

The Albanian government approved financial recovery plan of the electricity sector. The purpose of this Energy Sector Recovery plan is to provide a complete picture and detailed financial situation of the electricity sector, the main trends and lessons learned so far; and to propose a financial recovery plan associated with an action plan for the next 5 years. The evaluation concludes that overall financial effect of the actions taken by the Government to date shows that the combination of ongoing measures will reach a positive cash flow and will enter into a process that will lead to a sound financial position of the energy system actors.

Measures carried out continuously, such as: improving the billing, efforts to reduce losses, restructuring charges, rationalization of operations business, especially in Energy operator OSHEE, issuance of Government Guarantees for Capital Expenditure (Capex), the restructuring of the requirements for short-term commercial loans (overdraft) and strengthening the enforcement of payment discipline among sector companies and state institutions; and measures adopted for the first time, such as suppression of compensation obligations and non-budgetary funds reforms in the structure of the model Electricity Market, clearing arrears to the PPA / Ashta and possible injections in equity (equity) of OSHEE.

There are risks that must be managed, especially in three aspects: the ratio of total debt to total asset value (financial leverage), dependence on weather variability and implementation plan. Given promising recovery process, undertaken with strong political support, electrical system still remains very weak against unexpected changes. As a result, any capital expenditure (capex) new should be carefully considered and funding should be included as equity (equity) preferably in OSHEE (and further transmitted to the Albania Energy Copr AEC by reducing costs) to expand base its capital and to avoid negative overall financial projections for the period 2015-2017, as well as to reduce the negative impact of the financial effects of extreme increase of the ratio of total debt to total assets (financial leverage) in an environment too unsustainable.

Given the dependence of the energy sector by meteorological conditions, the Government through the Ministry of Energy and Industry will prepare a Risk Reduction Strategy and mechanisms to address the effects of dependence on weather volatility and reducing financial impact in case of hydro inflows below average. The plan is expected to be approved by the Council of Ministers in early 2016, will include a provision to the risk of unpredictable weather events based on the experience of different regions in the world. Support for this plan is agreed with World Bank financing.

In this regard the Government proposes:

a) To empower OSHEE management through a management contract based on the results, as described and supported by the Energy Recovery Project funded by the World Bank to ensure that costs, improve losses and collection targets to be monitored and be accessible,

which constitutes the key to success of the recovery plan;

b) turn into genuine independent commercial state companies and to improve the governance and management:

- by strengthening the responsibility of supervisory boards in accordance with the provisions of statutes,
- by strengthening the accountability of companies,
- by improving transparency and public private dialogue
- including the independent non-executive directors to strengthen the supervisory councils and help formulate policy and monitor performance management especially the technical and financial aspects;
- adapting commercial practices (eg maximizing the value of capital) in accordance with the regulatory framework.

c) Conduct formal separation of operations in OSHEE, singling distribution function (distribution network) from the supply, as provided in the new energy sector and by transferring public supplier wholesale and retail along with staff, assets and liabilities associated with, in this new entity. These must be completed within the period 2015-2017 and trading systems billing (billing) will be designed taking into account the structure;

d) Prepare a structured OSHEE to allow the participation of private capital and profit newly restored financial balances be back on sound financial condition, and determined a database to provide an efficient and transparent operational activities in the sector.

Combining these trade measures, financial and structural: a) would return the system from a financial risk, in stable at the end of 2018; ii) would bring private investment in the sector competitive and open manner; and iii) to improve the security of energy supply, including other forms of energy generation through gas.

The current model of market

Albanian electricity sector functions as an interconnected system of activities of generation, transmission, distribution and supply of electricity. Demand for energy is met mainly by public companies – production activities carried out by the Albanian Power Corporation (KESH); transmission network activities and market operation carried out by the Transmission System Operator (TSO), while the activities of distribution and retail supply carried by the Distribution System Operator or OSHEE (former CEZ Distribution).

The sector is monitored and regulated by the Energy Regulatory Authority (ERA). In October 2014 the Government regained back 100 percent of the shares of the former company “CEZ Distribution” that were given through a privatization process Czech company “CEZ as”. In order to start the process of market liberalization in 2011, all non-household customers to supply the high voltage line 220 kV and 110 kV, was forced to become qualified consumers to choose their suppliers, Albania has currently six qualified customers high voltage (HV) with annual consumption of 700 GWh per year (14 percent of

total demand of electricity), freeing KESH from the obligation to supply them with regulated tariffs.

On the other side of the generation capacity available to KESH were reduced by 81 MW due to the privatization of Hydro Power Plants Ulza Shkopeti, Bistrice 1, 2 and Lanabregas. In the current market model, the structure of KESH is responsible for ensuring the fulfillment of the demand for energy in Albania for regulated tariff market (excluding energy needed to cover losses in the distribution network). KESH as energy manufacturing company includes within it an autonomous structure "Public Supplier Wholesale" (WPS).

The role of the WPS is to buy electricity produced from small hydropower energy and Independent Power Producers (IPPs) through feed-in prices (approved by ERE) and set the Power Purchase Agreements, and the electricity produced by KESH with regulated tariffs approved by the ERE to the extent is necessary to meet the requirements of regulated market; if domestic production is not sufficient to cover market demand to adjust, WPS / AEC has the obligation to purchase additional energy imports from unregulated markets. According to the rules in force, it was decided to buy the first WPS energy produced by the SPP / EPP, further from the AEC / Gen, and further to meet the needs of importing power. The main issues identified in the segment of the power gen sector - KESH is a manufacturing and WPS involvement in its structure creates an additional burden on its financial plan due to unforeseen import costs, which are not fully reflected and clearly in its sales price of energy, or arbitrary charges imposed as a result of ongoing conflicts with CEZ Distribution between 2011-2014; -

Include the obligation to buy the production of PPE is not fully reflected in the sales fee, due to unforeseen production (production of electricity from hydropower depends on river flows) and / or suspension of decisions due to The legal conflict with CEZ Distribution in 2012-2014.

- Lack of service agreements between entities (KESH, OST, and OSHEE) and specific procedures in terms of insurance payments billed, has created financial unpredictable gaps not covered Financial agreements with the government. - Default or late payments from customers have made OSHEE not be able to fully pay KESH and TSO, leading to delays payments to third parties.

- Failure to pay bills to KESH by OSHEE for electricity consumed by the network for distribution losses.

- For the above reasons, KESH was forced to borrow through short-term loans (overdraft) with a high cost.

- Failure of KESH to operate as a commercial entity (sale and purchase with neighboring countries), which has limited the possibility of creating profits from exports (AEC can only sell when the market fix requires no power, or in exceptional situations of water flow). - Predictable weather conditions for the next few years the limit AEC (supplier of last resort)

from being able to accurately predict needs for import and therefore reflect the tariff approved by the ERE.

Current situation of the energy sector

The new government recognized the existence of crisis situation in energy sector and together with an IMF program, has implemented a clear strategy for the settlement of obligations and changes at the beginning of 2014. The energy sector was plunged further into a financial crisis due to the failed privatization of the distribution company owned by 76 % of its shares by the Czech company "CEZ as". In October 2014 the situation was resolved through the reversal of the stock by the state company "OSHEE", which owns 100% of the shares.

There is a huge dependence on rainfall and only through hydro power supply located on the Drin river cascade in the north, causing instability in the production of electricity supplied by the KESH. This poses a threat about forecast imports, thus bringing a risk to guarantee supply. Currently all production in the country depends on hydropower. An electricity sector dependent on weather instability and lack of diversification of its production.

The challenge of supplying electricity to Albania further is affected by transmission capacity, internal and external constraints associated with the region, as well as insufficient amount of energy available to supply and marketing of neighboring countries. For example, KESH made an assessment of a worst case scenario for the energy imports needed to cover the regulated market in 2014, estimated at the time equivalent to 1,200 GWh, or about 100 million US \$. Indeed, KESH imported 180 GWh (about 12 million US \$), during the year due to improved weather conditions starting in March as well as a better management of water reserves in the Drin river cascade.

Another difficulty with which the sector is facing today is the financial obligation to purchase power from independent power producers. This obligation is accumulated by increasing the quantity produced by private HPPs more than the amount of planning and with very favorable purchase, much higher than market energy prices ERE and that AEC bought energy by IPPs, the value of 9.3 lek / kWh (66.4 euros / MWh) for the period 2012-2014. Just for 2014, the cost of purchasing electricity from PES / EPP, not covered by the tariff regime WPS / AEC, reached the amount of about 2 billion.

DSO:

Suboptimal performance, lack of investment and poor management by the distribution sector brought higher energy losses, lower receipts and reduction of capital of the company much more than envisaged at the time of privatization.

The distribution sector faces a combination of challenges related to unbilled energy due to lack of meters, or defective meters and thefts in the system, as well as insufficient receipts billed electricity from families and businesses (84% in 2012), which led to the emergence of financial problems of the former private distribution company CEZ Distribution. Now the

Distribution System Operator facing financial difficulties and is unable to enter the capital markets for funding.

At the time of privatization of the distribution network CEZ Distribution expectation was that it would reduce losses to 17% by 2014 and will invest about US \$ 200 million over five years to the distribution system. The privatization of the distribution company did not work as expected. Acceptance of the level of losses and bad debts occurred later than initially anticipated and retail tariffs were restructured at the right time.

On January 21, 2013, ERE took the license from “CEZ Distribution” for violation of the obligations set out under the terms of the license and appointed a temporary administrator to lead and manage the distribution system. In this way, the Government took responsibility and basically fiscal risk to energy imports needed to compensate for energy losses.

As a result, KESH as the supplier of last resort, took short-term loans from commercial banks (overdraft) at the end of 2014 which reached the amount of 36.26 billion alb lek (about 2.6% of GDP), of which 10.2 billion is not supported with sovereign guarantee. Energy losses increased to 51.1% at the end of 2012 and with an annual average 45% by the end of 2013, while in 2014 resulted in a significant improvement in less than 38%; bill collection rate decreased from 85% in 2008 to 84,1% in 2012, to 78.7% in 2013, and rose to 84% in 2014.

Given that there has been insufficient investment capital from the former CEZ Distribution and due to lack of resources, Distribution Operator has been in trouble for importing electricity to cover losses, to liquidate its outstanding obligations to trade creditors and even more impossible to finance a major program to reduce losses.

Due to the above mentioned facts, and the fact that the energy sector is highly interdependent, any change in the system immediately gives a chain effect from one area to another. Given that OSHEE is impossible to generate enough revenue to pay its costs, the entire energy sector has been adversely affected. OSHEE is unable to consistently pay KESH, OST and / or electricity traders. KESH and OST are also poor solvent due to the revaluation of assets. This situation has become unstable and poses a special threat to the KESH, because it could not perform loan payments in installments, to buy electricity from IPPs, and to import the necessary energy to meet domestic market fix.

Although Vlora power plant was built, this property is still not operational due to unresolved technical problems. KESH is currently in the process of selection of the consultant, which is to ensure that a technical solution for the regulation of cooling water system, and the costs and time.

Because of the difficulties of network congestion resulting from deferred investments in transmission, TSO can not guarantee reliable transmission capacity for imports in case of emergencies. Therefore there is an urgent need to realize investments with the objective of reducing losses in the distribution system, and to expand and improve the transmission

network TSO, to achieve a secure supply of energy.

In these conditions, the International Bank for Reconstruction and Development (IBRD) has provided a loan US \$ 150 million to be disbursed over the next five years, mainly oriented to the distribution system. Given the high needs of the energy sector, self-funded project IBRD is not sufficient to address and solve all the financial gap inherited and current, which further requires additional measures and a profound reform to overcome the problems of the energy sector.

General objectives of the reform in electricity sector

The overall objective of the proposed reform of the electricity sector is to bring economic and financial viability of the sector, with a constant influx and stable cash (cash flow), energy loss reduction target levels, improve collections of billed electricity and implementation of regular payments invoiced between societies.

Specific objectives

1. Closing the financial gap which energy sector produces annually, within the next 5 years and the transformation of the energy system from a system that generates debts in a self-contained system and liquidation ability.
2. Security of supply continuous and reliable power for the entire country without blackouts; improving the energy efficiency of the system in the distribution sector by reducing losses and improving collections.

Actions / activities of financial recovery plan

It is clear that there is an urgent need to mobilize funds to:

- rapidly injected liquidity into the system to ensure timely imports from both companies KESH and OSHEE;
- clean sector financial statements, to restore stability, operational liquidity and credit market participants;
- restore commercial practices and relationships with suppliers and lenders to support operations and to provide an access to domestic financial markets.

The proposed Financial Recovery Energy Sector focuses on three main pillars : increase operational efficiency, strengthening institutional capacity and setting of the control and management of companies, and financial stability, without forgetting and improvements in infrastructure.

Addressing large energy losses and funding of an aggregate deficit projected at 60 billion alb lek is essential and overdue. This situation is unsustainable and can only be improved with urgent implementation of a comprehensive program of action for a long period of time, including improved cash collections, reduce losses, strong teams and management experience in each enterprise, restructuring of retail tariffs to a level that reflects the cost, as well as a review of the market model, to facilitate the progressive migration of customers to medium voltage regulated market towards energy market, which operates on commercial

principles.

It is clear that KESH is under burden of tariffs that do not reflect costs in the past because of the collapse of the privatization of DSO (now OSHEE). Effectively KESH is used to finance imports for OSHEE company since its privatization in 2008. After the revaluation of the assets of the company in 2009, it was concluded its inability to payment obligations to the AEC. This led to delays burden of obligations to IPPs, taxes, VAT, social security and other obligations towards the Albanian Government, as well as reaching the maximum limits short-term debt (overdraft) imposed by commercial banks .

At the end of 2014, reached the limit of obtaining short-term loans and became exhausted the capacity of the company to provide further support to the sector, without which presented a serious threat to the security of energy supply and fiscal stability of the country. The Albanian Government has identified this risk and is determined to apply emergency measures to turn the sector and all the energy system towards a sustainable development.

Moreover, OSHEE is unable to enter into domestic financial markets due to its insolvency and, as mentioned above, survives only by passing its obligations to KESH and the Ministry of Finance, pushing debt payments, payments for the purchase of energy from KESH, VAT, income tax as well as social security.

By creating a bank account (escrow), in accordance with the provisions of the loan agreement with the World Bank Energy Recovery Project, insolvency of OSHEE and KESH will be reduced significantly. However, a detailed analysis based on business plans in 2015 (as amended) for each of the companies, shows that the sector can be funded within the existing package agreed with the IMF and transformed by taking aggressive steps to improve efficiency operational, institutional capacity and financial stability.

The government abolished the tariff structure with two compresses for households and set a fee that reflects the costs for all categories of consumers, starting from January 2015.

Fee weighted average retail was restructured in a unique fee of 9.5 lek / kWh, bringing an improvement of 9.1% and the average tariff of 9.8 lek / kWh was at 10.7 ALL / kWh, because of tariff increase for non-household customers 15% . Also, the Government strongly supported the actions on the ground for the implementation of the program to reduce electricity theft and improve collection rates.

The results so far are encouraging, as reduced energy losses are in total from 45% to 37.6%, and increased level of receivables from 78% to 90%, including outstanding receivables during 2014.

Government is fully committed to improve efficiency, institutional capacity and financial sustainability by implementing the following important measures. To be effective, all steps of this action plan should be treated with the same importance. These actions include: a) Improvement of non-technical losses and increase collection rates with the support of the

Energy Recovery Project. Achieving timely operational objectives agreed (in percentage) is the key to turning the energy sector, while minimizing the required support from shareholders, energy consumers and taxpayers;

b) implementation in the short and medium term Recovery Plan Financial, including among others: - maintaining a tariff structure levels with a weighted average of 10.7 / kWh, indexed operational costs and exchange rates, subject to periodic review. Groups affected by this change have been identified and will be subsidized by the state budget through the Ministry of Social Welfare and Youth;

- The introduction of restrictions of a strictly controllable budget and cost control measures to improve efficiency, productivity and providing needed liquidity, especially during the next four years;

- Repayment of debt in two stages between the companies in the value of 4:44 billion / kWh and 8.0 billion by DPL respective agreements in 2014 and 2015, pursuant to Decision no. 126 dated 11.02.2015, which considers the upper limit 9.0 billion;

- Repayment of debts to the IPPs, 2015; -

All government agencies and non thereafter will be subject to the mechanisms of coercion within the treasury department to ensure timely payment of all bills consumed;

- refinancing / rescheduling / restructuring of debt where possible costly (especially amounts drawn as overdrafts) to reduce debt service KESH and improve cash flow (cash flow); -

Capital expenditures will be carefully reviewed by supervisory boards, as well as the line ministry and will be limited to essential items that are consistent with system security, program signatory to the reduction of losses and earning big in terms of short term; - the adoption of electric power and submitted to Parliament together with the model of the Energy Market which enables initiation of further market liberalization, the release of the AEC's role WPS and therefore creating opportunities for trade Additional energy freely coverage beyond tariff customers;

- Approval of amendments to the law on renewable energies and the adoption of the National Plan of Renewable Energy which will enable a clear planning of new production capacity, diversification of sources, as and better control energy costs already covered by the tariff regime.

- Setting reasonable fees and in accordance with the tariff levels ERE for independent power producers, eliminating the creation of new debt as a result of supply electricity beyond levels approved in the tariff.

- Approval by the ERE tariff access to the network by voltage level to enable the placing on the market of customers connected to the medium voltage kV 35/20/10/6 .

- Providing a ratio of debt to equity OSHEE, financed by the central budget guaranteed by the Ministry of Finance and used to pay off the power to the KESH and financial deficit

projected him to the border of the gap negative projected to create over the years 2015-2017 from the losses and receipts; and

- KESH is expected to be able to export energy over the next few years. Consequently, the Government proposes to reserve the amount of 30 million US \$, part of the World Bank loan allocated to imports of KESH, until the agenda of security risk mitigation water resources.

c) Maintenance fees appropriate to reflect the costs for the supply, transmission, distribution and sale of electricity. It should be noted that these fees only include technical losses and do not reflect non-technical losses are a result of theft of electricity from a large number of customers at the expense of other consumers; 5 Council of Ministers Decision no. 125, dated 11.02.2015, approved the methodology for determining the energy fixed fees for 2015, which will be paid to small producers of electricity from hydropower, while ERE by decision No. 27, dated 16.02.2015, set fee 2015 independent power producers in the value 7636 l / kWh.

d) Vlora TPP will recommission in anticipation of lower prices of crude oil and / or gas supply from the TAP project, bringing in a variable cost structure with low. e) Improving the management of companies, transparency and independence of the regulator to act in the public interest and in the interest of the public; and f) Reform of the market model and the legal / regulatory framework for the progressive transfer of medium voltage customers from market to market open regulated market and transfer the structure of the WPS.