

Exclusive report on Serbia Energy sector: If Serbia implements all announced reforms and projects, its energy system will look completely different in 2015

Categories : [News Serbia Energy](#)

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If the plans of Serbia's Government, Electric Power Industry of Serbia, Srbijagas and their foreign strategic partners, energy giants – the German Rhine-Westphalia Energy (RWE) and the Russian Gazprom – have been achieved, the construction works on five hydropower plants on the Velika Morava River with total installed capacity of 150 MW and Unit B3 of TPP "Nikola Tesla" with total capacity of 700 MW will begin by 2015, whereas the gas from the South Stream gas pipeline, with an annual capacity of about 40 billion cubic meters, will flow into Serbia through new pipelines installed under the Black Sea and Bulgaria. Yet the Ministry of Energy, Development and Environmental Protection doesn't end up its reforms with these projects: liberalization of energy market in Serbia should start at the beginning of next year. It is planned that a minimum of 40% of electricity and at least 80% of gas should come from free regional markets. The start of next year should be marked by the construction of the first wind turbine, introduction of "energy passports" for new facilities and "revamp" of old facilities in order to increase their energy efficiency. The Ministry has also announced the adoption of social maps for the poorest households to ensure that electricity price, which is currently the lowest and most unprofitable in Europe, could progressively move towards more realistic value: every euro cent above a current price of €5.5 cents per kWh would yield 350 million euros more to EPS, given the current collection rate.

Realization of these projects would not only increase the total capacity (currently about 8.350 MW) and electricity generation of all plants in Serbia (about 33.000 GWh per year), but it would also influence domestic energy market diversification, strengthen energy security and encourage a greater use of alternative energy sources. For instance, since Serbia is now solely connected to the gas pipeline in Hungary, it pays a gas price which is by 9% higher

due to costs of transportation through the territory of its northern neighbor. In addition, crisis situations, like the one we experienced last winter when snow blocked functioning of the “aorta” of energy system, i.e. the railroad by which lignite is delivered from coal basin Kolubara to coal stockyard in TENT A, would be prevented. The announced projects are likely to bring about substantial effects such as new investments of several billion euros, thousands of jobs, recovery of the industry which is currently in a free fall and boost for staggering GDP.

HYDROPOWER PLANTS ON THE VELIKA MORAVA RIVER

Let's focus on two major investments. The Memorandum of understanding and strategic partnership between the German RWE (more precisely, “RWE Innogy,” its daughter company, which operates with the so-called “clean energy”) and EPS was signed by Aleksandar Vučić, First Deputy Prime Minister, only a month and a half after government formation. It is projected that the construction of five hydropower plants (HPPs) on Velika Morava will cost about 360 million euros. Given that each power plant should have a capacity of 30 MW, they all should generate a total of 650 GWh of electricity per year, which are to be divided in accordance with the ownership structure of a newly created joint venture (51:49 percent in favor of RWE) into approximately equal parts. Unrealistically low electricity price in Serbia will not have an impact on the German company, because it will export its own half of electricity to the European market, thereby increasing a share of “clean” energy in its total energy production. On the other hand, RWE is a Europe's largest carbon dioxide emitter with nearly 162 tons emitted in 2011. Since last year the company exceeded its quota of carbon dioxide emissions by about 50 million tons, according to EU regulations it had to buy “emission permits” from the companies that stayed below their emission quotas, and to pay a price of slightly above 10 euros per ton or more than 600 million euros only in 2011. Hydropower plants on the Velika Morava and four hydropower plants on the Upper Drina in Bosnia and Herzegovina or, more precisely, in the Republic of Srpska (having total value of 470 million euros, capacity of 210 MW and an annual production of 750 GWh) will increase a share of “green” energy from renewable sources produced by the German company. This explains why RWE will not be a co-owner of TENT B3 – lignite produces “dirty” energy, which would put an additional financial burden on the German company: according to plans, Germans will design this unit of thermal power plant and provide their technology, while the construction will be financed by profits generated from the “Serbian” half of electricity on the Velika Morava. According to RWE's recommendations, the option based on rehabilitation and optimization of the existing plants, reduction of distribution losses (up to 14.31% in 2011, according to Dragomir Marković, a former CEO of EPS) and debt collection improvement would be more efficient for EPS than the resumption of construction works in Kolubara B.

THE SOUTH STREAM PROJECT

It seems that benefits of the South Stream gas pipeline for Serbia can be best described by those whose country it bypassed: “This decision caused a serious damage, not only in terms of material consequences, but also in terms of political, economic, energy and strategic negative effects,” said Davor Štern, a former Minister of Economy of the Republic of Croatia after decision that the South Stream gas pipeline should pass through Hungary instead of Croatia. “First of all, we missed an opportunity to make profits from gas transit fees. Croatia

can forget about millions in profits. We lost a strategic role in the European energy flows, a pipeline connection with Italy which could have passed through northern Adriatic coast or through our fields in northern Adriatic coast, and an opportunity of having another gas storage built and financed by Gazprom, and not by Croatia,” added Štern.

After the Shareholder assembly of the company South Stream Serbia (ownership structure of 51:49 percent in favor of Gazprom) had made its final investment decision about the start of construction on the section passing through Serbia, CEO of Srbijagas announced that construction works on the South Stream gas pipeline were expected to start in December, and that they would begin with preparatory works for the construction of two compressor stations near Vrbas and Paraćin.

In addition to the aforementioned energy security, alternative access to gas supply (though from the same source) and exemption from gas taxes, it is estimated that the construction of 411 km of gas pipeline through Serbia will attract 1.5 billion euros of foreign direct investments and create about 2000 jobs, as well as that Serbia will receive revenues from gas transit taxes in amount of 200 million euros per year. According to these data, the construction of the South Stream gas pipeline should be the largest investment project in Serbia in the last few decades. There are views that, in light of this fact, the sale of NIS to Gazprom for only 400 million euros makes perfect sense – according to them, it was politically conditioned or “associated” with a decision that the South Stream gas pipeline should pass through Serbia, instead of Romania.

AD HOC LAW

During his visit to Germany in September, Aleksandar Vučić, Deputy Prime Minister, announced that Serbia would “push for” an agreement with RWE or that “Government will accelerate investments as much as possible by making documentation preparation process less time-consuming than before”. The same measures were prepared in relation to the South Stream project. Zorana Mihajlović, Minister of Energy, announced that the first draft of the Law on South Stream gas pipeline would be finished next week, as well as that the Law itself would be adopted by the end of the year. According to information from the Ministry, the purpose of the law is to accelerate and facilitate procedures for issuing permits regarding the construction of gas pipeline.

Although, in general, there can be no objection to the determination to build such important facilities as quickly as possible, avoiding a “jungle” of Serbian regulations and administrative traps, the question is: Why do we need such a law? Why should we provide a special law for Gazprom, and not for RWE or any other investor? Wouldn't it be more sensible to adopt, on an expedited basis, a law which would relieve the entire economy from the burden of obviously redundant conditions and requirements? By adopting this law, the state directly undermines the principle of equal treatment of all investors – Gazprom will progress at an accelerated pace, while the others will have to face all the challenges described in the concluding remarks of Doing Business study, conducted by the World Bank. According to this study, “Serbia stands at 175th place in the ranking of 183 economies on the ease of dealing with construction permits. Dealing with construction permits in Serbia takes 279 days, requires 19 procedures, and costs 1604% income per capita. In order to obtain a building

permit for an industrial building in typical circumstances it is necessary to make 52 steps. As many as 90% of these steps are within the competences of public enterprises, agencies and institutions and 20 entities have public authority and participate in this process.” It is obvious that, if there is enough political will, the number of steps can be significantly reduced; otherwise, investors have to be prepared to wait in line – obtaining all necessary permits sometimes takes more time than constructing a facility.

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