



**Improving the Corporate Governance Framework and Transparency in
Publicly Owned Enterprises of Kosovo
(Follow-up Report)**

This follow-up report is part of the project 'Improving the Corporate Governance Framework and Transparency in Kosova', Phase Two, supported by CIPE (Centre for International Private Enterprise), Washington D.C.

June 26, 2008

Authors

Project Team

Professor Muhamet Mustafa – Project Leader

Salvador Elmazi, MA – Project Manager

Sejdi Osmani – Consultant

Ymer Havolli, PhD – Senior Researcher

Alban Zogaj, MSc – Senior Researcher

Alban Hashani, MSc – Senior Researcher

Vjollca Jashanica, MSc – Senior Researcher

Artane Rizvanolli, MSc – Senior Researcher

Desk Research and Survey

Bardha Qirezi, MSc – Senior Researcher

Saxhide Mustafa, BSc – Researcher

Albana Gashi, BSc – Researcher

Foreign Consultant

Professor Iraj Hashi – International Consultant
(Staffordshire University, United Kingdom)

CONTENTS

1. Abbreviations	4
2. Introduction	5
3. Executive Summary and Recommendations	7
4. Progress in Corporate Governance of POEs	8
5. Financial Situation	13
6. Conclusions	14
7. References	16
8. Appendices	17

ABBREVIATIONS

CEO	Chief Executive Officer
CIPE	Centre for International Private Enterprise
DS	Distribution System
ERO	Energy Regulatory Office
GWh	Gigawatt hours
IFRS	International Financial Reporting Standards
JSC	Joint Stock Company
KEK	Electricity Corporation of Kosovo
KOSTT	Electricity Transmission, System and Market Operator of Kosovo
KTA	Kosovo Trust Agency
MEM	Ministry of Energy and Mining
MFE	Ministry of Finance and Economy
MEUR	Million Euros
MTPT	Ministry of Transport and Post-Telecommunications
OECD	Organization for Economic Cooperation and Development
PIA	Prishtina International Airport
PISG	Provisional Institutions for Self-Government
POE	Publicly Owned Enterprise
PTK	Post and Telecommunications Corporation of Kosovo
ROCE	Return on Capital Employed
ROS	Return on Sales
VAT	Value Added Tax

INTRODUCTION

In 2006, the Riinvest Institute for Development Research completed the project 'Improving the Corporate Governance Framework and Transparency in Publicly Owned Enterprises in Kosova'. This project aimed at introducing and publicizing for the first time in Kosovo modern concepts of corporate governance based on Organization for Economic Cooperation and Development (OECD) Principles, and analysing the gap that exists between these principles and the current state of corporate governance in Publicly Owned Enterprises (POEs). Through advocacy, the project intended to contribute to filling this gap. The project focused especially on the Electricity Corporation of Kosovo (KEK jsc) and Post and Telecommunications Corporation of Kosovo (PTK jsc) due to their importance in economic and social development. The final report of the project, published and widely disseminated amongst stakeholders and civil society, made a number of policy recommendations for improving the corporate governance system and transparency practices of POEs.

Following the first phase of the project, which represented the first pioneering effort on this subject in Kosovo, and the need to strengthen and consolidate project outcomes, Riinvest Institute and Centre for International Private Enterprise (CIPE) considered it necessary to undertake further activities and launch a second phase for the project. This phase consists of three modules: (a) consolidation of the outcomes of the first phase of the project and their dissemination to a broader audience, particularly the members of the new government and parliament, (b) research the corporate governance practices at financial institutions, and (c) build a critical level of capacity amongst the key stakeholders through training and awareness-raising seminars.

This project will further promote modern corporate governance principles in Kosovo's banking and insurance sectors by (i) identifying weaknesses of the corporate governance system in the financial sector, and (ii) enhancing the awareness of POEs and financial sector companies by organizing a training programme for their board members and managers.

One of the modules of the second phase is to assess the progress achieved in corporate governance of POEs since late 2006 when the first phase of the project was completed. The present, follow-up, report aims to present the recent progress and the remaining deficiencies. It contains a short executive summary, an analysis of progress made in implementing the first phase recommendations, and new recommendations that suggest future priorities. For this purpose, Riinvest researchers interviewed POE board members, economic regulators, the Kosovo Trust Agency (KTA) Board and officials at the Ministry of Energy and Mining (MEM) and Ministry of Transport and Post-Telecommunications (MTPT), as well as a *Koha Ditore* newspaper journalist. Based on this research, Riinvest has prepared this follow-up report.

While this report was in preparation, a new Law on POEs was approved by the Parliament of Kosovo and signed by the President. The report makes a number of references to this Law and undertakes a brief analysis of some of its main features.

This follow-up report will be presented at a seminar to be held in Prishtina on 1 July 2008. Following feedback from the seminar, the newly proposed policy recommendations for POEs will be complemented and improved upon.

We would like to thank CIPE for supporting this project and for their valuable contribution in promoting economic reforms and the building of a market economy in Kosovo during the past ten years.

The conclusions and recommendations within this report are the responsibility of Riinvest Institute and do not necessarily reflect positions and opinions of other parties involved in the project.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Although the KTA approved and published a *Code on Corporate Governance of POEs*, the operational policies of the Code were not fully implemented. With the exception of Prishtina Airport, none of the other POE boards monitored implementation of the Code. Thus, KTA did not succeed in realizing its objective. Hence, the task of advancing the current Code and requiring its implementation has fallen to the new government.

The Parliament and Government of Kosovo have still not established clear ownership and control rights and reporting procedures for POEs due to the ambiguities of their relations with KTA. On the one hand, government was responsible for sector policies while, on the other, it did not possess a mechanism to ensure implementation of its sectoral policy or to receive regular reports from POEs because the KTA had control over POEs. This uncertainty discouraged Kosovo institutions from engaging in sectoral restructuring. After the declaration of independence and with new constitutional arrangements in place, the KTA was dissolved. However, a newly approved Law on POEs has not resolved a variety of problems. The Law seems to be biased in favour of concentrating ownership and control rights of all central POEs with the Ministry of Finance and Economy (MFE). Given that line ministries are in charge of sectoral policies, they have more expertise and better knowledge of individual POEs, and it is only natural to expect that they should have a greater role in the oversight of POEs through control of their boards.

Based on the research findings presented here, it is clear there have been some improvements made related to the creation of a critical mass of professional board members in PTK and the Electricity Transmission, System and Market Operator of Kosovo (KOSTT jsc), but there is still room for further improvement especially in the level of competence of board members. Board composition must reflect the multi-disciplinary nature of a company, and a CEO's proposals for organization of the management structure must be respected. The KTA abolished the supervisory boards of POEs, established to act as advisory bodies to boards of directors (BoDs). POE stakeholders are inclined toward linking remuneration with management performance; however, there is no clear evidence of such practices. The existence of board committees is uneven across different POEs. The lack of necessary human resources to establish such committees is evident. Therefore BoDs must be engaged with their establishment whether on an ad hoc or permanent basis and bring in international expertise when needed.

Audited reports of POEs are not available to the public and other stakeholders in a timely fashion. An exception is at KOSTT, the only company to have audited financial reports for 2007 and which has received a positive opinion from external auditors. POEs are recommended to publish their annual reports together with complete material information, auditors' reports and comments, and any risk assessment report. The only company that has published a full annual report is PTK. None of the POEs have disclosed the remuneration of top management, something that they are recommended to do.

The new Law on POEs has some important positive features, including recognition of the importance of corporate governance and requiring adoption and implementation of a code of corporate governance. But it also has a number of shortcomings, which have to be addressed in the near future to ensure that POEs are governed effectively and in the public interest while, at the same time, steps are taken for their restructuring and privatization.

PROGRESS IN CORPORATE GOVERNANCE OF POEs

As the starting point of the second phase of the project, Riinvest Institute conducted interviews with a number of major stakeholders of POEs, including in government, parliament, regulators and POEs (a list of interviewees is presented in Appendix A) to assess the implementation of recommendations of the first phase and to analyze the progress achieved in improving the corporate governance framework and transparency of POEs since the publication and dissemination of the first report. Over the intervening period, two important milestones have taken place: the adoption of a Code of Corporate Governance by KTA and the passage of the Law on POEs.

The Code of Corporate Governance for POEs (available on the KTA's website) was adopted by KTA in September 2007 in order to help¹ improve the governance of POEs. However, due to circumstances at the time, the operational policies needed to enforce the Code were not approved. The Code addressed legal and regulatory framework issues for POEs, governing authorities of POEs, relations with stakeholders, issues related to transparency and disclosure, and the responsibilities of boards. Despite these plans, the KTA was unsuccessful in establishing a mechanism to ensure the implementation of the Code. This Code was of non-mandatory character. Hence, it remains for the new Government of Kosovo to complete the task by improving the current Code and making its implementation mandatory for all POEs.

The previous phase of the corporate governance project was the first effort to raise the awareness of all stakeholders of the necessity of improving corporate governance of POEs. Adoption of the Code was an indicator of progress in this area with regard to understanding of stakeholders of the importance of corporate governance. However, our research shows that the progress made has been rather insignificant and a lot more remains to be done.

The main results of our interviews with a range of stakeholders are summarized as follows:

1. *Absence of a clear policy on restructuring and ownership transformation of POEs.* Government² has failed to create clear policies with regard to restructuring of different sectors, such as energy, telecommunications, airport and so on, including unbundling of enterprises, potential full or partial privatization, concessions or the creation of public-private partnerships, or both. This task has now fallen on the new government, even though the new Law on POEs promised clarification of the ownership policy within 90 days.

The officials interviewed had different opinions on the ownership and control of POEs. Some maintained that POEs must function under government control, while others thought that POEs must report directly to parliament. This makes the issue of future ownership and control very urgent.

2. *Political influence on boards.* One of the essential features of good corporate governance of POEs, absence of political influence on boards, seems not to have been

¹ According to Mr Ilir Salihu, the KTA Deputy Director for POEs

² According to Ms Myzejene Selmani (Head of Parliamentary Commission for Economy, Trade, Energy, Telecommunications) and many other interviewees

grasped in Kosovo. According to the KTA interviewee³, direct political interference in the operation of the boards, at odds with the interests of the POEs, has continued due to a lack of understanding of the role of board members. Nevertheless, despite this practice there was a general consensus among stakeholders that POEs should act freely of political influence and that management should be allowed operational autonomy⁴.

3. *Availability of financial reports.* There have been delays in conducting external auditing of financial reports and the publishing of annual reports. As discussed in Appendix D, audited accounts of the main POEs for years after 2006 are still not available. Of all POEs, only KOSTT has published audited financial statements for the year ending 31 December 2007.

4. *Appointment of boards and qualification of board members.* With the exception of KEK, new BoDs have still not been appointed; hence many POEs are led by acting managing directors, something that weakens the governance system and the authority of the management. Companies not led by appointed managing directors include KEK, PTK and Prishtina International Airport (PIA jsc).

The problem of qualification of board members has not been fully resolved though the new Law indicates some move in a positive direction. Although the by-laws of POEs lay down professional criteria for board nominations, according to the Chairman of the Energy Regulatory Office (ERO)⁵, there are fears that the board system in Kosovo's POEs would not provide for their professional composition and that these boards are not sufficiently free from political influence.

5. *Boards of directors and management.* In all POEs, BoDs have hired the management. However, it was difficult to find evidence where boards have set targets and that respective management teams have been asked to achieve those targets. Furthermore, it was even harder to find any evidence that boards have linked management remuneration with business performance of the firm.

Soon after the report of the first phase of the present project, the KTA board abolished all Supervisory Boards⁶ of POEs. Based on our research, there is now a clear division between the functions of management and those of a BoD. One exception, where the non-executive part of a board⁷ was more engaged in day-to-day activities of the company, was in KEK, probably due to the critical situation with power supply and the need to give more political support to management. In all companies analyzed, the managing director was a full board member with voting rights.

³ Mr Kevin McCann, on his position

⁴ Mr Dino Asanaj, KTA Board Vice Chairman stressed the fact that the system of accountability in POEs should be improved so that there is proper communication and feedback between management and company boards.

⁵ Mr Ali Hamiti

⁶ These were bodies additional to the BoD established to inform government of the development of POEs (see Riinvest 2006 for details).

⁷ We are referring to the previous board composition of KEK, when the board Chairman was the former Minister of Energy.

6. *Employee representation on boards.* None of the POEs have employee representatives on the board. Although this is recommended as good practice, almost all POEs stakeholders that we contacted and interviewed argued that employees may misuse their vote while sitting on the board. They added that existing trade unions are not real representatives of employees in that they are more politically motivated and are not seriously engaged in protecting real workers rights.
7. *Board committees.* Although PTK and PIA have established most board committees that are required, they need more expertise on these committees. Meanwhile, the domestic market is very limited as a source of appropriately qualified human resources⁸, which is why interviewees from KOSTT proposed engaging various institutes on an ad hoc basis instead of forming regular committees.
8. *Transparency.* With regard to transparency issues it is important to stress the fact that we were able to find on the KTA website the audit reports of only some companies and only up to 2006. For example, the KEK audit report for 2006 has not yet even been conducted. During our research, we found no evidence of the establishment of a clear policy on the disclosure of related party transactions and conflicts of interest. POEs still do not disclose the remuneration and benefits of their board members and top management.

Almost all POEs consider that the procurement law is not business-oriented. However, there have been some steps taken to improve transparency practices in the procurement processes. One of the key problems in implementing the current procurement law is that the regulator's decision is final and complainants have no effective means to protect their business interests against mistakes by the regulator. It is possible to make a claim at the Supreme Court, but that does not stop the contracting process and the situation may be worsened. The Law does not have the provision for compensating a claimant that has suffered losses. All this contributes to chaotic conditions for the public procurement process.

9. *Customer satisfaction.* While efforts have been made to improve the present poor image of POEs among the citizens, a lot more needs to be done in order to establish good and honest communication practices with customers. We found no evidence that POEs had been engaged in conducting customer surveys.

The second important related event was the passage of a new law⁹ on POEs, in June 2008. The previous Corporate Governance Report (Rinvest, 2006) highlighted the dilemma facing government: whether POEs should be placed in the custody of a central agency or ministry, or transferred to line ministries, e.g., KEK to MEM, PTK and PIA to MTPT, etc. Different models for the exercising of ownership rights and control rights of POEs are attached in Appendix C. The new law is an attempt to respond to this dilemma by adopting a relatively centralized approach. According to this Law, the Government of

⁸ In our discussions with MTPT a lack of sufficient human resources capacities was stressed. A good example of dealing with this problem is the initiative launched at MTPT to create a database of all Kosovar experts in telecommunications, transport and other sectors, whether living abroad or resident in Kosovo. According to the Deputy Minister of MTPT, Mr Adem Grabovci, this is being done in order to better manage the sectors that have in their hand. The same point was made by KOSTT.

⁹ See www.gazetazyrtare.com

the Republic of Kosovo, through the Minister of Finance, shall have exclusive competence in the exercising of shareholder rights in central POEs¹⁰. Government shall be accountable to the Assembly and shall report on the performance of POEs to the Assembly annually. A ‘POE Policy and Monitoring Unit’, to be established within the structure of the MFE, will be the custodian of all physical certificates representing shares in POEs owned by the Republic of Kosovo or any public authority. Boards of Directors of POEs will be appointed by government, based on the recommendations given by a Recommendations Committee, to be established by the Permanent Secretary of the Prime Minister’s Office.

Given that the importance of the privatization of POEs in the near future (subject to proper regulatory supervision¹¹) and the fact that government has hinted¹² at its intention to complete the privatization process (the law promised that government will develop an ownership policy for POEs within three months; it also specifies that government can decide to authorize a Privatization Committee to sell the shares of any POE), there are advantages in keeping POEs under a unitary organization (whether it be an agency or a ministry), which can take charge of preparing and implementing an integrated privatization programme for all POEs. Such a centralised approach will enable the agency or ministry to gain experience in due course and will prevent the fragmentation of privatisation expertise in different ministries. The agency will benefit from the externalities associated with economies of scale and the learning effects.

There are of course dangers inherent in any centralised approach. Such an approach would effectively replace the KTA with another powerful institution subject to political influence and control. A new centralised institution will, just as did its predecessor, be inherently inefficient; it would also be the subject of rent seeking and political favouritism.

A decentralised approach would avoid these problems. It would put each POE under the control of a line ministry with relevant expertise and technical knowledge of its activities and also responsible for the design and implementation of government policies in that sector. The line ministries will be able to take a holistic approach to the sectoral policy. For example, the operations of a company such as KEK could be monitored and supervised better by the MEM than by a central agency because the ministry has the competence and expertise of the energy sector and is in a position to integrate the company into the broader energy policy of government. It will also have the relevant expertise and competence to exercise effective oversight on KEK.

The stakeholders interviewed by the research team were mainly in favour of a decentralised approach. For example, the Deputy Minister of MTPT¹³ stressed the necessity for line ministries to have oversight of the respective POEs. In his opinion, line ministries should be able to exercise this oversight in order to increase their accountability and ensure implementation of sectoral policies.

In many countries (especially transition countries) a third approach—a combination of the first two approaches—has been utilised. In this model, ownership of POEs’ shares

¹⁰ Central POEs are those enterprises that perform activities in the whole territory of Kosovo. Municipalities will be the organ responsible for the ownership and control of shares of regional POEs (such as Water and Sewerage companies).

¹¹ The Regulatory Offices for the energy and telecommunication sectors are already established and are in operation.

¹² Clearly government has not made up its mind fully about the privatisation of POEs, a reflection of different approaches taken in government to economic policy.

¹³ Mr Adem Grabovci

(once transformed into joint stock companies) will be vested in one of the government ministers, usually the Minister of Finance or Minister of Privatisation, while the operation of POEs will become the responsibility of line ministries. The BoDs will be appointed by the line ministry and will be responsible to the line ministry, which is in charge of formulating and implementing the government's sectoral strategy. Once the decision on the method of privatisation is taken, the minister holding the company's shares will embark on selling these shares. When the majority of shares are transferred to the private sector, the private owners will become responsible for the management of these companies. The main characteristics of such a hybrid system are reported in Appendix C.

Despite the problem with centralised organisation of POEs, the new law has a number of important positive aspects that need to be highlighted:

1. *Explicit recognition of the importance of corporate governance of POEs.* The Law even requires regular corporate governance training for board members. It also requires each POE to adopt a code of ethics and corporate governance and the MFE to develop a model code.
2. *A competitive and transparent process for the appointment of board members.* New members should be chosen from an openly and transparently competitive procedure.
3. *Financial reporting.* Boards will submit quarterly reports to the minister and government for review.
4. *Consumer satisfaction.* CEOs will be obliged to assess regularly the satisfaction of customers with the services of their companies, annually adopting adequate procedures and publishing the results.

Irrespective of the approach chosen, POEs have to operate on a commercial basis, as entities independent of government, and must be subject to the OECD Guidelines for Corporate Governance of POEs. They must have competent board members appointed on the basis of their qualifications and experience. A requirement of the new law is the formation of an audit committee in each POE. However, the law does not prohibit formation of other committees that might be needed, such as remuneration and appointment committees, a financial affairs committee and others.

FINANCIAL SITUATION

We have analyzed in this report the reports of external auditors on POEs publicly available on the KTA website or on the companies' websites. While the first report on corporate governance of POEs took into consideration the last available audited reports (for the period 2002–2004), this follow-up report extends the analysis into the period for 2005 and 2006. The full financial analysis is reported in Appendix D.

The main shortcoming of the whole financial system of POEs is long delays in publishing the audited accounts of these companies. With one exception, none of the companies have yet published their 2007 accounts. As in previous years, KEK continued to operate with a loss. Accumulating losses in 2005 were to the amount of €482,392,000. In 2005 and 2006, the company billed only around 52 per cent of delivered electricity and collected only around two thirds of that billed. Thus, in 2005 and 2006, KEK only collected payments for about 35 per cent of electricity delivered through the distribution system. Unlike KEK, KOSTT, a relatively new company established in the process of unbundling KEK, obtained a positive financial performance both in 2006 and 2007. This is the only company among those studied in this follow-up report for which the auditors expressed the opinion that the financial statements of the company represented the financial position as of 31 December 2007, its financial performance, changes in equity and its cash flows fairly in all material respects and in accordance with International Financial Reporting Standards (IFRS).

With regard to performance of PTK jsc, a stable and progressing company is clear. In 2006, as in 2005, the auditing company of PTK did not express an opinion on financial statements, because they were unable to obtain sufficient appropriate audit evidence on various issues. This is a serious matter, which should have drawn the attention of the PTK board in 2005, but clearly the existing procedures are inadequate for resolving the problem: thus its reoccurrence in 2006. Revenues of PTK increased more than 46.6 per cent during the period 2002–2006, while its profit margin increased to 45 per cent in 2006. Most of this increase (81%) is attributed to mobile phone revenues. Contrary to this situation, KEK faced a decrease in revenue between 2002 and 2005 of 12.6 per cent. The operating profit of PTK increased from €3,884,000 in 2002 to €6,304,000 in 2006, an increase of 148 per cent. PIA also increased its level of profit, from less than €1.3 million in 2005 to €1.7 million in 2006.

With regard to assets value, we can note that PTK experienced an increase in value of total assets of 116 per cent from 2002 to 2006, in contrast to KEK, which saw a fall in value of total assets from 2002 to 2005 of 2.2 per cent and 9.9 per cent for fixed assets. Prishtina International Airport experienced a 44.6 per cent increase in assets from 2002 to 2006.

CONCLUSIONS

Since the publication of the report of the first phase of this project, there has been some progress made in the adoption of a corporate governance framework in Kosovo's Public Owned Enterprises but the progress has been slow and insufficient. Clarification of their future restructuring, ownership and control is currently the most important outstanding difficulty facing POEs and their governance, requiring an urgent government decision. The officials interviewed in the present survey had mixed opinions on ownership and control of POEs, with some believing that the enterprises must function under government control and others that they must report directly to parliament. It is clear that reform and restructuring (including unbundling) of POEs, and their full or partial privatisation must be resolved and explained to the public, as well as to all stakeholders. The new law did not resolve this matter and government has only hinted at an early resolution of the issue¹⁴.

Another major problem has been the understanding and perception of key stakeholders about the relevance of good corporate governance and the responsibilities of those involved in the process. Change of government since publication of the first report has meant that many new people have been appointed at various levels of government with little knowledge of corporate governance principles. While a majority of interviewees considered that the implementation of the Code of Corporate Governance (adopted by KTA) had served the best interest of companies, a number of interviewees were not even aware of the existence of this Code.

With regard to the role of the board, many interviewees regarded monitoring as its main role, while others regarded BoDs as having a broader function, responsible for the implementation of the Code of Corporate Governance, receiving reports of various committees, approving the financial statement of the companies and demanding action from managers when there are problems. There still exists among many interviewees no clear conception of the duty of care of BoD members and the board as a whole. Such a situation raises two important points:

- (i) *Important role of board with respect to company performance.* Board members understand their role more as overseeing the company's management rather than being responsible for its financial and market performance. This is a critical issue for the quality of governance of POEs. In this regard it is necessary to develop some form of performance measurement for board members, justified particularly as board membership is not voluntary: members receive a monthly salary that is, sometimes, five times the average salary of Kosovo's public sector.
- (ii) *Transparency and disclosure.* This is essential with regard to implementation of the OECD Principles on transparency and accountability. Weaknesses are characterized by delays in making public the financial statements of companies.

The procedures for the appointment, as well as competence, of board members and management are still unclear, though it is hoped that the new Law on POEs will improve understanding of this process. The interviewees, of course, believe that board members must be professional people, competent for the position they hold, and that they must be business oriented and free from political influence. Many of them, however, expressed

¹⁴ It seems that the procedure for drafting a new law on POEs has been very unclear: none of the POEs were officially involved or had any information about the drafting process.

their doubts about whether board members can be free of political interference, because they have been appointed by their political connections.

There has been no agreement reached about representation of employees on boards and the new Law has made no provisions for such representation. There is some confusion about the role of employee representatives and also that of trade unions on boards. It is necessary to debate this issue more and, furthermore, raise the awareness among stakeholders of the relevance of employee representation on boards.

While a number of board committees have been established in some POEs, they do not function properly and their contribution is not valued highly.

There was a general consensus among interviewees that management remuneration should be linked to business performance, but there is no clear evidence that this is currently the case with Kosovo's POEs. Most interviewees consider that the compensation of management must be made public. However, there are concerns that this will create dissatisfaction among poor people and civil servants.

All the interviewees believe that the current law on public procurement has many shortcomings, which need to be corrected through adoption of appropriate operational mechanisms and implementation of the forthcoming Code. Most importantly, there must be a mechanism to ensure that the provisions of the Law are enforced and that POEs will observe international standards and norms, e.g., timely publication of their annual audited financial reports together with annual reports.

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APPENDICES

A. LIST OF OFFICIALS INTERVIEWED

Ms Myzejene Selmani, Head of Parliamentary Commission for Economy, Trade, Energy,
Telecommunications
Mr Blerim Rexha, Deputy Minister, MEM
Mr Adem Grabovci, Deputy Minister, MTPT
Mr Elhami Gashi, Advisor to Minister, MTPT
Mr Blerim Stavileci, Adviser to Minister, MTPT
Mr Dino Asanaj, Vice Chairman, KTA
Mr Fadil Ismajli, Managing Director, KOSTT
Mr Naim Bejtullahu, Deputy Managing Director, KOSTT
Mr Agron Mustafa, Acting Managing Director, PIA
Mr Sebahudin Ramaxhiku, Acting Managing Director, PIA
Mr Ali Hamiti, Chairman, ERO Board
Mr Chabeenan Ramphul, Head, Civil Aviation Regulatory Office
Mr Ilir Salihu, Deputy Managing Director for POEs, KTA
Mr Kevin McCann, Member of Board, KEK, Termokos, KTA
Ms Syzana Bytyqi, Journalist, Koha Ditore daily newspaper

B. POLICY RECOMMENDATIONS FROM THE FIRST PHASE

1. *Code of Practice on Corporate Governance.* The governmental institutions should develop a Code of Practice on Corporate Governance for POEs, based on the OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005) and require POEs to report on their compliance with this Code in their annual reports and explain any reasons for non-compliance.

2. *Raising awareness of corporate governance amongst stakeholders.* It is necessary to improve and enhance the awareness of Provisional Institutions for Self-Government (PISG), POEs, the citizens and the media of the importance of modern corporate governance, not only for improving the performance of companies, but also for increasing the attractiveness of POEs to investors and reducing further budget subsidies.

3. *State as an effective and informed owner.* Government, in consultation with parliament, should develop a clear ownership policy towards POEs for the medium term that emphasizes the urgency of the restructuring of POEs and clarifies its intentions regarding the eventual evolution of their ownership. The state should commit itself to the eventual privatization, or partial privatization, of most parts of the restructured POEs. At the same time, the state should also develop a medium-term strategy for each POE and require the boards of POEs to work towards the realization of this strategy.

Government should also decide on whether it should concentrate the ownership and management of all POEs in one institution or decentralize them to relevant ministries. Although on the basis of the experience of other transition economies it seems preferable to keep POEs within the ministries, the advantages and disadvantages of these alternatives should be explored further before a final decision is made.

4. *Responsibility for POEs.* With the gradual transfer of government competencies to PISG and the developing status negotiations, it is recommended that the responsibility for POEs be transferred to PISG in order for these companies to be managed with one voice and on the basis of one coherent and consistent strategy. In the meantime, before such transfer, PISG should engage in the operations of POEs more actively. POEs should keep government and related governmental institutions informed of their financial and technical operations by providing them with detailed annual reports.

5. *Management structure of POEs.* It is essential to establish a management structure in POEs which is unambiguous and clear to all stakeholders. Although the law lays down a unitary board structure for POEs, with a BoD as the main decision-making body of the company (after the assembly of shareholders), the by-laws of POEs provide for a so-called 'supervisory board' as a body without any decision-making power which advises the 'government' on issues related to each POE. This is an unsatisfactory structure and the cause of much confusion, particularly because the term 'supervisory board' is a well-established title for the main decision making body of the two-tier board system. It is therefore recommended that the so-called 'supervisory boards' should be abolished. The government should be able to obtain information on the operation of POEs through its representatives on the BoD.

Furthermore, in addition to the BoD and ‘supervisory board’, some POEs have also established a ‘management board’ or ‘executive board’ consisting of the top management personnel of the company. This is also a source of confusion and should be avoided.

There is a general feeling amongst the project experts that the two-tier board system, with a supervisory board and a management board, may be a structure more suitable to POEs in Kosovo. It is therefore recommended that PISG and UNMIK investigate the possibility of amending the Regulation on POEs after consultation with stakeholders.

6. *Board System.* In addition to the above, the roles and responsibilities of the present BoDs should be clarified to ensure that:

- a) there are clear relations and division of functions between the BoD and the management personnel (whether organized in a board or not) in a consistent manner, especially full membership of the CEO to the board
- b) there are clear criteria (in terms of experience and qualifications) for the appointment of members of the board, with at least one half of board members to be elected or appointed as independent experts free from political influence
- c) the BoD of POEs should be responsible for selecting the top management, evaluating their performance annually, and linking their remuneration to targets based on business performance
- d) in line with the OECD Guidelines, employees should have one representative on the BoD of POEs
- e) the boards should have committees such as internal audit, nominations and remuneration, and procurement committees reporting to it directly, while the authority of the internal audit committee should be strengthened
- f) the activity of the boards must reflect customers’ interests.

7. *Transparency and disclosure.* POEs should observe a strict policy on transparency and disclosure on the basis of the OECD Guidelines (2005) and the European Commission’s Transparency Directive (2004). In particular, they should:

- a) make their annual financial and other company reports publicly available (based on International Accounting Standards), with free access for all interested parties, on a timely basis, together with all material information, the auditor’s reports and comments, any risk assessment report, etc.; the minimum content of the financial report should be in accordance with the Transparency Directive
- b) establish a clear policy on the disclosure of related party transactions and conflicts of interest
- c) disclose the remuneration and benefits (i.e. the total cost to the company) of board members and the top few managers (members of the management or executive board)
- d) advance transparency practices in the procurement process
- e) establish good and honest communication practices with customers, citizens and the media, undertake customer satisfaction surveys and endeavour to improve the present poor image amongst the citizens.

8. *Regulation of businesses.* There is a general need for a company law to regulate the operation of different types of companies in Kosovo as the UNMIK Regulation on Business Organizations is no longer suitable for the present stage of development of Kosovo's economy. A new company law should allocate a special chapter to the operation and governance of POEs.

C. OPTIONS TO ADMINISTER POEs

Option 1: Decentralized approach within government structures

Sector	Ownership rights	Control rights (appointment of boards)	Policy making	CEO	Other
Energy POEs	MEM	MEM	MEM	BoD	Sector policy approved by government and parliament
Transport and telecommunication POEs	MTPT	MTPT	MTPT	BoD	Sector policy approved by government and parliament

Option 2: Centralized approach within government structures

Sector	Ownership rights	Control rights (appointment of boards)	Policy making	CEO	Other
Energy POEs	MEF	MEF	MEM	BoD	Sector policy approved by government and parliament
Transport and telecommunication POEs	MEF	MEF	MTPT	BoD	Sector policy approved by government and parliament

Option 3: Centralized approach outside of government structures

Sector	Ownership rights	Policy making	POE Board of Directors	CEO	Other
Energy POEs	Independent agency	MEM	Independent agency	BoD	Agency reports to parliament
Transport and telecommunication POEs	Independent agency	MTPT	Independent agency	BoD	Agency reports to parliament

D. FINANCIAL PERFORMANCE OF POEs

This section, on financial performance, takes into consideration the external auditors' reports and financial reports for 2005 and 2006. For 2007, only KOSTT has conducted an independent auditor's report. While the first phase of the project dealt with audited reports for the period 2002–2004, this follow-up report extends the analysis across the period 2005 and 2006. This follow-up report has dealt only with those financial statements that are available on the KTA website or on the websites of the companies themselves.

The auditing company Grant Thornton concluded that they did not have a position, and did not express an opinion, on the KEK financial statements as of and for the year ended 31 December 2005. The reasons for this situation were that they were not able to obtain reasonable assurances and satisfy themselves with regard to inventory quantities, provision for slow-moving and obsolete stock, the carrying amount of the Company's property, plant and equipment, pension fund liabilities and VAT payables at 31 December 2005. The 2005 report is the last report conducted by KEK. There are concerns among energy sector stakeholders that, despite two independent appraisals of its property, plant and equipment by international values, the true value of KEK's property, plant and equipment are not reflected. Subsequent to initial revaluation effective 31 December 2002 and included in the Company's books, as of 1 January 2005, KEK has undertaken another independent appraisal of its property, plant and equipment. The results of this valuation showed that the carrying value of the property, plant and equipment, at the date of valuation, exceeds their fair market value. Therefore, the Company did not recognize any provision for impairment of its property, plant and equipment based upon the results of the independent valuation, both as of 1 January 2005 and 31 December 2005.

The main source of income for KEK is the sale of electricity. Table D1 reports the amount of electricity delivered to the Distribution System (DS), the amount billed and the amounts lost in the system. In 2006, the amount delivered was 3,896 GWh, compared to 3,883 GWh in 2005. Of this amount, only about 52 per cent is billed. Thus, around 48 per cent of electricity delivered is lost, of which 68.5 per cent is due to illegal consumption and the remainder (31.5%) is a technical loss.

Table D1. Electricity delivered, billed and lost in Publicly Owned Enterprise (joint stock company) KEK's distribution system

Indicator	2004		2005		2006	
	GWh	%	GWh	%	GWh	%
Electricity delivered into distribution network	3,666	100.0	3,883	100.0	3,896	100.0
Billed amount of electricity delivered	1,956	53.4	2,010	51.8	2,046	52.5
Electricity loss	1,709	46.0	1,873	48.2	1,850	47.5
technical loss	451	26.4	582	31.0	584	32.0
non-technical loss	1,258	73.6	1,291	69.0	1,266	68.0

Source: ERO Annual Reports 2004, 2005, 2006

Comparison between the amount of electricity bills collected from the billed amount shows that only around two thirds is collected, leading to a net loss of 65 per cent of electricity that has entered the network; KEK only collects around 35% of electricity delivered to the distribution network. From the energy billed in 2006, KEK lost or could not collect around 65 MEUR expected income. Similar losses occurred in previous years (2005 and 2004).

With regard to PTK's performance, a more stable and progressing company is observed. Revenues from mobile and fixed line phone services revenues are this company's main source of income. KPMG, which conducted the auditing of PTK in 2006 and 2005, did not provide an audit opinion¹⁵ on the financial statements as of and ending 31 December 2006, as they were not able to obtain sufficient appropriate audit evidence on the issues of fixed line revenues and trade receivables, pension obligations, and some other issues. Table D2 shows that revenues of PTK steadily increased between 2002 and 2006 resulting in an increase of 46.6 per cent over that period. Most of this increase (81%) is attributed to mobile phone revenues. In contrast to this company, KEK faced a fall in revenues, of 12.6 per cent between 2002 and 2005.

Table D2. Publicly Owned Enterprises (jsc) PTK and KEK revenues 2002–2006 (€000)

Company revenues	2002	2003	2004	2005	2006
PTK					
revenues	111,991	118,802	132,945 ¹⁶	134,600	164,152
mobile phone revenues	69,648	75,013	91,274 ¹⁷	95,101	126,525
KEK					
revenues	130,189	108,939	108,224	113,736	Unavailable ¹⁸

Source: KTA website, Independent Auditors' Reports 2002–2006, PTK and KEK

Table D3 reports the operating profit and losses of PTK and KEK. Profits for PTK increased from €38,884,000 in 2002 to €96,304,000 in 2006, an increase of 148 per cent, though there was a slight fall in profits between 2004 and 2005. In general, however, there was a steadily increasing trend over the period 2002–2006.

Table D3. Publicly Owned Enterprises (jsc) PTK and KEK profit/loss 2002–2006 (€000)

Company profit, loss	2002	2003	2004	2005	2006
PTK					
operating profit	38,844	50,747	59,036	55,115	96,304
net profit for the year	30,739	39,287	47,778	5,480	32,375
KEK					
operating loss		(93,092)	(118,735)	(85,879)	Unavailable
loss for the year	(27,616)	(39,776)	(39,990)	(38,937)	Unavailable

Source: KTA website, Independent Auditors' Reports 2002–2006, PTK and KEK

¹⁵ The same conclusion was reached also with regard to financial statements as of and ending 31 December 2005.

¹⁶ This amount was restated from 128,483 thousand EUR in the financial statements ending and as of 31 December 2004 to 132,945 thousand EUR in the financial statements ending and as of 31 December 2005.

¹⁷ This amount was restated from 86,812 thousand EUR in the financial statements ending and as of 31 December 2004 to 91,274 thousand EUR in the financial statements ending and as of 31 December 2005.

¹⁸ The 2006 external auditors' report for KEK is not available.

While we report here the profitability of PTK and this company's contribution to the Kosovo state budget and the overall functioning of its economic and social system, the situation contrasts markedly with the performance of KEK. Table D3 reports there are regular annual losses for this company. In fact, KEK lost at least €9 million each year between 2003 and 2005, with its accumulated losses reaching €482,392,000 by the end of that period (see ERO Annual Reports 2005). Despite a huge contribution from donors and the state budget, KEK has obviously been unable to stabilize its activities. The amount of annual non-technical losses reached a level of approximately 1,300 GWh in 2005, a huge total for a system with total annual demand of around four TWh. According to ERO, this presents the main obstacle for transformation of KEK into a self-sustainable and financially viable enterprise.

Although a relatively new organization, KOSTT jsc, another energy enterprise, has shown a positive performance for 2006 and 2007. This company was once part of KEK, but was unbundled and legally nominated by the Government of Kosovo on 1 July 2006 as the electricity transmission system and market operator of Kosovo. KOSTT's net profit for the year 2007 was €10,000. The largest part of its revenues comes from fees for electricity transmission and system maintenance. KOSTT is the only POE to have conducted an external audit report for 2007 and the only one for which Grant Thornton, the firm that did its external auditing for that year, expressed their opinion that the financial statements of the company present fairly, in all material respects, the financial position as of 31 December 2007, and its financial performance, changes in equity and its cash flows for that year ended in accordance with IFRS.

Another successful POE is the airport operator. PIA's level of profits increased from less than 1.3 MEUR in 2005 to 1.7 MEUR in 2006 (see PIA auditors' reports on the KTA website). The major incomes for this company derive from passenger, handling and landing fees.

Table D4. Value of assets of POEs (jsc) PTK, KEK and PIA (000€)

	2002	2003	2004	2005	2006
PTK					
total assets	175,510	207,779	257,515	331,605	379,868
fixed	75,445	74,337	72,628	153,780	144,347
current	100,065	133,442	184,887	177,825	235,521
KEK					
total assets	427,071	421,673	402,341	417,758	Unavailable
fixed	374,479	363,721	351,737	337,413	Unavailable
current		57,952	50,604	80,345	Unavailable
PIA					
total assets	32,499	38,776	49,449	45,594	46,986
fixed	14,422	25,147	34,807	22,845	28,291
current	18,077	13,629	14,642	22,749	18,695

Source: Independent auditors' report 2002–2006, KTA website

Table D4 reports the assets of PTK, KEK and PIA. On the one hand those of PTK have steadily increased, from €175,510,000 in 2002 to €379,868,000 in 2006, an increase

of 116 per cent. The increase comes from a 91 increase in fixed assets and 135 per cent in current assets (from an increase in cash and cash equivalents). Likewise, the assets of PIA have steadily risen. Its total assets increased by 44.6 per cent between 2002 and 2006, with its fixed assets almost doubling.

In contrast, the situation with KEK has worsened. From 2002 to 2005, this company faced a fall in the value of its total assets of 2.2 per cent, including 9.9 per cent for fixed assets partly offset by an increase in current assets (cash and cash equivalents).

Table D5 reports two profitability ratios calculated for the companies PTK and PIA: Return on Capital Employed (ROCE)¹⁹ and Return on Sales (ROS)²⁰. Because KEK has constantly operated at a loss, and as KOSTT is relatively new company established only recently, they were not included in this table.

Table D5. Profitability ratios (%) of PTK and PIA

Company / ratio	2002	2003	2004	2005	2006
PTK					
ROS	34.9	43.8	49.1	18.0	45.0
ROCE	22.3	25.0	24.5	8.1	22.7
PIA					
ROS	43.3	60.3	21.3	Operated with loss	11.2
ROCE	22.7	26.1	7.6	Operated with loss	6.5

Source: Independent auditors' report 2002–2006, KTA website

The profit margin, as represented by ROS, of PTK increased from 34.9 per cent in 2002 to 45 per cent in 2006, an increase of 28.9 per cent. (A 45% profit margin means that this company yielded 45 cents profit on each euro sold.) In contrast, PIA has experienced a 74 per cent decrease over this time.

Data used to calculate the efficiency of utilization of capital employed show that PTK utilized its total assets in a stable manner during the reporting period (2002 to 2006). PTK's percentage return on each euro of long term total assets utilized was 22.7 per cent in 2006, and in doing so utilized its long-term employed capital 3.5 times better than did PIA.

¹⁹ ROCE was calculated as a relationship between profit before tax and interest on the one hand, and capital employed on the other.

²⁰ ROS was calculated as a relationship profit before tax and interest on the one hand and total sales on the other.

E. QUESTIONNAIRE

Kosovo Trust Agency

KTA Code of Corporate Governance of POEs

- Are you familiar with the state of corporate governance in POEs? Have you seen the report published by Riinvest Institute last year?
- What has happened to the issue of CG since last year?
- What can you tell me about KTA's monitoring of the implementation of the Code on Corporate Governance for POEs?
- Do you think there is a need for establishing a mechanism for monitoring the implementation of the KTA Code on CG? If so, what mechanisms do you suggest?
- How could we approach the issue of POEs' reporting on compliance with the Code?

Composition of boards of POEs

- What do you think about proposed and/or approved composition of boards with regard to qualifications of board members?
- Do you think board members are able to exercise independent judgment?
- What is your opinion on the lack of employee representation on the boards of POEs?

Government of Kosovo (line ministries)

- Are you familiar with the state of corporate governance in POEs? Have you seen the report published by Riinvest Institute last year?

Sector-specific government policies

- Do you think there is a clear government policy on the POEs such as potential privatization, restructuring and/or unbundling?
- What do you think about concentrating ownership and management of all POEs in one institution or decentralizing them to relevant ministries?

Board members of POEs

- Are you familiar with the state of corporate governance in POEs? Have you seen the report published by Riinvest Institute last year?

Performance and remuneration

- What are the procedures for the evaluation of management performance by the BoD?
- What is your opinion on linking management remuneration with business performance?
- What is your opinion on disclosure of management remuneration packages? Reasons?

Supervision of management by boards

- How does the board exercise oversight on management?
- What do you think about existence of a formal executive board within POEs (i.e. a two-tier system)?

- With regard to efficient supervision of management by the board, has your company established committees, such as internal audit, nominations, remunerations, procurement committees, etc.? Do you think they are necessary?
- How can the authority of an internal audit committee, if it exists, be improved?

Transparency and disclosure

- What is your opinion on POEs' transparency and disclosure of information such as publishing detailed annual reports including their accounts and the auditor's report, relations with stakeholders, and so on?
- How can we improve disclosure policy and rules?
- Are there any benefits from conducting customer satisfaction surveys?

Parliamentary Commission

Legislation

- Are you familiar with the state of corporate governance in POEs? Have you seen the report published by Riinvest Institute last year?
- What is the current status of the new law on business organizations?
- What is the current status of the law on Publicly Owned Enterprises?
- How do you see the role of government in administration of POEs?
- In your opinion, how do economic regulators in Kosovo accomplish their duties?
- How do you see their role?