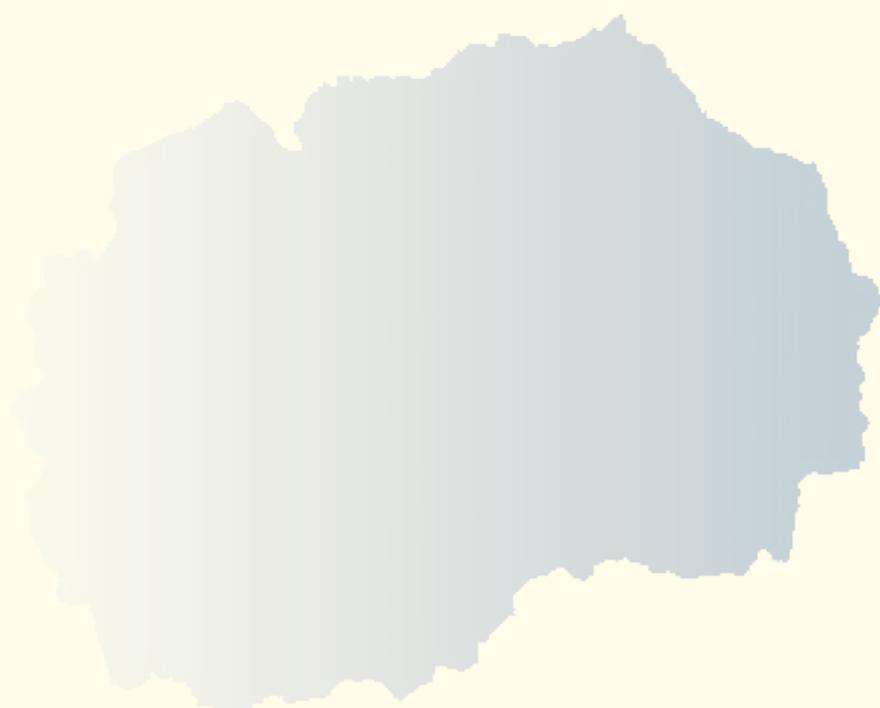




Former Yugoslav Republic of
MACEDONIA

In-Depth Review
*of the Investment Climate
and Market Structure
in the Energy Sector*



2006



Energy Charter
Secretariat

ENERGY CHARTER

NOTE TO THIS EDITION

The In-depth Report on Investment Climate and Market Structure in the FYR of Macedonia (ICMS-29) has been prepared by the Energy Charter Secretariat in cooperation with the authorities of the Republic of the FYR of Macedonia. The Report has been examined by peers and their policy conclusions are included in this edition of the Report. In addition, the Secretariat has summarized its main findings regarding the Report in a note (ICMS-30) distributed to peers concurrently with the Report and included in this edition as well.

Questions related to this document should be addressed to Mr. Boyko Nitzov at the Energy Charter Secretariat.

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POLICY CONCLUSIONS TO THE IN-DEPTH REPORT ON THE INVESTMENT CLIMATE AND MARKET STRUCTURE IN THE REPUBLIC OF MACEDONIA

Documents ICMS-29,30, Meeting of the Investment Group in May 2006

The Charter Conference,

Having regard to the Report from the Investment Group with respect to the In-depth Review on Investment Climate and Market Structure of the Republic of Macedonia (herein after “Macedonia”¹)

NOTED

- a) That the Review of Macedonia has shown great progress in many important areas in line with the Charter Conference’s policy conclusions adopted in 2000 to Document IC-2 (Investment Climate Report). The legal framework for foreign investors has been improved and there is now an established legal and regulatory basis for a competitive market structure in the energy sector,
- b) In particular:
 - Welcomed the emphasis of Macedonia’s energy policy on the adoption of EU’s *aquis communautaire* regarding restructuring and liberalisation, while assuring the attraction of foreign investors for new investments, and noted with appreciation that Macedonia is also a member of the Athens Process, which has led to the establishment of an energy community in Southeast Europe;
 - Encouraged the Macedonian authorities to make further efforts to add to and achieve the effective implementation of the new legislation in place, and to assure the full protection of investors’ rights, good governance and corporate management, which are needed to improve investor confidence. The authorities are also encouraged to reduce bureaucracy, improve SME access to finance, secure better transparency, and implement further regulatory reforms;
 - Noted with satisfaction that the privatisation process in the oil sector is complete, and also that the privatisation of the electricity sector has started and the privatization of the natural gas sector is to follow;
 - Took note with satisfaction that serious steps have been taken in the energy sector towards a regulatory system that is less prone to political interference, is more transparent, and is directed at the implementation of measures needed for the creation of a competitive market, but also noted that further

¹ The State to which this report relates has been admitted to membership of the United Nations under General Assembly Resolution 47/225 as the former Yugoslav Republic of Macedonia.

consistent action is needed, including the improvement of the collection rate;

- Welcomed the effort to make sure that an acceptable supply-demand balance is maintained on the emerging national liberalised and competitive markets, and noted that fuel diversification and reducing dependence on external resources are strong reasons for promoting energy savings and usage of renewable energy resources; priorities would also include increasing the penetration of natural gas;
- Took note of the intention of the Macedonian authorities to accelerate the process of definition of a new Energy Strategy in cooperation with the international community.

SUMMARY AND MAIN FINDINGS OF THE SECRETARIAT

The energy policy in the Former Yugoslav Republic of Macedonia² has undergone great changes in structure, method and objectives and is at the moment focused on further approximation to market-based ways and means. The policy now contains the following strategic directions:

- Approximation of the legislation to EU's acquis,
- Establishing market conditions in the energy sector, strengthening of the role of the newly created regulator ERC,
- Further development of the energy infrastructure by construction of new energy sources and multiple connections to the systems of the neighbouring countries,
- Higher energy efficiency,
- More intensive use of renewable energy resources, and
- Introduction of adequate environmental standards and measures.

The Republic of Macedonia has been developing an increasingly positive attitude towards foreign direct investment (FDI). It now strives to create a favorable investment climate for its attraction. It has opened its market for all forms of investments including participation through privatization. Foreign investors are accorded national treatment in all respects. Various types of incentives including tax-exemptions are offered to investors. The legal framework for foreign investment is provided by the new Law for Trade Companies adopted in 2004.

In July 2004, Standard & Poor's assigned the first long-term credit rating of the Republic of Macedonia ('BB/B' FC, 'BB+B' LC with positive outlook in the period to follow). Key factors for assigning positive ratings were the rapid progress in the political stability driven by the Framework Agreement and the prospect of EU membership, the macroeconomic stability, moderate levels of foreign debt and moderate-to-low budget deficit. In August 2005, Standard & Poor's raised its long-term foreign and local currency sovereign credit ratings to 'BB+' from 'BB', and to 'BBB-' from 'BB+', respectively, on sustained political stabilization. At the same time, the short-term local currency rating was raised to 'A-3' from 'B', and the 'B' short-term foreign currency rating was affirmed.

With the adoption of the new Energy Law, which is currently being discussed in the National Assembly, conditions for improving the investment climate for construction of new energy facilities will be created. An energy regulator (the Energy Regulatory Commission, ERC) has been established and is operative. ERC is independent from the Government and from the interests of the industry. The scope of its activities covers licensing, pricing, and all other issues of public interest in electricity, gas, oil and thermal and geothermal energy.

The electricity market has been completely reorganized in all of its aspects in compliance with the EU's acquis. Third party access has been implemented and

² The State to which this report relates has been admitted to membership of the United Nations under General Assembly Resolution 47/225 as the former Yugoslav Republic of Macedonia. For brevity, it is further referred to in this document as "the Republic of Macedonia" or "Macedonia".

secured by the Transmission System Operator (MEPSO), which is independent and state owned. The electricity industry is legally unbundled with respect to production and distribution, and the legal framework for a Distribution System Operator has been set up. The liberalization started in 2004 with providing eligibility option to consumers directly connected to the transmission grid (about 24% of the consumption). The Law supports further liberalization, planned in accordance with the commitments under the Treaty for Establishing the Energy Community of Southeast Europe, signed by the countries of the region in October 2005. The secondary legislation required for the market operation is also being upgraded.

The energy sector has been one of the areas where privatization has progressed with greatest difficulty. After lengthy and careful preparation, the privatization of the electricity sector started with the recent successful sale of 90% of the shares in the countrywide distribution business to a strategic investor (EVN AG from Austria), including an option for the transfer of a minor package of shares to EBRD. The privatization of the separated, stand-alone thermal power plant Negotino is under way. The other generation assets will be taken up for privatization by the end of 2006 or beginning of 2007.

Oil supply is regulated and open to competition. A major part of the consumption is supplied by the private company Makpetrol. There is a growing interest of other private companies to enter this market. The oil refinery OKTA was privatized in 1998 and is now owned and operated by an affiliate of Hellenic Petroleum of Greece.

The gas market is still underdeveloped. To move forward, substantial investments in the construction of a distribution network and the upgrading of the transportation infrastructure are required. The existing transmission system is partially private and the distribution grid and business are in the private ownership of Makpetrol AD. The gas Transport System Operator (GA-MA) is a state-owned company; it also acts as a public supplier according to the law. However, the legal dispute between Makpetrol and the Government regarding ownership of the gas transmission infrastructure must be resolved before investments in the sector could materialize.

Macedonia has recently made significant progress in energy sector reform, most notably through adoption of an Energy Law and establishment of an independent energy regulator. Notwithstanding this, further progress is required if the following objectives – agreed between the Government of Macedonia and the World Bank – for the Macedonian energy sector are to be met:

- To provide secure and affordable energy on a sustainable basis;
- To commercialize the energy industry;
- To improve energy efficiency; and
- To improve environmental performance of the energy industry.

A major policy challenge is the high and growing import dependence for energy supply, including the supply of electricity. For securing new electricity production capacity the emphasis will be on the construction of large and small hydro power plants, gas-fired combined heat and power plants, and thermal power plants. It seems urgent to clarify the policy for new lignite based electricity production. Lignite supplies from existing working mines will become exhausted in the medium term. This is a

crucial point given that currently around 70% of the electricity is currently generated from lignite, and power is used extensively in the residential (often for heating) and industrial sectors. In addition, energy demand has increased in recent years, a trend that is likely to continue given forecast macroeconomic growth. In these circumstances, action is required if the energy balance is to be maintained.

In the gas sector it is planned to extend the gas pipeline system to all the major cities in the country as well as to the power sector. There are several plans in the form of pre-feasibility studies for gas distribution in the capital Skopje and in other cities along the existing main gas pipeline from the Bulgarian border to Skopje.

In the oil sector, the most significant planned development is the construction of the product pipeline from Skopje to Pristina (UNMIK, Kosovo), with a total length of 115 km. The project will result in increasing the processing of crude oil at the OKTA refinery. Another major task in the petroleum sector is the phasing out of leaded gasoline and the improvement of the quality of other fuels, in particular the reduction of sulphur content of diesel and fuel oil.

The Secretariat's evaluation is that the Republic of Macedonia has covered a long way towards the establishment of investor-friendly, competitive structure environment in the energy sector. Great improvement is evident in all aspects. The country has adopted most of the important provisions of EU's acquis, established an independent regulator, developed non-discriminatory, market-oriented legislation, and is working towards the full-scale integration in regional and global markets. Privatization is complete in the oil sector and rapidly advancing in the power and district heating sectors, but the gas sector is lagging behind due to unresolved issues of ownership of major infrastructure, pending a court decision. The country has received credit ratings with positive outlook.

However, significant investment climate drawbacks still exist, mostly related to the inadequate implementation of the adopted energy sector legislation, to the efficiency of protection of investor rights (including the efficiency of the court system), the quality of governance and corporate management (the latter often as a side effect of earlier privatization done via management buy-outs). Further effort thus seems warranted for reducing systemic economy-wide constraints to business that undermine investor confidence, particularly creditor, property and contract rights. Other areas where much work is still needed include reducing bureaucracy, improving corporate governance standards, improving SME access to financing, reforming the judiciary and stepping-up the fight against corruption, strengthening the banking sector, implementing further regulatory reform and commercialisation in key utilities to attract strong investment flows to modernise relevant infrastructure.

The Republic of Macedonia is at a critical junction in its energy sector reform, where the country may soon reap the benefits of the reforms if the investment climate improvement and market restructuring keeps its pace, or significantly delayed if structural challenges are not duly recognized and properly dealt with.

IN-DEPTH REPORT

ON

THE INVESTMENT CLIMATE

AND

MARKET STRUCTURE

IN THE ENERGY SECTOR OF

THE REPUBLIC OF MACEDONIA³

³ The State to which this report relates has been admitted to membership of the United Nations under General Assembly Resolution 47/225 as the former Yugoslav Republic of Macedonia.

I. Executive Summary

The Republic of Macedonia became an independent country in 1991. It is a country with an economy in transition. Against this background, efforts have been dedicated towards implementing the provisions of the Energy Charter Treaty (ECT), especially in the field of the investment climate and market structure in the energy sector of the Republic of Macedonia.

The Republic of Macedonia is a small economy with a gross domestic product representing about 0.01% of the total world output. It is also an open economy, highly integrated into international trade, with a total trade-to-GDP ratio of over 90%. Agriculture and industry have been the two most important sectors of the economy, but the services sector has gained prominence in the past few years. Like most transition economies, problems persist, even as Macedonia takes steps toward reform. A largely obsolete industrial infrastructure has not seen much investment during the transition period. Work force education and skills are competitive, but without adequate job opportunities, many with the best skills seek employment abroad. A low standard of living, high unemployment rate, and relatively low economic growth rate are the central economic problems.

The Republic of Macedonia remains committed to pursuing membership in European and global economic structures. It became a full World Trade Organization (WTO) member in April 2003. Following a 1997 cooperation agreement with the European Union (EU), the Republic of Macedonia signed a Stabilization and Association Agreement with the EU in April 2001, giving Macedonia duty-free access to European markets. The Republic of Macedonia has signed Free Trade Agreements with Albania, Bosnia and Herzegovina, Serbia and Montenegro, Bulgaria, Croatia, Ukraine, Slovenia, Turkey, Romania, and the European Free Trade Association countries. It also has signed an Interim Free Trade Agreement with the UN Mission in Kosovo.

The major policy objective and priority of the Republic of Macedonia is full membership in the European Union. The membership in the European Union is its strategic interest. As a relatively small developing country which is landlocked, Macedonia strives to achieve openness, cooperation and connection with neighboring countries, as well as with the countries in the wider region. From both political and economic aspects, it is crucially important for the Republic of Macedonia to strengthen the connections and partnership, on the grounds of common interests. Furthermore, the stability and prosperity of Macedonia as a crossroad in South Eastern Europe is of major significance for the European Union. Late in 2005, the European Council granted the Republic of Macedonia a candidate status for membership in the European Union.

The country is not rich in natural resources, with the exception of lignite and hydropower. Fuel diversification and reducing dependence on external resources are strong reasons for promoting energy savings. Increasing the penetration of natural gas and improving the interconnections with neighbouring countries are high priorities.

Total consumption of energy in the Republic of Macedonia is around 120,000 TJ annually. In primary energy consumption, oil accounts for 30%, coal for about 52%, natural gas 2-3%, and the remaining around 15% are hydro energy, wood and

geothermal energy. Domestic energy production covers about 60% of demand and 40% are provided from imports.

The basic energy infrastructure in Macedonia includes the following: electricity power system, coal mines, gas pipeline system, an oil refinery, an oil pipeline, thermal and geothermal systems. The total installed capacity for electricity production is 1,524 MW, with annual production of around 6.5 GWh. Of installed capacity, 1,010 MW are at thermal power plants with annual production of 5 GWh, and 514 MW are at hydro power plants with annual production of around 1.5 GWh.

Macedonia has no oil or gas reserves. All crude oil is imported and is transported from Thessaloniki (Greece) to the refinery close to Skopje via an oil pipeline with a capacity of 2.5 million tons per year. The annual consumption of oil products is approximately 800,000 tons.

The main gas pipeline system of Macedonia has a capacity of 800 million m³ per year (one 20 inch line). The main transmission gas pipeline is around 98 km long, stretching from the border of Bulgaria to Skopje. So far, a few pipeline branches to cities have been built with a total length of 26 km and a distribution gas network exists with a length of 31.5 km.

The solid fuel used in Macedonia is lignite. The largest mines are part of thermal electricity plants and the coal from these mines is used for electricity production (around 7 million tonnes per year), while around 200,000 tonnes per year of lignite from other smaller mines is used by industrial consumers and households.

Currently, five district heating systems are operational with a total capacity of 600 MW, powered by heavy oil, natural gas and lignite. Around 50.000 households are connected to these heating systems.

Regulation of the energy market is performed by an independent regulatory body, the Energy Regulatory Commission of the Republic of Macedonia (ERC).

The energy policies aim at creating conditions for:

- secure and efficient energy supply;
- carrying out the business of the companies in competitive and non discriminatory energy markets;
- improvement of the investment climate for construction of new energy facilities;
- increasing energy efficiency and greater use of renewable energy resources in the energy supply and demand balances of the country.

II. Introduction

II.1. Basic facts about Republic of Macedonia

The Republic of Macedonia is a landlocked, mountainous country situated at the heart of Southeast Europe on the Balkan Peninsula.

Location	South-Eastern Europe, Balkan Peninsula
Area	25 713 km ²
Border countries	Albania (151 km), Bulgaria (148 km), Greece (246 km), Serbia and Montenegro (221 km)
Climate	Transitory from temperate continental to Mediterranean
Terrain:	Mountainous territory covered with deep basins and valleys; three large lakes, each divided by a frontier line; country bisected by the Vardar River
Population	2.1 million (Last Census 2002)
Ethnic groups	Macedonians (64.18%), Albanians (25.17%), Turks (3.85%), Gypsies (2.66%), Serbs (1.78%), Bosnaks (0.84%), Vlachs (0.48) and others (1.04%).
Age structure	0-14 years: 20.5% (male 217 057/female 202 465) 15-64 years: 68.7% (male 707 489/female 697 150) 65 years and over: 10.8% (male 97 117/female 123 984) (2005 estimate)
Constitutional name	Republic of Macedonia
Independence	8 September 1991
Constitution	Adopted 17 November 1991, effective 20 November 1991; amended November 2001 by a series of new constitutional amendments strengthening minority rights
Political system	Multi-party Parliamentary Democracy
Executive branch	Head of state: President Branko CRVENKOVSKI Head of government: Prime Minister Vlado BUCKOVSKI <i>Cabinet:</i> Council of Ministers elected by the majority vote of all the deputies in the Assembly; note - current cabinet formed by the government coalition parties SDSM, LDP, and DUI
Official language	Macedonian (other languages spoken Albanian, Serbian, Turkish, Vlach, Gypsy etc.)
National Currency	Denar (1 MKD) = 100 deni
Exchange rates :	1 EUR = 61.31 MKD (as of 31.12.2004) 1 USD = 45.06 MKD (as of 31.12.2004)
Capital	Skopje (600 000 inhabitants)
Administrative divisions	85 municipalities

With international assistance, the current governing coalition has completed the legislative implementation of the Ohrid Framework Agreement, which is a precondition for Republic of Macedonia's integration into Euro-Atlantic institutions. The government continues to make significant strides on the practical implementation of the Agreement⁴.

Macedonia has signed (along with other countries in the Western Balkans) a Stabilisation and Association Agreement (SAA) with the European Union that explicitly includes provisions for future EU membership of the country (signed 2001, in force since 2004). In late 2005, EU granted Macedonia the status of a candidate country for accession to the Union, but no date for the start of negotiations has been set yet.

⁴ Source: U.S. Department of State: Background note on the Republic of Macedonia.

The country credit rating determines its present and future creditworthiness – the overall fiscal capacity and ability to repay its financial commitments. The credit rating is a clear signal to all potential investors that the Macedonian economy is developing in the right direction. The assigned sovereign credit rating is a precondition for the private sector rating.

On 29th of July 2004, Standard & Poor's assigned the first long-term credit rating of the Republic of Macedonia ('BB/B' FC, 'BB+B' LC with positive outlook in the period to follow). Key factors for assigning positive ratings were the rapid progress in the political stability driven by the Framework Agreement and the prospect of EU membership, the macroeconomic stability, moderate levels of foreign debt and moderate-to-low budget deficit. On August 23, 2005, Standard & Poor's Ratings Services raised its long-term foreign and local currency sovereign credit ratings to 'BB+' from 'BB', and to 'BBB-' from 'BB+', respectively, on sustained political stabilization. At the same time, the short-term local currency rating was raised to 'A-3' from 'B', and the 'B' short-term foreign currency rating was affirmed.

II.2. Political System

The unicameral assembly (Sobranie) consists of 120 seats. Members are elected by popular vote from party lists, based on the percentage parties gain of the overall vote in each of six election districts of 20 seats each. Members of parliament have a 4-year mandate.

The prime minister is the head of government and is selected by the party or coalition that gains a majority of seats in parliament. The prime minister and other ministers must not be members of parliament.

The president represents the Republic of Macedonia at home and abroad. He is the commander in chief of the armed forces of the Republic of Macedonia and heads its Security Council. The president is elected by general, direct ballot and has a term of 5 years, with the right to one re-election.

General parliamentary elections were last held on September 15, 2002. Presidential elections were held April 14 and 28, 2004 to succeed President Trajkovski, who died in office in February 2004. Local elections on the basis of a new municipal division mandated by the Framework Agreement were held in March-April 2005.

The court system consists of a Supreme Court, Constitutional Court, and local and appeals courts. The Republic Judicial Council is composed of 7 members elected by parliament for a period of 6 years with the right to one re-election; it governs the ethical conduct of judges and recommends to parliament the election of judges. The Supreme Court is the highest court in the country and is responsible for the equal administration of laws by all courts. Its judges are appointed by parliament without time limit. The Constitutional Court is responsible for the protection of constitutional and legal rights and for resolving conflicts of power between the three branches of government. Its 9 judges are appointed by parliament with a mandate of 9 years, without the possibility of re-election. An independent Public Prosecutor is appointed by parliament with a 6-year mandate⁵.

⁵ Ibid.

II.3. Economy

II.3.1. Macroeconomic Situation

The Republic of Macedonia runs a consistent deficit in its balance of trade and services of about \$800 million, or 15% of GDP. The trade and services deficit is to a large extent compensated by transfers (including remittances from Macedonians working abroad) that run at over \$600 million per year. FDI inflows and other items allow the country to maintain a relatively balanced position in its external accounts.

Table 1: Key economic indicators (millions of Dollars unless otherwise indicated)

Year	2000	2001	2002	2003	2004	2005
Current account balance	-72		-358	-279		
FDI, inward	152	449	78	81	139	
Other investment (assets and liabilities)	100		169	146		
Reserve assets	-264		131	-49		
Financial account, net	11		379	195		
Capital and financial account, net	11		388	188		
Nominal GDP in million US\$ (PARE method –1994 as base)	3899	3723	3755	4521	4842	
Real GDP at 2004 prices in million denars	257404	245753	247858	254841	265257*	275750**
Per capita GDP at market rate of exchange \$	1771	1689	1866	2285	2641*	2831**
Real GDP annual average growth rate, %	4.5	-4.5	0.9	2.8	4.1*	4.0**
Inflation rate, % per year					0.2	1.0
Labor force, thousand					855000	
Unemployment rate, %					37.4	
Population below poverty line, %				30.2		
Macedonian Denar exchange rate to the Dollar, annual average	65.89	68.04	64.73	54.30	49.41*	49.29**
Government revenue						2169
Government expenditure						2253
External debt						2207
External debt, % of GDP					35.2	
Public debt, % of GDP						32.6
Industrial production growth rate, %						5.5
Gross fixed investment, % of GDP	16.2	14.8	16.6	16.7	17.8	
Current account balance	-72		-358	-279		
FDI, inward	152	449	78	81	139	
Other investment (assets and liabilities)	100		169	146		
Reserve assets	-264		131	-49		
Financial account, net	11		379	195		
Capital and financial account, net	11		388	188		

Sources: UNIDO, UNCTAD, CIA World Factbook, U.S. Department of State, State Statistical Office

*2004-preliminary data

**2005-estimated data

A conservative fiscal policy maintained a budget deficit of -0.1% during the first half of 2005; the government's target is -0.6% for 2005. Monetary policy also remained conservative, which provided little room for credit expansion. Exports grew faster than imports in the first half of 2005, narrowing the trade deficit to 10.6% of GDP, and reducing the current account deficit to about 2.1% of GDP. External debt remained stable at 35.2% of GDP.

In trade, the main export items are clothing and textiles (about 30% of exports), iron and steel (about 15%, mostly sheets and plates), non-ferrous metals (zinc, lead – about 5%), footwear and leather products (about 4%), and petroleum products (about 4%). In imports, the largest single item is crude oil and refined products (about 12% of

imports), followed by various kinds of machinery, equipment, tools and automotive (about 10%).

Most of the value added in the economy comes from agriculture and industry. In industry, the leading branches are food processing and cannery (over 30% of value added in industry), textiles and clothing (about 15%), iron and steel (about 10%), and glass & ceramics (about 9%). Basic chemicals and paper and paper products contribute about 6.5% each⁶.

Macedonia remains committed to pursuing membership in European and global economic structures. It became a full World Trade Organization (WTO) member in April 2003. Following a 1997 cooperation agreement with the European Union (EU), Macedonia signed a Stabilization and Association Agreement with the EU in April 2001, giving Macedonia duty-free access to European markets. Macedonia has signed Free Trade Agreements with Albania, Bosnia and Herzegovina, Serbia and Montenegro, Bulgaria, Croatia, Ukraine, Slovenia, Turkey, Romania, and the European Free Trade Association countries. It also has signed an Interim Free Trade Agreement with the UN Mission in Kosovo⁷.

Along with other Balkan countries, in October 2005 Macedonia signed the Treaty Establishing the Energy Community and started implementing the EU *acquis* in the energy sector.

Table 2 provides data about total energy supply and demand, energy intensity and CO₂ emissions in the Republic of Macedonia.

Table 2: Energy supply, demand, consumption, and CO₂ emissions from fossil fuels

	1998	1999	2000	2001	2002	2003	2004	2005
Total primary energy demand (thousand tons oil equivalent – toe)	2.904	2.837	2.765	2.677	2.897	n.a.	n.a.	n.a.
Total domestic primary energy supply (thousand toe)	1.744	1.698	1.595	1.642	1.577	n.a.	n.a.	n.a.
Total CO ₂ emissions from fossil fuels, million t C equivalent	1)	1)	2.870	1)	3.521	n.a.	n.a.	n.a.
CO ₂ emissions from fossil fuels per person, tons C equivalent	1)	1)	1.416	1)	1.743	n.a.	n.a.	n.a.
Carbon intensity (CO ₂ emissions from fossil fuels, t C equivalent per \$1000 Y2K Dollars, market exchange rate)						n.a.	n.a.	n.a.
Total primary energy consumption per person, toe	1)	1.407	1.365	1.316	1.432	n.a.	n.a.	n.a.

Source: State Statistical Office.

II.3.2. Foreign Direct Investment

The Republic of Macedonia is increasingly developing a positive attitude towards foreign direct investment (FDI). It strives to create a favorable investment climate for

⁶ Source: UNIDO.

⁷ Source: U.S. Department of State.

its attraction. It has opened its market for all forms of investments including participation through privatization. Foreign investors are accorded national treatment in many respects. Various types of incentives including tax-exemptions are offered to investors. The legal framework for foreign investment is provided by the new Law for Trade Companies adopted in 2004. Other important relevant legislations include:

- Constitution of the Republic of Macedonia;
- Law on Privatization (as amended and revised);
- Law of Foreign Citizens Residency;
- Law on Profit Tax (as revised or amended);
- Law on Insurance Supervision (Official Gazette of RM No. 27/02, 84/02 and 98/02);
- Law on Radio Broadcasting (Official Gazette no. 20/98);
- Law on Banks (Official Gazette no. 63/00);
- Foreign Exchange Law and accompanying regulations (Official Gazette no. 30/93, 40/96, 54/2000 and 41/2001).

The main features of the national FDI regime include the following:

- *Admission and establishment:*
 - As a rule, foreign investors may invest without a special permission in all economic activities, including banks, savings banks, organizations, insurance companies, cooperatives and other forms of collaborations and joint operations.
 - Foreign investment may be in the form of foreign currency, equipment and spare parts, raw materials, intermediate goods and rights.
 - Investment may be undertaken as a sole proprietorship or organized in the form of a public trade (general partnership), limited partnership, limited liability company, joint stock company and limited partnership as well as through establishment of branches and representative offices.
- *Ownership and control:*
 - Article 31 of the Constitution stipulates that a foreign person may acquire property rights under conditions set by law. Furthermore, Article 59 of the Constitution guarantees a foreign investor the right to free transfer of the invested capital and profits. Rights acquired in connection with invested capital may not be reduced by any other law or regulation.
 - A foreign person may establish the same types of companies as a Macedonian national.
 - In general, there are no limitations on foreign investment in the country, except in the areas of circulation and trade of narcotics and protection of historical monuments and cultural wealth, regulated in Article 55 of the Constitution of the Republic of Macedonia.
 - There are no restrictions on the participation of foreign capital in the banking sector. The banking sector is regulated by the Law on Banks (Official Gazette no. 63/00). The latest changes of the Law are expected to encourage foreign capital into the Macedonian banking sector, which will bring better corporate governance and improve their performance.

- There are no limitations for foreign investment in insurance. The Law on Insurance Supervision (Official Gazette of RM No.27/02, 84/02 and 98/02) stipulates that in an insurance company, the individual share of each shareholder (legal entity, individuals or linked entities/individuals) can be up to 25% of the equity with a right of management. If shareholders are banks or insurance companies, there are no limitations on participation in the capital.
 - Non-residents are required to register the investment and all subsequent modifications thereof in the Ministry of Economy within 60 days. Registered foreign investments are protected from nationalization.
- *Operational conditions:*
 - There are no requirements for local content, export performance, transfer of technology or obligatory participation of nationals in a foreign company except for the areas strictly limited by law (strategic and the financial sectors).
 - Foreign investors must obtain working and resident visas before they start to work in the country.
- *Foreign exchange controls:*

The foreign exchange regime is governed by the Foreign Exchange Law (Official Gazette of RM No. 34/2001, 49/2001, 103/2001, 54/02, 51/03) and accompanying regulations. According to this law, payments to or from foreign countries are performed by banks authorized for foreign transaction by the National Bank of Republic of Macedonia (Central Bank). All transactions that take place in Macedonia should be made in Macedonian Denars. Resident and non-resident companies and individuals may keep accounts in commercial banks in foreign exchange.

 - There are no restrictions on the current account payments. Profits and dividends from inward investments can be freely transferred abroad, after all tax obligations have been met. Such transfers are tax-free.
 - According to the foreign trade law, for capital account transactions, involving direct investments of Macedonian resident's abroad, a prior permission from the Ministry of Economy is required. Investments in real estate, as well as portfolio investments by Macedonian residents are not allowed.
 - There are no regulatory restrictions on FDI by non-residents in Republic of Macedonia.
 - Credit transactions between residents and non-residents may be undertaken freely, subject to registration at the Central Bank. Macedonian residents are not allowed to have bank deposits abroad: however, some legal entities, which have some business activity abroad can have deposits in foreign banks only with permission from the Central Bank.
 - Non-residents can freely open non-resident accounts in Macedonian banks authorised for foreign exchange transactions upon proof of identity.
 - The new Foreign Exchange Law introduces much more liberal regime for capital transactions. The new law liberalizes inward and outward FDI-related transactions, subject to registration at the Ministry of

Economy. The new Law allows for the introduction of domestic securities on foreign securities markets. In the first phase only the residential banks and investment funds can invest and trade abroad in foreign securities. Non-residents can introduce foreign securities on the Macedonian securities market with permission from Securities Commission⁸.

II.3.2.1. Actual Inflows of FDI

FDI Inflow

The total FDI stock in the Republic of Macedonia reached \$1.2 billion by the end of 2004. Year 2001 marked the biggest amount of FDI inflow, as a result of the sale of the Macedonian Telecom for \$310 million to the Hungarian Matav.

Table 3: FDI in Macedonia (\$ million)

Year	2000	2001	2002	2003	2004	2005 est.
FDI inflow	178.5	445.1	81.67	97.5	163	151

Source: National Bank of the Republic of Macedonia.

In period January – June 2005 an inflow was registered of \$75.5 million

FDI stock by sectors

The largest foreign direct investment that occurred was in connection with the privatisation of the Macedonian Telecom by Matav – Hungary. Large FDI inflow has been also attracted in the sectors of manufacturing, ferrous metallurgy, cement production, crude oil processing, food and beverages, textiles, as well as banking and insurance.

Table 4 FDI inflows by sectors (\$ million)

Activity	2000	2001	2002	2003	2004
Agriculture and fishing	0.00	2.31	0.42	1.59	6.05
Mining and quarrying	9.62	2.17	0.29	0.02	5.77
Manufacturing	34.70	37.74	27.22	15.60	54.18
Construction	18.90	12.32	4.01	0.07	0.057
Trade and repair	3.50	5.15	6.97	4.71	8.50
Hotels and restaurants	0.13	1.28	1.64	7.20	6.61
Transport and communication	2.36	337.39	10.28	32.47	62.79
Financial intermediation	104.70	11.20	24.78	30.55	9.38
Business activities & Real Estate	2.35	8.52	1.88	4.37	5.89
Other services and not allocated	2.10	26.97	1.23	0.01	0.35
Other	0.13	0.07	2.79	1.42	0.22
Total	178.52	445.13	81.67	97.55	163.11

Source: National Bank of RM

⁸ UNCTAD WID Country Profile 2005, based on information obtained from Government of Macedonia; from the Economic Chamber of Macedonia: Internet (<http://www.mchamber.org.mk>) and from the CountryWatch.com.

Table 5: FDI by country, 2000-2004 (\$ million)*

Country	2000	2001	2002	2003	2004	Total 1991-2004
Hungary	0.009	322.682	0.002		0.019	322.754
Greece	103.166	67.471	45.124	6.904	30.151	266.889
Netherlands	0.546	0.581	0.661	31.606	66.226	101.901
Cyprus	4.772	3.916	7.545	0.155	1.675	81.935
Germany	11.280	4.757	631	4.885	6.567	57.375
Switzerland	1.301	8.784	2.689	13.402	8.018	50.452
Great Britain	25.180	1.222	2.352	0.303	0.981	41.714
Austria	2.191	2.849	0.575	2.643	0.940	36.296
Slovenia	11.585	3.866	3.988	6.066	4.743	35.323
Italy	2.514	2.721	0.412	0.816	7.425	32.488
USA	3.472	15.147	4.279	3.507	1.056	30.756
Bulgaria	0.060	0.433	4.965	10.961	4.950	22.754
Turkey	0.160	0.079	0.236	0.700	2.428	21.524
Serbia & Montenegro	1.068	1.612	2.976	1.092	0.329	11.732
Others	11.220	9.014	5.241	16.305	27.611	94.975
Total FDI	178.524	445.134	81.676	99.345	163.119	1 208.868

Source: National Bank of RM

II.3.2.2. Current investment obstacles

While Macedonia's legislation does not contain any restrictions on foreign investment notified to the Energy Charter, the business environment in the country is still in the process of evolving towards competitive and transparent markets. In particular, the EBRD notes in its Strategy for Republic of Macedonia⁹ that the main transition challenges continuing to face the country are as follows:

- Improving the business environment, particularly for SMEs, reducing bureaucracy, improving corporate governance standards, and improving SME access to financing.
- Reforming the judiciary and stepping-up the fight against corruption.
- Improving governance and strengthening the banking sector, including through consolidation.
- Implementing further regulatory reform and commercialisation in key utilities to attract strong investment flows to modernise relevant infrastructure.

The EBRD mentions among lessons learned that:

- The lack of appropriate channels (including at a high level) for a *regular discussion between government and the investor community* hampers efficient legislative efforts as well as problem-solving on various sector- or investment-related issues. One-off events or individual lobbying can not replace

⁹ Strategy for the Former Yugoslav Republic of Macedonia, approved by the (EBRD's) Board of Directors at Its Meeting on 20 July 2004.

regular exchanges of views. The EBRD initiative to create an Investors Advisory Council, prioritised in the previous strategy, has been agreed but not yet implemented due to delays by the Government with appointing the council's members and then scheduling the first meeting;

- Macedonia is not the only transition country where *management/employee buyouts* (MEBO), the dominant form of privatisation, have not proved to be a success for company turn-around. Foreign investor interest in the country has been low and the few that have tried to approach local privatised companies for potential acquisition have often found that the management of these companies has an unrealistic valuation for their companies, which are typically characterised by stagnating or declining sales, over-employment and overvalued but decaying assets.
- Overall financial intermediation remains low and local banks typically have no or *low appetite to lend to new SME customers* and continue with their collateral based lending approach. Various SME credit lines from bilateral (e.g. export promotion credits) and multilateral (e.g. EIB) are poorly used.

Other problem areas mentioned by the EBRD in the document include:

- The lack of clear policies by the Government on commercialisation and privatisation of utilities vs. retaining Government control,
- Issues of local/central political interference in company matters or public sector procurement;
- General constraints to business in the country (e.g. inefficiency of the judiciary, the sluggishness on issuance of various permits, varied respect for commercial agreements signed by the Government and discretionary interpretation and application of legislation).

The EBRD points out that integrity is a major concern: Macedonia is ranked in the 106th place – together, inter alia, with Serbia and Montenegro and Ukraine – in Transparency International's 2003 Corruption Perceptions Index for 133 countries. According to a European Commission working paper that assesses the progress of the country's Stabilisation and Association Agreement, stepping up the fight against corruption and organised crime should be top priority for the government. The paper noted that organised crime was increasingly challenging state authority and putting at risk both the stability and the development of the society in the country. Urgent action is required to fight organized crime both more efficiently and more comprehensively. The paper recommended the adoption and implementation of a comprehensive strategy, in line with international and European standards and practices, including the setting up of appropriate bodies to prevent, investigate and prosecute corruption, financial as well as organised crime, to increased transparency and objectivity in various procedures performed by the executive bodies, to provide clarity in the financing of political parties, and to ensure the full implementation of public procurement legislation.

The World Bank considers the improvement of the business climate in Republic of Macedonia in a report detailing the aspect of legal and judicial reform¹⁰. The document identifies some key issues that undermine investor confidence, particularly creditor,

¹⁰ Improving the Business Climate in Republic of Macedonia: A Legal and Judicial Enforcement Assessment. 21 June 2005. The World Bank, Wash., DC.

property and contract rights. Other systemic constraints include procedural, organizational, material and human resource issues, as well as questions of judicial incentives and practice, such as case backlog and judicial inefficiencies, administrative dispute, judicial incentives and practice, information technology, enforcement of judgment, and alternative dispute resolution (ADR) - arbitration and mediation.

II.3.3. Privatisation

Transformation of ownership was recognized as crucial for the transition towards free market economy, so privatization became priority to the newly independent State. Privatization in Republic of Macedonia was initially introduced in 1989 with the Law on Social Capital of the former Yugoslav Federation. In this process, over 600 enterprises in Macedonia were transformed into joint stock companies or limited liability companies. Yet, a real boost to the process of privatization was given by the enactment of the new Law on Transformation of Enterprises with Social Capital in June 1993. According to the Law, around 1200 enterprises from the commercial sector have been subject to privatization. In 1996 began the privatization of the agricultural sector, including approximately 350 companies. In 1997 the scope of the privatization program expanded to include the companies operating in the insurance sector and companies that organize games on chance, or altogether approximately 1600 legal entities.

Bank privatization was a passive one and it depended on the privatization of the enterprises which were the founders of banks. Enterprises of infrastructure and utilities are currently being privatized. The electricity distribution and supply utility ESM AD was sold to the Austrian energy utility EVN AG, and the Macedonian telecom was sold to the Hungarian telecom company MATAV. The Privatization Agency (closed down in September 2005) is not in charge of the privatization of these sectors, as they are under the authority of the respective ministries.

Overall, privatization is almost complete (95%+) and only a few large public service companies are still in the hands of the government, with their privatization pending soon, too. For this reason, the subsequent discussion is more an account of experience, rather than forward-looking discourse.

Privatization procedure

The privatization process in Macedonia, generally, was decentralized, and the enterprises have been allowed a certain period of time to initiate their privatization autonomously. Documents required included valuation of the enterprise, program on the proposed method of privatization, report on the audit of the implementation of the Law on Social Capital, court registration and evidence on ownership rights on the real estate of the enterprise.

The privatization scheme was the following:

- 30% of the social capital (in the form of ordinary shares or stocks) were offered to the employees on privileged purchasing terms;
- Employees were offered a generous discount scheme. They had an initial discount of 30%, plus 1% for each year of work in the enterprise.

- 15% of the social capital (in the form of priority shares or stocks) were automatically transferred (free of charge) to the State Pension Fund. The Fund may, on a basis of an autonomous decision, sell those shares;
- 55% of the appraised value of the enterprise were available for sale as ordinary shares or stocks, on equal terms for both domestic and foreign investors.

Sales methods

The privatization models depended on the size of the enterprise.

Small enterprises were privatized according to the following methods:

- Employee buy-out. The employees had an opportunity to acquire the enterprise, by purchasing a stake of at least 51% of its appraised value. They were obliged to purchase the remaining part of the enterprise, with a possibility to pay in 5 annual installments.
- Sale of an ideal part of an enterprise (in the form of shares or stocks). Bids were collected through public tender, which was followed by a public auction, if there were more than one bidder.

Medium-sized enterprises used the following privatization methods:

- Sale of an ideal part of an enterprise (in the form of shares or stocks). This was the same method as the method applied to small enterprises.
- Enterprise buy-out. The procedure was organized by enterprises themselves, and the bidders only submitted a copy of the bid to the Privatization Agency.
- Management buy-out. The public tender, collection and evaluation of bids were administered by the Privatization Agency, through a committee formed for this purpose. A development program for the enterprise was the main part of the bid. The bidder that offered the most attractive program could take control over the enterprise by a down-payment of only 20% of its appraised value, with an obligation to purchase at least 51% stake over a period up to 5 years. There was a possibility for payment in 5 annual installments with no interest charge.
- Issue of shares for raising additional equity. The bidding procedure was identical to the one in the previous method, except that it was performed by the enterprise, while the Agency's authority was to approve the winning bid.
- Debt/equity swap. This privatization method was applied when the creditors of the enterprise found it a viable option. The Agency had certain control over the process, as it evaluated the submitted transformation plans.

For *large enterprises*, the privatization methods were identical to the methods for the medium-sized, with only slight differences, such as the amount of the down payment, or the value of the new issue.

Additional sales methods were also possible (leasing, sale of all assets of the enterprise after a liquidation, transformation of enterprises under bankruptcy procedure).

The various privatization models applied equally to all investors – individuals and legal entities, both from the country and abroad. However, the fact that the Law allowed managers and employees to propose the privatization method, gave them, in a way, a

preferential treatment. Therefore, most enterprises were privatized with the participation of insiders.

Residual shares

The basic common principle in all methods of privatization according to the Macedonian Law was (and still is) that the privatization is considered successful if at least 51% of the capital of the enterprise is sold. Hence, a substantial part of the shares in the privatized enterprises were transferred to the Agency as residual shares, in order to be sold afterwards.

Investment via privatization

Generally, investment via privatization was possible by purchasing on the Macedonian Stock Exchange and by public tender.

FDI via privatization

The Privatization Law provides for the same treatment of both domestic and foreign investors. The inflow of foreign investment through privatization started modestly. By end 2000, the total amount of foreign investments both through privatization and post-privatization sales was around \$235 million. Further major inflows of FDI were related to privatization of public service enterprises, such as the telecoms, which was not done by the Privatization Agency, but by the relevant Ministries.

Rehabilitation of banks and privatization

The reform of the banking system commenced in the beginning of 1995, by auditing the largest banks and by establishing the Bank Rehabilitation Agency (BRA). BRA undertook the bad loans of the largest Macedonian bank - Stopanska Banka and in a number of cases converted them into equity in the indebted enterprises, thus constituting a substantial portfolio of stocks in a number of Macedonian enterprises. These stocks were also available for sale through the Privatization Agency, and following a certain procedure the shares of the State, BRA and Privatization Agency (and alternatively the Pension Fund) could be combined to make a larger stake.

Restitution

The enactment of the Restitution Law in Macedonia lagged far behind the introduction of the privatization process. However, the Privatization Law addresses the rights of the former owners. When making the decision to privatize, the enterprise had to make a public announcement, to inform the general public and to invite the claims of the former owners.

Privatization and restructuring

A problem area in privatization has been the divesting of loss-making enterprises. Macedonia dealt with large loss-making enterprises by restructuring 23 loss-making firms into more than 165 separate business units under a special restructuring program supported by the World Bank that began in 1995. In the first half of 1999, significant progress was made in dealing with these firms: 108 were privatized and 8 were put in bankruptcy. Under the World Bank's Second Financial and Enterprise Sector Adjustment Program (FESAL II), 24 companies were still awaiting sale or liquidation at mid-2003, and 8 of these were reported to have been sold by late August 2003. At the same time, the Privatization Agency re-launched the privatization program in an effort to restore momentum. In each case, the asset was sold to the highest bidder, and

bidders were not required to commit either to making future investments or to retaining current employees.

Results of the privatization process

After more than a decade of privatization in the Macedonian economy, 95% of the enterprises which entered the process have already been privatized. The privatisation process continues, particularly in the public sector and parts of public companies regulated by separate laws (including the national power company ESM, the telecom, parts of health care (spa and pharmacies), culture (cinemas), broadcasting (some local radio stations and parts of Macedonian television), parts of the Macedonian Railways, parts of the Macedonian forests and other parts of public sector/companies).

The preferred method of privatization in Macedonia was the management-employee buyout (MEBO), with direct sales also widely used. Voucher privatization was not used and restitution had limited application, in particular because land was already mostly in private hands in the former Yugoslavia.

Privatization was complete (beyond the median) already in 1998. Large-scale privatization, which progressed slowly initially, is now nearing completion. Privatization of small and medium enterprises (SME), on the other hand, is even more advanced. Private enterprises produce now over 80% of the Republic of Macedonia's GDP. In the growth of the private sector, privatization has been the major source.

Macedonia has not evaded post-privatization problems that are common to many countries in the region. After a decade of privatization and the establishment of new private firms, changes in enterprise ownership have yet to produce competitively structured markets and competitive business operations. Weak incentives in market institutions and policy frameworks have produced little restructuring of large state-owned enterprises. Many firms with dominant sectoral positions continue to operate unchecked by a competitive market structure.

II.3.3.1. Electricity Sector

The energy sector has been one of the areas where privatization has progressed with greatest difficulty. In 2004, the World Bank noted that major steps toward the unbundling and privatization of the energy sector are yet to be taken in Republic of Macedonia. The problems can be illustrated in finding by the European Commission published in 2003 regarding the status of the electric power company of Republic of Macedonia (Elektrostopanstvo na Makedonija or ESM). At the time, the company struggled with its supply of electricity. ESM's bill-collection rate was below 71%, and the company had arrears of approximately \$200 million (of which more than 78% overdue payments of industrial consumers). To tackle the energy problem, the Macedonian government had signed an agreement with a foreign investment bank (Meinl Bank of Vienna) to provide advisory services in the restructuring of the state electricity utility and its privatization.

The privatization of ESM started at the end of 2004. In accordance with the restructuring plan approved at the start of 2004, electricity production and distribution activities of ESM were separated from transmission, to enable the privatization of the unbundled units. The state retained control over power transmission, but foreign investors were allowed to enter the energy sector by establishing new production

capacities and participating in the privatization of the distribution and generation assets. Restructuring of the energy users (particularly of public-owned companies) helped improve payment discipline by removing at the enterprise level one of the most important sources of soft budget constraints.

In 2005, ESM was split, initially into a transmission company (MEPSO) and generation and distribution company (ESM), and then in separate companies for generation and distribution:

- AD ESM is the distribution company which also owns 11 mini- and small hydro power plants with a total capacity of 35 MW;
- ELEM is the largest generation company;
- TEC (TPP) Negotino is a one-plant generation company;
- MEPSO is the electricity transmission system operator.

In December 2005, a tender for the sale of 90% of the capital share of AD ESM (distribution) was issued and on March 17 the sale was successfully closed. ELEM is to be privatized after parliamentary elections in 2006. ELEM owns the two coal mines it is supplied from.

The unbundling of the firm into separate generation, distribution, and transition companies, followed by the privatization of the unbundled and regulated monopoly, is key to liberalizing the sector and solving the local energy problems.

II.3.3.2. Hydrocarbon Sector

Oil

The OKTA Refinery (the only one in the country) produces most petroleum products consumed domestically, including the bulk of the gasoline and diesel and almost all of the heavy fuel oil. The OKTA Refinery was sold and is now owned by the Greek firm Hellenic Petroleum, following privatization in 1999. Built between 1978 and 1982 and using primarily Russian equipment, the refinery is small and adds little value. The refinery has simple hydro skimming configuration and a low rate of utilization, which result in a competitive disadvantage to imports from complex modern refineries in the region.

The largest oil product and gas distributor in the Republic of Macedonia is Makpetrol (established in 1947), since 1998 a totally private joint-stock company. Makpetrol is the owner of 114 petrol stations and 12 depots for oil products. It has over 60% of the oil product turnover in Macedonia.¹¹

Gas

Macedonia produces no natural gas, importing all its requirements. Gas is imported from Russia since 1997 via Ukraine, Moldavia, Romania, and Bulgaria. In accordance with the Decision of the Parliament of SRM in 1987, in 1999 the Macedonian Government and Makpetrol agreed to finance a gas pipeline system jointly, constructing the line from the Macedonian-Bulgarian border near Kriva Palanka to Skopje, in which project the state would have a minimum 51% ownership. Part of a

¹¹ In this section and the next one, information is used from the Austrian Energy Agency.

wider Russian gas export pipeline network in the region, this pipeline to Skopje is capable of transferring over 800 million m³ per annum, but is not fully used.

The Government established GA-MA as a public enterprise for the supply, transport and distribution of natural gas in October 1996. According to the Law on Trade Companies and the Law on Public Enterprises, JP GA-MA-Skopje should soon be transformed into a joint stock company. In that joint stock company, Macpetrol AD Skopje, should own maximum 49% of the shares, according to its investments in the pipeline.

II.3.4. Energy Policy

II.3.4.1. Endowment with natural resources

The Republic of Macedonia has resources of coal, hydropower, geothermal, solar, wind and biomass energy, and possible resources of oil shale and uranium ore. There are no known conventional oil and gas resources.

Coal Resources

The main domestic energy resource is low grade lignite. The total known reserves are about 940 million tons, of which about 280 million tons are proven reserves. Possible resources are an additional ~1,000 million tons. About 82% of proven reserves are suitable for surface exploitation. Current annual production is 7.2 Mt at four mines (two government-owned and two private). Table 6 provides information on coal mines in the country.

Table 6: Lignite mine resources and production.

Mines	Explored reserves [Mil. Tons]	Heating value [kJ/kg]	Average yearly production [Mil. Tons]	Usage	Start year	Available reserves to
Suvodol	91	8000	6.3	Electricity generation - TPP Bitola	1982	2014
Oslomej	14	6600	1.05	Electricity generation - TPP Oslomej	1980	2012
RIK Berovo	2	8370	0.08	Industry purposes and house heating	1986	2010
Piskupstina	3.8	10460	0.1	Industry purposes and house heating	1988	2026

Source: Energy Regulating Commission of the Republic of Macedonia.

There are large undeveloped known resources and also possible resources, particularly in Pelagonia (Bitola) – cf. Table 7.

Table 7: Undeveloped lignite resources

Lignite deposit	Proven, probable and possible reserves [mil. tons]	Heating value [kJ/kg]
Brod-Gneotino (Bitola)	106	8370
Zivojno (Bitola)	106	8370
Zvegor-Stamer (Berovo-Delcevo)	20	7110
Istevfnik (Delcevo)	29	7110
Lavci (Resen)	20	6700
Strogomiste (Kicevo)	7	6700
Popovjani (Kicevo)	11	6700
Vitoliste (Prilep)	110	6700
Pelagonija (Bitola)	1500	6700
Pelagovija (Prilep)	77	6700

Hydropower Resources

Resources of hydropower are important. The Republic is divided into 3 separate drainage units/areas, which are identified by their major rivers:

- a. The Vardar River water basin/drainage area of 20.535 km²
- b. The Crni Drim River drainage area of 3.350 km²; and
- c. The Strumica River drainage area of 1.535 km²

According to a Master Plan prepared as long ago as 1976 and other studies made later, “the technically usable” hydropower potential of the rives in the country are about 5.5 GWh. In 2003, output at hydropower plants (HPP) was just under 1.5 GWh, somewhat below the maximum production achieved earlier (1.8 GWh). There are plans to rehabilitate existing HPPs and construct several new small and medium-sized HPPs (see detail in the section on electricity below).

Hydropower plants are used for peak demand management. ESM has about 0.5 GW of hydro capacity, which includes pumped storage, run of river and small hydroelectric plants. The biggest hydro power plants are in the basin of Crni Drim, which generates about one third of the energy production (380 GWh) from hydro resources in the country¹².

Geothermal Energy Resources

Macedonia is quite rich in geothermal sources exploited for various uses other than for the production of electricity. The largest geothermal occurrences in Macedonia are related to the Vardar tectonic unit. Only a few geothermal occurrences are beyond this unit and its contact areas. There are seven main geothermal fields in Macedonia with 18 localities of thermal waters, and there are more than 50 occurrences such as springs and wells.

¹² Source: Austrian Energy Agency. The same source has been used elsewhere in this section.

Most thermal waters are found up to an altitude of 400 m above the sea level. Only the Kozuv Mountain springs and Baniste wells are at an altitude of 600 m above the sea level. Temperatures of the flow vary from 24-27°C to 70-78°C.

About 15 geothermal projects have been developed during the 70s and 80s. Some of them are still in operation but others have been abandoned or operate below design capacities. Four of them are very important to the development and utilization of geothermal energy in the country. These are the Kocani geothermal project, the Smokvica and Istibanja agricultural geothermal projects, and the integrated project in Bansko.

Other Energy Resources (Wind, Solar, Biomass, Oil Shale, Uranium Ore)

Wind

The wind energy potential has not been adequately studied in Macedonia. Although the issue has been discussed for many years, very few quality references to wind energy can be found in studies and papers. The Vardar river basin from Kumanovo to Gevgelija is considered as the most favourable area for wind energy applications. Other areas of possible importance are the Pelagonia region, Kriva Planka, Ohrid and other mountainous areas.

According to data published in the “Energy Sector Development Strategy” of the Academy of science, the area around Stip is one of the most favourable in terms of wind speed.

Solar

Solar irradiation in the Republic is amongst the highest in Europe. The most favorable areas record a large number of sunshine hours, reaching approximately 45%. The primary form of solar energy and technology used are flat plate collectors for heating houses and some commercial and public premises, but their contribution to the total energy consumption is insignificant (less than 1%). It is not expected that this figure will increase substantially in the near future.

Biomass

According to the energy demand and supply balance for the year 2005, biomass contributes 6.2% to the gross inland consumption (650,000 cubic meters annual).. Biomass, in the form of wood and charcoal is almost exclusively used in the domestic sector. Industrial or other uses are very small and represent less than 1% of the total biomass final energy consumption.

There are possibilities for a better utilization of forest output for energy purposes. Better forest practices, reforestation, planting of deserted or marginal land could make a contribution, be it relatively small, to the further development of this sector.

Residues of field crops, fruit tree plantations and livestock activities could have a significant potential for collection and utilization, along with waste (incl. manure from intensive farms). This could be done through incineration or anaerobic digestion technologies. But special studies and surveys will have to be carried out to determine

location, logistics, and size of units, economics and viability, likewise with municipal solid waste and the waste of sewage (sewage sludge).

In Kavadarci, centre for the wine production in Republic of Macedonia, there is interest in projects to prepare fuel briquettes from vineyard waste. The project sponsors have calculated that at current energy prices such a project would have a payback time of five to six years. Several other options for biomass use exist.

Oil Shale

Resources of at least 30 million tons of oil shale are known, but few studies, if any, have been done to assess the viability of production of hydrocarbons from this resource.

Uranium Ore

While deposits of uranium ore are known, they are generally not explored and no reliable estimates exist about the extent of the resource or the feasibility of its development.

II.3.4.2. Main Objectives of Energy Policy

The main objectives of the Republic of Macedonia's energy policy are:

- Harmonization of the energy sector laws and regulations according to the European Union directives.
- Restructuring of the energy sector.
- Adoption and implementation of the new Law on Energy.
- Fulfilment of the obligations that will arise from signing the Energy Community Treaty.

In electricity, the priorities are:

- Implementation of the Law on Electricity Market;
- Implementation of the new methodology for setting electricity prices;
- Implementation of the new tariff system for electricity.

In natural gas, the priorities are:

- Legislation pertaining to the natural gas market in conformity with the relevant EU acquis;
- Unbundling of the transportation, supply and distribution activities.

The Republic of Macedonia has recently made significant progress in energy sector reform, most notably through adoption of an Energy Law and establishment of an independent energy regulator. Notwithstanding this, further progress is required if the following objectives – agreed between the Government of Macedonia (GOM) and the World Bank – for the Macedonian energy sector are to be met:

- To provide secure and affordable energy on a sustainable basis;
- To commercialize the energy industry;
- To improve energy efficiency; and

- To improve environmental performance of the energy industry.

These objectives derive from the broader goal of the government to promote macroeconomic stability and growth whilst protecting poor groups in the population. Successful implementation of energy sector reform will support:

- Reduction of the fiscal and quasi fiscal budget deficits;
- Provision of reliable and competitively priced energy to industry;
- Provision of affordable energy to residential consumers.

Outstanding energy sector challenges fall into two broad categories: those relating to maintaining energy balance, and reform challenges. Challenges relating to the energy balance derive from the first three objectives above. Reform challenges derive from all four objectives.

The main challenge in **maintaining the energy balance** is the expected reduction in lignite availability. Lignite supplies from working mines will become exhausted in the medium term. This is a crucial point given that currently around 70% of the electricity is currently generated from lignite, and power is used extensively in the residential (often for heating) and industrial sectors. In addition, energy demand has increased in recent years, a trend that is likely to continue given forecast macroeconomic growth. In these circumstances, action is required if the energy balance is to be maintained.

Options for maintaining the energy balance include:

- Opening of new seams in existing lignite mines/opening of new lignite mines;
- Addition of gas fired power capacity;
- Increasing power imports;
- Reduction of losses in power distribution; and
- Increased gasification through construction of new gas distribution networks.

The main policy options recommended by the World Bank to the Government of Macedonia as regards energy balance are:

- The government should support the most economically beneficial investment projects from the various alternatives. This (economics based decision making) neither a priori prefers, nor precludes, the use of domestic primary resources for energy supply.
- A feasibility study is required to confirm the economic benefits associated with exploitation of new mine seams/new mines.
- A feasibility study is required to establish the economic viability of the proposed Skopje CHP plant. Should the study demonstrate viability, a strategic investor for the project should be selected through an international competitive tender. If the project is shown to be not viable, it should not proceed; the CHP plant would become a stranded cost for ESM (the national power utility) in these circumstances.
- ESM should develop a project for reduction of losses in power distribution.
- A Skopje gas distribution concession project should be developed.

- Further work is required to evaluate the economic benefits of new gas pipelines which would facilitate transport of Caspian gas through the Republic of Macedonia to Western Europe.

It should be noted that the World Bank is supporting several feasibility studies through its administration of a grant from the Japanese Government. These studies, which should be seen as fully complementary to this paper, were completed in 2004.

The World Bank recognizes that the Government of Macedonia may choose to incorporate other factors (e.g. political, social) in its decision making as regards energy sector investments. One key area will be the extent to which Republic of Macedonia relies on the regional energy market for supply of primary (gas) and secondary (power) energy.

Regarding **reform challenges**, it is necessary that further steps are taken in order that secure and affordable energy supply is sustained. Steps relate largely to implementation of the Energy Law as amended, and cover development of the energy sector regulatory framework (particularly as regards secondary legislation for pricing), commercialization and restructuring of ESM, and energy industry ownership.

Proposed reforms are consistent with requirements under the Athens Memorandum establishing the South East Europe Regional Energy Market (SEEREM), to which Republic of Macedonia is a party (discussed below).

The designation of the Republic of Macedonia as an accession country by the EU and the Athens Memorandum establishing the South East Europe Regional Energy Market (SEEREM) to which Macedonia is a party, are priority initiatives for the country, especially in the electricity and gas sectors. The current Law on Energy Sector should be harmonized with the provisions of *acquis communautaire* and the Athens Memorandum. The Law on Energy Sector regulates:

- Public service obligation and consumer protection;
- Unbundling of energy companies;
- Cross-subsidization;
- Third party access;
- Market liberalization;
- Transmission and distribution system operator;
- Construction of new energy facilities;
- Maintaining of security of supplies, etc.

The Ministry of Economy is the responsible authority to draft the new Law on Energy Sector.

II.3.4.3. Institutional Set-up

The main institutions dealing with the energy sector are the Ministry of Economy (in particular its Department for Energy), the State Energy Agency and the Energy Regulatory Commission. The Commission for the Protection of Competition is also involved in the energy sector.

The main functions of the **Department for Energy of the Ministry of Economy** are:

- To conduct energy policy of the state through the programs, measures and other activities,
- To create and develop laws, sub-laws, and other legal documents on energy,
- To initiate, join and implement the policy for energy sector restructuring,
- To create approvals and agreements for any energy activity and exploitation.

This Department is also in charge for collecting and providing all data regarding energy production, supply, demand, balance, etc., and compiling data in a public document. An obligation of the Sector is to implement energy-related European Directives into Macedonian laws.

The Department for Energy oversees and interacts with the State Energy Agency and the Energy Regulatory Commission.

The **Energy Regulatory Commission (ERC)** was established in 2002 by the Energy Law (“Official Gazette of the Republic of Macedonia”, no. 94/02, 38/03 and 40/05), when its five Commissioners were nominated by the Parliament.

According to the Energy Law, the Energy Regulatory Commission is authorized to regulate the activities related to electricity, natural gas, oil and oil products, heat and geothermal energy. In pursuit of further reform, amendments were made to the Energy Law in its part related to the ERC in 2003 and 2005. The purpose of the amendments was to bring Macedonian legislation in compliance with EU’s Directive 53/2003 regarding the common rules for the electricity market, particularly with the requirements to establish an independent regulatory body.

The Energy Regulatory Commission performs the following duties:

- ensures a safe, continual and high quality power supply;
- ensures the advancement of the competitive market of energy;
- defines the conditions for supplying of different types of energy;
- defines the methodology for the fixing of prices of different types of energy;
- defines the tariff systems for the different types of energy;
- makes decisions on the prices of different types of energy, according to the methodology of price fixing, tariff systems for different types of energy and other regulations;
- issues, changes, revokes and monitors the enforcement of the licenses for performing of separate activities in the energy domain;
- prescribes the rules for connecting to the power supply networks;
- takes care for the advancement of the protection of rights of the energy users;
- proposes initiatives for adoption of laws and other regulations in the energy domain;
- participates in the settlement of disputes and proposes measures regarding the disputes;
- submits proposals for taking of measures to the competent authorities, within the scope of their competencies, and in a procedure prescribed by Law, against the entities that perform the activity contrary to this Law;
- adopts a Book of Operations and other acts of the Regulatory Commission; and

- performs other tasks determined by Law.

The **Commission for the Protection of Competition** is a new body established in early 2005 by reforming the Monopoly Department of the Ministry of Economy. The Commission is an independent body with commissioners appointed by the Parliament, to which the Commission reports. As far as the energy market is concerned, the Commission for the Protection of Competition is responsible for:

- Facilitating the development of a competitive, safe and efficient market for energy and energy carriers;
- Tracking of the allocation of interconnection capacity;
- Tracking of the system load management practices;
- Tracking of the timing of repairs and hook-ups of consumers;
- Non-discriminatory third party access;
- Non-discriminatory balancing and dispatch of produced energy;
- Coordination of procurement of information for access to the energy system,;
- Transparency of tariffs and rules for access to the energy system by third parties;
- Coordination of keeping separate accounts for each energy sector activity;
- Tracking of cross-subsidization;
- Enabling energy consumers and systems to change suppliers at any moment of time.

In matters related to the energy sector, the Regulatory Commission and the Commission for the Protection of Competition cooperate in due course of business and by exchanging information.

The **Energy Agency of the Republic of Macedonia** is established with law adopted by the Parliament in July 2005. The Agency supports the implementation of the energy policy through (only main tasks are listed here, a detailed listing is provided in the Annex to this Report):

1. Preparation of medium term and long term strategies and development plans
2. Preparation of long term and short term programs
3. Energy efficiency (EE) and usage of the renewable energy sources (RES)
4. Preparatory and coordinating activities for implementation of investment projects
5. Regional cooperation and coordination of regional projects
6. Preparation of laws, bylaws and technical regulations in the energy sector

The operation of the Agency is based on the following principles: legality, competence, professionalism, transparency and responsibility for the work. The Agency shall be managed by a Management Board of the Agency, comprising five members, and the work of the Agency shall be managed by a director.

III. Legislative Framework for Foreign Investment in the Energy Sector

III.1. Investment-related Laws and Regulations

III.1.1. Overview

Foreign investors in the Republic of Macedonia enjoy national treatment. This is guaranteed by the Constitution. Other laws or regulations may not reduce the rights acquired on grounds of the invested capital. A foreign person may establish the same types of companies as nationals. In general, there are no limitations on foreign investment.

There are no restrictions imposed in regard to the participation of foreign capital in the banking sector. The banking sector is regulated by the Law on Banks that encourages foreign capital to come in the Macedonian banking sector. There are no limitations for foreign investment in insurance.

The Republic of Macedonia has concluded **Agreements for promotion and protection of the foreign direct investments** with the following countries: Albania, Austria, Bosnia and Herzegovina, Bulgaria, Belarus, Belgium and Luxemburg, Germany, Arab Republic of Egypt, Iran, Italy, Serbia and Montenegro, People's Republic of China, Republic of Korea, Malaysia, Poland, Republic of Romania, Russia, Republic of China, Slovenia, Turkey, Ukraine, Hungary, Finland, France, Netherlands, Croatia, Czech Republic, Switzerland, Sweden.

Macedonia is a small, highly open to the world country that continues to take steps to attract foreign direct investment (FDI). The country has enacted legislation that not only ensures an equal footing for foreign investors vis-à-vis their domestic counterparts, but also provides numerous incentives to attract such investment. The government is in the process of developing a strategy for stimulating investment with a particular emphasis on attracting FDI.

Even before gaining full membership to the World Trade Organization (WTO) in April 2004, Macedonia consistently provided national treatment to foreign investors. The country also concluded a number of bilateral investment protection treaties and other multilateral conventions that impose stricter protection standards for foreign investors. The Constitution of Macedonia, as the supreme law of the land, guarantees the equal position of all entities in the market, and provides free transfer and repatriation of investment capital and profits for foreign investors.

There is no single law regulating foreign investments. Rather, the legal framework is comprised of several laws, including: the Trade Companies Law; Securities Law; Profit Tax Law; Customs Law; the VAT Law; Foreign Trade Law, the Law on Acquiring Shareholding Companies, the Foreign Exchange Operations Law; the Law on Foreign Loan Relations; the Law on Privatization of State-owned Capital; the Law on Investment Funds; the Banking Law¹³; Law on Urban and Physical Planning, Law on Construction, Law on Expropriation, Law on Environment..

¹³ Source: U.S. Department of State.

III.1.2. Selected Policy Areas

The privatization process in the Republic of Macedonia is almost complete. When the Macedonian Privatization Agency closed at the end of 2004, the government still owned residual shares in a few companies, but those were mostly sold in early 2005.

Under Macedonian law, foreign and domestic investors have equal opportunities to participate in the privatization of the remaining state-owned capital. The World Bank's latest Financial Investment Advisory Service (FIAS) assessment made recommendations on removing barriers to registration and obtaining permits for land use, construction, and businesses¹⁴.

III.1.2.1. Forms of business organisation

Table 8 lists forms of business organization and corporate governance.

Table 8: Forms of business and corporate governance

Company Regime	Legal framework: Law on Trading Companies (Official Gazette of RM No.28/ 30 April 2004)
Forms of doing business	Sole proprietorship "Trgovec poedinec"; General partnership "Javno Trgovsko Drustvo" (JTD); Limited partnership "Komanditno drustvo" (KD); Limited liability company "Drustvo so Ogranicensa Odgovornost" (DOO); Joint-stock company "Akcionersko Drustvo" (AD); Limited partnership by shares "Komanditno drustvo so Akcii" (KDA);
Partnerships	Partners: 2 or more partners – domestic or foreign legal entities or individuals. Characteristics: The general partnership is an association of two or more legal entities or individuals who bear joint and unlimited liability by their entire property towards the creditors. In a limited partnership where two or more persons are associated, and at least one of them is liable for the limited partnership's obligations by his entire property (komplementar: general partner); at least one of them is liable for the limited partnership's obligations to the amount of the entered/registered investments in the limited partnership (komanditor: limited partner). There are no citizenship requirements to the shareholders.
Limited Liability Company	Members: From 1 to 50. If the whole capital belongs only to one member there is a single person limited liability company "Drustvo so Ogranicensa Odgovornost osnovano od Edno Lice" (DOOEL) Minimum capital: Denar equivalence of EUR 5 000. Share and contribution requirements: The minimum contribution of each member shall not be less than the denar equivalence of EUR 100. At registration at least the denar equivalence of EUR 2 500 of the capital and 1/3 of each shareholder's cash contribution must be paid in. Contributions in kind must be fully contributed at registration. Company governance: The Meeting of the members is the decision making body of the company. It must be convened at least once a year. The members vote proportionally to their contribution unless otherwise agreed in the agreement of incorporation. One or more managers are appointed by the members for a period stipulated in the agreement of incorporation. If such a period is not determined the

¹⁴ Ibid.

	<p>managers are considered elected for four years. There are no citizenship requirements for the managers.</p> <p>Supervisory bodies: Formation of a Supervisory Board or appointing a controller is an option for the company.</p>
Joint-Stock Company	<p>Shareholders: 1 or more individuals or legal entities could found a JSC.</p> <p>Minimum capital: Denar equivalence of EUR 25 000 for companies incorporated simultaneously (without public call) and Denar equivalence of EUR 50 000 for companies incorporated successively (through public call)</p> <p>Share and contribution requirements: The nominal value of each share shall not be less than the Denar equivalence of EUR 1. The shares are freely transferable. At least 25% of the nominal amount of each share must be contributed at registration. The total amount of all payments in cash should not be less than 12 500 EUR or 25 000 EUR. Multiple-vote shares are prohibited. Convertible bonds and other securities and financial derivatives can be issued.</p> <p>Company governance: The governance of the company may be organized as one-tier system (Board of Directors) or two-tier system (Management Board or a manager & Supervisory Board). The General Meeting of shareholders takes decisions by a majority vote of the represented share capital, except in certain cases when super majority is needed. Pursuant to the one tier management system, the general meeting appoints board of directors with 3 to 15 members. The number of the non-executive members shall be higher than the number of the executive members. Legal entities may only be non-executive members. The board of directors elects a President among the non-executive members. According to the two-tier management system, the general meeting appoints Supervisory Board consisting of 3 to 11 members. The supervisory Board appoints the managing board with 3 to 11 members.</p> <p>Specific Feature: Bearer shares are not regulated by the Macedonian legislation.</p>
Branches	<p>Foreign companies existing in their home country for at least 2 years can establish branches in the Republic of Macedonia. Branches have the right to carry out all forms of business and commercial operations and operate under the same conditions as domestic companies, which carry out the same of related forms of business.</p>
Representative office	<p>Can be opened by foreign companies, which are carrying out non-income generating activities, such as advertising or market research on behalf of their parent company. Representative offices cannot carry out commercial operations or act on behalf of any company other than their parent company.</p>
Bankruptcy	<p>Legal framework: Bankruptcy Law (Official Gazette of RM No. 55/97,53/00, 37/00)</p>
Anti-trust rules	<p>Legal framework: Law Against Limiting Competition (Official Gazette of RM No. 80/99)</p>

III.1.2.2. Registration requirements

Registration requirements, including the relevant forms and documents, and procedures for establishment of a company are the same for both national and foreign investors.

Foreign investors are not required to obtain special permission from state-authorized institutions other than what is customarily required by law.

A company established and registered in the commercial register by a foreigner is considered Macedonian one, i.e. this company has the same rights, obligations and liabilities as a company established by nationals.

The following is a listing of the sequential steps that should be taken to register a company in the Republic of Macedonia:

1. Check the uniqueness of the company name;
2. Deposit the legally required initial capital;
3. Notarize the company's deeds and other documents;
4. Procure extracts of criminal record;
5. Registration with the Commercial Registry;
6. Publish company establishment notice;
7. Make a company seal;
8. Register with the State Statistics Bureau;
9. Notarize the company registration certificate;
10. Open a bank account;
11. Register the company with the tax office;
12. Register the company with the Social Security Office;
13. Inform the Employment Office for hiring employees.

Step 5 is with the Court and carries a fee of about €60, step 8 carries a fee of ~€25 for the issuing of an ID and determining the area of activity, and step 11 carries a stamp fee of ~€5. The entire procedure lasts about 45 days and costs about €300 (not including lawyers' and notaries' fees).

In addition, Article 8 of the Foreign Exchange Law (No: 34/2001; 49/2001, 103/2001, 54/2002 and 51/2003), requires non-residents to report, within 60 days of the performance of the capital transactions serving as legal basis for making a direct investment in the Republic of Macedonia, the investment and all subsequent changes thereof in the Ministry of Economy. The Ministry of Economy registers the investment and all subsequent changes thereof in the Register of direct investments of non-residents in the Republic of Macedonia. The Minister of Economy prescribes the method of reporting, registering, as well as the form, contents and the method of keeping the Register of direct investments of non-residents in the Republic of Macedonia.

III.1.2.3. Investment promotion and protection

Principle of complete and constant protection, including expropriation and nationalisation

The Constitution of the Republic of Macedonia guarantees that rights acquired in connection with invested capital may not be reduced by any other law or regulation.

Article 10 of the Foreign Exchange Law accords to a non-resident, who is a direct investor, the right of compensation or indemnification proportional to the invested capital for the occurred damage, or loss from expropriation or because of other

measures of the government, which have similar effect, under a condition of real and legal reciprocity. Provided that another law or ratified international treaty does stipulate different conditions, the non-resident investor has a right to select the more favourable solution.

To guarantee that the investment will not be nationalized, the investor can reserve the right to withdraw the deposit in the form effectuated with the investment. This regulation offers an additional incentive to foreign investors, since it is not offered to national investors.

According to the Constitution of the Republic of Macedonia and the Law on Expropriation (Official Gazette 33/95, amended Official Gazette 20/98, and 40/99), foreign ownership is exempt from expropriation except during instances of war, natural disaster, or for reasons of public interest. Public interest, as defined by this Law, includes the following:

- Construction of infrastructure;
- Construction of power stations, waterworks, water supply systems, postal and communication systems and all accompanying and supporting infrastructure;
- Construction of buildings for defense and civil protection and regulation of border crossings;
- Buildings and equipment for research of natural resources, education, science, health, culture, social security, athletics or activities;
- Building settlements following extreme natural disasters and relocation settlements.

The beneficiary of expropriation is the state, especially when it allocates finances for public service, public enterprise, public funding and local government units. Under the Law on Expropriation, the state is obliged to pay market value for any property expropriated. If the payment is not made within 15 days of the decision brought for expropriation, default interest will be calculated¹⁵.

There have been no expropriation measures taken since the 1950s. The government does not impose confiscatory taxes of any kind.

Principle of Non-Discrimination

All foreign investors are granted national treatment. There are no restrictions for non-residents to invest in the Republic of Macedonia, except in ownership of certain kinds of real estate (construction sites, agricultural land, other land plots).

Stabilisation of investment conditions

Macedonia's Constitution guarantees that rights acquired in connection with invested capital may not be reduced by any other law or regulation.

Free use of funds

There are no restrictions on the use of funds by foreign investors.

¹⁵ Text in last two paragraphs is from U.S. Department of State.

Investment and profit repatriation

Article 59 of the Constitution guarantees a foreign investor the right to free transfer of the invested capital and profits. All current transactions of foreign entities are allowed. Article 9 of the Foreign Exchange Law defines that transfer of profit, transfer of proceeds from alienation and sale of ownership share in direct investments and the remainder of a liquidated investment shall be free, provided that the nonresidents have registered their direct investments according to this Law and have paid all legal obligations relating to taxes and contributions in the Republic of Macedonia.

By law, foreign investors are entitled to transfer profits and income without being subject to a transfer tax. Investment returns are generally remitted within the international standards of three working days.

Currency convertibility

Republic of Macedonia's national currency, the Denar (MKD), while fully convertible within the domestic market, is not convertible on foreign exchange markets. Conversion of most foreign currencies is possible on the official foreign exchange market. In addition to banks and savings institutions, numerous authorized exchange offices also provide exchange services. The National Bank operates the foreign exchange market, but participates on an equal basis with other entities. Sufficient foreign currency reserves are spelled out in the banking law. There are no restrictions on the purchase of foreign currency.

Parallel foreign exchange markets do not exist in Macedonia due to the long-term stability of the Denar. The National Bank's strategy is to maintain a stable exchange rate by pegging the Denar to the Euro, keeping inflation low¹⁶.

Imports/Exports

Foreign investors enjoy national treatment in foreign trade. There is no discriminatory export or import policy affecting foreign investors. Almost 96 percent of total trade (export/import) is unrestricted, with some exceptions for textile products. There are also quotas based on preferential agreements signed with the former Yugoslav countries. Current tariffs and other customs-related information are published on the Customs website.

There are no mandatory sales, origin or content requirements for foreign investments in the Republic of Macedonia. Foreign investors are not required to purchase from local sources or to export. There are no requirements to transfer technology.

Companies with at least 20 percent foreign capital are exempt from customs duties for the first three years after registration.

Employment of foreign personnel

The Law on Residency of Foreign Citizens sets requirements for both working and resident visas. There are some non-discriminatory limitations on obtaining a visa. A foreign citizen working in Republic of Macedonia can be issued a multiple entry visa. An employer should apply to the Employment Bureau to obtain a work permit for any

¹⁶ Information on convertibility is from U.S. Department of State.

foreign employees working in Republic of Macedonia on a temporary or permanent basis.

Transparency

Excessive bureaucratic 'red tape' still poses difficulties in all spheres of government administration, providing opportunities for corruption. Some foreign investors are also dissuaded from pursuing business activities by irregular or severely delinquent payment by Macedonian clients for goods and/or services.

Additional Rights and Guarantees

There are no legal barriers to the free flow of financial resources and portfolio investments. Financial resources are managed primarily through the Macedonian banking system, which is roughly 46 percent foreign owned. According to Central Bank data, at the end of June 2004 the percentage of non-performing loans in the total credit portfolio was 13.8 percent. Supervisory monitoring has been strengthened, restoring depositors' confidence. Banks have high liquidity but a relatively low intermediation rate. Credit is available on the local market and allocated on market terms. Retail interest rates have decreased slightly in 2004, to between 9 and 17 percent, depending on the type of loan.

Macedonia has no regulatory defense measures directed against foreign investment. Similarly, there are no private or governmental efforts directed toward restricting foreign entities from investment, participation, or control of domestic enterprises, consortia or industrial organizations. With the inflow of international aid, experts and projects, Republic of Macedonia is in the process of harmonizing its legal and regulatory systems with international standards.

Settlement of Investment Disputes

Under Macedonian law, arbitration of international disputes is distinct from that of domestic disputes. The parties involved in an international dispute may agree to settle through a domestic or foreign arbitration tribunal. Ratified international agreements trump domestic legislation.

International arbitration is recognized and accepted as valid by government regulation. The government accepts binding international arbitration on investment disputes and has over 40 internationally-accredited arbiters on the country's arbitration list. The arbitration court applies the appropriate law based on issues determined by the parties. In the event that the parties cannot agree on the issues involved in the case, the court then makes its own assessment of the merits of the case.

International sources of arbitration law consist of bilateral and multilateral conventions, which the country has signed or inherited from the former Yugoslavia on the basis of succession. Macedonia has signed the Convention Establishing the Multilateral Investment Guarantee Agency (MIGA), the New York Convention of 1958 (governing the recognition and enforcement of foreign arbitral awards), and the Geneva Convention on the Execution of Foreign Arbitral Awards. Republic of Macedonia is also a party to the Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States and the European Convention on International Commercial Arbitration.

Furthermore, Parliament has instituted legislative changes to administer laws related to foreign investment. With the 1995 enactment of the Law on Courts, the judicial body evolved into a three-tiered court system: the Basic Court (or Court of the First Instance), the Appellate Court and the Supreme Court¹⁷.

Investment Incentives

The incentives for foreign investors include exemption from customs duties as well as tax breaks, as follows:

- Foreign investors are entitled to a *profit tax exemption for the period of the first three years*, starting from the year in which profit is realized, under condition that the taxpayer who has used this exemption is operating at least three subsequent years after the end of the ultimate year in which he has used the right of tax exemption. This is applicable in companies where foreign capital makes at least 20% of total invested capital.
- To the taxpayer the tax base is reduced for the amount of the *investments in movable and immovable assets, up to €100,000* in MKD counter value in the current year, excluding cars, furniture, carpets, works of art and other decorations for equipping of administrative offices. In cases where the taxpayer does not use the tax exemption till the end of the current year, he has the right to transfer it to the next period till its complete use.
- To the taxpayer, for the amount of the investments in movable and immovable assets exceeding €100,000 in MKD counter value in the current year, excluding cars, furniture, carpets, works of art and other decorations for equipping administrative offices, the tax base is reduced up to 30%, but not more than the remaining unused part of the investment.
- The taxpayer who makes technological modernization, or purchases assets for protection of the environment and the nature, has a right to *accelerated depreciation* of the fixed assets, but maximum to the value that exceeds by 25% the depreciation calculated by one of the methods of depreciation calculations.
- To the taxpayer that placed an *investment in economically underdeveloped regions* and in specific areas (hill-mountain regions, border regions and compact undeveloped regions), the tax base is reduced for the value of the invested funds, but maximum at 50% of the base.
- To the taxpayer the tax base is reduced up to the value of the *funds invested for protection of the environment and the nature* (the amount invested for this purpose is acknowledged 100%).
- To the taxpayer who *starts business activity for the first time*, in the first year of earning profit the estimated tax is reduced for 50%, under condition of continued operation at least for three additional years from the day of implementing the reduction. Otherwise, he is due for the unpaid tax in amount revaluated by the retail price growth rate. A taxpayer who has made status changes (merger, acquisition, division, ownership transformation or similar) is not considered as a taxpayer who starts business activity for the first time.
- In function of the development of the stock exchange in the Republic of Macedonia, the estimated *profit tax is reduced for 50% for the taxpayer who is listed on the official markets of stock exchange*, three years after the start of the listing. This tax reduction will be implemented until 31 December, 2005. Also,

¹⁷ Information on employment, transparency, additional protection and settlement of disputes is from U.S. Department of State.

- there is no capital gain tax for all securities transactions by the end of 2005; and there is no taxation on securities transactions.
- To the taxpayer who, pursuant to the Law on Registration of Cash Payments is obliged to introduce and use an approved system of *equipment for registration of cash payments*, the estimated tax is reduced for the value of the maximum ten fiscal machines. If the taxpayer does not use the tax exemption till the end of the current year, they have a right to transfer it for the next period.
 - The *losses due to financial, business and non-business transactions* may be compensated with the profit in the future reporting periods, but maximum in 3 years following the year in which they have been registered. This right may not be used in the case of status changes of the taxpayer related to merger, acquisition, division, ownership transformation or similar.
 - The *capital gains* from the sale of securities, equipment and immovables are included to the tax base in amount of 70%. The capital gains from securities will not be subject to taxation until 1 January, 2006, in order to contribute to the development of the securities market in the Republic of Macedonia.
 - The *dividends* from participation in the capital of other companies are exempt from taxation under condition that they have been taxed by the taxpayer who makes payment, according to the general rate of the Profit Tax Law.
 - For the *transfer* of the part of the *profit* earned by a foreign entity, there is no additional tax paid for the amount that is transferred i.e. repatriation of the profit is free.

Investment Agency

The Agency for Foreign Investments of the Republic of Macedonia, an integral entity for realization of all activities for attracting and promoting foreign investments in the country, was established on January 2005. MakInvest is a National Agency for Support of FDI, founded by the state, in accordance to the “Law on foundation of the Agency for Foreign Investments of the Republic of Macedonia”, passed in June 2004.

The institution will be highly professional, flexible, and will have great independence in the decision-making for the everyday activities. Its task will not be only to attract foreign investors, but to also monitor and continuously give support to the foreign investors and to provide them with services in the pre-investment, investment, and re-investment period. Also, the Agency will actively participate in the process of creating investment policy in the country by submitting proposals and changes, thus to enhance the legislation for foreign direct investments. The basic idea for creating the Agency is attracting foreign direct investments, necessary for support of the economic development in the country.

The main focus of activities is providing services to the investors, securing and supplying them with all relevant information and services. Basic activities and services offered by MacInvest are:

- Promotion of the country and attracting FDI by implementing best practices
- Offering professional support and services to the investors in the pre-investment, investment and reinvestment phase
- Identifying of the sectors that offer best perspectives and their promotion
- Image building of the country as investment destination

- Development and implementation of innovative and proactive events on targeted markets
- Promotion of the regions of the Republic and stimulating foreign investors to use products and services from Macedonian companies
- Analyses and proposing changes in the legislation for improvement of the investment climate
- Stimulating and assisting in greenfield investments and technological parks.

Restriction, suspension or termination of investment activity

In Macedonia, there are no laws, policies, or legal regulations that impede foreign investments. On the contrary, the government seeks to increase the level of foreign investment by enacting legal provisions (i.e. tax incentives) favorable to investors.

Real estate ownership

Non-residents may acquire ownership of real estate (apartments, buildings and other immovable assets) for the purpose of business. Registration of the acquiring of the real estate within 60 days with the Central Register is required. Non-residents who acquired real estate may sell it locally.

Non-residents cannot acquire ownership right over construction land, but it is possible for a foreign company to purchase land under the condition that it is registered in RM. Construction land can be rented to foreign citizens under a Contract for a period of minimum 10 years and maximum 99 years. This long-term lease contract later on can be extended (Law on Privatization and Lease of Construction Land in State Ownership, Official Gazette of RM 04/05).

If a foreign natural and legal person establishes a mixed firm with domestic natural or legal person registered in the Registration Court in RM, the firm may obtain non-built construction land and acquire ownership thereof, due to the status of domestic legal person.

Concession on utilization of agricultural land in state ownership may be granted to domestic and foreign legal and natural persons by the Government of RM. Agricultural land in state ownership may be leased to a foreign legal or natural person under reciprocity conditions and consent by the Ministry of Justice, upon opinion from the Ministry of Agriculture and Forestry and the Ministry of Finance.

Taxation

Direct Taxation

Corporate Income Tax (CIT)

The Corporate Income Tax Law regulates corporate Income Tax. This Law introduces tax on profits and determines the means of profit taxation. The taxpayer carries out the computation and payment of tax on profits. Table 9 lists the most important provisions of corporate taxation in the Republic of Macedonia.

Table 9: Most important provisions of corporate taxation in the Republic of Macedonia

Taxpayer	The taxpayer of profit tax is a legal entity performing registered activity - resident of the Republic of Macedonia and earning a profit from an activity in the country or abroad. The resident is an established entity or has a head office on the territory of the Republic of Macedonia. The taxpayer is also a legal entity that is not a resident of the Republic of Macedonia, for profits earned through performing his activity on the territory of the Republic of Macedonia.
Tax base	The basis for computation of profit tax is the profit determined in the tax balance. The profit represents the difference between the total income and total expenditures of the taxpayer, in amount determined by accounting rules and standards.
Tax rate	The tax rate is quite low – 15%.
Investment relief	<p>The tax base of the taxpayer shall be decreased by the amount of his current investment in fixed assets undertaken so as to broaden the scope of his activities, but no such decrease occurs if funds are invested in cars, furniture, carpets, pieces of figurative and applied art and other decorative objects used to equip offices. The decrease must not exceed 25% of the tax base. The taxpayer shall be entitled to accelerated depreciation of fixed assets in cases of technological renovation or if he procures means for environmental protection, up to 25% over the depreciation.</p> <p>The tax base shall be reduced in the following cases as well:</p> <p>The tax base of the taxpayer who has used his profit to invest in economically underdeveloped regions and in specific regions (mountainous areas, border belts and completely underdeveloped regions) is reduced by the amount of his investments. The decrease must not exceed 50% of the tax base.</p> <p>The tax base of the taxpayer shall be reduced in amount of the funds invested in environment protection purposes.</p>
Tax exemption	The taxpayer, resident of the Republic of Macedonia, who has paid tax in a foreign country on the profit earned through work abroad, is entitled to reduced taxation in the country, to the amount of the profit tax paid abroad, and not exceeding the anticipated tax by application of the tax rate of 15%.
Tax holiday for foreign investment	<p>The tax base for companies with foreign shareholders (with holdings of at least 20%) is reduced by the proportion of the foreign investment, for the first three years following that investment. For example the tax rate for a company with a foreign shareholder of 60% is $15 \times (100\% - 60\%) = 6\%$. Therefore, 100% owned subsidiaries of foreign companies pay no tax during the first three years of operation.</p> <p>There is no tax on the transferred profit.</p>
Capital gains and tax losses	<p>Capital gains realized from the sale of securities, equipment and real estate is included in the tax base in the amount up to 70%. Capital gains derived from securities will not be taxed by January 1, 2006 in order to contribute to the development of the securities market in the Republic of Macedonia.</p> <p>Tax losses can be carry forward up to 3 years.</p>

Taxation of Individuals - Personal Income Tax

Personal Income Tax Law, which applies since 01 January 1994 and has had several modifications and amendments since then, introduces the personal income tax and regulates the taxation procedure of the individual's income.

Personal income tax is paid annually on the taxpayer's worldwide income from different sources. The following types of revenues earned in the country and abroad are included in the income according to which the tax base is determined: wages and salaries, income from agriculture, income from independent activity, income from property and property rights, income from copyrights and rights to industrial property, capital revenues, capital gains, gains from games of chance and other prize games, and

other revenues. All above-mentioned revenues, which are paid in cash, in kind or through other means, are subject to taxation.

Table 10: Most important provisions of personal taxation in the Republic of Macedonia

Taxpayer	Taxpayer is any individual who is a resident of the Republic of Macedonia, for the income earned in the country and abroad. A resident is any individual who has permanent or usual place of residence on the territory of the Republic of Macedonia, or individual resides continually on the territory of the Republic of Macedonia for at least six months. Taxpayer is also a non-resident individual for the income earned on the territory of the Republic of Macedonia.	
Tax base	Tax base is the positive difference between the gross income of the taxpayer and deductions provided with the Personal Income Tax Law such as: contributions for pension and disability insurance, health insurance and employment, contributions for the voluntary pension and disability insurance, personal allowance which for 2003 amounts to MKD 2,680 monthly or MKD 32,160 annually, and other expenses.	
Tax rate	The tax rates are progressive. 15% is applied to annual income up to MKD 360,000, 18% is applied for the part of the income up to MDK 720,000 and 24% for the part of income over MKD 720,000 Personal income tax	
	Monthly brackets of the Salary	Tax rate
	up to MKD 30,000	15%
	From MKD 30,000 up to MDK 60,000	MDK 4,500 +18% on the income from 30,000 up to MKD 60,000
	Above MKD 60,000	MKD 9,900 + 24% on the income above MKD 60,000
Payroll contributions	Payroll contributions are payable by the employer i.e. by the company, at the time of payment of the payroll. Employers are obliged to pay compulsory social contributions on the gross salary as follows: <ul style="list-style-type: none"> • 21.2% - pension and disability insurance • 9.2% - health insurance • 1.6% - employment. 	
Withholding Taxes	Individuals pay personal income tax (withholding tax) on the following revenues: <ul style="list-style-type: none"> • Personal income from the employment, pensions, income of the members of the management and supervisory boards in the enterprises, and other types of revenues; • Income from royalties and royalties from industrial ownership; • Income from property and property rights if the payer of the income is a legal entity; • Gains from games of chances and other prize games; • Dividend distributions to individuals; On the incomes from the interests of the savings deposits, current accounts and sights deposits the tax should not be paid, while the interests on the long-term savings deposits are tax-free until 2006.	

Indirect Taxation

Value Added Tax

Value Added Tax (VAT) is regulated under the Law on Value Added Tax, which came into force on 01 April, 2000. As a result, the existing turnover tax, being a one-time indirect sales tax, was replaced with a more developed system of multi-stage taxation on the consumption.

Table 11: Value added tax

Subject of taxation	Subject of value added taxation is: turnover of goods and services, affected with compensation by the taxpayer in the scope of his business; import of goods.
Taxpayer	According to the Law, a taxpayer is an individual, who, permanently or temporarily, self-performs a business activity, independent of the aims and results of this activity.
Tax base	The tax base for value added tax is the total amount of the compensation that is received, or that should be received for the turnover, in which the value added tax is not included. The tax base for import of goods is the value of the imported goods, determined on the basis of customs provisions.
Tax exemption	<ul style="list-style-type: none"> • The following text introduces the exemptions from value added tax without the right to deduction of the previous tax: • turnover with residential buildings and apartments, in that part in which they are used for residential purposes, with the exception of the first turnover that will be effected within the period of five years after building or construction; • rental of residential objects and apartments, if they are used for residential purposes; • turnover of banking and financial services; • services for insurance and re-insurance, including the connected services of insurance brokers and agents that are connected with them; • lottery games and entertainment games; • services of radio and television broadcasting stations, except commercial activities, • international transport of passengers, etc. <p>According to the Law, the following are exemptions from value added tax with the right to deduction of the previous tax:</p> <ul style="list-style-type: none"> • deliveries of goods that are transported or shipped abroad by the tax payer, recipient of goods or third person on their order, if the recipient of goods has a seat abroad; • turnover of goods that are transported or shipped from the country into free zones, customs zones or customs warehouses; • performing of services by brokers and other mediators that act on behalf and for the account of other person; • turnover of gold and other precious metals towards central banks; • international air transport of passengers. This tax release is valid for airway companies with a seat abroad, only in case of reciprocity, etc. <p>The following goods are exempted from value added tax upon import:</p> <ul style="list-style-type: none"> • goods, the turnover of which is released from value added tax in the country in compliance with articles of this Law; • goods that are encompassed with the regime of goods in transit; • goods that fall under the regime for temporarily imported goods and goods for re-export; • goods that are imported from the side of a foreign diplomatic or consular representative office for business needs; • goods that are imported by international organisations and their members, under conditions and limits determined with international agreements; <p>goods intended for exhibitions on fairs and trade exhibitions that will afterwards be exported, etc.</p>
Tax rates	VAT general rate of 18% and a preferential rate of 5% are applied on turnover of goods and services, as well as on their import. The general tax rate of 18% is applied on overall turnover and import, except on turnover and import that is subject to taxation with the preferential rate. The preferential tax rate of 5% is applied on turnover and import of certain goods and services.
Taxation period and calculation	Value added tax is paid during the year as an advance payment, and after expiry of one-year taxation period, when the tax for payment is finally determined. The

period	taxation period stated above, for which the tax is finally determined, is one calendar year. If the taxpayer performed business activities in one part of the calendar year, only that period shall be estimated as taxation period. The calculation period for which advance payments are calculated and paid is one calendar month.
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The value added tax, as a general consumer tax, is calculated and paid in all phases of production and trade, as well as in the entire branch that performs services, unless otherwise provided by the Law. Table 8 provides a listing of the main features of VAT.

Excise Duties

Excise duties are regulated in the Excise Duty Law, enacted on 1 July, 2001, which is aimed to support the establishment of a new system of indirect taxation. Currently, excise duties are levied on the consumption of certain goods, such as oil derivatives, tobacco products, alcohol drinks and motor cars. Excise commodities become subject to excise in three cases: by their production on the territory of the Republic of Macedonia, their import in the country and in cases when commodities are under customs custody. The excise can be determined in percentage - proportional excise, or in absolute amount per measurement units (kilogram, litre) - specific excise. Regarding certain goods (tobacco goods) combined excise is stipulated (proportional and specific).

Property Tax

The main element of the Law on Property Tax relates to the ownership of property. It also deals with tax on inheritance and gifts and the sale of property and property rights. Liability to property tax arises from the ownership of non-agricultural land, buildings or flats, business premises, administrative buildings, garages, etc.; moveable property such as cars with more than 1.800 cc, buses, trucks, tractors, etc., if the assets are not used for business purposes. Land and buildings are taxed on their market value at an annual rate of 0.10%, which is applicable to movable property as well.

The Law provides for exceptions depending on the type and the purpose of the property (e.g. agricultural land).

Tax rate on the sale of property and property rights is 3% and for the tax on inheritance and gifts for the tax payers of the relatives of direct lineage up to the second degree is 3%, while for the tax payers of the relatives of direct lineage up to the third degree or who is not in a relative correlation is 5%.

Environmental Protection

The Energy Law (“Official Gazette of RM“ No 47/97, 40/99, 98/00, 94/02 and 38/03), is a principal legal framework for this sector. This Law determines the national policy on energy which, among other things, emphasizes the importance of: increased use of natural gas as a high priority environmentally friendly fuel; incorporating energy efficiency into the construction standards; separating the funds necessary for realization of energy efficiency projects; identifying the possibilities for efficient energy consumption; adopting measures and activities for realization of the aforementioned activities.

Macedonia acknowledges the relation between the environment, energy efficiency and sustainable development, having in mind the fact that the environment (as one of the three pillars of sustainable development) is a key objective in EU’s energy policy. The country has adopted Community energy policy in its three main objectives:

- Security of energy supply
- Improvement of competitiveness and
- Quality of life of citizens and protection of the environment.

Energy efficiency is indirectly covered by the Law on Environment. The principle of sustainable development is incorporated in the Law on Environment. It mandates that, when an activity is undertaken or performed, care shall be taken as to the rational and sustainable use of natural resources so as to ensure a healthy environment, as well as the satisfaction of the social and economic needs of the present generations without jeopardizing the rights of future generations to satisfy their own needs.

For the purpose of harmonizing economic development, social progress and environmental protection on the national level, the Government may develop a National Strategy for Sustainable Development. The National Strategy for Sustainable Development shall be adopted by the Government, which shall prior to adoption submit it to the Assembly of the Republic for review.

Investors should assure that their projects meet the requirements of the Law on Environment, which incorporates the principles of energy efficiency. In particular, the Law on Environment requires energy efficiency to be taken into account when carrying out environmental impact assessment, issuing integrated pollution and prevention licences and introducing European environmental management scheme and environmental audits and eco-labeling.

The Law on Environment (Official Gazette of the Republic of Macedonia No.53/2005) includes environmental assessment legislation (Chapter IX: Environmental Impact Assessment of Certain Projects). There are two lists for screening of projects: an “Annex I” list, which defines projects requiring a full or obligatory EIA, and an “Annex II” list that identifies projects requiring further information. Based on the additional information, the Ministry of Environment and Physical Planning (MOEPP) will decide whether an EIA is required or not.

Macedonia has initiated the establishment of a System of Integrated Pollution Prevention and Control (IPPC) by the transposition of the EU Directive 96/61/EC on Integrated Pollution Prevention and Control in the Law on Environment, introducing the concept on Best Available Techniques (BAT), which takes into account energy efficiency. Three Chapters of the Law refer to:

- Integrated environmental permits concerning the operation of installations causing impacts on the environment;
- General environmental audit; and
- Compliance permits based on operational plans.

The Law on Environment also regulates this field and obliges MOEPP to support legal entities and natural persons performing economic or other activities, scientific and educational organizations and institutions, as well as state administrative bodies, which organize the protection of the environment on voluntary basis, in compliance with the European environmental management scheme and environmental audits.

The Law foresees that MOEPP adopts special regulations to define the environmental management scheme and environmental audits. The adoption of this regulation will reinforce the implementation of the EU legislation concerning the environmental management scheme and environmental audits.

In addition, the Institute for Standardization of Macedonia has set up a Committee responsible for the development and adoption of environmental management and environmental audit standards in compliance with the ISO 14000 standards. The MKS ISO 14001 and the MKS ISO14050 standards have been developed and adopted so far. There are several companies in the Republic of Macedonia that have been certified by international certification companies in accordance with ISO 14001.

The Law on Environment takes over the eco-labeling provisions from the old law and foresees the adoption of secondary legislation which will prescribe the procedure, the conditions for and the manner in which it will be awarded and used. The Law also foresees the adoption of special regulations which will define the environmental criteria for certain groups of products. The bylaws have been drawn up and are now in the process of consultation with other authorities and stakeholders. They transpose the European Regulation No. 1980/ 2000 of the revised scheme for EU eco-labeling. This by-law does not refer to food products, drinks or pharmaceutical products.

Climate change policy incorporates the Kyoto Protocol. The basic principles in the Climate Change policy are contained in the general principles of the Law on Environment (sustainable development and international cooperation).

In the Law on Environment it is stipulated that for the purpose of stabilization of green house gases concentration on a level that would prevent dangerous anthropogenic impact on the climate system within a time frame sufficient to allow the ecosystems to naturally adapt to the climate change, in accordance with the principle of international cooperation and the goals of the national social and economic development, a National Plan for mitigation of climate change shall be adopted.

Macedonia has prepared the First National Communication on Climate Change, which was adopted by the Government and submitted to the Secretariat of the Convention in 2003. The developing the Second National Communication is on-going process coordinated by the MOEPP.

The process of establishment of Designated National Authority (DNA) for the implementation of the Projects using the Clean Development flexible Mechanism (CDM) under the Kyoto Protocol is an on-going activity of the MOEPP.

As a result of obsolete equipment and lack of modern technologies, the industrial sector is a major air polluter. The main pressures derive from activities in the metallurgy sector¹⁸, and the chemical industry¹⁹. Energy production from thermal power plants (REK Bitola covers approximately 75% of the total national electricity demand) and district heating facilities are other sectors whose activities severely affect air quality.

¹⁸ Lead and zinc smelter MHK Zletovo-Veles and ferro-alloy SILMAK-Jegunovce, Maksteel-Skopje, Balkan Steel-Skopje, Metalski zavod Larnica-Skopje, FENI Industries-Kavadarci

¹⁹ OKTA Refinery, OHIS chemical complex and TITAN cement factory

The energy sector is the most important source of GHG emissions. The following table illustrates this issue.

Table 12: Major sources of CO₂ emissions.

Share of CO ₂ (equivalent) emissions	Energy sector	Industrial activities	Agriculture	Waste	Land use change and forestry
	70%	7%	14%	8%	1%

Ozone-depleting substances (ODS) have been reduced by 90% compared to the total consumption during the period 1995-2000. This is a result of the national action to phase out the ODS.

Other important environmental legislation of bearing to investment projects includes the following:

- The Law on Ambient Air Quality provides for the adoption of limit values; margins of tolerance; target values; and upper and lower assessment thresholds for individual pollutants as specified by the EU Framework Directive 96/62/EC. Furthermore the MEPP has begun to develop the secondary legislation on ambient air quality thereby providing for harmonization with the Framework Directive on Air Quality 96/62/EC and related directives. The national air quality management plan is confirmed as one of the obligations that must be implemented.
- Additional important steps are needed towards issuance of the secondary legislation with an emphasis on those elements that are of particular relevance in the Macedonian context including Directive 2004/107/EC on arsenic, cadmium, mercury, nickel and polycyclic aromatic hydrocarbons.
- The EU Directive on National Emission Ceilings for Certain Atmospheric Pollutants must be transposed thereby setting national emission ceilings for acidifying and eutrophying substances in line with the relevant Directive and for ozone precursors particularly related with the implementation of IPPC Directive. Furthermore, the implementation of the Directive on Volatile Organic Compounds (VOC) emissions constitutes a major potential challenge.
- In 2003 the “Master Plan for Phase-Out of Leaded Petrol” was developed. The Master Plan takes into account the Directive 98/70/EC on the quality of petrol and diesel fuels together with EU Decision 2000/159/EC, and Directive 96/62/EC on air quality.
- Macedonia is a party to the Convention on Long-range Transboundary Air Pollution and the EMEP Protocol (European Monitoring of Environment Programme). There is however a need for a thorough analysis of the Convention’s Protocols on SO₂, NO_x and VOCs in order to assess the available and required national capacities for their implementation. The requirements of these Protocols must be incorporated into the secondary legislation on ambient air quality.
- MOEPP completed the Cadastre of air polluters for Skopje in December 2004. The national Cadastre is scheduled for completion by the end of 2005. Through these efforts, the unique methodology of setting up pollution inventories in accordance with the CORINAIR (Core Inventory for Air Pollution) and SNAP (Selected Nomenclature for Air pollution) has been introduced.

- In the framework of the efforts aimed at integration into the modern trends of environmental protection in Europe and wider, and also as an important segment of the process of reforms, the Government of the Republic of Macedonia established the Ministry of Environment (Law on Amendment and Supplementing the Law on Public Administration Bodies", Official Gazette of RM" No.63/98). Article 122-a of the Law on Amendment and Supplementing the Law on Public Administration Bodies defines the following competencies of the Ministry:
 - state of the environment monitoring;
 - proposing of measures and activities aimed at water resources, air and ozone layer protection, protection against noise, radiation, conservation of biological diversity, geological diversity, national parks and protected areas;
 - remedial of polluted parts of the environment;
 - cooperation with scientific institutions for development of standards and regulations to regulate environment protection;
 - development of self-financing system from independent sources, types and levels of environmental charges and other payments;
 - cooperation with civil associations, civil initiatives and other forms of civic activity;
 - inspection supervision in the field of its scope;
 - other activities specified by law.

The “polluter pays” principle as well as the “user pays” principles are incorporated in the Law on Environment. **The polluter pays principle** imposes the obligation for the polluter to compensate for the costs of damage made in order to restore the environment, to the maximum extent possible, to the state before the damage. **The user pays principle** is aimed at the user of resources compensating for the costs related to the sustainable development and environmental remedy resulting from the use of natural resources.

List of bilateral treaties on the protection and promotion of foreign investments

The Republic of Macedonia has signed 29 Agreements on mutual protection and promotion of Foreign Direct Investments, with following countries:

Country	Date of Signature	Date of Entry into force
Albania	December 4, 1997	April 3, 1998
Austria	March 28, 2001	April 14, 2002
Belgium	February 16, 1999	November 11, 2002
Belarus	June 20, 2001	In force:
Bosnia and Herzegovina	February 16, 2001	In force:
Bulgaria	February 22, 1999	June 5, 1999

Croatia	July 6, 1994	November 4, 1995
Czech Republic	June 21, 2001	September 20, 2002
Egypt	November 22, 1999	Agreement still not ratified by Egyptian side
Finland	January 25, 2001	March 22, 2002
France	January 29, 1998	March 31, 2000
Germany	September 10, 1996	In force: September 17, 2000
Hungary	April 13, 2001	March 14, 2002
Iran	July 12, 2000	Agreement yet to be ratified
Italy	February 26, 1997	May 28, 1999
Malaysia	November 11, 1997	March 17, 1999
Netherlands	July 7, 1998	June 1, 1999
PR China	June 9, 1997	November 1, 1997
Poland	November 28, 1996	April 22, 1997
Republic of Korea	December 15, 1997	April 30, 1998
Republic of China	June 9, 1999	June 9, 1999
Romania	June 12, 2000	February 13, 2002
Russia	October 21, 1997	July 9, 1998
Serbia and Montenegro	September 4, 1996	July 22, 1997
Slovenia	June 5, 1996	November 4, 1995
Sweden	May 7, 1998	October 1, 1998
Switzerland	September 26, 1996	May 6, 1997
Turkey	July 14, 1995	October 27, 1997
Ukraine	March 2, 1998	March 25, 2000

List of bilateral treaties on the avoidance of double taxation

Table 13: Withholding Tax Rates under Double Tax Treaties of the Republic of Macedonia

Country	Direct dividends %	Portfolio dividends %	Interest %	Royalties %
Albania	10	10	10	10
Bulgaria	5	15	10	10
China-Taiwan	10	10	10	10
Croatia	5	15	10	10
Czech Republic	5	15	0	10
Denmark	5	15	0	10
Egypt	10	10	10	10

Finland	0	15	10	0
France	0	15	0	0
Hungary	5	15	0	0
Iran	10	10	10	10
Italy	5	15	10	0
Netherlands	15	15	0	0
Poland	5	15	10	10
PR China	5	5	10	10
Romania	5	5	10	10
Russia	10	10	10	10
Slovenia	5	15	10	10
Sweden	0	15	10	0
Switzerland	5	15	10	0
Turkey	5	10	10	10
Ukraine	5	15	10	10
Serbia and Montenegro	5	15	10	10

Treaties with Germany, Belorussia and Spain are prepared but not ratified.

III.1.3. Exceptions to National Treatment

All foreign investors are granted national treatment. There are no restrictions for non-residents to invest in the Republic of Macedonia, except in ownership of certain kinds of real estate (construction sites, agricultural land, other land plots)..

III.1.4. Membership in International Organisations

- United Nations Economy Commission for Europe.
- Black Sea Regional Energy Centre.
- Central European Initiative.
- Stability Pact.
- Southeast European Cooperation Initiative.
- Energy Community established by the agreement between the countries from the SEE union, signed in Athens, on 25.10.2005.
- Council of European Energy Regulators.

III.2. Energy-related Legislation

III.2.1. Overview

The Energy Law is a comprehensive legislation that deals with all energy sectors: electricity, gas, coal, petroleum, etc. It was adopted in 1997 and amended subsequently on several occasions (1999, 2000, 2002, 2003 and 2005) in response to the need to bring Republic of Macedonia's legislation in line with EU's acquis and other policy priorities.

The major thrust of the energy-related legislation in Republic of Macedonia is in the area of electricity and natural gas. Recent effort is mostly directed to the adoption of legislation related to the already selected model of the electricity market, and the definition of a model for the natural gas market.

The current edition of the Energy Law looks forward to the liberalisation of the electricity and natural gas markets. It establishes a licensing procedure and authorises the Energy Regulatory Commission to issue such licenses to market participants.

MEPSO, in addition to the license for operation of the electricity transmission system, has three more licenses, for organization and operation of the electricity market, transmission of electricity and wholesale supply of electricity for tariff customers. MEPSO is the sole owner of the transmission network. The text of the Law in this respect is in line with EU directives. The Law establishes system operators for the power sector (MEPSO) and the gas sector (GAMA, to remain in government ownership for the time being).

A problem for the restructuring of the gas sector is the dispute about the ownership of the gas pipeline with Macpetrol. Until the resolution of the dispute, transport of natural gas will be operated by GAMA, which is expected to be restructured as a shareholding company. In the meantime, the government intends to continue investing in gas industry infrastructure, since the gas sector is seen as an important contributor to growth and provider of a substitute to electricity.

The recent amendments and additions to the Energy Law provide a comprehensive framework for the electricity and gas markets and the restructuring of these sectors in line with the principles of efficiency, competition and prevention of abuse of monopoly and undue market power.

III.2.2. The Law on Energy

The Law on Energy (Official Gazette of the Republic of Macedonia No. 47/97, 40/99, 98/00, 94/02, 38/03 and 40/05) regulates the terms, conditions and manner of conducting activities in the energy sector, protection of energy facilities, devices and plants, and protection of environment and nature from the harmful effects caused by the operation of the energy facilities, devices, plants, and the supervision.

The Law is comprehensive and covers the following activities, which can be performed by both foreign and domestic entities and persons:

1. Electric power generation, transmission, and distribution;
2. Production and processing of coal;
3. Production, treatment, and transportation of oil and derivatives;
4. Production, transportation, and distribution of natural gas;
5. Generation, transportation, and distribution of heat and geothermal energy;
6. Generation of other types of energy.
7. Transit of energy and energy supplies; and
8. Trade with energy and energy supplies.

The Law defines *areas of public interest*: electric power generation, transportation, and distribution, production, transportation and distribution of natural gas and production, transmission and distribution of heat and geothermal energy, except for internal use. *Such activities require either the establishment of a public enterprise or a license.* Public enterprises for electric power generation, transmission, and distribution, and production, distribution of natural gas, are established by the Government of the Republic of Macedonia. Public enterprises for generation, transportation, and distribution of heat and geothermal energy, except for internal use, are also established by the municipalities and/or the city of Skopje.

The Law defines transit and trade in energy, including trade in services (Art. 10a-b), producers, dispatchers and consumers of energy (Art. 11), and producer and retail prices of energy, to be set by certain Methodologies (Art. 11a).

Investing in energy facilities is done on the basis of an Agreement with the Government (Art. 12a), and the Law defines the main content of such Agreement (siting, permitting, taxation, pricing, return on investment, etc.). Hook-up to grid systems requires a contract (Art. 13).

Third party access is dealt with in Art. 13a. Legal entities that do business with transmission power systems, transportation, and distribution of energy and energy carriers are responsible for providing services from the free capacities to the entities interested in transmission, transportation, distribution and transit of energy and energizers through these systems, on the basis of a contract. The Law lists the main content of the contract (provisions on the technical, energy and commercial/financial conditions for the use of the system, as well as provisions on the way of dispute settlement). Where a public enterprise is doing business in power transmission, transportation, and distribution of energy and energy, it may not refuse to provide services or discriminate against any entity interested in provision of these services. In cases of disputes, the aggrieved entity may request from the ministry responsible for energy to undertake steps to enforce compliance.

Public service requirements (continuity and quality) are defined in Art. 14.

Art. 16 requires the development of an Energy Strategy by the Government, to address the following issues:

- Energy demand, especially for natural gas as an environmentally friendly fuel;
- Available energy resources and facilities, along with their technical, energy and economic features;
- The needs for construction of energy projects;
- Funding required and resources to provide it;
- Measures and activities to implement the strategy;
- Possibilities for more efficient use of energy.

The Ministry competent for matters of energy is responsible for the implementation of the Strategy. Based on the Strategy, public enterprises must adopt a Development Program at the level of the central government and the municipalities. The Development Program on Public Enterprises established by the Government of the Republic of Macedonia, is approved by the Government of Republic of Macedonia, and the Program on Development of Public Enterprises, established by a municipality and /or city of Skopje, is approved by the municipality and/or city of Skopje after a review by the Ministry competent for matters related to energy (Art. 17).

Articles 17-a-b-c requires the adoption by the Government of a **long-term Program on efficient energy utilization**. For its implementation, the Government of the Republic of Macedonia must establish a **Fund of Energy Efficiency**. The Fund has no capacity of a legal entity. The fund's resources (to be distributed as credits via a bank and public announcement) may be from:

1. Bank resources and other financial institutions;
2. Foreign credits;
3. Grants and donors of local and foreign legal and natural entities; and
4. Budget of the Republic of Macedonia

The administration/technical works related to the needs for fund operation shall be performed by the commercial bank.

Art. 18 requires the **development of energy balances** and the identifications of sources of energy supply to cover the positions in the balances. The producers, suppliers and users of energy are liable to submit to the Ministry competent for energy data for preparation of the energy balance for the next year by the end of October. The annual energy balance in the Republic for the next year must be developed by the Government by the end of the current year.

Art. 19-20 deal with the **monitoring of production, distribution, consumption and stocks of energy**. Producers and distributors of energy must submit to the Ministry competent for energy, reports on monthly, quarterly and annual bases, whereas daily reports on electricity oil derivatives and gas of the actual production, purchase and distribution of energy to the users and the status of reserves. Large energy consumers must submit to the Ministry competent for energy matters, monthly, quarterly, and annual reports on the actual consumption of all energy types by the user, as well as stocks, including the actual electricity production and services provided (Art 20). **Large consumers** are defined as those with annual energy consumption of electricity exceeding 10 million kWh, of coal - 5000 tons, of coke - 1000 tons, of heavy oil - 1000 tons, of natural gas - 1 million m³, of diesel - 1000 tons, of engine petrol or propane-butane 1000 tons and above 300.000m³ of geothermal water.

Articles 21-24 deal with requirements for qualification and certification of personnel in the energy sector.

Art. 25-38 deal with requirements for assuring supply continuity and rules for interruptions.

Pricing is the subject of Art. 39, which mandates that prices of electric power, natural gas, heat energy, geothermal energy, and oil derivatives must be set by a Methodology on the pricing certain energy types. The decision related to the Methodology adoption is made by the Government of the Republic of Macedonia.

Tariffs are regulated by Art. 40. Power, natural gas and heat must be rated in accordance with a certain Tariff System for selling certain energy types. The decision on the tariff system for certain energy types is made by the Government of the Republic of Macedonia.

Art. 41-44 prescribe rules for hook-ups to the system by all consumers; in case consumption changes by more than 10%, the consumer has to re-apply with the distributor. Disputes are settled by the relevant Ministry.

Art. 45-49 mandate requirements for the protection of the facilities and the environment.

Licensing is the matter settled by Part V of the Law (Art. 50-60a). The Law requires that any activity listed in its Art. 4 must be licensed, and that a license shall be automatically granted if the applicant has already been granted the right to exploit energy resources (Art. 50).

Licenses for power generation, transmission and distribution, international transport of crude oil through the oil pipeline and production, transport and distribution of natural gas, are issued by the Government of the Republic of Macedonia. Licenses for production, transport, and distribution of heat and geothermal energy are issued by the relevant Municipality and the City of Skopje, with the consent of the Ministry competent for energy matters.

The license for performing the activity, except in cases from paragraph 2 Article 50 of the Law (issued by municipalities and the City of Skopje) may be obtained via public competition, but if there is no interested entity, the license may be issued on the basis of an application. The license to perform the activity without public competition by exception may be granted in case of a request (or a bid) made by a strategic investor, as determined by the Government of the Republic of Macedonia upon a proposal by the Ministry responsible for energy matters.

Art. 53-55 define the manner in which a competition for a license is held, information required to be submitted by the candidate(s), and the main content of a license. Art. 56 requires the licensor and licensee to sign a contract setting in detail the procedure and method of performing the activity, and Art. 57 lists terms and conditions for invalidating a contract, one of which is the revocation of a license. Art. 58 defines the cases in which a license may be revoked:

1. Failure of the licensee to commence the activity in the period set forth in the license;
2. Licensee ceases to comply with the conditions set forth for the performance of the activity;
3. Licensee ceases to perform the activity in a manner and under conditions prescribed in this Law and other regulations;
4. Contract is terminated and canceled; and
5. Licensee, in the defined period of time, fails to respond to a request made by the authorities to remedy faults.

Licenses may be extended upon an application by the holder before the expiration of a contract (Art. 59). Transfer of a license requires the consent of the issuing authority (Art. 60). *Art. 60-a makes the Law on Concessions applicable to energy sector activities that require license.*

Part VI (Art. 61) sets rules for supervision and inspection. *It authorizes the relevant Ministry to issue norms and standards and establishes the Republic Inspectorate for Technical Inspection, to operate under the rules of a separate law.*

Part VII contains rules for fines and penalties and other enforcement provisions (Art. 62-68).

Finally, in its transitional and final provisions, the Law defines ESM as a public company and introduces a timetable for the phasing in of the Law's dispositions. It also invalidates the earlier versions of the Law on Energy and the Law on Safe Transportation Through Oil Pipelines and Gas Pipelines (Official Gazette of the SFRJ, No. 64/73) including the by-laws passed in compliance with this Law.

III.3.3. The New Law on Energy

A new Law on Energy is currently discussed in the National Assembly. In accordance with the Ministry Work Program for 2006, the new Law on Energy should be adopted in April 2006.

The reasons for proposing the new Law of Energy include:

- The need to regulate the entire energy sector in one consistent law,
- approximation and harmonization of the legislation of the Republic of Macedonia to EU legislation, and approximation to the criteria and conditions for economic activities as defined in the *acquis communautaire*, and The need to create conditions for the integration of the country in the EU and to achieve membership criteria in the energy sector.

The new Law on Energy consists of 16 chapters as follows: general provisions, energy policy, the Energy Regulatory Commission, licensing, construction of new energy facilities, electricity market, natural gas market, oil and oil derivatives market, thermal and geothermal market, access to the power supply system, energy efficiency and renewable energy sources, protection of energy facilities, supervision, and penal provisions.

In the first chapter (***Energy Policy***) *the Law* defines that the Government of the Republic of Macedonia shall establish a policy for the energy sector. The Energy Policy shall be laid down in the Energy Development Strategy and the Implementation Programme of the strategy. The Government of the Republic of Macedonia upon proposal of the Ministry shall adopt an Energy Development Strategy for a period of at least 20 years. The Energy Development Strategy of the Republic of Macedonia shall address long-term objectives for development of specific energy activities; development priorities; sources and methods of supplying energy and fuels needs; identification and utilization of energy resources and capacities of strategic relevance for the country; transformation of the energy sector; incentives for investment in energy facilities that shall utilize renewable energy sources; incentives regarding the enhancement of energy efficiency; realization of the obligations arising from the international charters, treaties, contracts, conventions and other documents ratified and accessed to by the Republic of Macedonia; other elements with relevance for the energy development of the Republic of Macedonia. Upon proposal of the Ministry, the Government of the Republic of Macedonia shall adopt Programmes for realization of the energy development strategy for a period of five years.

In its second chapter, the new Law defines that the Energy Regulatory Commission is an independent body regarding the operation and decision taking process within the scope of its competencies. The Energy Regulatory Commission (ERC) was established by the law for amending the existing Energy Law (Official Gazette 94/2002) and became operational in 2003. The ERC is composed of five members, one of which acts

as its president. The members and the president of the ERC are appointed and dismissed by the Parliament of the Republic of Macedonia, upon proposal of the Government of the Republic of Macedonia, taking in consideration the adequate and just representation of all communities.

The ERC has the following scope of competencies: monitors the energy market operations and proposes measures for its promotion due to ensuring non-discrimination, efficient competition and efficient functioning of the market; ensures promotion of the protection of the rights of the energy users; adopts regulations for governing the energy activities, as defined in this law; issues, amends, revokes and monitors the compliance of the licensees in the pursuit of certain activities within the energy sector; settles disputes that arise between the energy entities; establishes cooperation with the competent state authorities, local self-government units, energy entities, energy users and other organizations and institutions; proposes to the relevant authorities undertaking of measures within the scope of their competencies and in a procedure as defined by this law, against the entities that pursue the activity contrary to the provisions of this law; gives initiative and proposes adoption of new and amendment to the existing laws and other regulations; adopts Rules of Procedure and other acts concerning the internal organization and operation of the Regulatory Commission; monitors the implementation of the tender procedure required to secure additional energy generating capacity; participates in regional and international organizations and cooperates with other regulatory authorities to contribute to the development of regional energy markets; and performs such other tasks as are required by this law or other regulation.

In the third chapter, the new Law deals with licencing. Entities performing activities referred to in Article 3 of the new Law on Energy may perform the activities without a license from the ERC. The performance of the following activities does not require a license: production of electricity exclusively for private needs without the use of the electricity transfer or distribution system; storage of oil or oil derivatives for private needs only; retail trade in oil or oil derivatives; retail trade in pressurized containers of LPG ; production of thermal or geothermal energy for private needs only; and transport of oil and oil derivatives by means of auto or railway tanks and other means of transport as well as their storage.

The license is issued for a period of three to thirty-five years depending on the type of activity, the means necessary for performing the activity, the duration of the right to use the relevant energy resource, the public interest, as well as the application by the entity performing the activity. The ERC prescribes the requirements, modalities and procedure for: issuing, modification, renewal, suspension and confiscation of licenses; layout and content of licenses and forms used in the procedure for issuing, modification, suspension and confiscation of licenses; control of the fulfilment of assumed obligations contained in the license; amount of means necessary for performing the relevant activity for which the license was issued; amount of costs for the procedure for issuing, modification, suspension and confiscation of licenses.

In the Republic of Macedonia, only one license can be issued for: transmission of electricity; electricity transmission system operations; organizing and operating the electricity market; distribution of electricity; operating the system for distribution of electricity; supply of electricity to wholesale tariff customers; supply of electricity to

retail tariff customers transmission of natural gas and natural gas transmission system operations.

The chapter on construction of energy facilities correlates with Directive 2003/54/EC. The construction of new facilities for electricity generation, combined electricity and thermal energy generation and thermal energy generation may be performed by domestic and foreign persons on the basis of an authorization. The authorization for construction of new electricity production facilities and combined production of electricity and thermal energy is granted with a decision by the Government of the Republic of Macedonia on a proposal of the Minister in charge of energy issues. The authorization for construction of new thermal energy facilities is granted with a decision by the Council of the relevant municipality or the council of the City of Skopje. An authorization for construction of new energy facilities is necessary for: generation of electricity exceeding capacity of 1 MW, except for private needs, combined generation of electricity and thermal energy exceeding capacity of 1 MW, except for private needs, thermal energy generation exceeding 1 MW for central heating, except for private needs.

The authorization for construction of new facilities for electricity generation, combined electricity and thermal energy generation and thermal energy generation, transmission and transit of natural gas, crude oil and oil derivatives determines: the type and location of the facility the authorization refers to, the delay for beginning and finalizing the construction of the facility, the modality and requirements for performing energy activities in the facility, according to the rules on granting, modifying, extending, suspending and revoking the license treatment of the facility after the cease of its activities, requirements concerning the use of public goods or public infrastructure, requirements for environmental protection according to law, requirements concerning the efficiency of the work of the facility; and fulfilment of special requirements concerning the technical, human resource and economic capacities as well as the financial capacity of the holder of the authorization.

By way of exception, in case if, based on the issued authorization and the Strategy for Energy Development in the Republic of Macedonia, the electricity demand forecast and an assessment of the possibilities for its satisfying, it is estimated that the long-term security of supply may be jeopardized, the Ministry may launch a public announcement concerning the construction of new electricity generation facilities. The public announcement procedure, the requirements for participation and the criteria for selection are in accordance with the Law on Public Procurement.

The construction of new electricity transmission and distribution facilities is performed by the holder of the license for transmission and the holder of the license for distribution of electricity, in accordance with the Law, grid code and the obligations contained in the licenses. The construction of new natural gas transmission facilities is performed by the holder of the license for transmission of natural gas in accordance with this law, grid code and obligations contained in the licenses.

The construction of new natural gas distribution, thermal energy distribution and geothermal energy distribution facilities are performed by entities that have acquired the right to construct such facilities on the specific location within the municipality or the City of Skopje. The right for the construction of such facilities on a certain location

is extended by the council of the municipality or the council of the City of Skopje on the basis of a public procurement.

The construction of new facilities for the transmission and transit of crude oil and oil derivatives in a specified geographic service territory may be performed by domestic and foreign persons on the basis of an authorization issued by the Government of the Republic of Macedonia under the proposal of the Minister in charge of the energy sector.

Chapter five (Electricity Market) elaborates on the participants in the electricity market, their relations, rights and obligations. This law determines the rights and obligations of electricity generators, electricity transmitters, the electricity system operator, the electricity market operator, wholesale tariff consumers and eligible customers.

Electricity generators may own, manage and operate generation plants and sell power, energy and/or system services. The electricity generators are liable to provide availability of the planned power, energy and/or system services up to the overtake point; operate pursuant to the laws, other regulations as well as the transmission grid rules and the distribution grid rules, the market rules and under terms and conditions determined in the licenses; submit to the transmission system operator reports regarding the equipment, plants, maintenance plans, planned availability pursuant to the transmission grid rules; submit all electricity sales contracts, excluding the commercial-financial data, to the ERC and the electricity market operator and respect the generation, i.e. power, energy and/or system services delivery contracts.

The **electricity transmitter** is liable to maintain, upgrade and extend the transmission grid and connect it to the electricity producers, as well as the transmission systems of the neighbouring countries, pursuant to the transmission grid rules, the appropriate operation manuals in compliance with the rules and regulations determined by the ERC. Also, he is liable to provide secure, safe and quality electricity delivery through the transmission grid, from the overtake point to the delivery point; provide transmission grid development and maintenance for secure and efficient functioning of the transmission grid; participate in the preparation of the transmission grid rules; submit annually to the ERC a transmission grid development and extension plan for a period of five years, prepared in collaboration with the electricity transmission system operator, an annual program for realization of the plan, and a report regarding the previous year program realization; and provide connection to the transmission grid users pursuant to the transmission grid rules.

The **electricity system operator** is responsible for long-term transmission system planning for providing safety, reliability and security of the electricity supply in the Republic of Macedonia. He is liable to submit plans, studies and other information to the ERC regarding the transmission grid capacity increase or existing transmission facility substitution, including an expenses financial plan for the increase and substitutions and to submit to the ERC a report for the financial and physical range of realized services, in a manner and under the terms and conditions determined in the license.

The ***electricity market operator*** is responsible for the efficient functioning of the market, managing the system for electricity sale and purchase pursuant to the principals for publicity, transparency, non-discrimination and competition, provide all services hereby provided by this law and pursuant to the conditions determined in the license, under regulated prices and conditions approved and published by the Regulatory commission. The electricity market operator prepares and submits on a daily basis to the electricity system operator a dispatch schedule for meeting the load and updates the schedule in regular time intervals as provided with the market rules and keeps a record and a schedule of physical electricity transactions, pursuant to all electricity sale and purchase agreements.

The ***wholesale tariff consumer electricity supplier*** purchases the necessary quantities of power and electricity from the regulated generator, other electricity generators and/or electricity traders, as well as the necessary transmission capacity and regulated services for the requirements of the retail tariff consumer and tariff consumer directly connected to the transmission grid electricity supplier. The wholesale tariff consumer electricity supplier signs regulated agreements, approved by the ERC, with the regulated generator for purchasing the entire power, electricity and system services. They keep the entire tender documentation and record of the power, electricity and system service purchasing, and provide access to the above upon request from the ERC, and submits monthly detailed reports for the purchased power, electricity and system services to the ERC.

The ***retail tariff consumer electricity supplier*** purchases electricity and power from the wholesale tariff consumer electricity supplier and from the distributed electricity generators, as well as the necessary transmission and distribution capacity and regulated services for the requirements of the consumers connected to the distribution system, at prices approved and published by the ERC. He is liable to prepare balances for the needs of the tariff consumers connected to the electricity distribution system and submit them to the electricity market operator pursuant to the market rules, transmission grid rules and distribution grid rules.

The new Law defines ***eligible customers*** as any direct consumer that consumes or plans to consume at least 20 GWh of electricity during each calendar year. The Government of the Republic of Macedonia can extend the consumer category that can be considered as eligible customers with a decree based on criteria that include consumption, voltage level, consumer groups, or type of grid (transmission or distribution). The eligible customers may sign agreements for power and electricity with electricity generators and electricity traders and are liable to record each such agreement for electricity purchase at the electricity market operator and they are liable to submit their electricity and power requirements to the electricity market operator, pursuant to the market rules, the transmission grid rules and the distribution grid rules. Changing the status of an eligible customer into a status of a *tariff customer*, i.e. the status of the tariff customer into a status of eligible customer, cannot be executed prior to the expiration of the term of one year from the day of the last status change.

In the chapter on natural gas the Law elaborates on the participants in the natural gas market, their relations, rights and obligations. The Law determines the rights and obligations of the natural gas transmitter, the natural gas transmission system operator, natural gas distributors, natural gas traders and eligible natural gas customers.

The ***natural gas transmitter*** is liable to provide safe and secure functioning of the gas transmission grid; development and maintenance of the transmission system and the other capacities that are in the function of transmission, as well as the interconnection lines with the other systems pursuant to the natural gas transmission system operation rules and the system development plans; connection with the natural gas transmission systems of the other countries; taking all measures provided for safety during the use of the transmission system and other capacities that are in function of transmission, as well as environmental protection measures; and provide quality transmission of natural gas.

The ***natural gas transmission system operator*** is liable to provide: reliable and secure transportation of natural gas through the transmission system; operational management of the natural gas transmission system through regulating the flow and the pressure of natural gas through the natural gas transmission system; conforming of the driving manipulations in the transmission system with the natural gas transmitter; following the technical and functional readiness of the natural gas transmission and distribution facilities, and approving the overhaul schedule for the natural gas transmission facilities; balancing the deviations between the current and agreed natural gas consumption; purchasing natural gas for providing system services; using, maintaining and upgrading the systems for supervision and management of the natural gas transmission system and providing reliability of business data of the natural gas transmission system users.

The ***natural gas distributor*** is liable to provide: safe and secure functioning of the distribution gas pipe grid, development and maintenance of the distribution system and the other capacities that are in the function of the distribution system, pursuant to the natural gas distribution system operation rules and the system development plans taking all measures provided for safety during the use of the natural gas distribution system and other capacities that are in function of the natural gas distribution system, as well as environmental protection measures. Natural gas supply through the distribution system from the connection point with the natural gas transmission system to the natural gas consumers connected to the distribution system, under the terms and conditions and in a manner determined with this law, other regulations and pursuant to the terms and conditions determined in the license and quality supply of natural gas through the distribution system.

A ***natural gas trader*** is a legal entity that trades natural gas on the territory of the Republic of Macedonia based on a license and he provides gas from import or from other natural gas traders and sells it to eligible customers and/or natural gas suppliers of tariff customers. The natural gas trader can supply tariff consumers directly connected to the transmission system with natural gas, pursuant to a license to supply these consumers and pursuant to the set tariffs and prices and other rules and regulations for supplying tariff consumers.

Eligible natural gas customers are consumer categories that consume over 10,000,000 m³ of natural gas and natural gas distributor to tariff consumers. The government can extend the categories of those that can be qualified as eligible customers with a Decree based on criteria that may include consumption, pressure, consumer groups or connection point, etc.. Changing the status of an eligible customer to the status of a

tariff customer or vice versa cannot be executed prior to the expiration of one year from the day of the last status change.

Chapter seven deals with the market of oil and oil derivatives. It elaborates on the participants in the market of oil and oil derivatives, their relations, rights and obligations. This chapter also defines and elaborates on the manner of setting-up and maintaining commodity reserves of oil derivatives.

Service providers in the area of transport of crude oil and/or oil derivatives by means of oil pipeline and/or product pipeline have to provide, through negotiation, access to the available capacities for transport to legal or moral entities seeking for transport of oil or oil derivatives which satisfy the technical requirements for access and connection. The entities performing transport of crude oil and/or oil derivatives by means of oil pipeline and/or product pipeline may refuse providing access to third parties for the transport of crude oil or oil derivatives by taking a decision, in case there are technical, technological or safety restraints or if the capacity of the oil pipeline or product pipeline has already been subject to previously assumed contractual obligations. The entities providing transport of crude oil and/or oil derivatives by means of oil pipelines or product pipelines must explain the reasons for the refusal of the request for access and transport to the submitter of the request for access and transport of crude oil and oil derivatives.

The entities performing ***wholesale trade of oil derivatives*** may provide filling and distribution of containers for liquid petroleum gas (butane-propane) if the technical regulations and standards are met, if special devices for LPG are built and if 1,000 containers for LPG are provided.

With this new Law, the following types of oil derivatives stocks will be mandatory as commodity reserves: all types of motor and aircraft fuel currently in use, all types of diesel fuel and kerosene currently in use, household liquid petroleum gas (propane-butane) and mazut (fuel oil).

Commodity reserves of oil derivatives that are of crucial importance to the population of the Republic of Macedonia, are stocked according to the consumption of such specific types of oil derivatives in the previous year, whereby the total quantity of reserves of a specific kind of oil derivative in the current year cannot be lower than the average consumption of that oil derivative for a period of 90 days in the previous year, or at least 25% of the total consumption of the relevant oil derivative during the previous year.

The Government of the Republic of Macedonia, in compliance with the new Law must adopt a rule that would provide further details on the financing, conditions, procedure and manner of stocking, maintenance, utilization and renewing of the commodity reserves of oil derivatives.

Part of the commodity reserves of oil derivatives may temporarily or permanently be maintained and stored outside the territory of the Republic of Macedonia, in an EU member state for which the Government shall adopt a decision. The governments of both countries must conclude an agreement regulating the mutual rights and obligations pertaining to the storage and maintenance of the commodity reserves.

In the chapter on thermal energy market, the Law elaborates on the participants in the thermal energy market, their relations, rights and obligations. The Municipalities and the City of Skopje shall provide conditions for performing distribution and supply of thermal energy within the frame of their competences. In this chapter the Law defines the regulated producer, the distributor of thermal or geothermal energy, the manager of the thermal or geothermal energy distribution system

The ***regulated producer*** must provide public services and shall conclude, upon the approval of the ERC, a contract with the supplier of thermal or geothermal energy for the sale of the entire available thermal or geothermal energy intended for the needs of consumers, with regulated prices and tariffs approved and published by the ERC.

The ***producer of thermal or geothermal energy*** may construct, own, and operate a production installation and sell thermal or geothermal energy and they shall manage the production capacity according to the tariffs, conditions and criteria stipulated in the licence itself; submit annual reports to the ERC concerning the equipment, facilities, plans for maintenance as well as the projected availability; submit to the ERC all the contracts for purchase of thermal energy and all the contracts for purchase of thermal energy and electricity for 30 days or longer; and respect the terms of its contract for production of thermal energy and shall, in case of co-generative production, respect the conditions for delivery of power, electricity and/or ancillary services.

The distributor of thermal or geothermal energy may construct, own, operate, upgrade and expand a distribution network for thermal or geothermal energy and they shall provide safe and secure functioning of the thermal or geothermal energy distribution system and of other facilities connected to the thermal energy distribution system; develop and maintain in good condition the thermal or geothermal energy distribution system and of other facilities connected to the thermal energy distribution system, in accordance with the regulations for network distribution of thermal energy and with the plans for development of the system; undertake all the safety measures for the use of the thermal or geothermal energy distribution system and of other facilities connected to the energy through the distribution thermal or geothermal energy system from the point of connection of the energy producing facility to the users connected to the thermal energy distribution system, under the modalities and conditions prescribed by law or other regulations, and in accordance with the terms defined in the licence; and assure quality delivering of thermal energy through the distribution system.

The supplier of thermal or geothermal energy shall purchase all of its' thermal or geothermal energy from a non-regulated producer of thermal or geothermal energy which is in the scope of the territory serviced by the supplier, if the non-regulated producer offers a price equal to, or lower than the price defined in accordance with the tariff methodology approved by the ERC. The terms of such a purchase shall be defined by a contract concluded between the non-regulated producer of thermal or geothermal energy and the supplier of thermal or geothermal energy, and approved by the ERC.

In the chapter on energy efficiency and renewable energy resources the Law deals with the policy for improvement of energy efficiency and for the exploitation of renewable energy resources, activities from the field of energy efficiency and

renewable energy resources. Upon the proposal of the Ministry, the Government of the Republic of Macedonia must adopt a Strategy for improvement of energy efficiency and a Strategy for the exploitation of renewable energy resources for a period of ten years. Upon the proposal of the Ministry, the Government of the Republic of Macedonia adopts a Programme for the implementation of the Strategy for improvement of energy efficiency and a Programme for the implementation of the Strategy for the exploitation of renewable energy resources

The Law requires the Energy Agency of the Republic of Macedonia (EARM) to issue and maintain a registry of guarantees of origin for electricity produced from renewable energy resources and from high-efficiency cogeneration facilities in the Republic of Macedonia and guarantees of origin associated with imports of electricity issued by other authorised national bodies. The ERC must establish preferential tariffs for electricity sold by preferential producers of electricity and producers of electricity from high-efficiency cogeneration facilities. The ERC shall impose an obligation on Wholesale Electricity Supplier for Tariff Customers to purchase such electricity and shall allow the cost of such purchases to be recovered through the transmission tariff charged by the Electricity Transmission System Operator. A preferential producer of electricity and a high-efficiency co-generator shall be required to present to the ERC a document from the EARM certifying that it uses renewable resources or that it uses high-efficiency cogeneration processes in order to receive preferential tariffs for its production. The ERC may require the electricity transmission system operator, when dispatching generation facilities, to give priority to generation facilities producing electricity from renewable resources and from high-efficiency co-generative installations.

A mechanism for financial assistance is established for the realisation of the Strategy for renewable energy resources exploitation. The means for financial assistance shall be provided by: the Budget of the Republic of Macedonia, the budgets of municipality or budget of Town Skopje grants, donations, sponsorships by foreign and domestic legal and moral entities, and foreign and domestic loans and state subsidiary in accordance with Law for state subsidiary.

The new Law on Energy is expected to help establish and maintain reliable, safe and good quality supply of energy and energy fuels to the consumers, and to stimulate the competition on the market, thus respecting the principle of non-discrimination, publicity and transparency, energy efficiency enhancement and encouragement of the utilization of renewable resources and improvement of the investments climate for constructing the new energy facilities.

III.2.4. The Law on Restructuring of ESM

The Law on Restructuring of (Republic of Macedonia's integrated power company) ESM was adopted in 2004, for the purpose of separating power generation, distribution and supply activities and assets from power transmission and grid management activities and assets. By virtue of the Law, two companies were established: ESM (generation, distribution and supply) and MEPSO (system operator and manager), both fully owned by the Government. Subsequently, most plant assets were assigned to a generating company (ELEM), with ESM keeping distribution and 11 small and mini-power plants (total 35 MW) and the Negotino TPP set up as a one-plant generating company.

To the extent that the Law on restructuring of ESM does not mandate otherwise, the provisions of the Trade Law are applicable to the companies (Art. 1-4).

Art. 5 and 6 deal with the asset base split between the two companies (generation, distribution and supply assets were assigned to ESM, the grid, management and dispatch assets are assigned to MEPSO), and prohibit claims on the assets of the integrated company ESM on the grounds of restructuring.

Art. 7 deals with the privatization of the “new” ESM, by allowing the sale of part or all of its shares or of part or all of the shares in its daughter companies to an investor, in one or more transactions, by means of:

- Sale of minority block of shares to international financial institutions;
- Tender with a pre-qualification procedure, under rules and procedure established by the Government;
- Other ways and means established by a law.

An “investor” may be any domestic or foreign legal entity or any international financial institution where Republic of Macedonia is a member.

The Law allows a certain percentage of shares to be reserved for persons who by 31 December 2003 have been employees of the “old” ESM. Shares may be distributed free of charge or at a reduced price among such persons, under rules and in a manner defined by the Government.

The restructuring and the privatization of ESM must be transparent, non-discriminating and objective as market conditions circumscribe (Art. 8).

III.2.5. Other Important Regulations

- Law on construction (Official Gazette of the Republic of Macedonia No 51/2005).
- Law on Urban and Physical Planning (Official Gazette of the Republic of Macedonia No 51/2005).
- Law on Environment (Official Gazette of the Republic of Macedonia No 53/2005).

IV. Market Structure and Privatization

IV.1. Overview

The main thrust of the effort in restructuring and privatization has been directed to the electricity market, with oil and natural gas also often in the focus of attention. This approach is natural, as the electricity sector is the only energy sub-sector in the country based primarily on indigenous resources (lignite and hydro), and is seen as the key for assuring a degree of energy security and independence. Restructuring of the power sector is quite advanced, based on EU’s acquis, and the first privatization in this sector was recently completed (for the distribution business of ESM).

In the oil sector, privatization is complete and competitive markets exist.

The gas sector is being restructured along the lines of EU's acquis, with privatization also advanced.

IV.2. Oil and Gas

IV.2.1. Upstream Activities

Exploration for hydrocarbons has been carried out during the 60s and 70s, with a few wells drilled. Only very minor shows of hydrocarbons have been detected in several wells, and no significant prospects have been identified; for this reason further exploration has been discontinued.

Deposits of oil shale have been identified, but not well explored. In-place resources have been estimated at 25-50 million tons. No studies of possible production have been carried out.

There is currently no exploration or production of hydrocarbons in the country, and no plans to engage in such activities.

IV.2.2. Oil and Gas Pipelines

IV.2.2.1 Oil Pipelines

Domestic

The only oil pipeline links the Mediterranean port of Thessaloniki in Greece to the OKTA refinery near Skopje (total ~200 km). The pipeline was constructed (at a cost of \$110 million) and is owned and operated by Hellenic Petroleum, which also owns the OKTA refinery (privatized 54% in 1999). Pipeline capacity is up to 2.5 million tons per year, matching the nameplate capacity of the OKTA refinery, but throughput is just a third or less of capacity (around 800,000 tons per year), as the refinery operates at a low load factor.

The proprietary nature and the absence of any outlets from this pipeline (dedicated to servicing the OKTA refinery) have deemphasized the relevance of issues such as tariff setting and third party access. The pipeline is essentially a part of the refinery operations at OKTA.

International

One of the most important oil pipeline projects in development in the Balkan region is a proposed 750,000-barrel-per-day (bbl/d) pipeline connecting the Bulgarian Black Sea port of Burgas with the Albanian Adriatic port of Vlore across Republic of Macedonia. The Albanian-Macedonian-Bulgarian Oil (AMBO) Pipeline Corporation has been established with exclusive rights to construct the pipeline, which is estimated to cost between \$850 million and \$1.1 billion.

The AMBO pipeline, which would run via Republic of Macedonia, would allow oil that is being shipped across the Black Sea to be piped across the Balkan Peninsula to the Adriatic Sea, thereby reducing tanker traffic through the congested Bosphorus Straits and the Aegean Sea. With oil exports from the Caspian Sea region projected to increase

rapidly in the next decade, the AMBO pipeline proposal is one of several "Bosporus bypass" oil pipeline proposals that are currently under consideration or in development.

The AMBO pipeline proposal has received letters of acceptance from the governments of Albania, Bulgaria, and Macedonia, and a \$980,000 feasibility study, partially funded by the U.S. Trade and Development Agency, concluded that the 560-mile pipeline project was feasible. AMBO began to assemble financing for the project in June 2001, with construction originally scheduled to start in 2001 and completion by 2005. However, luring foreign investment has been difficult and hindered efforts to fund the pipeline's construction. Once the financing is in place, construction is expected to take three years²⁰.

On December 28 2004, the Minister of Regional Development and Public Works of the Republic of Bulgaria, the Minister of Industry and Energy of Republic of Albania, the Minister of Economy of the Republic of Macedonia and the President & CEO of AMBO LLC signed in Sofia a Tripartite Memorandum of Understanding.

Figure 1 illustrates the routes of existing and planned pipelines in the Republic of Macedonia and Southeast Europe.

Figure 1: Oil Pipeline Routes in Southeast Europe



Source: U.S. EIA / DOE.

In addition to the crude oil pipelines, the owner of the OKTA refinery in Skopje (Hellenic Petroleum) has begun the construction of a product line from the refinery to Kosovo's capital Pristina, with a capacity of 300,000 tons per year. Hellenic petroleum intends to eventually build a product line from the refinery to South Serbia as well.

IV.2.2.2. Natural Gas Pipelines, Transmission and Storage

Domestic Markets

The main gas pipeline system of Republic of Macedonia runs from the Macedonian-Bulgarian border to Skopje. Construction of the 100 km, 20 inch pipeline began in 1993 and the line was commissioned in 1997. The total length of the line from the point

²⁰ Source: Inogate.

in side Bulgaria where it branches off the pipeline leading to Greece to Skopje is about 165 km. Gas originates in Russia.

The pipeline was designed for nominal flow of 800 million m³ gas per year and maximum flow of 1.2 billion m³ at a pressure of up to 54 bar for natural gas but actual utilization rate is about 10% of the capacity. There are no compressor stations in Macedonia and no plans to build compression related to domestic market service, although a station may be constructed at Skopje in case the line is extended to Albania and/or Kosovo. Apart from the 100 km main line, there are just 25 km of distribution gas pipelines and 40 km of urban gas pipeline networks (all in Skopje). There are only about 20-25 users (all industrial and district heating) connected to the system.

The Government established GA-MA as a public enterprise for the supply, transport and distribution of natural gas in October 1996. Since Makpetrol (which since 1998 is a completely private company) is a shareholder in this enterprise, the enterprise (according to the Law on Trade Companies and the Law on Public Enterprises) has been approached with an offer to be transformed into a joint stock company.

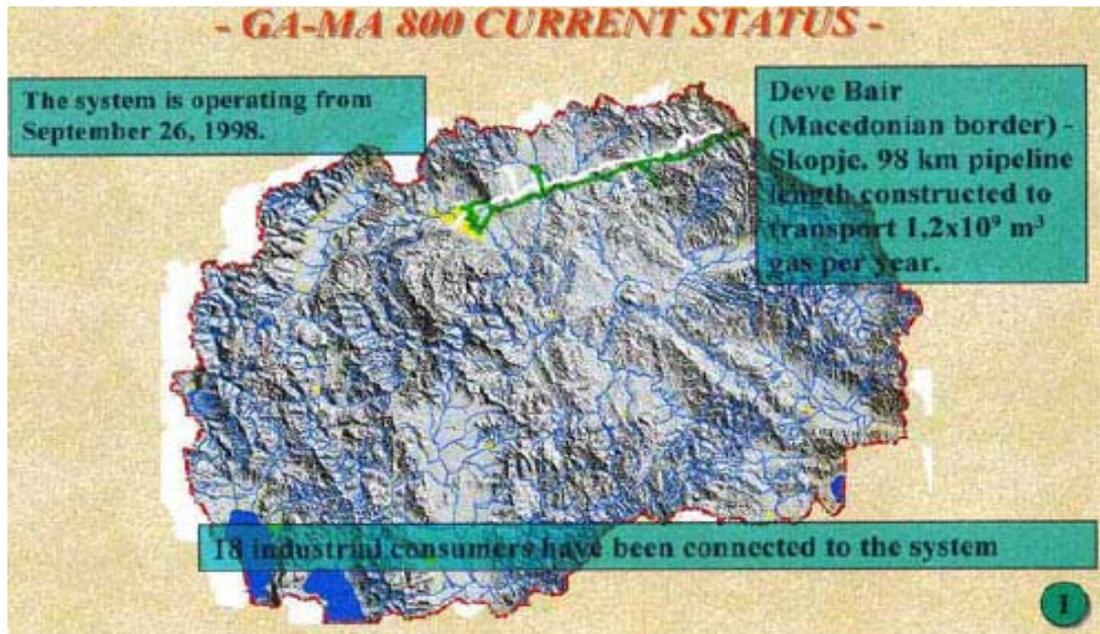
Macedonia and Makpetrol AD are investors in the gas pipeline system, with the state holding the majority rights. According to the various law provisions, particularly the Law on Energy, JP GA-MA-Skopje is the only authorized legal body to operate the natural gas transmission system. However, Makpetrol AD Skopje operates the gas pipeline system. At the moment, court procedures are underway about defining the ownership, control and management of the gas pipeline system. The unsettled issues of ownership, control and management of the gas pipeline system are factors that hinder the development of the gas sector infrastructure.

Immediate plans for the development of the system include the construction of a second ring in the western part of Skopje. In February 2005, the Russian and Macedonian governments signed an agreement under which \$15 million of Russia's debt will be paid off with the construction of the pipeline ring around Skopje. The pipeline will be constructed by the Russian company Rosneftgazstroy and the Macedonian company GAMA. The project is a priority for the Government. Rosneftgazstroy's vice-president Vassiliy Medvedenko linked the importance of the project to the perspectives for further transport of gas via Macedonia to Albania and Greece²¹.

Gas demand may be boosted by the construction of a combined-cycle cogeneration gas-fired plant in Skopje. Figures 2 and 3 illustrate the current status of the gas transmission and distribution system in the country and the plans to expand the system.

²¹ Alexander's Gas and Oil Connections, 10 March 2005.

Figure 2: Current status of the gas transmission and distribution system of the Republic of Macedonia.



Source: Energy Regulatory Commission of the Republic of Macedonia.

Apart from the second ring in the area of the capital, gas infrastructure projects are lagging many years behind schedule.

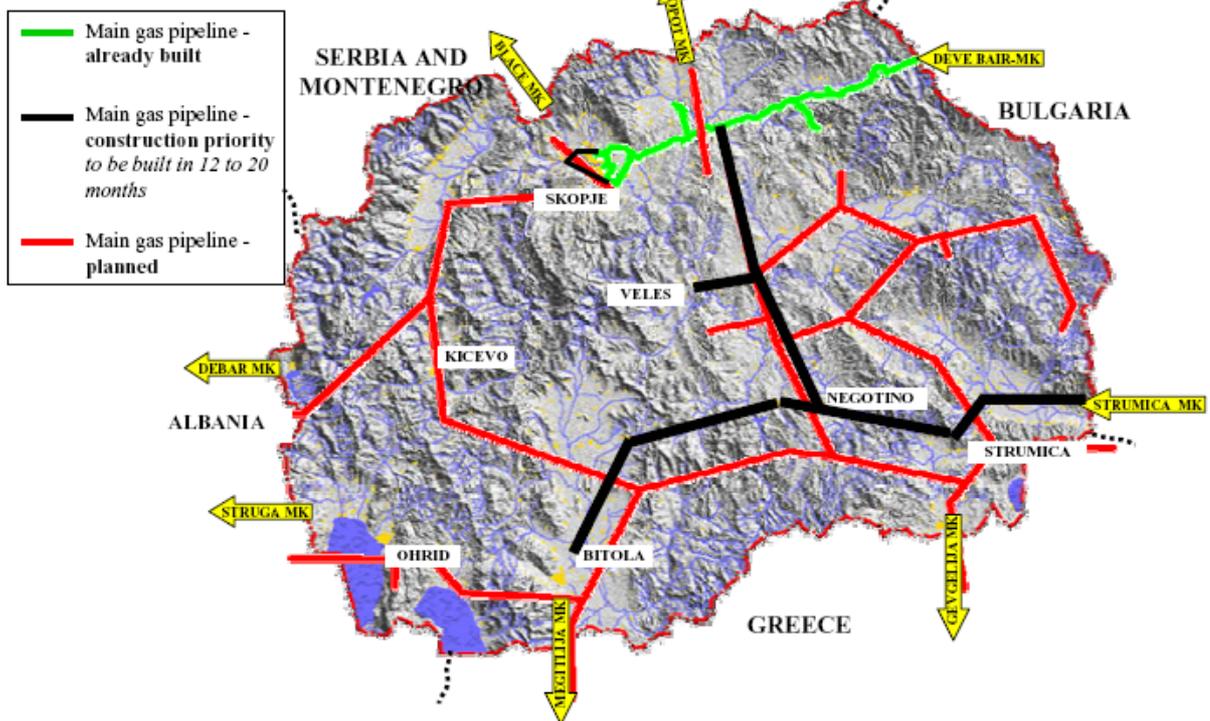
The Energy Regulatory Commission sums up the status of the gas industry in the following manner:

- Current usage of the gas pipeline capacity is less than 10% of capacity;
- Natural gas is not used for residential needs;
- Stagnation in the construction of main gas pipelines in the country since 1996 is due to unresolved issues related to the ownership structure of capital in the main pipeline;
- There is no tariff system in place for natural gas pricing (price is determined by natural gas supplier quarterly).

With the adoption of the Athens Memorandum, Macedonia has agreed to implement EU's *acquis* in the gas pipeline business. The transportation, supply and distribution activities will be legally unbundled.

There is a customs duty on natural gas imports of 2%.

Figure 3: Gas infrastructure development plans in the Republic of Macedonia.
REPUBLIC OF MACEDONIA - THE GAS PIPELINE SYSTEM



Source: Energy Regulatory Commission of the Republic of Macedonia (2004).

The Energy Regulatory Commission has considered the following incentive-based methods consisting of price and revenue caps for tariff design and calculation in natural gas transmission, distribution and retailing:

- Natural gas transmission:
 - Revenue caps;
 - Sliding scale for the initial period of price control to decrease the risk of high profit/loss due to inadequate data.
- Natural gas distribution:
 - Price caps;
 - Additional encouragement to reduce technical loss
- Retail margin:
 - Price cap;
 - Additional encouragement to reduce technical loss.

Since all of the gas is supplied from a single source (Russia's Gazprom), distribution is limited, and end-users are but a few, the issue of third party access has so far been largely irrelevant. However, the adopted legislation (Energy Law and other acts) does take into account EU's acquis third party access and sets rules for non-discriminatory use of available capacity that are compliant to the acquis.

International markets

Various interconnections to neighboring countries and transit gas pipelines have been proposed:

- To the north, 18-20-inch interconnection from Kumanovo via Leskovac to Nish in Serbia has been considered. Capacity would be about 0.5 billion m³ per year.

- To the west, an extension of the existing 20 inch line to Albania, with a capacity of 0.5-0.8 billion m³ (will require the construction of booster compression station at Skopje);
- In the south, a second 15-20 inch interconnection from Bulgaria (Petrich) to Macedonia (Strumica) leading to Negotino-Prilep-Bitola-Ohrid to the Albanian border, and eventually connecting to the existing system at Skopje (reverse flow from the north to the south is an option);
- A large diameter, high pressure, high capacity (up to 20 bcm/year) transit line for gas originating in the Caspian basin, to be transited across Turkey, Greece, Republic of Macedonia, Albania and/or Serbia on to Europe (either Italy or Central Europe).
- A large diameter line to Albania and Italy (28 inch or larger, will require upgrades in Bulgaria and other countries upstream from the Republic of Macedonia).
- Trans-Adriatic gas pipeline - TAP Project (Bulgaria – Macedonia –Albania – Italy).

One of the most important gas pipeline regional projects under consideration in the Balkan region is the TAP Project. The basic technical characteristics of this regional project are as follows: length of 585 km (of which 200 km in Macedonia), capacity 8 to 12 billion m³ per year (of which 1 billion m³ per year for Macedonia, Bulgaria and Albania), total investment €1.2 billion, construction period 2.5 years.

EGL (a Swiss company) has prepared a pre-feasibility study, and the company plans to prepare a detailed feasibility study. The investor of TAP is EGL. For the realization of this project, the governments of the four involved countries signed on 14 July 2004 bilateral memorandums of understanding with EGL. So far, all these projects are at the stage of preliminary studies and discussions, with little actual project planning or structuring underway.

Gas storage

There is no gas storage and there are no plans to construct one.

IV.2.3. Oil Refining, Storage, Distribution

OKTA, the sole refinery, was commissioned in 1982 as the regional facility for southern Yugoslavia. It was acquired in 1999 by Greece's state-owned oil refining group, Hellenic Petroleum (in which Russia's Lukoil has a stake) as part of its strategy to enter the Balkans energy market.

With an annual capacity of 2.5 million tons, OKTA is well able to meet the country's own need for about 0.8 million tons of refined products per year - expected to rise to 1.5 million tons by 2007. After the construction of a crude oil pipeline from Thessaloniki, a ready, and cheaper, supply of crude oil means the spare capacity can be used to produce products for export to neighboring areas like Kosovo and southern Serbia. Hellenic Petroleum holds an 80% stake in the pipeline through its subsidiary El Pet Balkaniki, with the remaining 20% held by the Macedonian government.

However, even with expanded markets, the refinery, which is of simple hydroskimming design using primarily Russian equipment, is fundamentally uneconomic when

compared to the alternative of importing petroleum products. For this reason, a reduction in custom duties for imports of crude oil was negotiated as part of the privatization deal (from 23% to just 1%). Later on, however, buoyed by a European Court ruling, the government was able to re-negotiate the contract. Charges for the use of the pipeline remain high until 2007, to allow the re-payment of loans extended for its construction. The refinery's management expects to recover the investment in about 10 years.

In the meantime, Hellenic Petroleum has started to modernize the refinery and bring it up to EU standards. Production includes liquefied petroleum gas, naphtha, motor gasoline, diesel fuel and fuel oil. Environmental protection is regarded as a priority. OKTA is the only company in Macedonia which has complete physical, chemical and biological waste water treatment. The refinery's power supply comes from its own power station. Surplus supply electricity is directed to the national distribution system. Another strategic objective of OKTA is to extend the distribution network by building around 30 modern petrol stations²².

The country's domestic demand for petroleum products is relatively stable at about 780,000-800,000 tons per year. The main products in demand are gasoline (20% of consumption), diesel fuel (40%) and heavy fuel oil (30%). Miscellaneous products (LPG, jet fuel, lubricants) account for the remaining 10% of consumption.

The biggest oil product and gas distributor is Makpetrol, established in 1947, since 1998 a totally private joint-stock company. There are a total of more than 200 petrol filling stations, of which Makpetrol owns 114. The company handles over 400,000 tons of oil products, most of them (about 65-70%) sold via its retail facilities. Makpetrol also owns 12 depots for products. The remaining 130 or so fillings stations are owned by small retailers. Hellenic Petroleum has announced intentions to enter the retail market and Russia's Lukoil signed in 2005 a MoU with the Government to facilitate access to sites for petrol stations that the company intends to build.

A new project has been launched - to build a \$40 million pipeline to transport refined product from OKTA to the Kosovo capital, Pristina. However, at the moment the project is not advancing due to the ambiguity related to land rights. The project will be reconsidered later in 2006 or in 2007.

Imported oil products are subject to a 20% import duty (for LPG the rate is 2%), except for import from countries that Macedonia has signed free trade agreements with. For example, custom duty from Bulgaria is 0%, from EU countries 14% from 2006 and, 12% from 2007.

Prices for oil products are set by the Energy Regulatory Commission in compliance with the price-forming methodology (capped at refinery and retail outlets).

Taxes include VAT (18%), excise tax (42-46% for gasoline, 30% for gas oil / diesel, 10% for light heating oil). Certain consumers are exempted from excise tax. Tax evasion and corruption are almost extinct from the petroleum sector.

²² Source: Summit Communications, Austrian Energy Agency.

Reserves stocks of oil products are held by the Government, and oil companies are not liable to form compulsory stocks.

Liquid fuel standards allow sulphur content of maximum 2% in heavy fuel oil. Leaded gasoline is still being produced and consumed, but phase-out is underway. At the moment, the oil product quality standards in force are the ones which were valid in former Yugoslavia, but Euro standards are being introduced. A Commission has been formed within the Ministry of Economy to create new standards which are to be applied from 2006-2007.

Table 14 provides data on refining capacity by type of product, and Table 15 lists the consumption of petroleum products.

Table 14: Refining capacity by type of product at OKTA (2004)

Derives	%	Installed capacity [tons]
Motor gasoline-86	3.42	85.500
Motor petrol-98	15.67	391.750
Unleaded motor gasoline-95	0.42	10.500
Diesel fuel D-1	10.83	270.750
Diesel fuel D-2	10.50	262.500
Extra light oil EL	8.33	208.250
Light oil	37.50	937.500
Medium oil	2.67	66.750
Jet fuel GM-1	0.67	16.750
Liquid oil gas	2.08	52.000
Other	7.91	197.750
Total	100	2.500.000

Source: ERC.

Table 15: Petroleum products demand in the Republic of Macedonia, 2004-2005.

Derivative / use	2005 thousand tons	2006 (forecast) thousand tons	Index (%)	Structure (%)
1. Motor petrol	121.782	125.300	102,89	15,02
- MP-96	25.000	30.300	-	-
- UMP-90	5.000	6.000	-	-
- UMP-95	91.782	89.000	-	-
2. Diesel fuel	351.627	350.000	99,54	41,96
- D	213.625	212.000	-	-
- D2	6.089	-	-	-
- UL	131.913	138.000	-	-
3. LOG (liquid oli gas)	37.907	42.800	112,91	5,13
4. Crude oil	230.000	297.000	129,13	35,61
5. Jet fuel	16.593	12.000	72,32	1,44
TOTAL	757.909	834.100	110,05	100

Source: Ministry of Economy.

IV.2.4. Natural Gas Distribution and Utilization

The Energy Regulatory Commission is responsible for the development of licensing rules, methods of pricing for natural gas, terms and conditions of supply, tariffs, network rules for transportation and distribution, and natural gas market rules. In practice, there is just one licensed company for transmission and operating gas transmission systems, and that is JP GA-MA-Skopje, while at the moment Makpetrol is a licenced company for trade and supply of natural gas to end users.

Gas distribution is to industrial consumers and district heating plants only (total about 23 customers); a 180 MW electric, 150 MW thermal, gas-fired combined cycle cogeneration plant is under construction in Skopje. There are plans to develop distribution nets, but the pace of their implementation is quite slow, primarily because of the ongoing dispute regarding ownership of the high-pressure lines. Consumption in 2005 was around 100 million m³, but is expected to grow as power generation begins to use gas and distribution nets are developed.

The following projects for the expansion of the gas distribution grid have been identified as priority:

- Completion of the gas ring in Skopje (14 km new line, total cost €6.42 million). The project has been contracted with a Russian company as part of the repayment of Russian debts to Macedonia.
- Expansion of the distribution gas network in the cities of Skopje, Kumanovo, Kratovo and Kriva Palanka. In Skopje, it is planned to construct about 250 km of low pressure line that would allow the increase of annual consumption by 110 million m³. Investment cost is estimated at €36 million (excluding costs for hook-ups of consumers). For the cities Kumanovo, Kratovo and Kriva Palanka, it is expected to construct a total of 94 km of line, leading to increase in annual consumption by 50 million m³, at a cost of €23.6 million.
- Pipeline Klecevice-Negotino;
- Pipeline Skopje-Tetovo-Gostivar-Kicevo (with branch to Debar) - Struga and Ohrid.

IV.3. Coal

Reserves

For coal reserves, see section II.3.4.1.

Mining and consumption

The lignite mines at Bitola and Oslomej are part of the power generation company (ELEM) and operate as an integrated facility with the power plants at these locations. The mine at Bitola feeds TPP Bitola I, II and III and produces 6.25 – 6.5 million tons of lignite per year (about 85% of production). The mine at Oslomej feeds the Oslomej TPP and produces 0.8-0.95 million tons of lignite per year (about 12-14% of production). Two other small mines have been privatized and produce minor quantities. Total production runs at about 7.3-7.4 million tons of lignite per year. Hopes for the increase of lignite production are linked to the resources of the region of Pelagonia (Bitola), where deposits in excess of 1.5 billion tons of lignite are believed to exist.

The country has no reserves of coking coal and other high grades of coal. For this reason, it imports about 150,000 tons of good quality coal and about 115,000 tons of coke, mostly used by the metallurgy. Coal is generally not used by residential and commercial consumers (under 10,000 tons in 2004).

Table 16 shows the main items in the coal balance.

Table 16: Coal demand by sector (thousand tons)

Consumers	Hard coal		Brown coal		Lignite		Total		Index %
	2005	2006 forecast	2005	2006 forecast	2005	2006 forecast	2005	2006 forecasr	
1. Industrial consumers	102.600	114.300			221.760	240.306	324/360	354.686	109,35
2. TPPs - TPP Bitola					7.093.000	7.044.000	7.093.000	7.044.000	99,31
I, II, III - TPP Oslomej					6.381.000	6.240.000	6.381.000	6.240.000	
Other					8.000	9.000	8.000	9.000	112.50
TOTAL	1025.600	114.380			7.322.760	7.293.306	7.425.360	7.407.686	99,76

Source: Ministry of Economy.

IV.4. Electricity

IV.4.1. Power Sector Overview, Generation Capacity

About 80% of the electricity needs are satisfied by domestic production of thermal and hydroelectric power. The total annual production of electricity in the country is about 6,400 GWh. The state-owned electricity company ESM has been restructured into four separately owned entities – generation, distribution, transmission and a one-plant generation company. At this stage, ESM has completed the process of privatisation.

There are a total of 47 generating units in the country, of which 5 thermal and 42 hydropower units. Of the latter, 22 are small and microplants with total installed capacity of ~36 MW. A combined cycle cogeneration plant (180 MWe) is under consideration in Skopje, and HPP Kozjak was commissioned in June 2004.

Most of the generating capacity is at the coal-fired TPP Bitola 1-3 (225 MW each) and Oslomej (125 MW) and the oil-fired TPP Negotino (210 MW). The high prices of oil in recent years have pushed TPP Negotino out of the market and its load factor has decreased. Total thermal capacity is 1,010 MW.

The six largest HPP are Vrutok (160 MW), Tikves 112 MW), Spilje (84 MW), Globocica (42 MW), Raven (22 MW) and Vrben (12 MW) and they have been rehabilitated; they account for 85% of installed HPP capacity. Total installed HPP capacity is 540 MW, used primarily for load management.

The electricity system has been unable to meet demand by its own generation and has been importing electricity on a regular basis (up to 2 billion kWh/year in 2005). For this reason, plans call for the construction of new generation capacity. Table 17 lists projects for new and rehabilitated generating capacity.

Table 17: Planned changes in capacity

Plant type / location	Capacity, MWe	Expected year of commissioning	Available system capacity, MW
Skopje Zelezara CCGT	180	2007	1629
Gas turbine	200 MW	2008	
Spilje 2 HPP	73	2012	1814
CCGT (Skopje?)	220	2012	2033
CCGT (Skopje)	220	2013	2044
Bitola 4 (import coal)	200	2014	2248
Bitola 1 (rehabilitation)	200	2014	2248
Boskov Most HPP	45	2015	2317
Matka 2 HPP	36,4	2009	2317
Bitola 2 (rehabilitation)	200	2018	2420
Gradec HPP	55	2019	2474
Bitola 3 (rehabilitation)	200	2020	2680

Source: ERC.

The Government has decided to accelerate the implementation of some generation projects. At this time, the following is underway:

- Pre-qualification has been carried out for the construction of the Matka 2 HPP (installed capacity 36.4 MW, expected annual production of 66 GWh, total investment €44.63 million). With pre-qualification now complete, it is expected submit the tender documentation to the companies that passed the pre-qualification, submit offers by the end of April 2005 and sign contracts after evaluation and choice of the best offer.
- For the Boskov Most HPP (installed capacity 70 MW, annual production 127 GWh, total investment €70 million), the preparation of tender documentation is underway. At the end of 2005 an international tender is expected. The implementation of the project will last 4.5 years.
- CCGT – Activities for constructing the TE-TO “Skopje” CCGT plant started in August 2005 with the signing of a Memorandum for cooperation between the Government of the Republic of Macedonia and NGK Itera. For the realization of this project, a new legal entity was set up (TE-TO AD Skopje). The founders are NGK Itera from Moscow (70% of the capital) and Toplifikacija AD Skopje (30% of the capital). The aim of the project is to construct a plant for combined production of electricity and heat in Skopje with modern technology that will use natural gas and will be located on the site of the existing boiler heat plant “Istok”-Skopje. The electricity capacity of the plant will be about 200-220 MW, and the heating capacity would be about 160 GW. The cost is estimated at €100-120 million. The construction is expected to start at the beginning of August 2006 and to last 20-24 months, which means that the project should be commissioned by the end of 2008.
- Small hydropower plants (70 small hydropower plants, installed capacity 180 MW, annual production 700 GWh, investment €1,0-1,5 million/MW). The preparation of tender documentation for a package of 10 small plants is underway. Construction will last 6 month to 2 years²³.

IV.4.2. Generation and Consumption

Tables 18 and 19 provide data on power generation, imports, exports and consumption in 2004-2005.

²³ Source: S. Andonovski.

Table 18: Electricity generation and consumption (in million kWh and TJ)

	2005		2006		Index
	Quantity	10 ³ TJ	Quantity	10 ³ TJ	
Electricity (10 ⁶ kWh)					
a) production	6.459	22.30	5.935	21.41	91.89
- hydro	1.495	5.39	1.127	4.07	75.51
thermal	4.964	17.91	4.808	17.35	96.87
b) import	1.662	6.00	2.994	10.80	180.01
c) export	-	-	-	-	-
d) consumption (a+b+c)	8.121	29.30	8,929	32,21	109,94

Table 19: Electricity demand by sector (2006).

	Million kWh
I. DIRECT CONSUMERS	2,715
II. DISTRIBUTION CONSUMERS	4,846
Industrial consumers	781
Households	3,265
Other consumers	800
III. NETWORK LOSSES	1,368
- distribution network	1,128
- transmission network	240
EXPORT	0
TOTAL NEEDS	8,929

IV.4.3. Electricity Transmission and Distribution Infrastructure

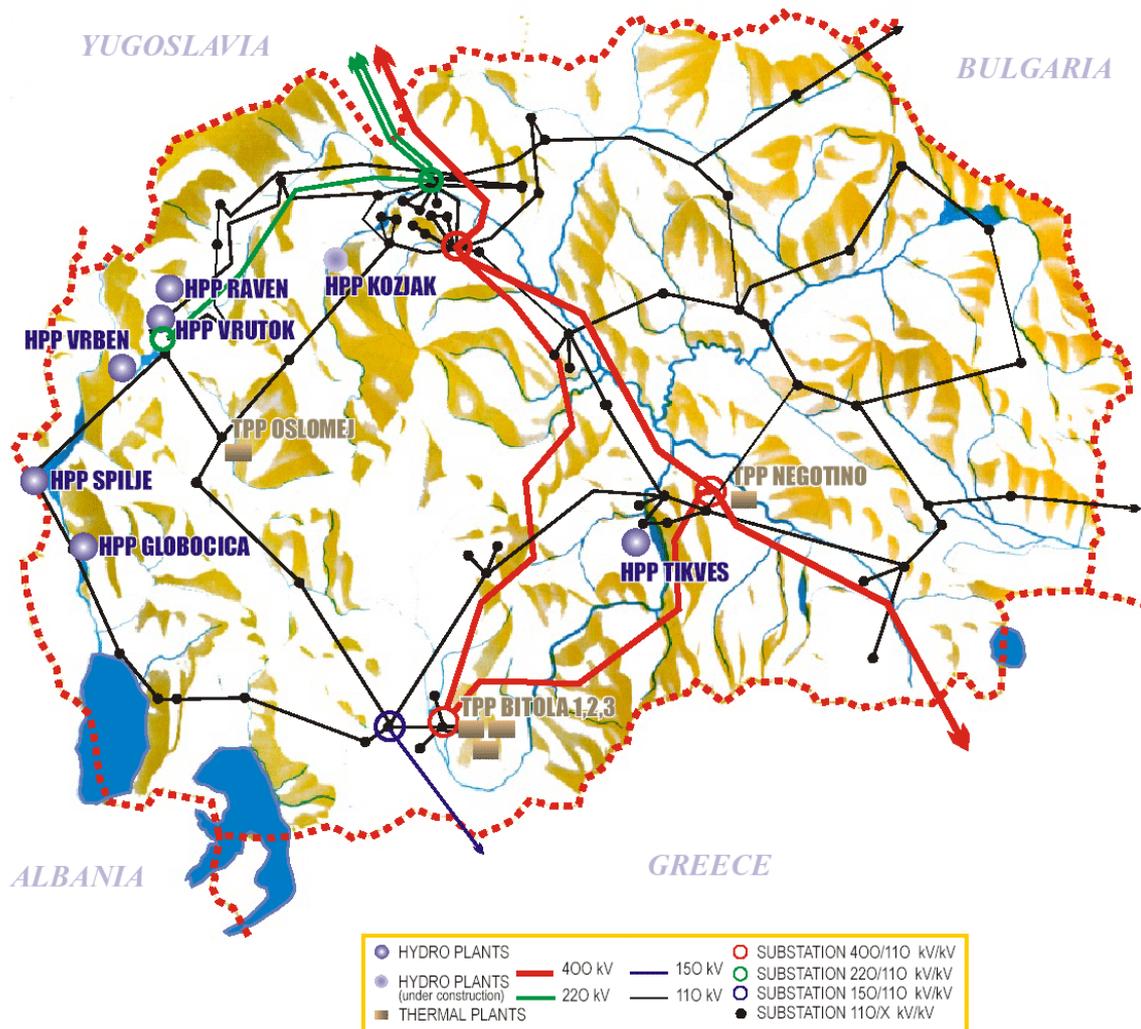
High voltage transmission system operates at four (4) voltage levels: 110, 150 (which will be phased out, i.e. upgraded at 400 kV), 220 and 400 kV. The power system of Macedonia in 2005 included 66 substations 110/x kV with total 3617 MVA installed capacity, one substation 110/150 kV with 100 MVA installed capacity, two substations 220/110 kV with total 600 MVA installed capacity and four substations 400/110 kV with total 2100 MVA installed capacity. The length of overhead transmission lines is about 419 km of 400 kV lines; 103 km of 150 kV lines; 22 km of 220 kV lines, and 1480 km of 110 kV lines.

The backbone of the system is the ring of 400 kV lines, which connects the biggest consumption area in the northern part in the country (Skopje) with the main power generation plants situated in the southern part (Bitola and Negotino).

The high-voltage system is connected by 400 kV lines with Greece and Serbia and Montenegro. The power system is also connected to Greece by one 150 kV transmission line. There are two 220 kV lines connecting to Serbia and Montenegro, but they are out of operation since 1999 and there is no rehabilitation project at this moment for these lines. The Macedonian and the Bulgarian power systems operate in parallel and synchronous mode using the existing 110 kV lines.

Figure 4 illustrates the transmission and interconnection capacity.

Figure 4: Power transmission and interconnection system



Source: ERC.

There are plans to enhance interconnections with neighboring countries, particularly the following:

- Within the frame of Corridor 8:
 - 400 KV line between Stip (Macedonia) and Cervena Mogila (Bulgaria), with a total length of 150 km (70 km in Macedonia) and investment cost €50 million. The line will allow power exchanges of up to 600 MW. The construction of the line will be financed with a €40.5 million loan from EBRD, of which the amount of €15.3 million will be used by Bulgaria and refunded by deliveries of electricity during the construction;
 - 400 KV transmission line Macedonia-Albania-Italy with length of 80 km on Macedonian territory, 160 km on Albanian territory and 80 km direct current submarine cable. The total length of the 400 kV line on Albanian territory and the DC submarine cable depends on the connection point on Italian territory. The investment cost of this project on Macedonian territory is estimated at €12 million. A feasibility study for the 400 kV land and 400 kV submarine cable interconnections from

Macedonia to Albania and to Italy, undertaken by SEETEC at the request of KESH of Albania, NEK of Bulgaria, MEPSO of Macedonia and TERN from Italy, is ongoing.

- Within the frame of Corridor 10:
 - 400 KV transmission line Skopje (Macedonia) –Nis (Serbia) with a length of about 195 km (55 km on Macedonian territory and 145 km on Serbian territory) and cost estimated for Macedonian part at about €8,88 million.
 - 400 KV transmission line Bitola (Macedonia) - Florina (Greece) is an upgrade of the existing 150 KV line, with a total length of 41 km (19 km on Macedonian territory and 22 km on Greek territory) and cost estimated at \$10 million, of which in Republic of Macedonia \$5,9 million. The construction of the Macedonian part will be financed by World Bank and will start in 2006 and finish in 2007.

Table 20: Main parameters of low voltage (distribution) power grid in the Republic of Macedonia

Distribution lines	110 kV	35 kV	10 (20) kV	0,4 kV	total
Overhead (km)	203,3	968,79	7499,1	11355,5	202026,69
Underground (km)	0	72,2	2229,5	2672,5	4974,2
Total	203,3	1040,99	9728,6	14028	25000,89

Transformer	No. of transformer	Installed power (MVA)
110 kV	72	1916
35/20 kV		
35/10 kV		
35/6 kV	130	659
20/0,4 kV		
10/0,4 kV		
6/0,4 kV	6945	2326
Total	7147	4901

AD “Elektrostopanstvo na Makedonija” (ESM), now reorganized as a joint stock company, is 10% in state ownership, with 90% of the shares recently sold to EVN AG (Austria). The EBRD holds deferred right on a minority stake and the Bank’s decision is now pending. ESM operates as the electricity distributor throughout the territory of the Republic of Macedonia. Four licenses have been issued to ESM by the ERC of the Republic of Macedonia:

- For use of the power distribution grid of 0,4 kV, 10(20)kV, 35 kV and parts of 110 kV voltage;
- For electricity supply to the tariff customers;
- For managing the distribution electric power grids; and
- For power generation at the small power stations connected to the distribution grid.

Out of the entire electricity delivered, 73% is distributed via distribution grids to various end-customers (households, administration, commercial entities, medium and small industrial customers, street lighting etc.), and 27 % to wholesalers connected to

the transmission grid. The total number of customers connected to distribution grid in Macedonia is about 620,000.

During the last years, electricity supply to distribution customers has been accomplished in complex technical and economic conditions. The customers have been allowed to get power, in the requested quantity and at any time, even though not all criteria have been met regarding the distributed electricity at all locations. Current conditions in ESM require the implementation of a new economic and organizational concept in order to consolidate operations. The reasons are the following:

- In some parts of the distribution grids the degree of equipment wear and tear threatens its stability and causes increasing operational costs (power losses);
- There is a mismatch between electricity prices and the cost of raw materials and operation. As a consequence, power sales revenues cannot provide financial support for the construction of new facilities according to customers needs, as well as according to the required technical quality of distributed electric power.
- Losses are excessive - more than 30% of the electricity “vanishes” and approximately 40% of payments due are not collected;
- The natural electric potential in the Republic of Macedonia is limited, a circumstance that mandates the rational use and saving of electricity;
- Regional cooperation with countries from Southeast Europe is expected. Besides, the transformation of electric power systems and the creation of a regional electric power market are expected.

Given these hindrances, solving the problems related to electric power (organizational, technical and financial) will require a comprehensive approach.

Annual investment programs in distribution grids have been financed by using funds raised as main assets depreciation, credits, warehouse stocks funds drawdown, and external resources (means provided by co-investors, etc.). However, the annual investment programs have not been fully implemented, due to the lack of financial means. For example, the 2004 annual investment program was implemented at 43% of the planned levels, and the 2005 program – at only 30%.

The mid-term distribution grids development plan (2006-2012) foresees that €50 million per year would be needed to rehabilitate the existing and construct new distribution facilities. The aim is to:

- Increase of reliability, stability and efficiency of distribution grids
- Reduce operation costs (losses decreasing and maintenance costs)
- Improve the quality of distributed power (decreasing of number of malfunctions / failures)
- Decrease customers' damages due to electricity interruptions, etc.

IV.4.3.2 Small Hydropower Plants (HPP)

A concession was extended over seven small hydropower plants (Kalimanci, Zrnovci, Matka, Pena, Doshnica, Sapuncica and Pesocani) with a total installed capacity of 35.8 MW and average annual generation approximately 100 million kWh in 2001 to the Czech company Hydropol. In accordance with the agreement, ESM purchases the

entire output of electricity, and the concessionaire is obliged to reach certain targets. Up to now, investment activities have started only at HPP Matka and HPP Kalimanci.

ESM owns four small hydropower plants (Popova Sapka, Turija, Babuna and Belica) with a total installed capacity of 8 MW and average annual generation around 22 million kWh.

IV.4.4. Privatisation and Restructuring in the Power Sector

The restructuring and privatization of the power sector started back in 2002, when the Government contracted the Meindl Bank Consortium from Austria for advisory services on the issue. The Restructuring Model for the power sector and its Implementation Plan were developed by the end of 2003. In 2004 the Law for Restructuring and Privatization of the power utility ESM AD was enacted.

At the beginning of 2005 the Electricity Transmission and System Operator was separated from ESM and established as an independent company (MEPSO AD). In the second half of 2005 further unbundling of ESM was conducted, resulting in the separation of electricity generation in a separate company (ELEM AD), along with a spin-off of the single Thermal Power Plant Negotino AD. ESM remained as the electricity distribution and supply utility in state ownership until its privatization in late 2005 and early 2006, when it was sold 90% to EVN of Austria.

IV.4.4.1. Sector Structure and Management, Pricing Policies

Policy Principles

The management of the electricity sector is entrusted by law to the Ministry of Economy, the Energy Regulatory Commission and other institutions as described in Section II.3.4.3 (Institutional Set-up) of this Report. The principles upon which the sector is organized include the following main values:

- **Universal service** – the energy system should provide access to reliable supply of electricity for all retail consumers at appropriate economic costs;
- **Recognition of Assets** – pricing and economic decisions, including investment and privatization, should take advantage of existing assets and resources and accommodate limitations;
- **Cost Recovery** - in the energy sector, prices should be set on cost recovery basis including return on investment or capped revenue principle (the latter has been taken as the one to be used in the Methodologies developed by ERC);
- **No Cross-Subsidies** - cross-subsidies between different classes of customers are forbidden;
- **EU compatibility** – market structure, rules, pricing principles, etc., must meet the relevant requirements of applicable EU legislation and contain no contradicting criteria (must comply to the acquis), while taking advantage of rights granted to market participants and consumers;
- **Human impact** – the policies recognize human needs and are designed to assure acceptable impact on consumers, businesses and utility employees;
- **Public Service** – the policy requires household customers to have an opportunity to purchase energy at affordable prices;

- **Sustainable Development** – the policies require non-renewable resources to be used rationally and renewables to be used in a sustainable manner;

Licensed activities

The following activities require separate licenses:

- Generation of electricity (multiple licenses may be issued):
 - Generation for tariff customers;
 - Generation for the free market.
- Transmission of electricity;
- Operation of the electric power system (including TSO);
- Organization and operation of the electricity market;
- Distribution of electricity (multiple licenses may be issued, but each one for a given territory);
- Operation of the electricity distribution system;
- Supply of electricity (multiple licenses may be issued):
 - to wholesale tariff customers;
 - to retail tariff customers.
- Transit of electricity;
- Trade with electricity (multiple)

Market participants

The following is a listing of the electricity market participants and their functions and responsibilities:

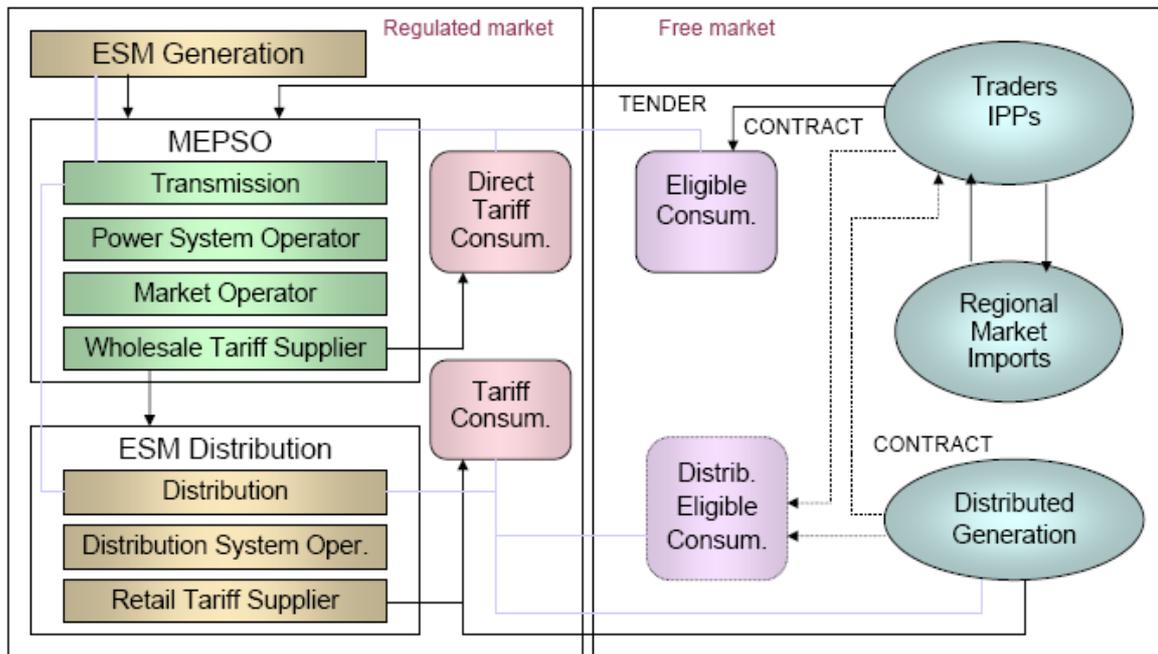
- **Generators of electricity**
 - Independent power producers (IPPs);
 - Regulated Generators - liable to public service. Regulated generators must conclude regulated power purchasing agreements (PPA) with the supplier of electricity for wholesale tariff customers for selling all available power, electricity and system services for supplying tariff consumers, on regulated prices;
 - Distributed Generators - may sell electric power, and/or energy to both electricity traders and to the supplier of electricity to the retail tariff consumers.
- **The Transmission service provider (TSP) must assure:**
 - Connection to the transmission network of licensed entities;
 - Secure, safe and quality delivery of electricity across the transmission network;
 - Maintenance, planning and development of the grid.
- **The Power System Operator's (TSO) functions are to:**
 - Operate transmission and transit across the transmission system and assure parallel operation with the neighboring systems;
 - Provide balancing of the offset between current and contracted delivery;
 - Implement the schedule of switching on and off of generation capacities and its amendments;
 - Provide resolution of overloads (load management services).

- **The Electricity Market Operator:**
 - Is responsible for implementing efficient control mechanism for sale and purchase of electricity
 - Provides the TSO with day-to-day dispatching schedules and performs continuous updating;
 - Produces forecasts and plans supply and demand based on concluded sale and purchase agreements;
 - Keeps record of the transactions and provides data to the settlement agent;
- **The wholesale tariff customer supplier:**
 - Purchases the quantities of power, electricity, regulated services and network capacity required for the Retail Tariff Supplier and the directly connected tariff consumers
- **The Distribution service provider:**
 - Is liable for the provision of secure, safe and quality delivery across the distribution network;
 - Provides connection to the distribution grid for retail (distribution) customers;
 - Provides control, maintenance and enlargement of the distribution grid.
- **The retail tariff customers supplier:**
 - Purchases power and electricity from Wholesale Tariff Customers Supplier and from Distributed Generators, and the required transmission and distribution capacity and regulated services for the retail tariff customers connected to the distribution system;
 - Performs billing of electricity.
- **Electricity traders:**
 - Buy electricity from IPP or outside the country for resale to eligible customers, the Wholesale Tariff Supplier or for export, or act as a broker or reseller
 - Reserve transmission capacity and regulated services and provide information to the Market Operator on quantities and the diagram of loads from the sale contracts
- **Eligible Customers (currently set at 20 GWh threshold):**
 - May conclude contracts for power and electricity with generators and traders and are liable to register the contracts or submit requirements to the Market Operator
 - Eligibility status must be maintained
 - Declared market opening is currently 28%, planned for 2006 - 40%.

Market Model

Figure 5 illustrates the adopted market model.

Figure 5: Electricity market model in Republic of Macedonia.



Third Party Access

Current legislation mandates that in the course of fulfillment of public service obligations, producers, traders, suppliers and consumers must be provided access to the system according to:

- The principles of transparency, objectivity and nondiscrimination;
- The terms and conditions prescribed and determined by the license;
- Regulated prices and tariffs previously approved by the Regulator.

TPA to the system may be refused due to lack of capacity, overload, functional impediments or threats to the safety, security or quality of supply. Denial of TPA must be on the basis of a documented decision, which may be appealed with the Regulator.

IV.4.4.2. Sector Privatization and FDI

The preparation of the privatization of AD ESM (at the time, an integrated monopoly) started back in 2002. The process was guided by an advisor (Meinl Bank Consortium from Vienna). The privatization framework was set by the Law on Restructuring and privatization of AD ESM enacted in March 2004. In the meantime ESM AD was unbundled and restructured into four companies (ELEM – generation, ESM – distribution and small-scale hydropower generation, TPP Negotino as a one-plant generator, and TSO – MEPSO). According to the Law, the Transmission and System Operator MEPSO will remain in state ownership, while the rest of the companies may be privatized. The Privatization Strategy was adopted in January 2005 and amended in May 2005. According to the Strategy, in the first phase only the distribution and supply utility ESM AD would be privatized.

In October 2004, an Agreement for Conditional Deferred Sale and Purchase of Shares in the Privatization of AD ESM was signed with the EBRD, with a commitment for

providing the Bank priority rights in purchasing a minority share in the electricity generation and distribution utility.

In December 2005 was launched a tender for the sale of a 90% stake in the recently unbundled distribution company Elektrostopanstvo na Makedonija (ESM). ESM is a distribution company, supplying about 620,000 distribution customers nationwide. It also owns a total of 11 mini and small hydropower plants, with a total combined capacity of 35 MW, as distributed generation, seven of which are currently leased until 2012 to a private operator (Hydropol of the Czech Republic) on a Rehabilitate, Operate, Transfer concession basis.

Strategic investors (or a consortium of strategic investors or a consortium of strategic and financial investors) were invited to submit expressions of interest together with a pre-qualification application.

Out of seven received applications, four were selected as qualified bidders. The Tender was eventually won by the Austrian company EVN AG, which offered €225 million for 90% of the shares, plus a commitment for investing another €92 million in the core business.

Under the terms of the privatization, within the 90% stake put up for sale, the European Bank for Reconstruction and Development (EBRD) has a right to acquire up to 19.9% and the Bank will decide on the exact percentage (if any) soon after the winning bidder is selected. This anyway gives the strategic investor (EVN AG) an absolute majority of the votes.

The Government has been advised on this transaction by an international advisory consortium led by Vienna-based Meindl Bank AG and comprising the law firm Harrisons Solicitors, the Italian engineering consultants CESI and the US-based investment bank Crimson Capital Corporation. Ernst & Young was employed as a subcontractor.

ESM came into its current form of existence after two phases of restructuring. The new national grid company MEPSO was separated from the former vertically integrated ESM followed by the second phase in which the generation assets were split from ESM and incorporated into two new generation companies called ELEM and TEC Negotino, a single plant company.

The heavy oil-fired thermal power plant TEC Negotino is slated for privatization with a fuel-conversion investment commitment in view, along with a business plan for operation as an IPP and sale of the generated electricity on the international market. The TPP TEC Negotino privatization announcement was launched on April 7, 2006.

ELEM, the largest generation company will be considered for privatization after the parliamentary elections due in mid 2006.

IV.4.5. International Trade and Transit in Electricity

The focal point of Macedonia's policies in international trade and transit in electricity is its participation in the Southeast Europe Regional Energy Market (SEEREM), which is based on the Athens Process and the Energy Community Treaty. The Athens Process

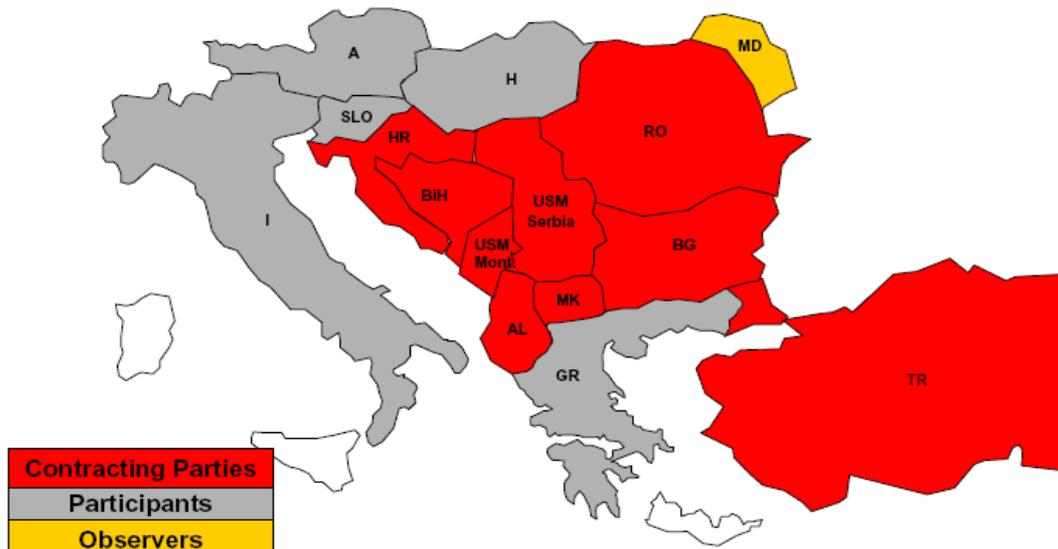
began with the Declaration of Intent for the Establishment of Competitive Electricity Market in South East Europe (Thessaloniki, September 10th,1999), developed the Memorandum of Understanding on the Regional Electricity Market in South East Europe and Integration into the European Union Internal Electricity Market (Athens, November 15th, 2002) and the Memorandum of Understanding on the Regional Energy Market in South East Europe and its Integration into the European Union Internal Energy Market (Athens, December 8th, 2003), and culminated with the Treaty establishing the Energy Community in SEE (2005).

There are four classes of parties to the Treaty:

- The European Community
- Contracting Parties:
 - Adhering Parties: Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Republic of Macedonia, Montenegro, Romania, Serbia, Turkey;
 - United Nations Interim Administration Mission in Kosovo (UNMIK)
- Participants: any Member State of the European Community
- Observers: Moldova – within six months of the entry into force of the Treaty

Figure 6 illustrates the parties to the Treaty.

Figure 6: Energy Community in SEE



Source: ERC.

The Energy Community pursues the following major goals:

- Create a stable regulatory and market framework capable of attracting investment;
- Create a single regulatory space for trade;
- Enhance the security of supply of the single regulatory space;
- Improve the environmental situation, energy efficiency, foster the use of renewable energy sources and set out conditions for energy trade;
- Develop market competition and exploit economies of scale.

The major activities of the Energy Community include the following:

- Implementation of the *acquis communautaire* for energy, environment, competition and renewables;
- Setting up of a specific regulatory framework permitting the efficient operation of Network Energy markets across the territories of the Contracting Parties and part of the territory of the European Community, and including the creation of a single mechanism for the cross-border transmission and/or transportation of Network Energy, and the supervision of unilateral safeguard measures;
- Creation of a market in Network Energy without internal frontiers, including the coordination of mutual assistance in case of serious disturbance to the energy networks or external disruptions, and which may include the achievement of a common external energy trade policy.

The Contracting parties also agreed that each party must ensure that the eligible customers are from 1st January 2008 all non-household customers, and from 1st January 2015 all customers.

In harmonization of network markets, the Energy Community may take measures concerning compatibility of market designs for the operation of Network Energy markets, mutual recognition of licenses, and measures fostering free establishment of Network Energy companies.

Regarding the operation of network energy markets, the Contracting Parties agreed that the Energy Community shall take measures establishing a single mechanism for the cross-border transmission and/or transportation of Network Energy.

The Treaty also called for the establishment of a Regional Energy Information Center, defined a Decision Making Process, ways and means to implement decisions, and a dispute resolution procedure²⁴.

IV.5. Other Types of Energy (Wind, Biomass, Solar, Geothermal)

Please refer to Section II.3.4.1.

IV.6. District Heating

There are 5 autonomous regional district heating systems in Macedonia among which the largest is Toplofikacija AD Skopje (Shareholding Co. Heat Supply Skopje), a private company based in Skopje. The district heating system of Toplofikacija AD Skopje is a hot water system with a hot water capacity of 479 MW and 26 MW of steam capacity. Annual heat produced is about 700 GWh, mainly for residential and commercial consumers²⁵. The system of Toplofikacija AD Skopje is modern, with a high degree of process automation and fully computerized monitoring of heat production.

Toplofikacija AD Skopje has 5 heating plants serving a connected load of ~ 590 MW, of which two (Istok–East and Zapad–West) have an installed capacity of 280 MW and 171 MW respectively and serve a load in excess of 500 MW. The Vodino plant (4

²⁴ Natasha Trimcheska, ERC: “Regional Energy Market in Southeast Europe”. NARUC Presentation, Vermont, 23-27 May 2005.

²⁵ Source: PWC.

MW) is in a standby mode. Annual consumption of fuel is about 70,000 tons of fuel oil (75% of input) and considerable quantity of natural gas (~ 25 % of input). The system consumes ~ 19 GWh of electricity.

The other four companies are

- City of Skopje northern part - AD “Skopje–Sever” (Shareholding Co. Skopje-North). Commissioned in 2000 with a hot water capacity of 46 MW, the facility uses natural gas as fuel.
- City of Skopje industrial zone - “Sektor za energetika – ESM” (ESM-Energy Sector) is controlled by the Republic of Macedonia’s power company. The facility serves enterprises in the industrial zone of the capital.
- Heating utility of the town of Makedonska Kamenica – “Doming”. It has hot water capacity of 12 MW.
- The residential area of the town of Bitola - “Toplifikacija-Bitola” DOO (Heat Supply Bitola Ltd.). The facility has a hot water capacity of 26 MW.

The Energy Regulatory Commission is responsible for pricing rules for heat and tracking of margins in the sector. Heat pricing is currently done according to the pricing methodology for specific energy types (“Official Journal of RM” 43/98). Based on this Methodology, “Toplifikacija” has identified several classes of heating energy consumers and the manner of service billing, including the following:

- Residential and commercial customers are billed either by a lump-sum depending on the area of the dwelling (per square meter), or based on metering. Metered billing takes into account installed capacity and actual delivered energy.
- Experimental heating areas are billed either on a lump-sum basis per square meter, or, for commercial customers, on the basis of installed capacity.

To encourage DH companies to increase efficiency, a system of incentives has been put in place. It uses the price caps/revenue caps method for price and tariff design.

IV.7. Nuclear Power

There are no nuclear power facilities in Macedonia.

Annex

Detailed Tasks of the Energy Agency

1. Preparation of medium term and long term strategies and development plans

- Development and maintenance of an energy database for RM;
- Analysis of conditions in the energy sector as well as the conditions for sustainable energy development;
- Monitoring and collection of information on the development of demand for energy and supply possibilities from domestic sources and imports;
- Involvement in the preparation of studies, development plans and strategies for the energy sector in the medium and long term;
- Ensuring the incorporation of environmental and natural protection aspects in the medium and long term strategies and development plans for the energy sector; and
- Development and organization of promotional activities.

2. Preparation of long term and short term programs

- Involvement in the preparation of the long term programs (more than ten years), which the Minister of Economy shall submit to the Government. The long term programs shall provide a general concept for energy development, energy efficiency and the application of renewable energy sources with potential long term goals and planned resources for their achievement;
- Involvement in the preparation of short term programs of one to three years, based on the long term program;
- Cooperation with the line ministry securing successful implementation of the projects and measures of the long term and short term programs, in cooperation with the local authorities, commercial entities, consumer associations and other non-profit organizations and reporting on the implementation of the programs, to the Minister of Economy.

The programs shall contain the goals, the methods of achievement, measures for energy efficiency and increased application of renewable energy sources, deadlines for realization, performance indicators as well as other necessary activities.

3. Energy efficiency (EE) and usage of the renewable energy sources (RES)

- Provide initiatives, propose and coordinate the preparation of studies and projects for EE and RES;
- Cooperate with the line ministry with respect to matters in the energy sector for implementation of the action plan for realization of the Energy Efficiency Strategy;
- Propose and be involved in the implementation of measures for reduction of the energy losses in the energy systems and increase of the exploitation efficiency;
- Encourage the usage of renewable energy sources (solar energy, wind energy, geothermal energy, biomass energy etc.);
- Issue green certificates to the producers of electric energy from RES and maintain a registry of issued certificates;
- Promote methods for energy savings by using energy efficient techniques and technologies, substitution of fuels and initiatives for raising of the awareness of

- the users for rational energy use;
 - Promote methods for efficient and economic utilization of energy and energy systems;
 - Propose and be involved in the implementation of measures for environmental and natural protection in energy projects.
- 4. Preparatory and coordinating activities for implementation of investment projects**
- Analysis of the conditions, possible solutions to specific energy sector problems and assessment of the priorities regarding investment projects;
 - Preparation and proposal of possible projects for potential investors;
 - Assessment of the projects from the point of view of economic sustainability;
 - Cooperation with the line ministry with respect to matters related to the energy sector in the preparations for realization of investment projects from technical and financial aspects; and
 - Advise potential investors on the conditions for realization of investment projects.
- 5. Regional cooperation and coordination of regional projects**
- Involvement in the regional cooperation in the field of energy;
 - Taking care of the implementation of regional projects; and
 - Participation in the process of determination of priority infrastructure structures in the region.
- 6. Preparation of laws, bylaws and technical regulations in the energy sector**
- Preparation of laws, bylaws, books, technical and other regulations, adoption of certain standards;
 - During the preparation of the acts above cooperate with relevant ministries, commercial entities, non-governmental associations and other non-profit organizations.