debt.
Y2% = the interest rate on new long-term debt multiplied by the share of new long-term debt in total long-term debt.

The interest rate on old debt is the actual rate fixed in the sub-loan agreement between OSSH and KESH under which all of KESH's pre-privatization long-term borrowings from IDA and other lenders for power distribution are transferred to KESH in exchange for a single bundled long-term debt on which OSSH pays interest at the agreed rate.
The interest rate on new debt will be determined at the time the debt is incurred on the basis of fair, transparent and lawful tender procedures proposed by OSSH to ERE by the end of February 2009 and approved by ERE by no later than the closing of privatization of OSSH. OSSH will also have the right to raise debt from multinational lenders in which case such tender procedures would not apply and the actual cost of debt would be fully pass-through into the applicable tariff by way of the WACC.

16. DSO Services: The DSO is licensed to provide five types of service: use of network, metering and meter-reading, meter disconnection and reconnection, reactive power compensation and connections. The DSO Methodology specifies the different types of prices and charges that it will approve for the DSO.

17. The DSO will disconnect customers for non-payment or other violation at the request of the RPS, or qualified supplier or at its own will. It will charge all customers above 50 kVA for reactive power compensation. This charge does not exist now and will require the installation of new meters. The consumers will be required to pay for their connections, and each new connection will be priced in accordance with rules set out in the Methodology.

18. Each customer is to pay a defined capacity charge for use of network as well as an energy charge. There is no capacity charge in the existing tariff. The DSO may also apply to ERE for peak and off-peak charges. These do not exist now and would require new meters.

19. Retail Public Supplier (RPS) Tariff Methodology: RPS tariffs for regulated sales to electricity end-customers will be determined on the basis of this methodology and the Regulatory Statement. Tariff submission will be required to be made by September 1 and approved by ERE on December 7 before the beginning of each year. Tariff applications for years 2009 and 2010 are required to be submitted by 30th September and reviewed by ERE by 15th December at the latest with a view to the issuance of a Tariff Order by the Ist of January 2010.

20. The RPS will buy the electricity needed by final consumers from the WPS at a regulated tariff which will be adjusted annually by ERE (WPSt) It will also pay to the TSO the charges approved annually by ERE for transmission use for final consumers (TSOt) The RPS will also pay the TSO for imbalances according to the Market Rules if applicable and there is to be an annual adjustment for the previous year including energy and capacity adjustments from the

WPS compared to forecasted levels. The simultaneous annual adjustment of the WPS, TSO and RPS tariffs will ensure precise pass-through of the RPS's electricity supply costs to the end-use tariffs.

21. The Revenue Requirement associated with end-user tariffs will be calculated on the basis of the following formula:

$$RRactn = (WPStariffn + TSOtariffn) \times Vn + DSOtariffn \times Vdn + PSOcostsn + RPScosts - \Delta COMPBn$$

where

RRactn = actual applied revenue requirements in million Leks from final users recognized by ERE in year n.
WPStariffn = the WPS tariff recognized by ERE in year n.
TSOtariffn = the TSO tariff recognized by ERE in year n.
Vn = total sales volume of electricity in GWh to tariff customers agreed by OSSH and ERE in year n.
DSOtariffn = the DSO tariff recognized by ERE in year n.
Vdn = total sales volume of electricity to tariff customers connected to the distribution system agreed by OSSH and ERE in year n.
PSOcostsn = public service obligation costs (such as energy efficiency programs) recognized by ERE in year n.
RPScostsn = retail public supply costs plus RPS profit margin equal to 2.2% of the purchases from the WPS, excluding VAT, recognized by ERE in year n
ΔCOMPBn = reduction in the compensation account in year n recognized by ERE in compliance with the agreed compensation mechanism

22. The tariff to final consumers will include an adjustment to compensate the RPS for differences between forecast and actual revenue as of result of deviations in forecasting demand in individual consumer categories when they are newly created or when there are tariff changes that are not in the same proportion for all customer categories.

23. The tariff to final consumers will also be adjusted to reflect the allowed bad debt level.

24. **Bad Debt Level**: The allowed bad debt level (equal to uncollected revenue in the given year divided by total billed revenue of RPS excluding VAT for the same year) is assumed to be at 14% base level in 2009. The level for 2010 and subsequent years will be equal to the 2009 base level reduced by one percentage point each year up to Year 2014 The Regulatory Statement provides for OSSH to carry out by 2010 a Bad Debt Study to be undertaken by an independent financial expert to be agreed by CEZ and ERE. This study will determine the methodology to be used to calculate the bad debt level and the actual 2008, 2009 and 2010 level of bad debts. The actual bad debt level for 2010 determined by the Study will then be used as the base for the subsequent bad debt reduction schedule provided for in the Regulatory Statement. In case the actual 2009 and 2010 bad debts are higher in 2009 and 2010 than 14% and 13%, respectively assumed prior to the Study then the resulting loss to the RPS from the difference between the assumed and actual levels can be recovered through the Compensation Mechanism described below. If the actual bad debt in any year after 2009 is less than the base level to be allowed by ERE, the RPS will be allowed to keep the extra revenue.

25. The RPS tariff methodology specifies the prices and charges that are to be put into effect for the RPS. The bills for household customers and non-household customers supplied in 0.4 kV may include the following charges:

- Generation services (Lek/kWh)
- 1st Block (x kWh/month for households)
- 2nd Block (residual kWh
- Transmission services (Lek/kWh)
- Distribution services (Lek/kWh)
- Customer charge (Lek/month)
- Public Service Obligations (Lek/kWh)

26. The bills for each group of non-household customers, according to the supply level of voltage may include the following separated charge:

- Generation services (Lek/kWh)

- Capacity charge (Lek/kWh)
- Energy charge (Lek/kWh)
- Transmission services (Lek/kWh)
- Capacity charge (Lek/kWh)
- Energy charge (Lek/kWh)
- Distribution services
- Capacity charge (Lek/kWh)
- Energy charge (Lek/kWh)
- Reactive power charge (Lek/kWh)
- Customer charge (Lek/month)
- Public Service Obligations (Lek/kWh)

27. For HV and MV customers, the monthly invoice is to include a capacity charge. It will be set at zero until the customer installs electronic meters to record and store hourly customer demand.

28. **Compensation Mechanism:** The Compensation Mechanism provides for OSSH to be compensated in subsequent years for any financial losses incurred in any previous year as a result of ERE approving the DSO and RPS tariffs below the required levels provided for in the Regulatory Framework. In the event that the calculated Revenue Requirement of OSSH for a given year, in its function of RPS, result in an increase of the weighted average end-user tariff (the total required revenues of OSSH in its function of RPS in given year divided by total estimated volume of electricity sales in a given year) higher than 15% plus CPI, then ERE may allow a tariff increase of only 15% plus CPI and carry forward any unrecovered revenues to be reflected in future year tariff increases. These unrecovered revenues will form the compensation account from the year when the entitlement arises and ending in the year (inclusive of) in which the amount is fully compensated. Should the expected increase of the weighted average end-user tariff for the following year be lower than 15% plus CPI, then ERE is expected to take into account any unrecovered compensation amount in the tariff increases for that year, up to 15% plus CPI. OSSH will be compensated for such compensation amounts at the DSO WACC

prevailing in the year preceding its application. The precise mathematical formula for the Compensation Mechanism is set out in the Regulatory Statement.

29. In addition to the portion of RPS' Revenue Requirements which are not reflected in ERE approved tariff increases up to the 15% minimum tariff plus CPI, the following components would also be subject to the Compensation Mechanism:

(i) Financial Losses for the Transitory Year of 2009 when no tariff increases are to take place. ERE will provide compensation to OSSH for any financial loss incurred by the DSO and the RPS in 2009 resulting from actual tariffs prevailing on March 1, 2009 being lower than the tariffs that would come into effect from 1st January 2010 based on the Regulatory Framework.

(ii) Financial Losses to the RPS relating to bad debt levels resulting from base level of bad debt allowance assumed in 2009 and 2010 being lower than actual bad debt levels determined by the Bad Debt Study as described in the Regulatory Statement.

(iii) Financial Losses to the DSO in the event actual distribution losses are higher than the base level assumptions of 32% for Years 2008 and 2009 as determined by a Loss Audit and Loss Study described in the Regulatory Statement.

30. The Government will transfer a controlling stake of 76 percent of OSSH's shares to the CEZ Group (CEZ), an integrated electricity conglomerate based in the Czech Republic[15]. CEZ's principal businesses encompass electricity generation and distribution, sales of electricity and heat, as well as coal mining. In 2007, CEZ owned about 14.3 GW of electricity generation capacity, sold 73,793 GWh of electricity and had more than 70,000 employees in its operations in the Czech Republic, Poland, Hungary, Romania, Bulgaria and other countries. In November 2008, CEZ was among the top ten European power utilities with about 6.8 million customers and a market capitalization of about €16.3 billion. The company serves about 3.5 million electricity customers in the Czech Republic and owns controlling stakes at electricity distribution companies in South East Europe (1.67 million customers in Romania and about 2 million customers in Bulgaria). CEZ reported net income of CZK 42.8 billion in 2007 and estimates a net income of CZK 48.6 billion (about US$ 2 billion) in 2008, while it maintained the lowest debt leverage ratio among European power utilities and a rating of A-/A2[16].

31. Initially the RPS will be part of OSSH, but it will be organized under a separate management structure (with separate accounts) and later as a separate legal entity in order to conform to the EC's Electricity Directive. Whether combined or separate, the RPS and OSSH will need to coordinate their activities to reduce distribution losses and improve collections. The RPS is responsible for billing and collection, with the bills of final customers including a charge for use of the DSO's network as well as purchase of energy. The DSO is responsible for meter reading and maintenance and for consumer connections. Therefore the RPS will have to request the DSO to disconnect consumers who have connected illegally or are in default, but operational control for both entities can be effectively coordinated as they are both owned by OSSH.

32. At the end of 2007, KESH's receivables from customers totaled just under Lek 50 billion (US$500 million), of which Lek 44.2 billion were from households. However, the opening balance sheet for OSSH includes only receivables of households relating to bills after January 2007. At the time of privatization, all household debt for unpaid electricity bills prior to 2007, amounting to Lek 45 billion, will be transferred to KESH. Collection of long-dated bills is likely to be challenging, but OSSH is authorized to collect all receivables before 2007 on behalf of KESH and receive a fee equal to 10 percent of the value of the receivables collected, including VAT, for doing so.

33. A number of long-term loans received by KESH for the distribution system have been consolidated into a single long-term liability in the opening balance sheet of the OSSH. OSSH will pay debt service on this liability to KESH. The long-term loans are mainly those provided to KESH by international donors. The result of this treatment is that OSSH will deal with KESH rather than the donors, and KESH will continue to be responsible for the debt service on the individual loans, as well as for honoring the other commitments under the loan agreements.

[15] CEZ group is owned by ČEZ a.s. a joint-stock company incorporated in May 1992 and listed in the stock markets of Prague and Warsaw; the Czech Republic continues to be the company's largest shareholder with a 69% stake as of March 2009.

[16] *Sources*: CEZ Annual Report 2007; CEZ Quarterly Presentation to Investors, November 2008.

KESH's short-term liabilities incurred mostly for importing electricity up to June 30, 2008 remain with KESH rather than OSSH.

34. The DSO will operate under a tariff designed to cover the costs of operating the distribution system, including the costs of purchasing electricity on the market to cover distribution losses plus an allowed rate of return on the approved rate base. The tariff will be based on specified distribution loss reduction levels and collection rates to be achieved (see paragraph 21 above, subject to qualifications set out in Annex 5). The DSO can make additional profits by over achieving the targets, but must absorb any financial losses from failing to meet the targets. Powerful incentives to improve performance are therefore in place.

35. The RPS will operate under a retail tariff that passes through the cost of buying electricity at a regulated price from the WPS plus the transmission tariff plus the distribution tariff plus a margin to cover operating costs, and a designated fee of 2.2 percent of purchases from the WPS for performing the retail supply activity. The tariff is based on the assumption of a bad debt allowance that will be reduced from 14 percent of billed revenue in 2009, by one percentage point each year (subject to qualifications set out in Annex 5).

36. CEZ's plans to improve the performance of OSSH include:

- Organizational restructuring from the current geographic based approach to a combination of functionalities and regional focus
- Strengthening and upgrading of existing 10 kV lines and 110/10 substations
- Installation of metering to all customers and advanced technology metering to selected private customers
- Replacement of old transformers with new ones that have low losses.
- Metering of reactive power and metering of customers of above 50 kVA with electronic meters
- Investment in 0.4 kV networks introducing Aerial Bundled Cable lines that minimize unauthorized access to the network
- Improvement of the billing and collection systems by introducing a new information technology system that will maintain clean, centralized, client information.
- Training of personnel
- Introduction of performance-based remuneration system
- Strengthening of OSSH's environmental performance.

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Annex 7: Economic and Financial Analysis

1. ***Projections of Required Electricity Tariffs, Amounts in the Compensation Account and Possible PRG Exposure.*** The following table presents projections of revenue requirements for the DSO and RPS together with estimates of required tariffs up to 2014, the last year of the third regulatory period. It also presents estimates of tariff growth assuming the maximum increase in any year is limited to 18 percent and tariffs in subsequent years are determined in accordance with the operation of the agreed compensation mechanism. In addition it includes estimates of amounts in the compensation account by year for each tariff scenario and possible payments to OSSH required under the PRG mechanism in the event that tariff increases are less than the floor rate of 18 percent and there is still money in the compensation account.

2. The main results are the following.

- If tariff increases are limited to 18% per year, the tariff would need to grow from Lek 8.15/kWh ($US0.08/kWh) in 2008 to Lek 9.6/kWh (US$0.094/kWh) in 2009 and Lek 11.3 kWh (US$0.111/kWh) in 2010 in order to cover current year costs as well as pay off financial losses from previous years, but would thereafter fall gradually to Lek 9.1/kWh (US$ 0.089/kWh)in 2014 as a result of reductions in distribution losses and improvement in collections in accordance with the agreed schedules for these two variables. The amounts in the compensation account would increase from Lek 5.8 billion (US$57 million) in 2009 to Lek 10 billion (US$98 million) in 2010, diminish to Lek 5.8 billion (US$57 million) in 2011 and to zero by 2012.

- PRG payments would be triggered if the tariff trajectory is below the 18 percent per year path. If the tariff increases were limited to 5 percent per year plus inflation adjustment of 3 percent, payments would be required of Lek 3.4 billion (US$ 34 million) in 2010,, Lek 8.3 billion (US$81 million) in 2011, and Lek 4 billion (US$39 million) in 2012.

3. The table is based on the following assumptions:

- The provisions of the agreed regulatory framework, including the Regulatory Statement dated March 3, 2009.

- Projections of electricity production, production prices and demand prepared by KESH for the draft Ninth Power Sector Action Plan (December 2008) and of estimates of costs of purchase of materials and product and supply and services for the DSO presented by KESH in the Eighth Power Sector Action Plan

- Bank staff estimates of inflation, import prices, personnel costs, new debt amounts and interest rate, depreciation, and investments after 2008.

Electricity Balance Assumptions

	2009	2010	2011	2012	2013	2014
Net KESH hydro (GWh)	4,200	4,200	4,200	4,200	4,200	4,200
Net Vlore thermal (GWh)	400	742	742	742	742	742
Private generators (GWh)	80	85	90	99	109	120
Total net generation (GWh)	4,680	5,027	5,032	5,041	5,051	5,062
Imports by WPS (GWh)	381	139	393	626	888	1,162
Average import price (Lek/kWh)	7.5	8.5	9.5	9.5	9.5	9.5
KESH hydro price (Lek/kWh)		0.78	0.78	0.78	0.78	0.78
Vlore thermal power price (Lek/kWh)		8.5	9.5	9.5	9.5	9.5
Private generators price (Lek/kWh)		8.3	10.4	9.0	9.2	9.5
WPS price (Lek/kWh)	1.6	2.70	3.26	3.52	3.81	4.10
Total transmission losses (GWh)	319	314	330	318	322	326
Transmission charge (Lek/kWh)	0.51	0.53	0.54	0.56	0.57	0.59
Electricity sold by WPS to RPS (GWh)	4,742	4,852	5,095	5,349	5,617	5,898
Small hydro sold to distribution (GWh)	64	62	62	62	62	62
Electricity sold to HV consumers (GWh)	200	200	200	200	200	200
Use of dist. by eligible consumer (GWh)	100	100	100	100	100	100
Electricity subject to dist charge (GWh)	4,642	4,752	4,995	5,249	5,517	5,798
Imports to cover dist. losses (GWh)	2,184	1,848	1577	1395	1224	1023

Projected tariffs, Compensation Account and PRG Exposure

(Lek million)

	2009	2010	2011	2012	2013	2014
DSO						
Imports to cover losses	16,384	15,708	14,984	13,256	11,632	9,720
Transmission costs	1,114	971	853	778	703	605
Personnel costs	4,173	4,272	3,804	3,307	2,633	2,847
Purchase of materials and product	1,457	1,603	1,603	1,603	1,603	1,603
Supply and services	1,705	1,876	1,876	1,876	1,876	1,876
Total OPEX w/o deprec.	24,833	24,430	23,120	20,820	18,447	16,650
Deprec	2,097	2,034	1,789	1,864	2,031	2,031
Total OPEX w deprec.	26,930	26,464	24,910	22,683	20,478	18,681
Working capital	2,069	2,036	1,927	1,735	1,537	1,388
Investment	1,900	2,440	2,684	2,952	3,248	3,572
Debt repayment	1,560	1,560	1,560	1,560	1,560	1,560
Recognized fixed assets	15,354	15,697	16,347	17,815	17,815	17,815
RAB	17,226	17,733	18,274	24,272	24,272	24,272
Old debt, interest rate of 3.1%	21,146	21,146	21,146	21,146	21,146	21,146
New debt,interest rate of 8.5%	1,363	1,966	2,455	2,649	2,777	3,101
Weighted average interest rate	0.034	0.036	0.037	0.037	0.037	0.038
WACC, RoE of 16.44% with 40% weight	0.086	0.087	0.088	0.088	0.088	0.089
Required revenue	28,417	28,009	26,513	24,819	22,617	20,830
Required distribution charge (Lek/kWh)	6.1	5.9	5.3	4.7	4.1	3.6
RPS						
Purchases from WPS	7,587	13,091	16,629	18,814	21,424	24,178
Transmission costs	2,418	2,549	2,756	2,981	3,224	3,487
Billed distribution charge	28,417	28,009	26,513	24,819	22,617	20,830
Profit (at 2.2% of purchases from WPS)	167	288	366	414	471	532
Required revenue w/o bad debt provision	38,589	43,936	46,265	47,028	47,737	49,026
Required revenue of RPS w bad debt prov.	44,871	50,502	52,573	52,840	53,041	53,875
Required average retail tariff (Lek/kWh)	9.5	10.4	10.3	9.9	9.4	9.1
Actual 2009 tariff rate	8.15					
Estimated collected revenue in 2009	33,237					
Financial loss of DSO and RPS in 2009	5,352					
Incl interest for one year at WACC	5,815					

Assume tariff increase limited to 18%/yr	9.6	11.3	11.1	9.4	9.1
Total uncompensated loss with interest	9,953	5,810	0	0	0
Assume tariff increase limited to 13%/yr	9.2	10.4	11.1	9.4	9.1
Total uncompensated loss with interest	11,823	10,400	0	0	-
PRG payment	1,720	4,220	-		
Loss net of PRG payment	9,953	5,810	0		
Assume tariff increase limited to 8%/yr	8.8	9.5	10.3	9.4	9.1
Total uncompensated loss with interest	13,693	14,792	4,352	0	0
PRG payment	3,440	8,258	4,000	0	
Loss net of PRG payment	9,953	5,810	0	0	
Loss if 18% increase in 2010, 0 in 2011	9,953	14,251			
PRG payment		7,761			

Sources: Energy balance projections for 2009-2011 from draft 9th PSAP. Projections for 2012-2014 are Bank mission estimates.
DSO cost estimates for 2009 are from 8th PSAP.
Personnel cost projections for 2010-2014 are by IFC and make provision for downsizing plus compensation to redundant employees.
1. For 2009, the price paid to WPS is the approved tariff rate of Lek 1.6/kWh. For later years the prices are calculated from the projected costs of KESH hydro electricity, imports, Vlore thermal power, and private generators.
2. New debt in any year is assumed to be equal to the sum of investment and repayment of old debt less depreciation.
3. No explicit account is taken of the 10% corporate tax rate since this tax would not have any effect on required revenue. It will be paid out of the equity return.
4. The short term debt of KESH is currently Euros 180 million. It is assumed that Euros 30 million will be eliminated by a government subsidy It is also assumed that the rest will be handled in such a way that there will be an interest expense at the rate for new borrowing of 8.5% The interest expense equal to Lek 1,556 million is included in the required revenue for the WPS and raises its tariff after 2009 correspondingly
5. The loss in year n is equal to the loss plus interest in year n-1 plus the loss in year n plus interest at WACC for the total in year n.

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Annex 8: Safeguard Policy Issues

1. No land acquisition or resettlement is required due to privatization. The new DSO owner may reduce the number of employees and provide legal compensation.

2. Low-income consumers benefit from the social subsidy scheme established in 2006 to compensate targeted socially vulnerable groups for the increase in the price of electricity for monthly consumption below 210 kWh from Lek 4.5/kWh to Lek 7/kWh. Only those consumers in the targeted groups that are confirmed by KESH to be paying their electricity bills are allowed to receive the subsidy. In 2007 Albania switched from an increasing block tariff pricing to a single tariff in electricity pricing. Until 2006, households which consumed less than 210 KWh paid 4.5 LEK per KWh, while those which consumed more paid 9.0 LEK per KWh. In 2007, all households were charged a flat 7 LEK per KWh. However, the block-tariff system was re-established in 2008 with a first block of consumption for households (up to 300 kWh/month) at a low rate of Lek 7/kWh, while for higher consumption the tariff was raised to Lek 12/kWh. More than half of electricity consumers use less than this amount, which is therefore set too generously to protect only the poor.

3. The 300 kWh level is considerably larger than the estimate of about 200 kWh per month made by the National Agency of Energy in 2003 as the minimum required consumption for an acceptable standard of living. It could, therefore, be reduced over time when there is need for overall increases in tariffs. By July 2009 the pricing structure is expected to be reviewed to improve targeting. While some consumers will be affected by this re-structuring, the poor are expected to fall within the re-defined first consumption block. While vulnerable consumers with very low consumption would be little affected, all other consumers would receive larger electricity bills. However, these are justified since electricity costs far exceed the current price of Lek 7/kWh for the first block.

4. A 2006 Bank study on the Poverty and Social Impact Assessment of electricity tariff reforms for all the countries in the Western Balkans shows that, the share of electricity expenditures in total household expenditures was around 5 percent for the poorest quartile of the population of Albania. The same study also indicates that current electricity prices in Albania are below cost recovery prices, and should pricing move towards cost recovery, the share of electricity expenditures would rise to about 5.4 percent of total household expenditures for the poorest quartile. Other estimates place the share of electricity expenditures in total household expenditure for the poorest 10 percent of the population at 6 percent[17]. A household is considered energy poor (unable to afford electricity) whenever its share of electricity expenditure reaches or exceeds 10 percent of total expenditures. On this basis, it does not appear that at current prices, many households are electricity poor in Albania. However, it is also clear that the poor spend a higher share of their expenditure on electricity than richer households and there might be some social pressure to reduce the burden of further increases in electricity prices on the poor. The study explores the alternative mechanisms for mitigating the impact of additional price increases

[17] Samuel Fankhauser, Sladjana Tepic, *"Can Poor Consumers Pay for Energy and Water?"* EBRD Working Paper No.92, August 2005

on the poor and reaches the conclusion that, as currently designed, a tariff based subsidy is preferable to support the poor than through the Ndihma Ekonomike program.

5. In accordance with ERE requirements, the DSO will be obliged to carry out connections of new customers and furnish all customers with meters. This is likely to lead to more rapid regularization of connections with customers in recently built-up areas on the outskirts of large cities than has occurred in the past, resulting in much improved quality of supply to those consumers. This regularization would be accompanied by significant reductions in distribution losses and improvement in collections from formalized customers, but could impose considerable expenses on users that have intentionally managed to avoid it up to now. With respect to consumer protection, the DSO will be obliged to handle consumer complaints in accordance with satisfactory procedures enforced by ERE.

6. The potential environmental impacts concerning electricity distribution systems activities are relatively low, rather reversible, and of low significance. However, the continuous practice of certain activities over a number of years (30-40 years) can potentially cause more significant impacts than those normally expected.

7. A general environmental concern in distribution systems are PCBs[18] present in the mineral oil used in transformers manufactured before the mid-1980s. If PCBs are present they would likely be in old transformers still in use in the distribution, as well as any other dismantled material /equipment contaminated with PCBs. The Bank financed a study to investigate whether PCBs were present in power sector in the 1990s under the Power Transmission and Distribution Project. The consultants that reviewed it did not find any indication that PCBs were present.

8. Unchecked growth of tall trees and accumulation of vegetation may result in a number of impacts, including power outages through contact of branches and trees with distribution lines; ignition of forest and brush fires; corrosion of steel equipment; blocking of equipment access; and interference with critical grounding equipment.

9. IFC's consultants have reviewed OSSH's standards and found that the health and safety issues concerning the operation of the installations are well performed in most OSSH substations. Potential dangers concerning the managing of low, medium and high voltage equipment seem to be well understood by all personnel, safety equipment (gloves, boots, helmets) is available, and staff are able to handle materials using such equipments. Moreover, there were always preventive signs in evident locations and fire extinguishing equipment was in place both inside the building and outside in the transformers' area.

10. OSSH is required to comply with the environmental laws and regulations of Albania. However, because of Albania's obligations under the Energy Community treaty, the European Union environmental standards (Acquis Communitaire) would be applicable in the sector.

11. No physical works would be supported by the PRG. The Environmental Assessment category is C.

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[18] Polychlorinated biphenyls (PCBs) and polychlorinated terphenyls (PCTs), which are halogenated aromatic hydrocarbons, which belong to the group of persistent organic pollutants (POPs). PCBs and PCTs are liquid and solid substances, which are virtually not soluble in water. Because of their physical properties and high ignition temperatures, PCBs are used mainly as heat-transfer or insulation liquids in electrical transformers, capacitors and condensers, and are used as hydraulic oils in the mining sector. They were manufactured until the mid-1980s, after which they were banned due to their toxicity and persistence.

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Annex 9: Project Preparation and Supervision

	Planned	Actual
PCN review	06/26/2008	06/30/2008
Initial PID to PIC	07/01/2008	03/17/2009
Initial ISDS to PIC	07/10/2008	03/17/2009
Appraisal	04/06/2009	04/07/2009
Negotiations	04/09/2009	
Board/RVP approval	05/05/2009	
Planned date of effectiveness	05/15/2009	
Planned date of mid-term review	03/03/2012	
Planned closing date	05/31/2017	

Key institutions responsible for preparation of the project:

The Government of Albania (in particular the Ministry of Trade and Economy and the Ministry of Finance and their advisers), KESH, OSSH, ERE, CEZ's project team including their advisers.

Bank staff and consultants who worked on the project included:

Name	Title	Unit
Demetrios Papathanasiou	Sr. Energy Economist	ECSSD
Farida Mazhar	Lead Financial Officer	FEU
Mohinder Gulati	Country Sector Coordinator	ECSSD
Monica Teresa Restrepo	Counsel	LEGCF
Kirsten Burghardt Propst	Counsel	LEGEM
Erjon Luci	Economist	ECCU4
Yolanda Gedse	Program Assistant	ECSSD
Upali Perera	Information Management Assistant	FEU
Richard Hamilton	Consultant	ECSSD

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Annex 10: Documents in the Project File

1. "Regulatory Statement. " March 4, 2009
2. Energy Regulatory Authority. Board of Commissioners Decision No. 69. 24.06.2008. "License for Distribution of Electric Energy"
3. Energy Regulatory Authority. Decision No. 71. 24.06.2008. "License for the Activity of Retail Public Supply of Electric Energy"
4. Energy Regulatory Authority. Decision No. 79. 26.06.2008. "Electricity Distribution System Operator Tariff Calculation Methodology"
5. Energy Regulatory Authority. Decision No. 80. 26.06.2008. "Retail Sales to Regulated Tariff Customers Tariff Calculation Methodology"
6. Share Purchase Agreement between the Ministry of Economy Trade and Energy and CEZ a.s. March 11, 2009
7. Preliminary Business Plan of OSSH for the years 2009-2014, prepared by CEZ for the World Bank, March 2008.

ALBANIA
Privatization of the Power Distribution System Operator

Annex 11: Statement of Loans and Credits

Project ID	FY	Purpose	Original Amount in US$ Millions				Cancel.	Undisb.	Difference between expected and actual disbursements	
			IBRD	IDA	SF	GEF			Orig.	Frm. Rev'd
P110845	2008	Disaster Risk Mitigation	3.00	6.16	0.00	0.00	0.00	9.20	1.23	0.00
P110481	2008	ECSEE APL 5 DAM SAFETY	0.00	35.30	0.00	0.00	0.00	32.21	0.37	0.00
P107833	2008	SECONDARY AND LOCAL ROADS	0.00	20.00	0.00	0.00	0.00	14.40	-3.58	0.00
P096643	2007	BERIS	5.60	3.70	0.00	0.00	0.00	9.48	3.84	0.00
P096263	2007	LAND ADMIN & MGMT PROJ	19.96	15.00	0.00	0.00	0.00	31.44	4.38	0.00
P078949	2007	TRANSPORT	20.00	5.00	0.00	0.00	0.00	10.55	2.14	0.00
P100273	2006	AVIAN FLU - AL	0.00	5.00	0.00	0.00	0.00	3.33	2.33	0.89
P082814	2006	HEALTH SYST MOD	0.00	15.40	0.00	0.00	0.00	13.50	6.84	3.31
P078933	2006	EDUC EXCEL & EQUITY	0.00	15.00	0.00	0.00	0.00	12.24	5.41	0.00
P090656	2005	ECSEE APL2 (ALBANIA)	0.00	27.00	0.00	0.00	0.00	26.68	17.52	0.00
P086807	2005	COASTAL ZONE MGMT (APL #1)	0.00	17.50	0.00	0.00	0.00	13.26	12.20	0.00
P082375	2005	NATURAL RES DEVT	0.00	7.00	0.00	0.00	0.00	3.94	2.51	0.00
P082128	2004	WATER RES MGMT	0.00	15.00	0.00	0.00	0.00	2.59	0.48	0.00
P077526	2004	POWER SECTOR GENER & RESTRCT'G	0.00	25.00	0.00	0.00	0.00	12.73	12.45	12.48
P041442	2003	MUN WATER/WW	0.00	15.00	0.00	0.00	0.00	1.40	-1.06	0.00
P055383	2001	SOC SERV DEVT	0.00	10.00	0.00	0.00	0.00	2.46	0.40	0.40
		Total:	48.56	237.06	0.00	0.00	0.00	199.41	67.46	17.08

ALBANIA
STATEMENT OF IFC's
Held and Disbursed Portfolio
In Millions of US Dollars

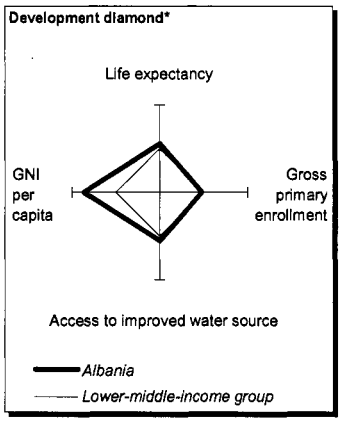
FY Approval	Company	Committed				Disbursed			
		IFC				IFC			
		Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
2005	Fushe Kruje	30.00	0.00	0.00	0.00	30.00	0.00	0.00	0.00
2002	INSIG	0.00	0.00	6.23	0.00	0.00	0.00	6.22	0.00
2000	NCBank	0.00	2.00	0.00	0.00	0.00	2.00	0.00	0.00
1999	ProCredit ALB	0.00	0.98	0.00	0.00	0.00	0.98	0.00	0.00
2003	Vodafone Albania	17.83	0.00	0.00	3.70	17.83	0.00	0.00	3.70
	Total portfolio:	47.83	2.98	6.23	3.70	47.83	2.98	6.22	3.70

FY Approval	Company	Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic.
2002	Savings Bank	0.00	0.02	0.00	0.00
	Total pending commitment:	0.00	0.02	0.00	0.00

ALBANIA
Privatization of the Power Distribution System Operator

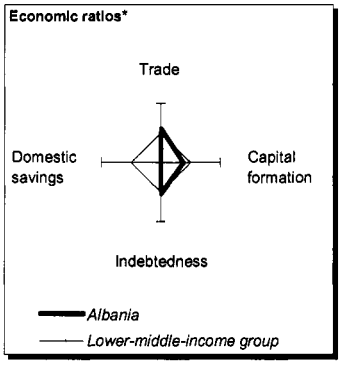
Annex 12: Country at a Glance

POVERTY and SOCIAL	Albania	Europe & Central Asia	Lower-middle-income
2007			
Population, mid-year *(millions)*	3.2	445	3,437
GNI per capita *(Atlas method, US$)*	3,290	6,052	1,887
GNI *(Atlas method, US$ billions)*	10.5	2,694	6,485
Average annual growth, 2001-07			
Population *(%)*	0.5	0.0	1.1
Labor force *(%)*	1.1	0.5	1.5
Most recent estimate (latest year available, 2001-07)			
Poverty *(% of population below national poverty line)*	25	..	..
Urban population *(% of total population)*	46	64	42
Life expectancy at birth *(years)*	76	69	69
Infant mortality *(per 1,000 live births)*	15	23	41
Child malnutrition *(% of children under 5)*	..	..	25
Access to an improved water source *(% of population)*	97	95	88
Literacy *(% of population age 15+)*	99	97	89
Gross primary enrollment *(% of school-age population)*	105	97	111
Male	106	98	112
Female	105	96	109

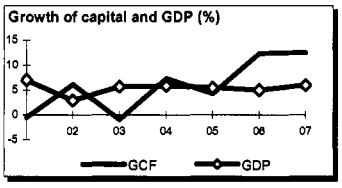


KEY ECONOMIC RATIOS and LONG-TERM TRENDS	1987	1997	2006	2007
GDP *(US$ billions)*	2.2	2.2	9.1	10.6
Gross capital formation/GDP	28.4	16.8	25.0	26.6
Exports of goods and services/GDP	15.5	10.5	25.1	27.2
Gross domestic savings/GDP	28.3	-9.5	1.0	0.2
Gross national savings/GDP	28.3	4.9	17.4	17.3
Current account balance/GDP	..	-12.4	-7.2	-9.0
Interest payments/GDP	..	0.3	0.3	..
Total debt/GDP	..	23.4	25.7	..
Total debt service/exports	..	4.4	3.4	..
Present value of debt/GDP	..	..	19.9	..
Present value of debt/exports	..	..	46.9	..

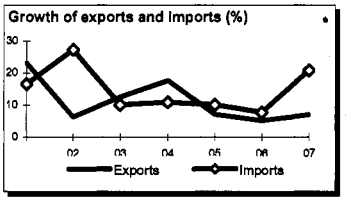
	1987-97	1997-07	2006	2007	2007-11
(average annual growth)					
GDP	-1.9	6.3	5.0	6.0	6.1
GDP per capita	-1.7	5.9	4.4	5.7	5.0
Exports of goods and services	15.6	19.9	5.2	7.0	6.1



STRUCTURE of the ECONOMY	1987	1997	2006	2007
(% of GDP)				
Agriculture	33.2	33.6	..	..
Industry	45.8	18.7	..	..
Manufacturing	..	13.3	..	..
Services	21.0	47.7	..	..
Household final consumption expenditure	62.0	98.7	90.1	90.3
General gov't final consumption expenditure	9.6	10.8	8.9	9.5
Imports of goods and services	15.6	36.7	49.2	53.5



	1987-97	1997-07	2006	2007
(average annual growth)				
Agriculture	4.5	2.0	..	..
Industry	-11.1	8.0	..	..
Manufacturing	..	6.7	..	..
Services	-0.2	8.0	3.5	5.8
Household final consumption expenditure	2.6	8.5	5.0	14.8
General gov't final consumption expenditure	-1.1	3.0	5.2	4.9
Gross capital formation	21.6	12.5	12.4	12.6
Imports of goods and services	17.9	17.3	7.8	20.9



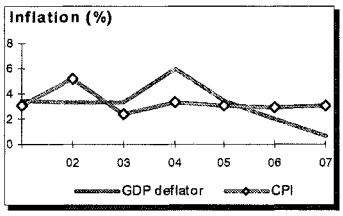
Note: 2007 data are preliminary estimates.

This table was produced from the Development Economics LDB database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

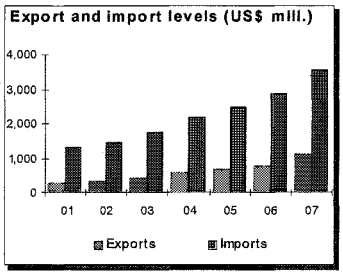
PRICES and GOVERNMENT FINANCE

	1987	1997	2006	2007
Domestic prices				
(%change)				
Consumer prices	..	33.2	3.0	3.0
Implicit GDP deflator	0.0	13.9	2.0	0.7
Government finance				
(%of GDP, includes current grants)				
Current revenue	49.2	18.3	25.3	26.9
Current budget balance	23.7	-8.8	2.4	2.1
Overall surplus/deficit	..	-13.1	-3.2	-4.3



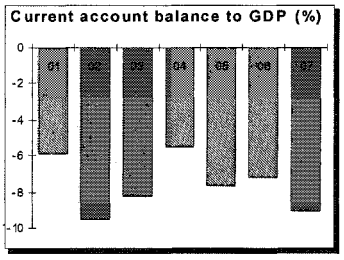
TRADE

	1987	1997	2006	2007
(US$ millions)				
Total exports (fob)	311	159	789	1,142
Agriculture	..	34	50	50
Mineral products	..	8	135	135
Manufactures	..	75	805	1,144
Total imports (cif)	316	694	2,895	3,570
Food	..	177	486	553
Fuel and energy	..	12	266	303
Capital goods	..	272	977	1,190
Export price index *(2000=100)*	..	158	153	206
Import price index *(2000=100)*	..	164	140	142
Terms of trade *(2000=100)*	..	96	110	145



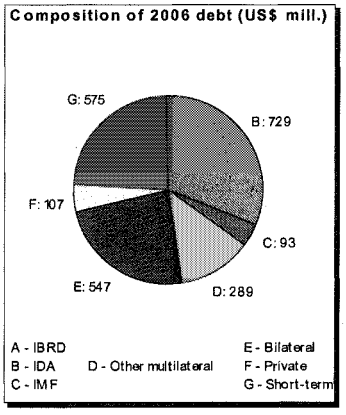
BALANCE of PAYMENTS

	1987	1997	2006	2007
(US$ millions)				
Exports of goods and services	334	222	2,283	2,805
Imports of goods and services	336	809	4,472	5,527
Resource balance	-2	-586	-2,189	-2,723
Net income	0	50	253	288
Net current transfers	..	265	1,280	1,481
Current account balance	..	-272	-656	-954
Financing items (net)	..	312	736	1,055
Changes in net reserves	-12	-40	-80	-101
Memo:				
Reserves including gold *(US$ millions)*	..	339	1,332	1,420
Conversion rate *(DEC, local/US$)*	8.0	146.7	98.5	90.5



EXTERNAL DEBT and RESOURCE FLOWS

	1987	1997	2006	2007
(US$ millions)				
Total debt outstanding and disbursed	..	515	2,340	..
IBRD	..	0	0	6
IDA	..	148	729	803
Total debt service	..	24	132	..
IBRD	..	0	0	0
IDA	..	1	10	11
Composition of net resource flows				
Official grants	..	75	147	..
Official creditors	..	46	121	..
Private creditors	..	-1	-11	..
Foreign direct investment (net inflows)	..	48	325	..
Portfolio equity (net inflows)	..	0	0	..
World Bank program				
Commitments	..	30	46	70
Disbursements	..	19	46	54
Principal repayments	..	0	5	6
Net flows	..	19	41	48
Interest payments	..	1	6	6
Net transfers	..	18	35	42



Note: This table was produced from the Development Economics LDB database. 9/24/08

US$ millions)
Exports of goods and s
Imports of goods and s
Resource balance
Net income
Net current transfers

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Annex 13: Maps

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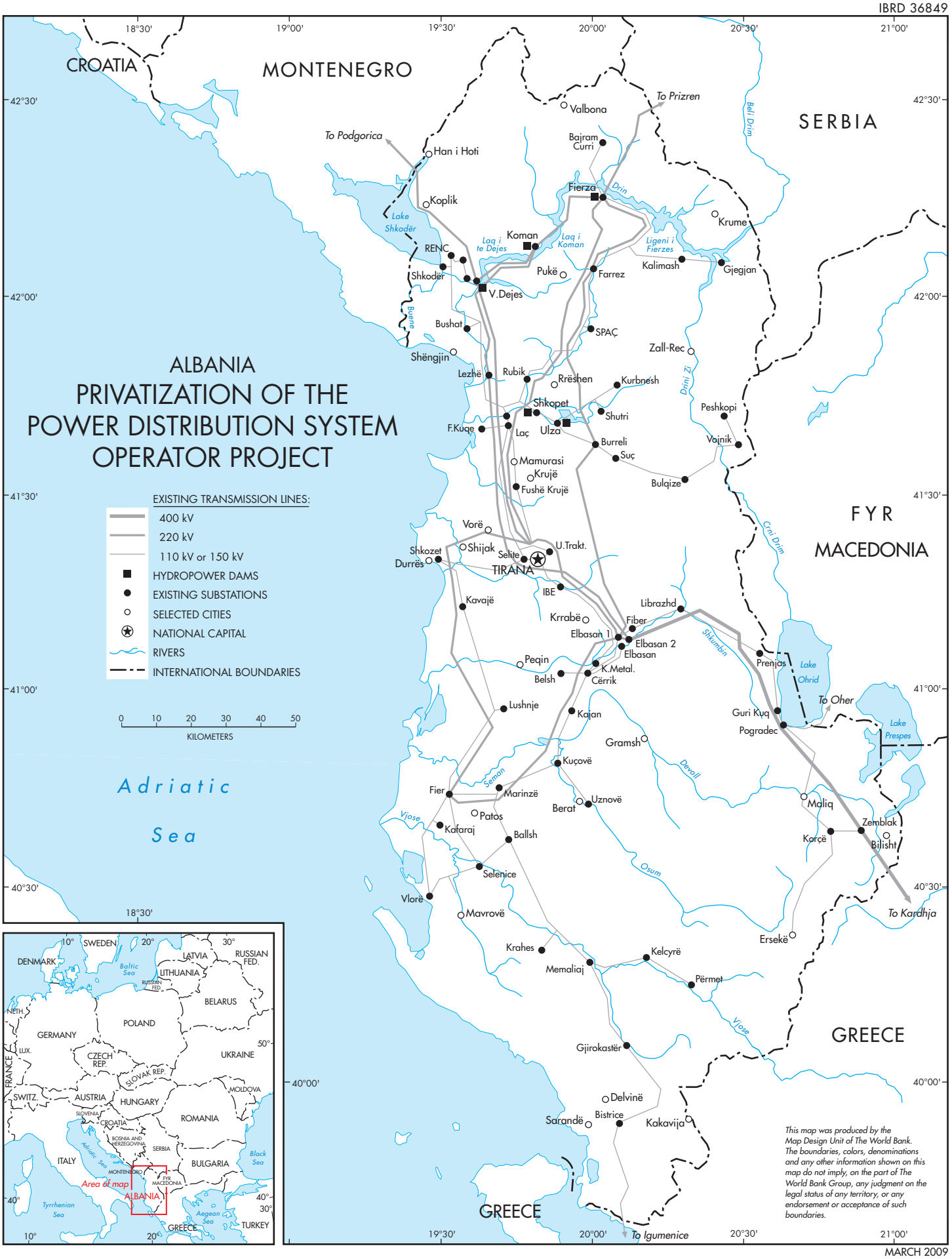

MARCH 2009