



Republic of Serbia
FISCAL COUNCIL

**ASSESSMENT OF STATE-OWNED ENTERPRISES IN SERBIA:
FISCAL ASPECTS**

Belgrade, July 31, 2014

Contents

I.	State-Owned Enterprises: Summary and Tabular Overview of Findings	3
	1.1. Summary	3
II.	State-Owned Enterprises: Group Analysis.....	7
	2.1. Basic Data and Fiscal Costs	7
	2.2. Main Problems in the Performance of State Enterprises.....	9
	2.3. Guidelines for Solving the Problems	15
III.	Analysis of Major Enterprises.....	19
	3.1. <u>Elektroprivreda Srbije (EPS, Electric company)</u>	19
	3.1.1. Basic Assessments.....	19
	3.1.2. Detailed Analysis	22
	3.1.3. Box: Impact of the May floods on the operation and energy stability of EPS	33
	3.2. <u>Srbijagas (Gas Company)</u>	35
	3.3. <u>Železnice Srbije (Railways)</u>	42
	3.4. <u>Železara Smederevo (Steelworks)</u>	44
	3.5. <u>Galenika (Pharmaceuticals)</u>	45
	3.6. <u>Resavica (Coal Mines)</u>	46
	3.7. <u>Telekom Srbija (Telecommunications)</u>	47
	3.8. <u>Dunav osiguranje (Insurance)</u>	49
	3.9. <u>GSP (Belgrade public transport) and Other Public Utilities</u>	50
IV.	Enterprises in Restructuring.....	52

I. State-Owned Enterprises: Summary and Tabular Overview of Findings

1.1. Summary

State-owned and public enterprises threaten to sink the public finances of Serbia. Their overall adverse effect on public finances has been growing over the past five years and in 2014 costs have reached 3 percent of GDP. This includes subsidies, guarantees and unpaid taxes and contributions - all of which burdens the state budget. 3 percent of GDP equals to about 115 billion dinars (EUR 1 billion) and it is the cost that government bears each year due to the unsuccessful performance of state-owned enterprises. In some cases these costs cannot be completely avoided (as is the case with subsidies to Železnice Srbije/Serbian Railways), but they can definitely be lowered to a great extent. In recent years, the state spending on public enterprises has been growing due to the activated guarantees – including those issues to Srbijagas (state gas company).

Instead of making the announced shift, the situation has been additionally aggravated in 2014. In its Program of Public Sector Reform Measures of June 2013 (which is still on the home page of the website of the Ministry of Finance), the Government committed to promptly bring order in the operations of public enterprises, to resolve the issue of the enterprises in restructuring in the first half of 2014, and to cease issuing guarantees on the borrowings of Srbijagas. In the meantime, not only did the operations of public enterprises remain out of control but their problems continued to grow. At the moment there is a serious risk that loss generating operations of the largest state-owned enterprise, EPS (state electric company), could become a fiscal cost and completely undermine the public finances of Serbia. Future status of state enterprises in restructuring was not resolved within the planned time frame. While some progress is evident in the approach of the new government and the new Law on Privatization, their immediate effect will most probably be an extension to the current deadline at least to 2015. Meanwhile, these companies remain completely shielded from the creditors as no form of enforced collection can be taken against them. This affects the whole economy, but especially EPS (state electric company) and Srbijagas that pursue political agenda by supplying them with gas and electricity. A new guarantee has already been approved to Srbijagas, and since problems of its major debtors (other SOEs: Petrohemija, Azotara, MSK, etc.) have not been resolved, it is almost certain that this will not suffice for the upcoming heating season. It is reasonable to assume that Srbijagas will need an additional guarantee that will eventually be repaid by the government. Moreover, instead of resolving the future status of Železara Smederevo (steelworks) in the first half of 2014, as announced and budgeted, the state has now restarted production in that enterprise and increased the fiscal cost.

Without bringing order to the state-owned and public enterprises, it is impossible to successfully implement fiscal consolidation and avoid a public debt crisis. A large and growing fiscal cost of state-owned enterprises is one of the main reasons for the unsustainable growth of fiscal deficit and public debt in recent years. The analysis of the Fiscal Council indicates that the implementation of fiscal consolidation without including public and state-owned enterprises - is bound to a failure. A good example of this statement is precisely the year 2014 in which the new fiscal costs of only two enterprises (Srbijagas and Železara) was bigger than all the state revenues collected from the increase of reduced VAT rate (from 8 percent to 10 %) and from the introduction of solidarity tax. Hence, we believe that all future fiscal savings (reduced salaries and pensions, for example) would be a useless sacrifice without solving the major problems of state-owned and public enterprises concurrently. For that reason, the Fiscal Council has analyzed business operations of public and state-owned enterprises with the intention to point out the costs and risks assumed by the state, to

emphasize the most important problems faced by each one of the enterprises and suggest possible solutions.

The problems of public and state-owned enterprises are not easy to solve and require long-term changes both in enterprises and economy as a whole. It is important to point out that the resolution of one or a small number of causes will not eliminate the problems in the functioning of these enterprises - to bring order in the business operations of public enterprises completely will take at least two to three years. A good example for this claim is EPS. The analysis of the Fiscal Council shows that an increase in the price of electricity is really necessary (see the section on EPS). However, the increase in the price of electricity by itself cannot result in the substantial improvement in the company's operations and bring major investments. Specifically, it is not encouraging to know the fact that even in the period in which EPS faced major problems with insolvency it did not reduce its unreasonable costs and losses. On the contrary, the already high salaries were increased faster than in other enterprises; the problem of employees in Kosovo and Metohija (KiM) was not addressed; non-payments and even thefts were tolerated; and to top it all, now the unprofitable companies that previously spanned off from EPS (PD Kolubara-Usluge with 1470 employees) are being re-merged into EPS. Different governments tolerated, in the least, the inappropriate decisions of EPS, and it is possible that in certain cases they initiated them. Until these problems are addressed individually, any increase in the price of electricity may prove to be insufficient. The failure to solve the problem not only would reduce the motivation of EPS to improve the current performance, but there is a substantial risk that such additional funds would sooner or later be spent on higher salaries and/or merging of some new loss-generating businesses (Resavica Coal Mines?). We have used this example to show that a real solution to the issue of state-owned enterprises will require an in-depth and thorough approach to each individual enterprise and several years of work, rather than swift, general and standardized measures, because their effects would be quickly annulled by other forms of wastefulness. Through examples, we show the disastrous relationship between: high purchase and low selling prices, business operations with non-solvent counterparties, uncollected receivables, social role of public enterprises, overstaffing, internal wastefulness and other bad business decisions.

The table below shows the basic characteristics of the group of public enterprises (separately for the most important ones - Srbijagas, EPS, Železnice Srbije), the group of enterprises in restructuring (separately for Galenika and Resavica) and other state-owned enterprises (Telekom, Dunav osiguranje, GSP). These are the enterprises discussed in more detail below. The table indicates the essential causes of problems in their operation, their effects on public finances and necessary solutions. The individual enterprises have been selected by taking into consideration their effects on public finances to date, the importance for the functioning of economy and the potential future contribution to the public finances of Serbia.

Tabular Overview of the Findings

	Basic operational characteristics	Sources of problems	Consequences on public finances	Solutions
Public enterprises				
	730 enterprises 130,000 employees Operational performance indicators at low level (age and condition of capacity, productivity, etc.)	Internal inefficiencies Insolvency and growing indebtedness Administered, non-market prices below the level of justifiable costs	Annual cost of 3 percent of GDP: subsidies, activated guarantees, unpaid taxes and contributions Generation of insolvency and consequences on economic activity and public revenues Toleration of arrears and debts that become the state's obligation	Elimination of basic business problems (price disparities, soft budget constraint, etc.) Regulation (reduction) of employment and salaries Professionalization of management and reduction of wasteful spending and corruption
Srbijagas (Gas company)				
	Annual loss of 50 billion dinars Annual liabilities to banks in the amount of 17 billion dinars Collection of payment for the gas supplied – 60 percent	Many years of low sales prices (now adjusted) Taking over of loss-generating entities Gas supply to non-payers	Issuance of state guarantees and growth of public debt – about EUR 800 million to date Enterprise's liabilities are paid from the state budget Possible annual fiscal cost of 30 billion dinars	Suspension of gas supply to non-payers Sale of subsidiaries Negotiations on import volumes and prices
EPS (Electrics Company)				
	Over 38,000 employees Accumulated loss of 121 billion dinars Technological obsolescence: ¼ of transmission lines and substations are in good condition; the average age of thermal power plants is 30 years and of hydro power plants 40 years	Inefficient decentralised organisation - autonomy of subsidiaries Uncollectible receivables for sold electricity Overstaffing and excessive salaries Losses in the distribution network (including theft) are the highest in Europe (15 percent)	Spreading insolvency on the entire economy Possible issuance of state guarantees for additional borrowings to cover due financial obligations (30 billion dinars in 2014) Inability to pay the corresponding share of profit for 2013 to the state budget	Business and financial restructuring accompanied by the increased efficiency in all operational segments Downsizing and salary cuts Increase in the price of electricity for households Shift in the policy of payment collection and introduction of financial discipline
Železnice Srbije* (Railways)				
	20,000 employees Annual operating loss of 4-5 billion (accumulated loss at the end of 2013 was 146 billion dinars) Poor condition of infrastructure (low speed of rail traffic, more than half of railroads were built in the 19 th century, the length of repaired railroads has been reduced, etc.).	Low regulated prices High operating loss that leads to a lack of funds for maintenance and investment Generous subsidies are not used to improve the railway system	Annual subsidies from the state budget equal 13 billion dinars Activated guarantees for the loans paid by the state instead of Železnice (over 5 billion dinars were projected for the period 2014-2016)	Abolition of privilege and adjustment of tariff zones Detailed elaboration of financial and operational criteria and setting of measurable goals Changing the current system of non-transparent subsidies and passive state role

Enterprises in restructuring				
Galenika (Pharmaceuticals)				
	Since 2010, a drastic decline in operating income, accumulation of losses, intensive growth of debt	Inappropriate business decisions of company management (write-off of receivables)	Potential fiscal cost of about 3 to 4 billion dinars in 2014 (for the activation or issuance of new guarantees)	Privatization
	Illiquid and insolvent although the need for short-term borrowing has been reduced recently	Large overstaffing (surplus of about 500 employees)		Downsizing
JP PEU Resavica (Coal Mines)				
	4,000 employees	A large number of employees in administration	Annual cost of 4-5 billion dinars	Downsizing
	There is no coal exploitation in several mines		Cumulative amount of unpaid taxes and contributions from previous years is about 8 billion dinars	Making arrangements with the strategic partner and enhancing the scope of business and sales
Other state-owned enterprises				
Telekom (Telecommunications)				
	Operating results have worsened, the market value has decreased	Inefficient state management	Smaller dividends and other income paid to the budget	Privatization
	Decrease in the number of users	Surplus of employees	Contribution to the economic growth smaller than possible	Downsizing and reducing the cost for salaries and wasteful spending
	Decline in the share of total income from mobile telephony	Financing of various state projects that do not contribute to business success		
Dunav osiguranje (Insurance)				
	Over 3,000 employees	High and growing costs of earnings due to the noticeable increase in the number of employees; the cost of advertising and sponsorship are five times higher (for the same scope of business operations)	Collected public revenues smaller than possible	Reducing the cost for salaries (downsizing)
	Loss of about 1.5 billion dinars in 2012			Privatization
GSP Beograd (Belgrade public Transportation)				
	6,000 employees	Low rate of tickets and cards payment collection and generously established system of privileged categories of users	Current subsidies of the City of Belgrade are growing every year - 7.5 billion dinars in 2013	Improvement of payment collection system
	In the period 2010-2013 it continuously has an operating loss (the accumulated loss of about 20 billion dinars in 2013)		Expenditures from the budget of the City of Belgrade for capital subsidies	Review of the level of discount for some privileged categories

*Zeleznice (Railways) is, formally, a joint-stock company.

**RSD to EUR exchange rate is around 120

II. State-Owned Enterprises: Group Analysis

2.1. Basic Data and Fiscal Costs

State-owned enterprises are numerous - we estimate there is about 1,400 of them, but the number would be higher enterprises in which the state holds a minority interest are to be included. State-owned enterprises represent a diverse group. They include state and local public enterprises, but also a large number of former socially-owned enterprises. Some of the former socially-owned enterprises that are now owned by the state have a status of enterprises in restructuring. At the moment, there are about 670 enterprises in restructuring and privatization that fall under the jurisdiction of the Privatization Agency, and about 730 state and local public enterprises. In addition, there is a small number of joint stock and limited liability companies (they include enterprises such as Telekom, Železnice Srbije, Železara). It all sums up to a little more than 1,400 state-owned enterprises, all of which are subject to this analysis of the Fiscal Council. However, this is not the final list of enterprises owned by the state. According to the media statements given by the previous Minister of Economy, we conclude that if we add the socially and state-owned enterprises which are in bankruptcy and the enterprises in which the state holds a minority interest the total number of state-owned enterprises is more than double, amounting to almost 3,000. A complete list of all the enterprises in which the state holds a majority or minority ownership interest does not exist.

The state-owned enterprises employ approximately 250,000 people, which is almost a quarter of the employees in all companies. With regard to the aforementioned fact that the exact number of such enterprises is not known, it is not possible to accurately determine the number of employees in state-owned enterprises. We have estimated there are about 250,000 employees based on a direct insight into the largest and most important enterprises (and some available data pools for certain groups of state enterprises) and estimates of the number of employees in the remaining enterprises. Most of the employees are still concentrated in a relatively small number of enterprises. Of the total number of employees, almost two-thirds (about 160,000) are employed in the public enterprises (in 730 enterprises) and in the three major state-owned enterprises (Telekom, Železnice, Železara). However, in only 33 state public enterprises (the largest public enterprises) there are over 63,000 employees (more than half of them are employed in EPS – 34,000¹). Slightly more than one-third of the total number of employees is in enterprises under the jurisdiction of the Privatization Agency (90,000 employees, of which more than 50,000 in enterprises in restructuring). We estimate that the local enterprises employ about 60,000 people.²

¹ The total number of employees in EPS is actually about 38,000, while the number of 34,000 refers to the number of employees excluding the electricity enterprises in Kosovo and Metohija. We discuss these relations separately further in the text that refers specifically to the enterprise Elektroprivreda Srbije.

² The World Bank's recently published study on the local self-government has estimated that the local public enterprises employ 77,000 people (more on that below). Our estimate of the number of employees in local public enterprises, of 60,000, is based on insight into certain enterprises whose financial statements are published by the Agency for Business Registers. Since we have no data on the scope of analysis of the World Bank, it is possible that the difference results from the indirect budget users.

Table. Summary of the number of enterprises and the number of employees in various groups of state-owned enterprises

		Number of enterprises	Number of employees
State-owned enterprises	Total	≈1.400	≈250.000
	1. State public enterprises	≈40	≈80.000
	2. Commercial state-owned enterprises	≈40	≈20.000
	3. Enterprises under the jurisdiction of the Privatization Agency	≈670	≈90.000
	4. Local public enterprises	≈650	≈60.000
1. State public enterprises: Public enterprises that operate in regulated markets under (mostly) monopolistic conditions or that provide services in infrastructure-related activities; Železnice Srbije, formally a joint stock company, is included in the public enterprises.			
2. Commercial state-owned enterprises: Enterprises that operate in competitive industries (Telekom, Železara Smederevo, Aerodrom Beograd, Skijališta Srbije...)			
3. Enterprises under the jurisdiction of the Privatization Agency: Enterprises in restructuring and enterprises in various stages of privatization			
4. Local public enterprises: Enterprises under control of local government (local utility enterprises in the commercial sectors and enterprises that provide public goods but do not generate revenues).			
Note: The summary does not include: 1. enterprises in which the state holds a minority interest, and 2. state-owned banks and other financial institutions.			

State-owned enterprises generate great losses, which then lead to a significant increase in expenditure and fiscal deficit of Serbia. There are many channels through which the poor performance of these enterprises spills over to the government finances:

- directly increases public expenditure: a) subsidies that are paid from the budget of the Republic or local self-government, b) activated guarantees, c) loans of the Development Fund which essentially are subsidies (since they are non being repaid);
- directly decreases the public revenues: unpaid taxes and contributions;
- directly increases the public debt: the guarantees which are approved for loans of the enterprises (and which directly increase the public debt and the future costs of debt repayment);
- indirectly increases the deficit and the public debt: a) bridging of employees' service periods and increase in the state's obligation for future pensions, b) toleration of arrears and debts that may prove to be state's obligation (in case of, for example, privatization of the enterprise), c) generation of illiquidity in the economy, and decreased activities and public revenues on that basis, d) promotion of soft budget constrain and tolerance of non-payment of obligations toward public enterprises (which results in further deterioration of public enterprises and need to cover the losses).

Poor condition of state-owned enterprises and the consequent fiscal burden is nothing new, but in recent years the problems have significantly increased. Problems in most of the enterprises originate from the period prior to year 2000, however they became a lot worse in the last five or six years with the beginning of the global economic crisis. The Fiscal Council, since its establishment (2011), has pointed out the necessity of a reform of the state-owned enterprises, and the most comprehensive overview of the situation and the

appropriate measures were given in May 2012.³ Since the business operations and the attitude towards these enterprises have not changed, the negative effects on the public finances, meanwhile, have become even stronger.

The direct negative effect on public finances has increased in the past five years and reached 3 percent of GDP in 2014. Subsidies, activated guarantees and unpaid taxes and contributions directly burden the state budget. We estimate that up to 2012 the state-owned enterprises in general created annual fiscal cost of around 2 percent of GDP⁴, whereas in 2013 and 2014, the effects have grown to about 3 percent of GDP - a major source of expenditure growth in recent years are activated guarantees (enterprises are not able to repay the government-guaranteed loans, so the state now has to repay them). 3 percent of GDP corresponds to a value of about 115 billion dinars and it the direct cost taken by the public finances. These effects probably can't be completely avoided (as is the case with subsidies to Železnice), but they can definitely be lowered to a great extent with better performance of the enterprises. However, the issues with state-owned enterprises have not been solved yet, so the costs to public finances in the upcoming years could continue to grow.

If the situation does not change, the problems of state-owned enterprises may destroy the public finances and reverse the effects of savings in other areas (salaries, pensions, goods and services). Repayment of government-guaranteed loans poses the biggest risk. If in 2014 government-guaranteed borrowing were to completely cease, in the next five or six years we would still see large budget expenditures for repayment of the guaranteed loans from the previous periods. Most of these loans relate to Srbijagas, Železara Smederevo, Galenika, former JAT and others. We estimate that these expenditures in the upcoming years could amount up to 40 billion dinars per year (the trend would be declining trend as loans are repaid). These are huge costs and therefore it is of the utmost importance for the state-owned enterprises, primarily Srbijagas, to reform and improve their performance sufficiently in the next two to three years so to be able to service their debts by themselves. Unfortunately, the current performance of these enterprises indicates that it is actually more probable that the budget expenditures for state-owned enterprises will increase. Currently the greatest risk is that EPS, which until now was servicing its obligations by itself, will no longer be able to do so in 2015 - which means that its debts would have to be taken by the state. Furthermore, it is possible that Srbijagas will need a new guarantee for the upcoming heating season; this is an addition to the already outstanding EUR 200 million guarantee for its liquidity. In addition, it is possible that in the upcoming period the state will assume significant obligations in order to resolve the restructuring process. We believe that, if realized, these risks could be fatal to the public finances of Serbia. In such a scenario, painful measures such as pension and salary cuts would be meaningless since all the savings would actually be spent on the poor performance of the state-owned enterprises. In short, there is no fiscal consolidation without putting the public enterprises into order - which primarily means a decisive turning point in the performance of EPS, and as fast and as cheap as possible resolution of the fate of the enterprises in restructuring (most of the Srbijagas' debtors are enterprises under restructuring).

2.2. Main Problems in the Performance of State Enterprises

The functioning of state enterprises is systemically wrong. State-owned enterprises have an important role in the economy, but due to poor management, they have operated

³ In the study "Proposed fiscal consolidation measures for 2012 – 2016", in Sections 8 (Reform of state- and socially-owned enterprises), 3 ("Policy of granting government guarantees") and 9 ("Analysis of possible savings on subsidies").

⁴ For 2010 and 2011, please see more in the study, "Proposed fiscal consolidation measures for 2012 - 2016", Section 8 (Reform of state- and socially-owned enterprises).

unsuccessfully, and finally, imposed high fiscal costs. In the past few decades, including the past few years, state-owned enterprises were misused for hidden and very expensive social policies: manifested mostly through regulated or imposed low prices of their products and services and tolerance of non-payments, sometimes even from the private enterprises. Moreover, there was also a tolerance for poor management, overstaffing, employee privileges, inefficiency, negligence and corrupt practices, and in some cases they were used to absorb other loss-making enterprises with no real prospects. Most of these weaknesses are now due and directly affect the public finances, either through the subsidies, soft loans, guarantees, assumption of debts or through some other perverse form (“bridging the service periods of employees”, for example).

The contribution of state-owned enterprises in the overall economic activity is not what their assets or equity would suggest. According to data from the records⁵ of the Agency for Business Registers, the ineffective performance of the group of state-owned enterprises is reflected in the fact that they hold over 23 percent of the equity of all enterprises, as well as over 20 percent of the total assets, but earn a modest 9 percent of total operating income.⁶ An additional issue is the fact that loss-making enterprises (a group of state enterprises that generate losses) account for 26 percent of the total net losses of all enterprises in Serbia for 2013. Accumulated losses of this group reach almost 500 billion dinars, or about 13 percent of GDP. A significant number of these enterprises remained almost without equity, thus generating a total loss exceeding the amount of equity by as much as 250 billion dinars. Total debt (liabilities) of this group of enterprises amounts to about 1,250 billion dinars or about EUR 11 billion (and account for 17 percent indebtedness of all enterprises).

Problems can be noticed even at the level of basic business results. Analyzing the performance of state-owned enterprises we found that a large number of their income-to-expense ratios would be impossible in real market circumstances (i.e., operating income is systematically lower than the operating expense). This is a clear indication that even without any additional elements (bad debt write-offs, additional expenses) in a large number of enterprises the core of the problems is that the basic business model is unsustainable. This is actually the case in Srbijagas, Železnice, GSP, Galenika, Resavica, as well as EPS. We are going to mention just few examples. The income earned by Železnice alone is sufficient to cover only one-third of its operating expenses. Železnice generates income of around 10-11 billion dinars, but pays 15 billion dinars for salaries only. GSP (Belgrade public transport) income from sale is not sufficient to cover even the salaries (for about 6,000 employees, cca 7 billion dinars), not to mention the total operating expenses amounting to 12-14 billion dinars. In Resavica, income from sales is insufficient to cover half of the salaries, amounting to 4.5 billion dinars for about 4,000 employees.

The short-term financial position of enterprises is also at risk. Liquidity of state-owned enterprises is far below the desired level measured by the standard liquidity ratio.⁷ The benchmark value of the ration is 2, and the group of state-owned enterprises, according to the

⁵ Data from the Business Registers Agency (BRA) is not complete. It refers to approximately 500 state and local public enterprises to which, for the needs of this analysis we have added data for three major state-owned enterprises (Telekom, Železnice and Železara Smederevo) and about 160 enterprises in restructuring. The data of BRA do not cover approximately 230 public enterprises that are direct and indirect budget users and whose financial flows are going through the Treasury Administration of the Ministry of Finance, and combined data for about 500 enterprises in the portfolio of the Privatization Agency in which the state holds interest (there are only non-aggregated data). If we include these enterprises into the analysis, the comprehensive data would be most likely even worse. The above facts also indicate that the state does not really have reliable records on the number and the performance of state-owned enterprises, and thus it can be immediately noticed that this area is neglected and not well researched.

⁶ Income would have been less if we excluded direct subsidies that many enterprises receive and which are recorded as operating income.

⁷ Basic indicator of liquidity is mostly the ratio of short-term liabilities to the most liquid part of the assets (current assets) from which these liabilities can be covered.

records of BRA (500 + 3 + 160 enterprises), generates a value of only 0.86. Although the overall economy does not have a high level of liquidity (ratio of 0.91), the private sector is certainly more liquid.⁸ Of course, value of the indicator is different across the public enterprises. Resavica has an alarmingly low liquidity ratio; only 0.11 of its short-term liabilities is covered by assets convertible into cash within a year. A dramatic decline in liquidity is evident in the example of Galenika, whose liquidity ratio fell from 2.6 to 0.2 due to a significant increase in uncollectible and written off debts. To stay afloat, in recent years Galenika took short-term borrowings which carry higher interest rates (short-term debt has increased threefold). Although some enterprises have liquidity ratios above the group average, (the most notable are EPS and Srbijagas) these enterprises are not immune to liquidity issues. This is mostly due to uncollectible receivables that have a significant share in the operating assets. The actual cash inflows of both EPS and Srbijagas are not sufficient to cover the overdue liabilities, and in the case of Srbijagas we can already observe an increasing frequency of additional loans. Only a number of the large state-owned enterprises have sufficient liquidity (Posta, Aerodrom Nikola Tesla).

These liquidity issues are felt throughout the whole economy. An increase in trade payables and arrears is evident. Enterprises in restructuring and other enterprises under the jurisdiction of the Privatization Agency are protected against the creditors as no means of enforced collection can be taken against them. As a result, all the arrears they accumulated are locked up and their solvency problems are directly transferred to the creditors. According to the estimates of the Fiscal Council, enterprises in restructuring owe some EUR 1 billion to the suppliers. Also, two-thirds of that is a debt to public enterprises - which shows how problems of the enterprises in restructuring and other public enterprises are intertwined. On the other hand, the analyzed sample of public enterprises has outstanding payables to suppliers as well in the amount of EUR 1 billion. The largest generators of insolvency among public enterprises are Srbijagas (almost 50 billion dinars in outstanding payables to suppliers) and EPS (13 billion dinars), while from the enterprises in restructuring it is Petrohemija (about 30 billion dinars) and RTB Bor (15 billion dinars). The spread of liquidity issues from public enterprises to the rest of the economy can be seen by comparing the receivables collection period and trade payables settlement period. In 2012, 10 major state-owned enterprises have practically financed their entire business cycle through non-payment to the suppliers, since the average payables settlement period was more than twice longer than the receivables collection period.⁹

Chronic illiquidity of state-owned enterprises may be a sign of a solvency crisis (long-term illiquidity) - some enterprises have already eroded the capital. Although the standard leverage ratio (debt to equity ratio) is not alarming (owner's equity is still a dominant source of funding), there is a significant maturity mismatch between the funding sources and the assets. It is worrisome that in the group of 10 major state-owned enterprises the fixed assets, which should be financed with the owner's equity, are financed by short-term liabilities.¹⁰ It should also be noted that the owner's equity also includes revaluation reserves that in some cases (EPS, Putevi Srbije) represent even three-quarters of the total equity. In a certain number of enterprises, the accumulated losses exceed the amount of the capital and the enterprises are insolvent and fully financed by borrowed funds. Such is the case with Srbijagas and Galenika where the amount of the loss is more than twice the equity. This is the case in about 60 other public enterprises as well.

Previous bad decisions - delivery to non-payers and absorbing other loss-makers – became due and result in high write-offs and consequent losses. The practice of a few enterprises undoubtedly shows that the takeover of loss making businesses and tolerance of non-payers resulted in significant bad debt, which when written-off leads to losses and deterioration of the financial position. Losses of Srbijagas in 2012 and 2013 are primarily a

⁸ Since the value of the indicator of 0.91 of entire economy includes also the state-owned enterprises whose liquidity ratio is 0.86, it means that the liquidity ratio of the private sector is certainly more favorable.

⁹ Glisic, M. "Financial performance of state-owned enterprises", Quarterly Monitor No. 33 (April-June 2013).

¹⁰ Glisic, M. "Financial performance of state-owned enterprises", Quarterly Monitor No. 33 (April-June 2013).

consequence of high other expenses, reaching 50 billion dinars in 2013 (almost 40 percent of the total expenses and almost equal to the purchase value of gas). These expenses are due to overtaking loss-making enterprises and non-collected receivables for delivered gas (in accounting terms: provision for impairment of receivables and equity interest). Most of this is due to other state owned enterprises: Azotara, Petrohemija, Metanolsko-sirćetni kompleks, GP Rad, Agroživ, Srpska fabrika stakla, municipal heating plants and other subsidiaries. Similarly, accumulated losses of EPS are largely a result of other expenses, which from 2009 have more than doubled, and in 2012 reached an amount of 55 billion dinars. Other expenses of EPS include systemic delivery to non-payers, but also expenses arising from payment of salaries to employees in the territory of KiM (EPS). Approximately half of the accumulated losses of Galenika are a result of uncollected receivables (the most significant bad debt write-off on this basis took place in 2011, around 10 billion dinars). Since the accumulated loss is a deductible item of share capital, it directly reduces the value of the enterprise.

Poor results are also driven by regulated, non-market based prices, which are sometime even below the operating costs¹¹. Selling prices of goods and services of certain enterprises are non-market based and are mandated below the level that would cover operating expenses (for example, cost of electricity, and some utility services). The intention behind keeping regulated prices so low is to boost the purchasing power of citizens and reduce costs to the economy. Thus, the public enterprises are imposed a social function that effectively subsidizes the rest of the economy. The problem is not just that this is a direct cost to public finances but also that it is very ineffective as a social policy. Effectiveness of social policies is always conditional on targeting those in need and artificial prices do just the opposite. Analyses at the individual level show that low prices are a significant cause of losses for the public enterprises. This is primarily the case with EPS, but also with Srbijagas where we estimate that persistently low gas prices contributed to about 40 percent of total losses.

Large number of employees and size of the wage bill are amongst the major causes of financial imbalances. Despite the financial troubles, there is no reduction neither in the number of employees nor in the size of the wage bill. Probably the largest and most obvious excess of employees is in the enterprises undergoing restructuring (taking into account that many of them actually have no perspective what so ever). However there are evidences or strong indications that there is overstaffing in almost all of the state-owned enterprises. In Dunav osiguranje (insurance) the number of employees increased by over 50 percent from 2007 to 2012, while the total premium remained unchanged. This is undoubtedly the main reason for extensive deterioration of the company's performance. The comparative analysis of the number of employees in enterprises engaged in production, distribution and sale of electricity in comparable countries indicates a considerable opportunity for rationalization of the number of employees in EPS. Telekom has approximately the same total operating income as Telenor, VIP and SBB together, but it earns it with over three times more employees than these three companies combined.

In addition to the number of employees, the salary levels are also significant contributor to the poor performance. It is noticeable that in some enterprises the salary costs are not just at an unexpectedly high level but also exhibit an increasing trend. EPS has the highest wage bill of all state-owned enterprises, primarily due to the largest number of employees, but also because of the unusually high salaries that are almost twice the average salary in Serbia - which is far from being the case in other electric utilities in the region. The analysis further shows salaries in EPS are not being monitored well enough even though they are by far the biggest costs for the company. Despite the reduction in the number of employees in EPS from 33,500 in 2009 to about 32,000 in 2013 (without KiM), there has been a substantial nominal increase in the salary costs (about 40 percent, from 39 to 54 billion dinars). This is considerably faster than the growth of average salary than in the economy.

¹¹ Prices may be regulated, but at the "level justifiable costs" - when covering the long-term marginal costs.

Only in 2012 salary costs increased by over 7 billion dinars, which cannot be explained with the approved bonuses for overtime work (effect of the winter frosts in February is about half a billion dinars).

With the exception of salaries, payments to employees are not viable. In some enterprises, such as Telekom, a 13th salary is regularly paid to the employees despite deteriorating performance and scarce investments. What's worse, this and similar models of additional benefits seem to apply not only to enterprises that formally make a profit, but also to loss-makers and monopolies. For example, in 2012 EPS approved a loan to each individual employee in the amount of 50,000 dinars (total of 1.5 billion dinars), although that year the company made a loss of around 12 billion dinars. This practice continued in 2014, when, under a threat of a strike, the union of EPS signed with the Government of Serbia an agreement on another non-interest bearing loan to employees. In addition the union push for even more harmful merger with the unprofitable and previously spanned off company PD Kolubara-Usluge (1,470 employees). We would also like to point out that in public enterprises unions typically have a large and often detrimental effect on the performance, which should also be taken into consideration.

Procurement process in state-owned enterprises is inefficient and leads to irrational spending. Public enterprises (at state and local levels) have by far the largest share in public procurement. In 2012 they accounted for 60% of the total procurements. In 2013 this further grew to 70%. In 2012, public enterprises have conducted public procurements amounting to 205 billion dinars, which is twice the value of public procurements of the entire state administration¹² (92 billion dinars).¹³ Therefore, the reduction of the cost of public procurement mainly depends on rationalization in public enterprises where, certainly, there is significant room for reduction (primarily for goods and services). The State Audit Institution in its audit reports on the financial statements of certain public enterprises draw a particular attention to the conducted public procurements. That, all together, suggests that there are indications that the process is inefficient and questionable, and that there is a significant room for improvement and cost saving in this area.

The considerable reduction in the cost of public procurements (over 60 billion dinars in a single year) indirectly shows the extent of irrational business operations of the public enterprises. Improvements were made with the implementation of the new Law on Public Procurement, in the second half of 2013. The share of public enterprises in the total public procurements is significantly reduced to 53%.¹⁴ By reducing the public procurement cost by more than 60 billion dinars, it becomes obvious that there were considerable unnecessary costs in the public enterprises. Furthermore, the value of public procurements conducted in direct negotiations (the least transparent procedure) was reduced by half in 2013, and with regard to the public enterprises it was reduced to 15 billion dinars. There are indications that most of the reduction in public procurements was achieved in enterprises where share of direct negotiations in total procurements was reduced to 10 percent (state administration average is 20 percent). Although there are obvious improvements in the public procurement process in the public enterprises, for sure there is room for further improvement and cost saving.

Bad debt is also a big chunk of the problem. Srbijagas already wrote off 75 billion dinars of uncollected receivables (three-quarters of its total accounts receivable), the majority of which relates to the receivables from enterprises in restructuring and subsidiaries of Srbijagas that do not pay for the delivered gas. From 2004 to 2012, due to the debt write-off EPS incurred a loss of about 100 billion dinars (half of the annual operating income).

Investments are at an extremely low level and this jeopardizes medium to long-term prospects of enterprises. We particularly emphasize the example of EPS, which in the

¹² The term "state administration" at this point applies to: government authorities, city and municipal government, the Ministry of Justice, Health and Social Welfare, Culture, Education, Science and Sport.

¹³ Data are taken from the Report on Public Procurement in Serbia in 2012, Public Procurement Office.

¹⁴ Data are taken from the Report on Public Procurement in Serbia in 2013, Public Procurement Office.

last twenty years could not finance any intensive investment activity from its own funds. EPS used guaranteed loans only for maintenance of the existing production and distribution facilities, and even they are unlikely to be repaid without government assistance. EPS can't generate economic growth due to the poor state of its production facilities and development of new capacities requires intensive capital investment. In the analyzed sample, low levels of investments are evident in Železnice as well, and there is no doubt that a large number of other state-owned enterprises have the same problem.

Operational performance indicators are in most cases extremely low. Due to the low level of investments and poor management, services and goods offered by state owned enterprises are usually uncompetitive in the market. In the railway transport, more than 55 percent of the railway tracks were constructed in the 19th century, and the largest number of rail cars is more than 30 years old. So it is no surprise that the average speed of trains on the railway tracks in Serbia is about 40 kilometers per hour, and due to lack of maintenance the number of kilometers of tracks with permitted full speed reduces each year. Lack of investment of EPS in new distribution and production facilities threatens the sustainability of the electric power system. The average age of the hydropower plants is more than 40 years, while of the thermal power plants, over 30.¹⁵ Also, only less than a quarter of transmission lines and substations are in good condition, which contributes to the high “losses in the distribution grid”.

Last but not least, we are addressing the poor and politically influenced management of state-owned enterprises, which actually accounts for a good share of the current problems. Influence of political parties fuels negative selection in the appointment of senior managers. This results in losses from an increase in the number of employees and their salaries, financing of various non business related projects, political decision making, takeovers of failed enterprises, sponsorships, weaknesses in public procurement, wrong reporting, harmful agreements that are probably accompanied by corruption, etc. An additional problem is that interplay between political and professional criteria, and the resulting negative selection, has become integrated into the structure that even the lower levels of the management are not immune to it. This means that it will be a lot more difficult to eliminate.

Besides the immediate managers, the government itself bears the accountability for the poor performance of state-owned enterprises. Generally, the business model of state-owned enterprises has not changed over many years of deterioration in these enterprises. Not a single government has done anything to curb the bad trends and eliminate the structural problems. On the contrast, government decisions have even supported certain bad management decisions (Srbijagas, a large loss-maker, took over other loss-makers and rescued them from bankruptcy), social peace was bought with artificial prices (at the cost of rising debt), and overstaffing was tolerated. In addition, fiscal non-compliance, such as issuance of guarantees in exceeding the limits estimated by the Fiscal Strategy and the arrangements with the IMF, “jumping out” of the wage policy in the public sector (with numerous exceptions and acceptance of the trade unions' demands), non-compliance with the Law on Public Enterprises in relation to adoption of business plans and appointment of a managers through a public call, ignoring the recommendations of the State Audit Institution - are some of the examples in which the Government was inconsistent in the enforcement of its own decisions and laws. Failure to comply with the law in management of public enterprises is a signal that the state had no sincere intention to systemically improve their performance. Once again, this is a signal that it pays out not to play by the book.

¹⁵ A revitalization of some plants was carried out during the last ten years, extending their life for another 30-40 years.

2.3. Guidelines for Solving the Problems

Problems of the state-owned enterprises are not simple and require changes both in the enterprises and economy as a whole. Before listing the options for solving the problems, it is important to point out that solving one or a small number of causes will not eliminate the problems in the functioning of these enterprises. It is not possible to identify (only) one cause whose elimination would make the position of the enterprise satisfactory. Often, it is believed in the public that the internal inefficiency of state-owned enterprises is the sole or main cause of poor performance. Without disputing the fact that it is necessary to increase efficiency and reduce irrational use of funds (including rationalization of staffing and salaries), the analyses show, however, that much more has to be done. Through various examples we will show the harmful relationship among: artificial prices, business with insolvent counterparties, uncollected receivables, the social role of public enterprises, as well as internal irrationalities and bad business decisions. Improper managing of public enterprises, acts simultaneously with inadequate government policies through which fiscal and social functions are transferred to the public enterprises. These include: mandating low prices, enforcing delivery of goods to non-paying customers, support to non-productive employment, avoidance of closure of non-productive facilities (railway lines, some mines, etc.)

One of the options for solving the problems in state-owned enterprises should be privatization. A large number of state-owned enterprises cannot survive without privatization. Privatization of Telekom, Galenika, Železara Smederevo, Dunav Osigurenje, subsidiaries of Srbijagas, all enterprises in restructuring and all enterprises under the jurisdiction of the Privatization Agency is justifiable from the standpoint of economic efficiency, prevention of losses and, in rare cases, decline of profit and negative spillover effects on the public finances. It is also justifiable to consider privatization of some parts of EPS and the railways. The problem is, however, that there is still no clear, comprehensive and systematic Government program that would include selection of enterprises for sale, rationale for doing so, as well as the accompanying analyses to substantiate such plans. Instead of systematic and transparent resolution of the fate of public and state-owned enterprises (especially the large ones - Telekom, EPS, Dunav osiguranje), the Government generally opts for vague privatization strategies and occasional bilateral negotiations with potential investors. This would, in some specific cases, probably be justified (when selling loss-making enterprises), but such negotiations are generally very inefficient and expensive. Bilateral negotiation may be especially harmful in case of an enterprise with a significant commercial value (Telekom). In such cases, competitive bidding will give the best results but it can be achieved only with involvement of privatization consultants, strong public oversight, and a predictable and completely transparent privatization procedure would maximize the price that Serbia could gain from sale of these enterprises.

Non-payment of debts must not be tolerated any longer and debt collection should not be selective. It means to terminate the supply of gas, electricity, provision of utility services to all non-payers.¹⁶ Improvement of debt collection of state-owned enterprises is possible as a part of the measures to improve the overall financial discipline in Serbia. This prerequisite assumes primarily fast resolution of the status of the enterprises in restructuring. Until these enterprises are privatized or bankrupt it is necessary to abandon the practice of tolerating non-payment of dues. If necessary, temporary subsidies can be budgeted to pay for their obligations. Until now, the problem was ultimately transferred to the state i.e., to all taxpayers, given the fact that the enterprises received direct or indirect subsidy (tolerating unpaid debts and failed investments of the Development Fund), while losses and debts were piling up in the public enterprises that actually borne the burden of the enterprises in restructuring (EPS and Srbijagas primarily). This is not just the matter of debt collection but also of suspending the supply of goods and services to non-payers. This applies primarily to

¹⁶ The state is responsible for socially vulnerable citizens.

debtors of Srbijagas, including Azotara, Petrohemija, Metanolsko-sirćetni kompleks, etc. This solution requires a strict commitment of the state to clear the position of the debtor enterprises – to privatize them, to maintain them (temporarily and transparently) on direct subsidies or to place them into bankruptcy.

Liberalization, market pricing, and economically sound pricing for monopolies should prevent further erosion of public enterprises. This primarily refers to the prices of electricity and railway transport services. Any eventual social consequences of high prices should be solved through social policies, rather than through low prices subsidized by all citizens. In addition, it is a paramount not to revert to the old practice (till the end of 2013) of maintaining the selling price of gas at a level lower than the purchase price. Since there is a possibility that gas prices will decrease in the following period, it is necessary to renegotiate the import terms (quantities and prices). Speaking of electricity, liberalization of the market should gradually drive the prices to an economic level, and thus ensure sustainability of the system.

Increase in efficiency of operations means less spending on salaries, rationalization of costs, introduction of performance indicators and larger investments. The analysis shows that in many state-owned enterprises salary costs are too high, either due to overstaffing, high salaries, or both factors (EPS, Železnice, Galenika, Dunav osiguranje, Telekom). Future layoffs, however, must be made according to sound plans for rationalization of individual enterprises (the preparation should start immediately) and not as it is now, by waiting for voluntary resignations and/or by applying some simplified linear model. Also, all state-owned enterprises should be covered by the announced reduction in public sector salaries. This measure must be strictly enforced and not partially or completely discredited by increasing the coefficients, bonuses or borrowings. Within (significantly reduced) wage bill, it is justifiable in some enterprises to consider a change in wage policy. A small number of high quality professionals should be retained in the state-owned enterprises by offering them competitive salaries, however this can't serve as a justification for the average salary in these enterprises to be much higher than the average in the country - especially not with 20 percent unemployment. Furthermore, the reports of the State Audit Institution and the expenditure analysis indicate that some expenditure could be reduced or completely eliminated (irrational public procurement, sponsorship, etc.). To the aim of further improvement of the performance, it is necessary to develop key performance indications in each industry and to start governing these enterprises using an integrated performance management system. In this area, the expertise of the World Bank, and the studies and analyzes that have already started should be used. As a final point, in certain parts of the public sector, performance improvement is impossible without investments (Železnice Srbije, EPS). Therefore it is important, by determining priorities, to rationally target new investments and, wherever possible, use concessions and other forms of cooperation with private investors, which do not assume engagement of public finances.

Strict budget constraint and, whenever justified, privatization and liberalization should be the principles for the future business operations of local public enterprises. In addition to rise in prices and improvement of the poor performance of local public (utility) enterprises, the key is to improve their cost-effectiveness (downsizing, efficient public procurement, etc.). Local self-governments must be obligated (for example, through the system of government budget transfers) to enforce a strict budget constraint in the local public enterprises in order to stop the spread of insolvency throughout the entire system. In the example of Belgrade public transport (GSP), we show that, at the state level as well, a combination of several factors led to a very poor condition of this enterprise (too many employees, low collection of receivables for services rendered, a large number of privileged categories of customers) and to transfer of the losses to the public expenditures (specifically to local self-government subsidies).

Transparency of the business operations of state-owned enterprises should be increased. Reporting of the enterprises on business plans is limited to annual plans, and the

reporting usually lacks clear objectives and operational performance indicators. Business plans are adopted with delay (sometimes even at the end of the year for the previous year). Little attention is paid to evaluation of the achieved results. In addition, some enterprises ignore the legal obligation to disclose publicly their business plans and financial statements, or they do so with unacceptable delay (of several years). Although the relevant ministry (currently the Ministry of Finance) supervises the business plans and financial statements, this supervision is mainly focused on financial indicators, rather than on strategic planning and ongoing management. The opinion of the Fiscal Council is that the public must be informed in detail, accurately and timely, about the operations of state-owned enterprises in order to identify problems and provide timely and adequate responses from both the public and the Government.

Resolving the fate of the enterprises in restructuring must be quick, efficient and with minimal fiscal cost. The enterprises in restructuring actually did not use the period in which they were protected against the creditors to reorganize and establish a sustainable business model. On the contrary, in most of these enterprises problems were not solved, and the losses grew, and so did they their actual and potential fiscal costs. Therefore, the new Law on Privatization is the last opportunity for these enterprises to be put into operation, if possible, and if not - to go bankrupt. In that process, the state should not be generous in writing off and taking over the debts of the enterprises in restructuring since fiscal deficit and public debt are unsustainable even without these additional costs.

Implementation of the laws and improvement of the legislation may improve corporate governance and contribute to solving the problem of state-owned enterprises. In an environment where laws are not strictly enforced it is pointless to discuss the quality of the legislation. The Law on Public Enterprises has not been implemented yet, and even when it does the effectiveness of its provisions is questionable. The Law stipulates that executives should be appointed through a public call, but in the last year and a half (with the law in place) the deadlines for the public call and for the selection procedure were generally not met. In some cases a public call was not announced at all (Srbijagas, Pošte Srbije (Serbia Postal Service), etc). Concerning the weaknesses of the Law on Public Enterprises, the Fiscal Council evaluated the draft of the law and pointed out to the possibility of a pronounced Government influence on the selection of executives (the Government appoints three of five members of the Appointment Committee and makes the final decision on selecting the candidate to be appointed as a head of a public enterprise).¹⁷ Furthermore, the new amendments to the Law should be considered as they provide for a possibility that members of the Supervisory Board as well be appointed through an open call. If implemented this could foster professionalization and de-partization of public enterprises, Also, it is necessary to precisely define the required qualifications for executives and members of the Supervisory Board, whereas it is not consistent to demand greater responsibility and effort without any or with modest remuneration. In any case, regardless of any changes in the legal framework, it should be insisted on strict budget constraints, transparency and financial discipline of state-owned enterprises.

Centralized monitoring of state-owned enterprises may improve the performance of public enterprises. The analysis shows that some of the characteristics of the group of state enterprises are: inadequate controls, poor results, mismanagement, and lack of transparency in business operations and management responsibility. The consequence is larger fiscal costs and continuous pressure on public finances. Given the seriousness of the problems and the need to make a quick shift in this area, it would be rational to establish a body, within the Government or the Ministry of Economy, that would monitor and coordinate plans of state-owned enterprises, initiate reporting and analysis, determine the procedures for developing objectives and operational indicators, initiate and ensure cross-sectoral business

¹⁷ See Report of the Fiscal Council: "Assessment of the revised budget for 2012 and the draft law with fiscal effects", September 2012, p. 58.

analysis (including financial) and involve in other activities that would contribute to the operations of state-owned enterprises to the aim of being more transparent, more accountable and, ultimately, more successful. This body would deal with what is common in the operations of public enterprises, while the relevant ministries would remain competent for specific sector policies. In the first phase, the centralized management should certainly focus on a significant increase in transparency (financial ratios and performance of enterprises) and identification of any violation of the law.

III. Analysis of Major Enterprises

3.1. Elektroprivreda Srbije (EPS, Electric company)

3.1.1. Basic Assessments

EPS and its subsidiaries is the largest state-owned enterprise on several bases. EPS is the parent company of 13 subsidiaries¹⁸, and holds founder's rights in three public electric utilities in the territory of the Autonomous Province of Kosovo and Metohija (KiM). On several bases (employment, operating income, total assets), EPS may be considered the biggest and the most important state-owned enterprise. EPS employs over 38,000 people,¹⁹ which is about 15 percent of the total number of employees in state-owned enterprises. The size and significance of EPS is supported by the fact that in 2013 it had the second highest operating income (220 billion dinars) in Serbia, right behind NIS, and it ranks first in the amount of total assets, as well as by the amount of equity. Therefore, it is striking and disappointing that, on the other hand, this enterprise shares the first place, along with Železnice Srbije, for the amount of accumulated losses (about 120 billion dinars).

EPS has serious performance problems and their resolution must not be delayed. The main problems of EPS relate to uncollected debts for delivered energy, low selling price of electricity for households, overstaffing and unfounded privileges of employees, large losses in the distribution grid and electricity theft, as well as the problems of operations in the territory of KiM, including payments for the employees in KiM. Therefore, EPS, which with its strategic investments and operations should be a powerful driver of economic growth and support, does not have that role at the moment. On the contrary, EPS currently generates illiquidity, hinders the economic growth and represents a threat, if its problems are not resolved, to become a large fiscal cost. In other words, EPS somewhat reminds of Srbijagas from a few years ago when the unsuccessful business operations were concealed with large loans (partly used for repayment of previous loans). Therefore, it is necessary for EPS to start resolving the problems immediately - before it becomes (as now in Srbijagas) a direct cost to the state.

The Fiscal Council considers it necessary to improve the debt collection and to increase the electricity price for households. Financial indicators show that EPS currently does not have sufficient inflows neither to invest in modernization nor to meet its current liabilities (for previously taken loans, trade payables, etc.). Thus it has to borrow to maintain its liquidity. There are two main problems on the income side due to which EPS has liquidity problems: first – large bad debts for delivered energy, and the second - low price of electricity, which is the lowest from any comparable country. The first problem, bad debts, has its own social and political dimension (for example, enterprises in restructuring that do not pay their electricity bills). Such losses can be reduced through suspension of electricity supply to consumers who do not pay - which can be painful in the short term, but it is the only economically viable and sustainable solution. If the state is determined at all costs to support the survival of certain enterprises in restructuring, then it is much better and more transparent to give these enterprises subsidies from the budget that would cover the electricity costs and

¹⁸ Subsidiaries are: HE Đerdap, Drinsko-Limske HE, TE Nikola Tesla, RB Kolubara, TE-KO Kostolac, Panonske TE-TO, Obnovljivi izvori energije, Elektrovojvodina, Elektrodistribucija Beograd, Elektrosrbija, Jugoistok, Centar, EPS snabdevanje.

¹⁹ At the end of 2013, EPS was employing about 32,000 people, and in early 2014, re-acquiring the previously spanned off companies, the number of employees increased by about 1,500. When adding over 4,500 employees from the electric utilities in KiM, the number of employees is 38,000.

not let their loss to contaminate and even jeopardize the performance of EPS (or Srbijagas). The second problem, i.e. the problem of low prices, can be partially solved through liberalization (which is already implemented for medium and high voltage consumers). Critical, however, will be the scheduled start of price liberalization (2015) for the low voltage consumers, which covers by far the largest portion of consumers (over 60 percent). In commercial terms, EPS will be able to increase prices for households, as the current price is the lowest in the region. But the question is whether EPS will use that opportunity, because it is owned by the state, and the state so far used the price of electricity as a social policy. The Fiscal Council considers that such practice is bad and social protection implemented in such a way is expensive and non-targeted.²⁰ EPS should then (protecting the most vulnerable) be allowed a further increase in electricity price for households, which we estimate at 15 percent.²¹

EPS has to cut staff costs through layoffs, but also through review of the privileges given to employees. The largest items on the cost side (on a consolidated basis) are staff costs - about 54 billion dinars²², out of 187 billion dinars of total operating expenses. Hence the necessary rationalization of costs of the enterprise would have to include staff costs. The analysis of the Fiscal Council indicates that EPS has a lot more employees than any comparable system. There are strong arguments that the employees enjoy far more rights than the rest of the economy and the public sector. According to available data, the average net salary in EPS in 2013 of almost 80,000 dinars was almost twice the average salary in Serbia, which is not the case in the region (for example, data for Croatia and Republika Srpska show that the salaries in the electric power industry are 30-40 percent higher than the average). Furthermore, the January warning that the employees in EPS will go on strike, was resolved by the state accepting most of the strikers' demands, and it revealed that EPS employees, besides the salary, have other privileges that are not in line with the (not very successful) performance of the enterprise itself, and that are ultimately paid by the consumers. They include various types of loans (for heating, food supplies, housing) given with no interest, and which are actually written off at a particular amount. The employees were also promised the certain advance payments as a compensation for the solidarity tax. All of this was accompanied by accepting the demand of the strikers, EPS to re-acquire the unprofitable and previously spanned off companies and to take over their losses - which is totally wrong. The Fiscal Council believes that without decisively opposing the demands of the trade union and reducing the number of employees and their privileges, it would not be possible to transform EPS in a successful enterprise. It is particularly important to note that with this kind of company management there is also a great risk that the additional income from, what we consider reasonable, future increases in electricity price, sooner or later will be spent on increasing the number of employees and/or their benefits, rather than on the actual needs of EPS – such as debt repayment, revitalization of existing and construction of new facilities.

EPS has a numerous organizational and operational problems that need to be solved. The complicated organizational structure of EPS generates a lack of responsibility in the chain of management of the entire system, and even generates internal liquidity problems between EPS and its subsidiaries (for example, towards RB Kolubara). There were some publicly made proposals to increase the centralization of the system, because it is now impossible for the head of EPS, if dissatisfied with the operations of any of its subsidiaries, to

²⁰ Appropriately targeted system of social cards should provide the poorest with even lower electricity price, while the wealthy individuals would pay more.

²¹ This price increase would be enough to enable regular settlement of the liabilities of EPS and provide a small surplus of funds for revitalization of existing infrastructure. To establish the desired parity of electricity price with other energy sources, but also to transform EPS into a profitable company that can start a new investment cycle, the price increase would have to be even larger. We believe, however, that it is still too early for such a price increase, because EPS first has to solve its organizational problems, lay off the surplus employees, regulate the wage and benefits system, rationalize its ineffectiveness, etc. If these processes are not completed, proceeds from the price increase would be irrationally spent, and the enterprise would lose its motivation to reform.

²² Excluding the expenses for staff in KiM. With them, staff expenses would be over 60 billion dinars.

directly influence them – by, for example, replacing the managers. Centralization would reduce unnecessary expenses incurred because of doubled job positions and the loss of economies of scale. Although this and other proposals sound reasonable, proposing organizational changes within EPS more accurately goes beyond the expertise of the Fiscal Council. We point out, however, that increase in centralization and other organizational changes in EPS are necessary, and that during the detailed analysis of this enterprise, we faced a number of difficulties, illogical aspects and problems that may be attributed to the operational organization of the enterprise. It is especially important to solve the problem with the employees and management of property in KiM, which was also stressed out by the State Audit Institution and the Constitutional Court. Additional problems burdening the operations of EPS are the losses in the distribution grid, which largely arise due to “non-technical” reasons – non-functional meters, electricity theft, etc. - which could be solved through more sophisticated meters and better control, suspension of the electricity supply and penalty for electricity theft.

There is still no clear strategic determination of the state concerning the future of EPS. The Government, at its session of November 16, 2012 adopted a Conclusion accepting the Baselines for the reorganization of the Public Enterprise “Elektroprivreda Srbije”. Baselines provided also for a change in the legal status of EPS, from a public company into a joint stock company and greater centralization in the management of economic, financial, legal affairs, etc. These changes, however, have not been implemented yet, which, we believe, indicates an indecision and probably not completely defined position of the state in regard to the future of EPS. The dilemma is perhaps even more accentuated by the exposé of the Prime Minister in April 2014 when a possible minority interest privatization of EPS was announced. This however is still not accompanied by adequate analysis that would show in detail what and under which conditions would be privatized, why the state is considering this particular method of privatization, or by defining transparent procedures seeking minority partners. The impression is, therefore, that the state does not yet have a clear vision of the future perspective of the enterprise, and without defined and sustainable long-term objective, any kind of proposed reorganization of the enterprise cannot be optimal.

So far EPS has not created any direct fiscal cost, but that is not excluded in the future. Borrowing for the purpose of providing liquid assets in 2012 and 2013 is an indication of possible difficulties in repayment of matured liabilities from its own funds (the similar happened in Srbijagas a few years ago). The deepening of these tendencies could lead to a state intervention for direct funding of matured financial liabilities of EPS. For such liabilities, according to the estimates, in 2014 it will be necessary to allocate more than 30 billion dinars (including interest costs), which is about 0.8 percent of GDP in additional fiscal deficit. If the manner of doing business in EPS does not change, these liabilities will increase each year, as well as the fiscal risks associated with them. The problems of fundamental mismanagement and lack of liquidity (despite occasional accounting profit) are reflected in the public revenue in other ways, since the state does not receive the dividends that could belong to it if EPS operates successfully. A particularly interesting example is the payment of dividends for the year 2013, when EPS, despite its accounting profit, was not liquid to pay to the budget the relevant portion of the profit for the state. It is still possible to prevent the impact of bad performance of EPS on the fiscal cost, and therefore it is necessary to undertake timely actions while problems are still controllable.

The Fiscal Council believes that the changes in the business operations of EPS could ensure sustainable operations of the company, while the planned large investments will have to be implemented through private investments. EPS currently does not operate sustainably, so it is not realistic to expect that this company will be able at any time soon to invest sufficiently (thermal power plants, hydro power plants, renewable energy sources) and thus support the planned economic growth based on the production of tradable goods. Currently achievable targets for EPS are to operate without loss and, as a result of its operations, to invest and repay the current and new loans to revitalize the plants, to meet the

necessary environmental standards and to eliminate the effects of recent floods. The Fiscal Council considers, however, that this should not be a reason to postpone necessary major investment projects in the energy sector. Those are projects that during their implementation directly and significantly impact the GDP growth and create conditions for further dynamic growth of the economy. Such investments should not wait for sufficient improvement of the operations of EPS,²³ and could relatively quickly be implemented through foreign or domestic private investments, for which it would be necessary to improve the legislation and the activities of the public administration.

Energy policy is an essential element of the economic policy of EU, so the future performance of EPS will be influenced by the upcoming negotiations on Serbia's accession to EU. The electric power system is an essential part of a common economic policy of EU (for example, Europe 2020 Strategy). Since 2005, Serbia has been a part of the Energy Community of the European countries that is based on the implementation of the relevant *acquis communautaire* and liberalization of the domestic energy markets of the member states of the Community. In the process of negotiations between Serbia and the EU, however, new issues related to meeting the environmental standards, renewable energy, etc. will be open, which could significantly affect the performance of EPS. It is therefore important that during the negotiation process, the interests of this enterprise are completely protected, and that the costs of adaptation to the European standards (which will undoubtedly exist) are reduced to a minimum.

We will now give a detailed overview of the performance of EPS, its current problems and suggested solutions.

3.1.2. Detailed Analysis

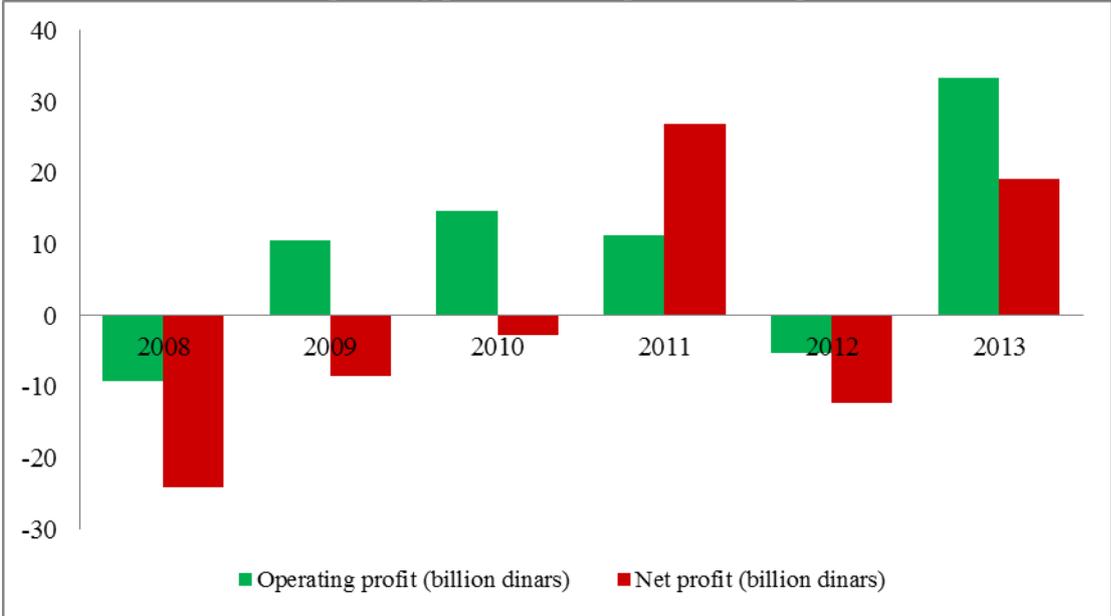
In the last few years EPS makes small accounting profit, but it actually does not operate successfully. The net profit of the enterprise for the period 2008 - 2013 is shown in Chart 1. The chart shows that over the past few years, EPS recorded both profits and losses, but in the last few years the result of the enterprise was mainly positive. However, the financial results have to be taken with reserve due to the underlying bad debts, depreciation and revaluation, internal relations within the system etc. We use net and operating profits to illustrate that net profits are not a true measure of the success of the company (Chart 1). It can be seen that there is a big difference between these two values – for certain years the difference is over 15 billion dinars. This difference is primarily due to the large “non-operating” expenses of the enterprise: bad debt write-offs, KiM staff costs, decrease and sometimes even increase of the value of assets.

Indicative for the actual assessment of the performance of EPS may however be the fact that even in the years when it earned profit, EPS had problems to pay out the dividends to the state - which implies that the real performance of the company could be worse than the actual results measured by net profit (or operating profit). Inability to pay out dividends reveals that the accounting profit includes very large and growing uncollected receivables. Thus, the increase in uncollected receivables from 2009 to 2013 amounted to about 50 billion dinars, which is far more than the cumulative net profit of the period (about 20 billion dinars (Chart 1)). Therefore, the actual cash inflow in the period (despite posting cumulative profit) was actually negative, so the enterprise did not have the cash to pay out the dividend to the state. The problem of uncollected receivables is actually forwarded into the future, when the enterprise will have to show losses on this basis. In fact, in the upcoming years most of the

²³ The necessary changes at the organizational level, in the core corporate governance, reduction of the number of employees, etc. will last for years. Even if all inconsistencies and inefficiencies in the system are eliminated, for starting major investments by EPS, it would be necessary to raise the prices more than the estimated 15 percent.

accumulated debts will have to be written off, so then the poor performance of the company over the past five years will become evident in the accounting as well. Because of these and similar examples, the Fiscal Council has further analyzed a number of different financial indicators (liquidity, indebtedness, profitability), but also the price and collectability of receivables from electricity supplied as well as technical, operational and organizational parameters of the performance of the company (number of employees, losses, etc.) that can show the real performance of EPS. The results of the analysis indicate a number of problems that threaten to escalate but we believe that they can still be solved with decisive measures.

Chart 1. Operating profit and net profit for the period 2008-2013



Source: Analysis by the Fiscal Council, with data from the financial statements of EPS

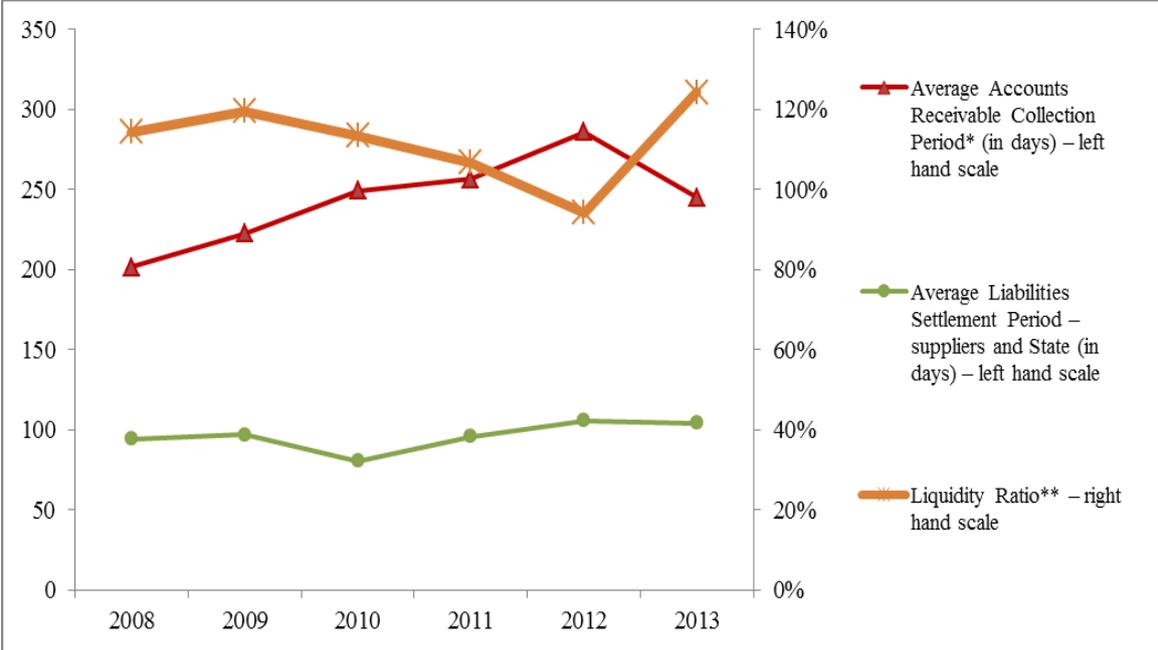
The liquidity position of EPS is very poor. In 2013, after a worrying trend of deterioration, there was a slight improvement in the liquidity, but it is still below the satisfactory level. Chart 2 shows the liquidity ratio, which measures the ratio of current assets to the current liabilities. It is desirable for this indicator to be above two (200 percent in the chart), but the chart shows that, even with the improvement in 2013, this indicator is just about 1.2 (or 120 percent). Another indicator not shown in the chart that clearly indicates problems in EPS is the liquidity ratio based on the net cash flows from operating activities in relation to current liabilities. It is desirable that the value of this indicator is above 0.4, which was the case until 2009. However, from 2009 this ratio was in a large decline and in 2012 it reached its minimum of less than 0.2. Lack of liquid assets during 2012 and 2013 was reflected in an alarming borrowing to settle the matured obligations (financial and operational).

The worsened liquidity position of EPS is primarily a result of a significant increase in bad debts. Concerning the accumulated bad debts, a very long average collection period can be seen, which in 2009 was about 200 days, increasing to almost 300 days in 2012 (Chart 2). However, this indicator does not say much about the actual average period of accounts receivable collection, because the biggest part of the bad debts will be written off at the end, but points out to the center of the problem - huge and growing bad debts.²⁴ On the other hand, the average period of settlement of EPS payables to suppliers and to the state is relatively stable at around 100 days (Chart 2), whereas until 2012 the period of settlement of

²⁴ The indicator that tracks current receivables only, that are still not bad debt, does not show a satisfactory collection schedule as well, since the average period for collection of these receivables is stable at around 70 days, which is longer than the prescribed period for payment of electricity bills.

payables to suppliers was slightly longer than the period for settlement of payables to the state. In 2013, there was a significant slowdown in settlement of payables to the state, while payables to suppliers were settled slightly faster. Comparing the average accounts receivable collection period (250 days) and the payables settlement period (about 100 days), it can be seen that receivables are collected twice slower than the payables are settled, which largely contributed to the disruption of the enterprise’s liquidity.

Chart 2. EPS Liquidity indicators for the period 2008-2013



*For the calculation of the indicators we have used the total accounts receivable - including bad debts from the position of allowance for impairment of receivables.

** Liquidity ratio equals the ratio of current assets to current liabilities

Source: Analysis by the Fiscal Council, with data from the financial statements of EPS

Bad debts are one of the main problems in the performance of EPS. Total outstanding debts have more than doubled since 2009, and at the end of 2013 amounted to about 195 billion dinars, which is approximately the amount of the total annual operating income. Three-quarters of total gross receivables relate to receivables from customers in the country and abroad (about 135 billion dinars). About 75 percent of the receivables from customers are already recorded as allowance for bad debt, which is an indicator that nearly that much will remain uncollected. Allowance for bad debt is the part of receivables that, at this point, have an estimated low probability of collection, so it can be expected that in the upcoming period these bad debts will be written off. Allowance for bad debt therefore does not still represent a loss for the enterprise, but it can be seen as a potential future loss when they are finally written off. Therefore, in the following period, EPS could record loss of about 100 billion dinars just on the basis of bad debts. Another negative effect of bad debts on the liquidity of the enterprise is that EPS is required to pay VAT on the invoiced amount of income, regardless of its collection. Therefore, the enterprise, along with the lack of inflow from debt collection, has additional outflows concerning VAT on sold but unpaid electricity.²⁵

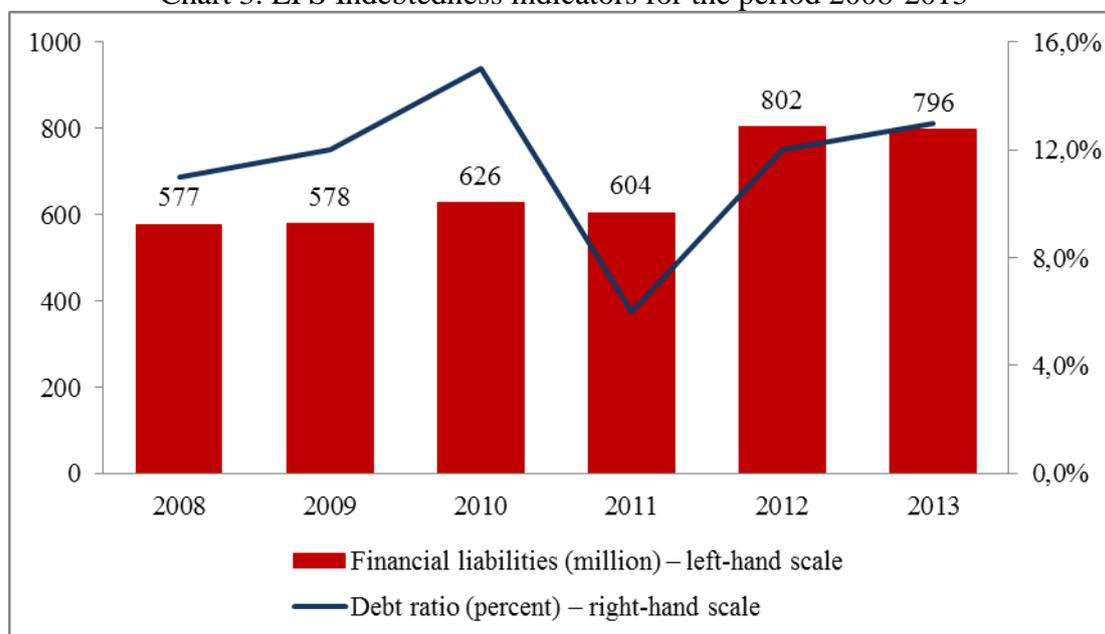
The volume of bad debts indicates that EPS non-selectively tolerates non-payment for electricity. Suspension of electricity supply to enterprises and households that do not pay has its political, social and economic consequences. Yet it is the only solution to stop further accumulation of losses of EPS on this basis. The fact is that some enterprises (especially those in restructuring) and households, probably really cannot pay electricity bills

²⁵ In case of accounting write-off of such bad debts, the amount of paid VAT will be refunded to the enterprise.

- but tolerating non-payers is no solution to these problems.²⁶ In other words, social and economic problems of the citizens and the economy should not be solved through EPS. For those enterprises whose survival is of an interest to the state, the state should have to transparently allocate funds for payment of their electricity bills, as well as to provide sufficient social protection to the actual socially vulnerable households. In all other cases, further tolerance of non-payment of electricity bills is very harmful and unfounded.²⁷

Financial indebtedness of EPS, analyzed in absolute value (million EUR), increased from EUR 580 to 800 million in the period 2008 - 2013.²⁸ Chart 2 shows the growth of indebtedness of the enterprise by years. The debt ratio (the ratio of financial liabilities to equity), is also on the rise, although in 2011 there was a one-time decline (Chart 3). The reason for the decline in debt ratio is clearly not repayment of the dues as they have actually increased. Decline in the ratio is driven by but the increase of revaluation reserves, which are counted in as equity. Revaluation reserves increased significantly in 2011 (by more than 500 billion dinars), due to the revaluation of assets of EPS, which only seemingly improved the relatively measured indebtedness of the enterprise. In addition, at first glance alarming, value of this ratio of about 12 percent should be also interpreted with caution, since almost $\frac{3}{4}$ of the equity consist of revaluation reserves whose increase is not accompanied by actual cash inflows.

Chart 3. EPS Indebtedness indicators for the period 2008-2013



* share of financial liabilities in the equity

Source: Analysis by the Fiscal Council, with data from the financial statements of EPS

It is obvious that the financial position of EPS is getting worse each year. During the reporting period (2008-2013), EPS had to take loans because its income was not sufficient to fully finance even the basic maintenance of the existing generation facilities. Since the loans were taken for recovery of the existing facilities rather than building new ones, there has

²⁶ The most significant debtors in the country in 2013 are RTB Bor Group with about 8 billion dinars, Zorka energetika with about 1 billion dinars, Železnice Srbije a.d. with about 750 million dinars and Železara Smederevo with 567 million dinars.

²⁷ For example, enterprises that do not pay for electricity compete in the market with those who pay, and so undermine the business of healthy enterprises. Also there is no reason for the households that are not socially vulnerable not to pay for electricity.

²⁸ The financial indebtedness of EPS, expressed in billions of dinars increased from 51 to about 91 billion dinars.

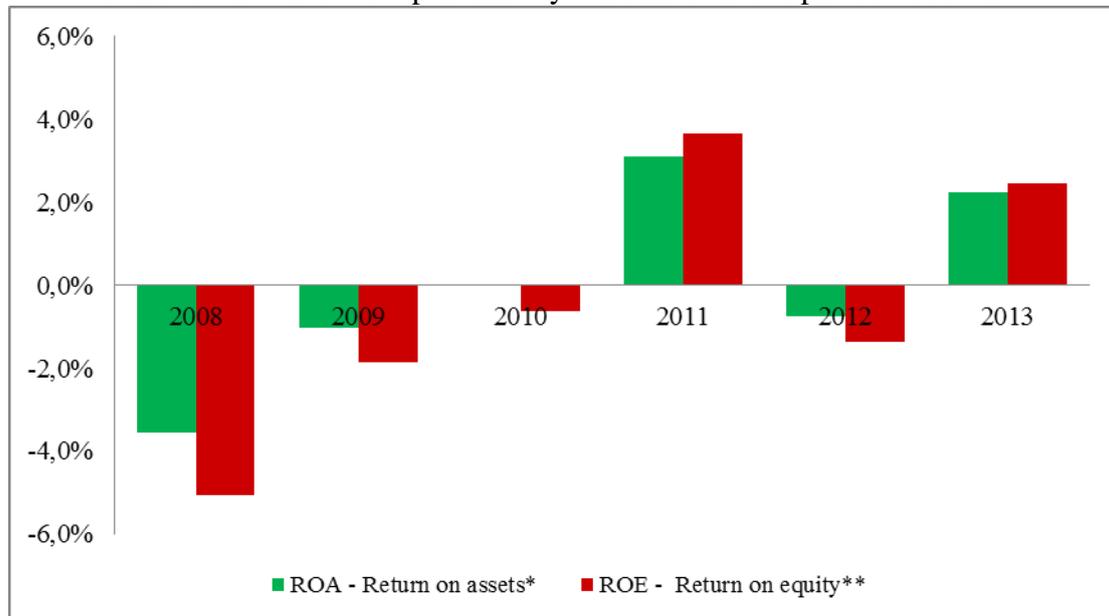
not been any large increase in generation capacity or in operating income of EPS.²⁹ The financial position of the enterprise was therefore getting worse - because the slightly increased generation and income now had to be used for repayment of relatively large and fast-growing loans. The financial statements of EPS confirm the tendency of continuous growth of long-term and short-term liabilities, and the subsequent increase in funds allocated by the enterprise for servicing the loans. Lacking a significant increase in cash flow from operating activities, the enterprise was forced to solve the problem of liquidity through new long-term and short-term borrowings - which then further increase the liabilities of the enterprise in the future. Long-term and short-term liabilities at the end of 2013 amounted to 66 billion and 122 billion dinars, respectively. Part of short-term liabilities (about 13 billion dinars) accounts for trade payables. The latter has resulted in spilling over the insolvency of EPS to other enterprises, thus generating illiquidity throughout the entire economy. It is expected that in 2014 the liabilities of the enterprise will further increase by taking an additional 20 billion dinars loan for repairs and routine maintenance (a government-guaranteed), and it will probably be necessary for EPS to take loans for the recovery of flood damages. Therefore, the cost of servicing the liabilities in the upcoming years will certainly continue to grow, and that has to be taken into account during the projection of the EPS performance. On the other hand, the rapid and continuous growth of liabilities of EPS is a clear indication that the current operations of this enterprise in the long run are unsustainable.

Although there is an accounting profit in 2013, profitability ratios are nowhere near satisfactory. Profitability of EPS, measured by the returns on assets (ROA) and equity (ROE), is shown in Chart 4. We have to take into account the fact that even in the years when EPS achieved positive return, that return is very debatable. For example, in 2011 it resulted from recording significant "other" income from an increase in the carrying value of property, plant and equipment.³⁰ In addition, throughout the period bad debts accumulated, which is not yet fully reflected in the loss of the enterprise. Therefore, we conclude that EPS is not profitable for a long period of time. However, even if we use, as an indisputable fact about a profitability of an enterprise, the net profit of 19 billion dinars in 2013 - that would not be a completely satisfactory result either. Since, when we put the profit into the context of the funds with which EPS achieved profit (ROA and ROE), we see that the return on equity, even in the somewhat more successful year, amounted to only about 2 percent (Chart 4). We would also like to point out that on the market EPS is currently borrowing at an annual interest rate that substantially exceeds 5 percent in foreign currency, while in dinar even more than 10 percent.

²⁹ But it did ensure better supply reliability, less damages, etc., which is the main objective of the implemented revitalizations.

³⁰ Source: JP Elektroprivreda Srbije, Notes to the consolidated financial statements, December 2011.

Chart 4. ROA and ROE profitability indicators for the period 2008-2012



* ROA shows the ratio of net profit/loss to average total assets

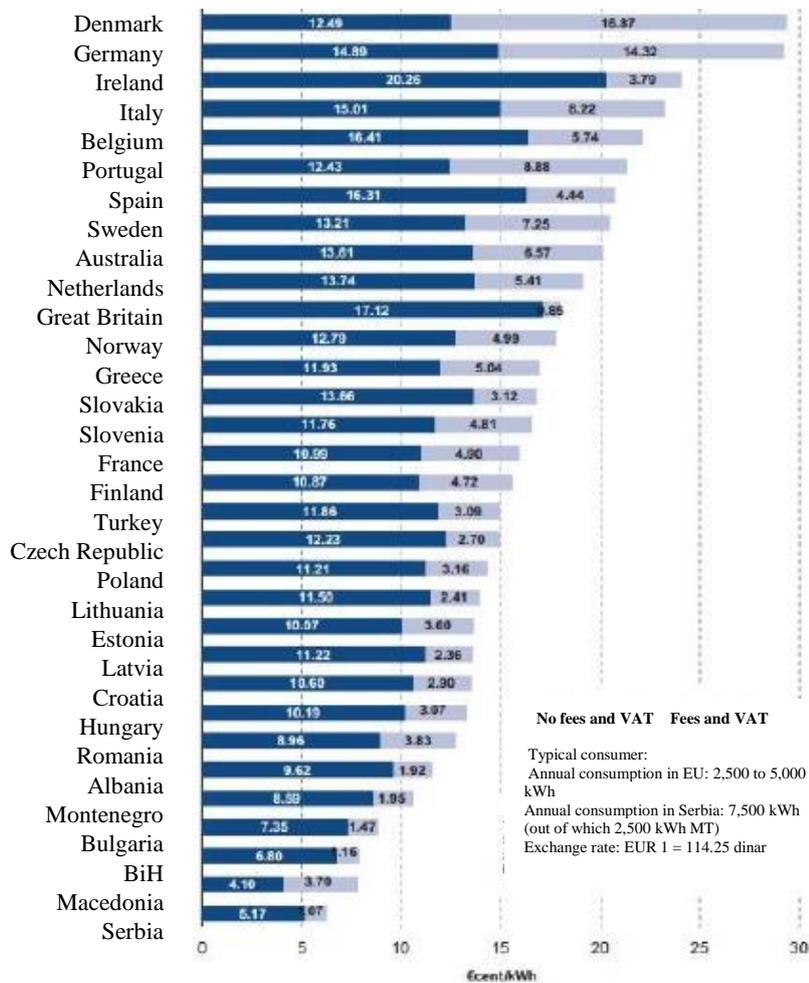
** ROE shows the ratio of net profit/loss plus interest expense after tax and average own funds (equity)

Source: Analysis by the Fiscal Council, with data from the financial statements of EPS

Serbia has a lower electricity price than any other comparable country. We believe that one of the key issues that led to poor performance of EPS is the low price of electricity. According to data from the Energy Agency, the electricity price, calculated using the comparable Eurostat methodology, in Serbia for many years is by far the lowest in Europe, and apparently insufficient for EPS to be a successful enterprise. The latest available data from the Energy Agency refer to the second half of 2013, and we have presented them in Figure 1. We decided to show the comparative electricity prices for households only because they actually constitute the largest segment of the EPS's consumers, but also because the liberalization of prices for medium and high voltage consumers in 2014 significantly changed the parity for the industrial consumers, which will be further discussed in the following paragraphs. Regulated, low electricity price (in addition to bad debts) has led to poor performance of the enterprise and lack of investments in the past years. The very low price and income have actually hindered intensive investment activity financed from its own resources, which is essential to ensure long-term sustainability of the electric power system. Lack of funds for financing the revitalization of the existing plants was compensated by taking government-guaranteed loans for investment projects, which contributed to significant increase in indebtedness of the enterprise and of the country as well. Low electricity price has resulted in establishment of illogical parity price of electricity in comparison to other energy sources, and thus in irrational use of electric power in Serbia. Cheaper electricity price compared to other energy sources (oil, gas) resulted in irrational use of electricity by large number of households, and due to low electricity price the population is not motivated to increase the energy efficiency. As a consequence of (unwanted) stimulation of irrational use of electricity, Serbia has a very unusual structure of consumption compared to other European countries, since the share of households' electricity consumption of about 50 percent is almost twice higher than in EU.³¹

³¹ Source for the EU: Final *electricity consumption by sector (ENER 018)* - Assessment published Apr 2012, European Environment Agency

Figure 1: Electricity prices for households - second half of 2013



* Data from the previous six months

Source: Taken from the Report on the activities of the Energy Agency for 2013

Liberalization of the electricity market brought the electricity price closer to the economic price - but so far for medium and high voltage consumers only. The liberalization of the electricity markets means, in other words, introduction of market principles in the generation and supply of electricity, while in the activities of transmission and distribution of electricity the control is retained (natural monopolies). It means that the terms and price of supplied electricity which is subject to agreement between the supplier (EPS or other) and the end customer, i.e., the price of supplied electricity will not be regulated – but subject to regulation will be the grid fees only (costs of transmission and distribution of electricity). So the price offered will depend on the level and dynamics of consumption, how regular the payments of electricity bills are, etc. So far, about 40 percent of the electricity market has been liberalized. The first stage of liberalization was completed at the end of 2013, when the high voltage consumers made a transition from public supplier to a supply at the free market. At this stage of liberalization, EPS remained the main supplier, since only one high voltage consumer made a transition to another supplier, while the remaining 26 chose EPS (about 97 percent of the market participation). The second stage of liberalization should be fully completed by mid-2014, for about 3,200 medium voltage consumers. Certain number of medium voltage consumers have still not chosen a supplier (primarily public institutions and state-owned enterprises - due to problems with conducting public procurement procedures), due to which they are currently on reserves which is more expensive by 30 percent. The liberalization of the electricity market for high and medium voltage customers has led to a noticeable rise in prices in this segment - which is another indication that the

previously valid, regulated prices were unreasonably low. In the case of high voltage consumers, the average price increase was 43 percent, while the estimate of the increase in medium voltage consumers is around 20 percent. The fact that high voltage consumers, despite the increase in electricity prices of 43 percent, remained loyal to EPS, shows how much the electricity price in recent years was underestimated.

Liberalization of the electricity market for households and small consumers is planned to start in 2015 - which does not necessarily mean an automatic increase in price. The third and last stage of the liberalization of the electricity market will be the most important and will start in 2015, when households and small consumers will have the options offered by the market. Households will be able to choose whether they will continue to purchase electricity from EPS, or will go at the free market and choose one of the licensed suppliers. In Serbia at the moment there are about 70 licensed suppliers, but only thirty are active and mainly engaged in cross-border trade of electricity (wholesale). Experience with high voltage consumers and electricity prices for households in the region indicates that EPS is able to significantly increase prices for households and still remain competitive compared to all other suppliers. However, a huge increase in electricity price is pretty unlikely, not so much due to formal reasons,³² but because EPS is state-owned and it is unrealistic to expect that the decision to increase the electricity price for households will be devoid of political factors.

The Fiscal Council considers it necessary to increase the electricity price for households - by 15 percent. Low voltage consumers, including households, are still the largest segment of consumers of EPS (over 65 percent are low voltage consumers, while about 50 percent are households)³³ and without adjustment of prices in this segment, it is difficult to establish sustainable operations of the enterprise. An illustrative calculation of the Fiscal Council shows that the increase in electricity price for low voltage consumers of about 15 percent so far would probably be enough (taking into account the previous price increase for high and medium voltage consumers). With this increase, EPS would be able to self-finance its liabilities (without taking loans for refinancing) and to have something left from the resources to finance investments in revitalization of existing facilities – provided the expenses of EPS are kept under control. The urgency of increasing the electricity price for households too, is especially pronounced taking into consideration the large damages that EPS suffered due to the floods. Elimination of the results of the floods by taking new loans would just additionally burden the already unenviable financial position of EPS. On the other hand, and with the increase in price of about 15 percent for households, EPS would remain competitive in comparison to other energy producers and the cheapest in the region, so there would be no risk of losing the market after the liberalization (Figure 1). In medium term, gradual increase in the electricity price until establishment of required parity in relation to the prices of other energy sources and electricity prices in the region, should probably continue.

Increase in electricity price does not make much sense if costs of the enterprise are not kept under control. EPS still has relatively low production costs, so that even with a competitive electricity price, it could be a successful enterprise. The largest and, by all accounts, the worst controlled enterprise's costs are staff costs, so it is essential that there is a full control and rationalization established. Otherwise, it can easily happen that, sooner or later, the additional financial benefits from (implemented and expected) increase in the electricity price, to be spent on increasing salaries and other privileges of employees, rather than on improvement of the performance of EPS. The analysis of the Fiscal Council shows that it is not only necessary to prevent redirecting of the potential additional income of EPS towards the employees, but to provide opportunities for some serious savings on the position of staff costs, which would increase the profitability of the enterprise.

³² Although the Energy Agency might be able to temporarily restrict excessive price increase of EPS.

³³ Energy Agency, 2014, "Report on activities for the year 2013".

Although it is not easy to compare different national energy systems, there are clear indications that EPS is overstaffed. At a consolidated level there are over 38,000 employees (including about 4,500 employees in the territory of KiM). The different energy sources, structure and type of consumption of electricity and other specifics, make it difficult to directly compare the number of employees in the electric utilities in Serbia with those in other countries. For a more precise comparative analysis it is therefore necessary to take into account the different characteristics and analyze the number of employees in each activity of the electric utility. Comparative analysis of the number of employees in certain countries, engaged in generation, distribution and sale of electricity, implies that it is possible to rationalize the number of employees in EPS.

When examining the number of employees in absolute value, the Czech electric power system could be used for comparison. The dominant source of electricity generation in the Czech Republic is coal (about 60 percent), as well as it is in Serbia (70 percent). On the other hand, the Czech electricity utility has approximately the same number of employees as EPS (excluding KiM) - about 34,000; while the volume of generated electricity is twice as big. Determining the exact number of excess employees is beyond the scope of this analysis since the volume of generated electricity and the number of employees are not in a complete linear relationship. Furthermore, it should also be taken into account that much of the activities in the Czech electricity utility are outsourced, as well as that the facilities in the Czech Republic are probably technologically more advanced and efficient. But the fact that the Czech Republic produces twice as much electricity from approximately the same energy sources, and with the same number of employees as in Serbia - undoubtedly shows that EPS has excess workforce.

For further analysis, we could also take Hungary, with a volume of electricity generation at the level of Serbia, but with significantly different generation sources. In Hungary, the generation from nuclear power plants dominates, which does not require a large number of employees (as opposed to the electricity generation from coal). Therefore (to make the systems comparable) we have excluded from EPS the employees of Rudarski Basen Kolubara, which is engaged in production, processing and transportation of coal (about 12,500 employees) and the employees in KiM. Thus we come to a figure of over 20,000 employees in the “narrower” EPS, which is, although reduced as previously specified, higher than the number of employees in the three private enterprises in Hungary, which are engaged in a full generation, distribution, transmission, supply and sale of electricity (a total of about 18,000).

Relative indicators such as the ratio of number of customers to number of employees, the ratio of number of employees in a generation enterprise to generated GWh, as well as the ratio of number of employees in a distribution enterprise to the length of a distribution grid, also indicate that there is larger number of employees than in the other compared countries.

Salaries in EPS are much higher and grow faster than in the rest of the economy. The consolidated average net salary in 2012 amounted to about 73,000 dinars, and in 2013 it increased to almost 80,000 dinars. In the system of EPS, the highest net average salary in 2013 of about 126,000 dinars was paid in JP EPS Snabdevanje, whereas the lowest one of about 73,000 dinars in JP Elektrosrbija. Despite the fact that in the other countries the salaries are also significantly higher than the average, we have not noticed anywhere that the salaries are almost double the average - as it is the case with Serbia.³⁴ Also, the salary costs grow

³⁴ The usual argument supporting the relatively high salaries in EPS (and some others state-owned enterprises, for example, Telekom) is the outflow of experts from the enterprise if the salaries are lower. However, the main reason for this is in the inadequate wage policy, rather than in the level of the average salary. The enterprise, which has an annual turnover of around EUR 2 billion and supplies electricity to households and businesses, should provide adequate market (much higher than the current) salaries for the most responsible and the most qualified individuals. On the other hand, it is certain that most of the employees do not have “indispensable” expertise, so there is no reason for their salaries to significantly differ from the average salary, especially in an environment of high unemployment – where it would be relatively easy to find a replacement on the market.

relatively quickly and significantly faster than in the rest of the economy. Nominal increase in salary costs from 2009 to 2013 was about 40 percent, from about 39 to 54 billion dinars, and the number of employees in EPS at the same time decreased from 33,500 in 2009 to about 32,000 in 2013 (excluding KiM). This would mean that in the reporting period the average growth of cost of salaries in EPS amounted to about 48 percent, while the average nominal increase in salaries in Serbia during the same period was 38 percent.

At a request of the trade union of EPS, employees are granted different types of borrowings, and EPS re-acquired the unprofitable companies. Each year the employees are approved various types of borrowings (for fuel, food supplies, housing), and compensation and meal allowance are paid. In 2012, at the request of the trade union, the employees of EPS were approved a borrowing in the amount of 50,000 dinars (nearly 1.5 billion dinars), although that year the enterprise made a loss of around 12 billion dinars. The amount was paid in two installments (December 2012 and March 2013) even though the original plan was to have twelve monthly payments. This practice continued in 2014, when, due to warnings that employees will go on strike, the trade union of EPS signed an agreement with the Government of Serbia and the management of the enterprise on an interest-free loan to the employees, return of 1,470 employees of PD Kolubara-Usluge within EPS and 209 persons who were engaged through cooperation to be employed in PD TE-KO Kostolac. The trade union also demanded the employees in the public sector to be exempted from the reduction in the net income (solidarity tax), which has not been formally accepted. Instead, a borrowing to the employees was agreed. The total amount of the borrowing is estimated to 2-2.3 billion dinars, and the amount of the borrowing per employee shall be determined in one of the three ways: an equal amount for each employee, part of the borrowing in equal amounts while the remaining part proportionally according to the criteria to be defined or the entire borrowing according to pre-defined criteria. EPS states that this is not a standard loan, because the employees will be paid out from the profit earned in 2013 and in a form of the so called advance payment of profit (the exact amount is still not known), so they will not have an obligation to repay subsequently all the funds received.³⁵

Salary costs for employees in Kosovo and Metohija are over 5 billion dinars per annum.³⁶ The statements of EPS reveal that each year there are salaries paid for about 4,500 employees in the territory of KiM, on the following three bases: 1. Employees who work and live outside the territory of KiM, in line with the Special Collective Agreement; 2. Employees who work and live in KiM, whose salary increases by 50 percent; 3. Employees who do not work, in the amount of 60 percent of the salary that they would have earned if they have worked. The report of the State Audit Institution for 2012 states that during the audit procedure the Auditor did not gain any reasonable assurance that the payment of these expenses, which relate to salary compensation, temporary compensation and other earnings, is made on the abovementioned bases. We also point out that with a Decision of the Constitutional Court³⁷, these payments made on the basis of the Conclusion of the Government³⁸ are declared unconstitutional and illegal. Therefore, it is clear that it is necessary to find a way to solve the problem with the employment status of those employees, which would be within the legal framework. It is important that such a solution would not burden the net result of EPS, since it has no control over the assets and operations of the enterprises in the territory of KiM. Therefore, the above mentioned payments should be made

Better wage policy would therefore at the same time significantly reduce the salary expenses and increase the profitability of EPS, but it would also reward high quality employees and prevent outflow of the employees.

³⁵ Source: Agreement of the Government of the Republic of Serbia, JP "Elektroprivreda Srbije" and the trade union of Elektroprivreda Srbije, dated February 11, 2014, link: http://www.sindikateps.rs/images/dokumenti/Najnovije/20140211_Sporazum_sa-vladom.pdf

³⁶ The 2014 plan estimated their increase to about 6 billion dinars.

³⁷ Decision of the Constitutional Court IU No. 412/2003, dated April 16, 2010, published in "Official Gazette of RS" No. 56/2010, dated April 10, 2010.

³⁸ Item 1 of the Conclusion of the Government of the Republic of Serbia 05 No. 02-4586/2003-001, dated July 17, 2003.

transparent and remove them from the financial statements of EPS, since they do not represent operating expenses of the enterprise itself, but a kind of social welfare.³⁹

Distribution losses of about 15 percent are extremely high (the highest in Europe). The reasons for such high “distribution grid losses” are of both technical and non-technical nature. Technical losses are losses on the basis of transmission in the distribution system to the consumer. It should be noted that only less than a quarter of transmission lines and substations are in good condition. According to some estimates it is not possible to further reduce this kind of loss from the current 10 percent, due to the condition of the distribution infrastructure, as well as due to the structure of final consumption of electricity. In Serbia, the low voltage electricity represents most of the consumption (the households have the largest share in the consumption), and it is associated with a higher percentage of distribution loss than the high and medium voltage electricity. However, not only that the economic cost of electricity could facilitate investments in the distribution grid but it would also discourage the use of electricity for household heating. This would reduce the consumption of low voltage electricity. On the other hand, non-technical losses (5 percent) refer to the electricity consumed that the enterprise is not able to identify (wrong meter readings, theft, etc.). For the purpose of minimizing the non-technical losses, EPS was granted an investment loan for purchase of “smart” meters; the loan is still not disbursed because the procurement tender was canceled. Also, it is evident that further reduction of various other operating expenses is possible, since the State Audit Institution in its report identified several weaknesses concerning the public procurement procedures carried out, in particular that the enterprise has not always followed the principle of most favorable prices.

A change in the organizational structure of EPS is needed to recover the disturbed financial and operational relations between the parent company and its subsidiaries. This area undoubtedly needs to be regulated better. From the report of the State Audit Institution, but also by examining the balance sheet positions of the parent company and its subsidiaries, it is evident that there are significant amounts of non-collected receivables, as well as unsettled liabilities between them, which increase in the reporting period. The report of the State Audit Institution also notes that there are no internal settlement mechanisms between EPS and its subsidiaries, concerning the liabilities related to loans (terms and conditions) taken by the parent company for its subsidiaries. The report explicitly states that the enterprise has not established an adequate system of functioning of financial management and control. Having this in mind, a certain centralization of the enterprise would probably be justified because it would result not only in improvement of the control, but also in direct reduction of costs - since now there are many overlapping functions in the parent company and its subsidiaries. Finally, we point out the need to refrain from the announced intention to re-acquire the unsuccessful spanned off companies that were previously part of EPS. We believe that such re-acquisition would actually just result in further concealed subsidization of non-core activities, which is unjustified not only operationally but financially as well. Poor performance of these companies must be resolved through their internal reorganization and rationalization, or, if there are no other options, through closing them down – and not by any means through transferring the losses to EPS.

It is necessary to substantially restructure EPS, in business and financial terms. Given the potentials of the industry in which it operates, as well as the amount of its assets and equity, EPS should change from generating illiquidity in the economy to driving the economic growth. Stopping and reversing these negative trends must be the fundamental reason for the announced restructuring of the enterprise. The announced corporatization of the enterprise would be meaningless if the objective is not to increase the efficiency in all business segments. The Fiscal Council does not analyze whether the future of EPS is in

³⁹ Furthermore, every year EPS supplies electricity to the territory of AP KiM in the amount of over 800 million dinars, with an estimated collection rate of less than 10 percent. Consequently, in 2012 the amount of outstanding (but still not written-off) receivables was approximately 3.5 billion dinars.

corporatization, sale of any minority or majority ownership interest in the enterprise, but we believe that fundamental and comprehensive changes are necessary in order to make the performance of this enterprise sustainable and to avoid the risk of becoming a fiscal cost in the future.

The problem of insufficient level of investments of EPS puts at risk the long-term development strategy of Serbia - and thus alternative models have to be considered to increase the electric power facilities of the country. In the past the electricity price was not sufficient to finance intensive investment activity. The enterprise used guaranteed loans only to revitalize the existing generation and distribution facilities. The result of the lack of intensive investment activity is that there was no new generation facility built in the past twenty years, and the average age of hydroelectric power plants is over 40 years, while the age of thermal power plants is over 30. The obsolete and limited electricity generation facilities of EPS certainly call into question the long-term development of the Serbian economy based on the production of tradable goods. According to the World Bank⁴⁰ in the second half of the decade Serbia will face a shortage of electric power facilities needed for the economic growth. Since now, but also in the next few years EPS will certainly not be able to independently build new large generation facilities, the state must reconsider alternative models of development of the electric power system. To this end, we consider necessary to enable and facilitate private (domestic and foreign) investments in the generation and distribution of electricity - instead of using funds provided by the over-indebted country or EPS which has yet to establish a sustainable business model. Effective liberalization of prices as well as of generation would stimulate the private sector interest in investing in new generation facilities, and the competition would just add pressure for cost rationalization of EPS, which, we believe, can be improved a lot.

3.1.3. Box: Impact of the May floods on the operation and energy stability of EPS

The May floods have caused immense damage to the public enterprise “Elektroprivreda Srbije”, estimated at about 16 billion dinars. The flood in Serbia in mid-May caused a great damage to property, plant and equipment of the companies that operate within EPS. Assessments which are still preliminary indicate that the total damage sustained by EPS is about 16 billion dinars, which also includes the estimated costs necessary to restart the electricity generation facilities of the enterprise to the full extent. Rudarski Basen Kolubara was damaged the most, because the Kolubara River flooded the opencast pits of Veliki Crljeni and Tamnava-Zapadno Polje with the entire equipment. The final assessment of the damage in RB Kolubara is not possible until the pits are completely dry, when it will be possible to accurately estimate the total cost of repairs and replacement of damaged equipment i.e., recovery of the pits. Currently it is estimated that the total damage, i.e., the cost of draining the mines, their rehabilitation and repair of damaged equipment could amount to around 11.5 billion dinars. The facilities and equipment of TE “Nikola Tesla” in Obrenovac sustained significant damage, in particular the railway tracks used primarily for transport of lignite from the Kolubara mines to TE “Nikola Tesla”. According to the estimates of the EPS officials, the damage and cost of rehabilitation of the plants and damaged railway tracks amount to about 2.5 billion dinars. Damages and cost of rehabilitation of the remaining companies within EPS (hydro power plants, TE Kostolac, etc.) are slightly lower and are estimated at about 2 billion dinars.

The damages suffered will reduce the generation capacities during 2014 and that will have to be compensated by importing electricity worth about 18 billion dinars. TE “Nikola Tesla” in Obrenovac, because of the suffered flooding and interruption in the supply of lignite, worked with reduced capacity during the emergency situation. Since this thermal power plant produces more than half of the total domestic generation of electricity, it has

⁴⁰ World Bank, December 2011: *Country Economic Memorandum: The Road to Prosperity: Productivity and Exports*

resulted in a sharp drop in electricity generation in May (according to data of the Statistical Office of about 20 percent compared to May 2013). For the purpose of maintaining energy stability and regular supply to consumers, during the 10 days of emergency situation, the electricity imports amounted to about 800 million dinars. The generation of electricity in Serbia is primarily based on coal - about 74 percent of the total electricity in 2013 was produced in the largest domestic power plants TE “Nikola Tesla” and TE Kostalac. Therefore, the main problem in the generation of electricity during the rest of the year, which could be up to 30 percent less than planned, would be the reduced lignite production in RB Kolubara, which is a major supplier of TE “Nikola Tesla”. Assuming a regular upcoming winter and no large negative shocks in the energy market, it could lead to additional electricity imports worth about 17 billion dinars by the end of 2014. Due to the flooding of the opencast pits of Veliki Crljeni and Zapadno polje, RB Kolubara produces only half of the normal daily production of lignite (45,000 instead of 90,000 tons as planned), so the amount of loss of EPS based on lower generation of electricity will directly depend on how quickly they will be rehabilitated. Recovery of the mine Veliki Crljeni is underway, and according to the announcements it will be completed in August, while the coal production will begin in September. However, even then, the daily generation will not exceed 70 percent of the planned and it is essential for the operations of EPS and stable electricity supply to fully enable as soon as possible the production facilities of RB Kolubara.

However, efforts to repair the damages in the mining and energy sector are not appropriate to the emergency of the situation. Although lower generation of electricity during the summer months is not a problem, there are many risks that could jeopardize the stability and sustainability of the national energy system during the upcoming winter. The first estimates show that there is no larger surpluses of electricity in the immediate vicinity, which might complicate the planned imports and adversely affect the price of imported electricity – and thus increase the losses of EPS. The gas crisis, due to the escalation of the conflict in Ukraine, as well as a possible shortage of coal in the market for household consumption, represent additional risk to the sustainability of the energy system since it would then increase the consumption of the energy which is in short supply. Nonetheless, procedural reasons have delayed the actions to repair the damage and unnecessarily postponed them. Due to the lack of balance sheet positions in the financial plan of EPS which would cover expenses in case of emergency and waiting for permit from the government, two months after the floods there is no conducted public procurement for high-capacity pumps and other equipment necessary for dewatering the mine Tamnava-Zapadno Polje. Since it is planned this mine to produce 47 percent of the total production of lignite of RB Kolubara, its rehabilitation is of a priority significance for EPS and sustainability of the energy system in the future. The initial striking announcements that the drying of Tamnava-Zapadno Polje will take at least 15 to 18 months are not in accordance with the terms of the call for tenders in which the contractor is required to complete the work within 105 days. If the determined deadline is realistic and such a contractor is found, announcing a call for tenders as soon as possible will enable recovery of the production in Kolubara at the planned level before the start of the heating season, which with the current timeframe is practically impossible⁴¹. Due to the same reason, costs for repairing minor damages are financed by redirecting funds earmarked for regular summer repair, but in case of increased load to the energy system during the heating season it could pose a threat to its viability. It is therefore necessary for the government as soon as possible to eliminate all existing and potential formal barriers and thus create conditions for a more efficient elimination of the consequences of the floods in the mining and energy sector.

⁴¹ It will take at least a month to start the works, since there is a given deadline of two weeks for submission of bids, followed by selection of the best bid and starting the drying activities. Even if the deadlines are fully met, the completion is probably not possible before mid-December.

The flood increases the risk that EPS operations in the upcoming period will become a direct fiscal cost. The analysis of EPS operations showed that although EPS in the previous period did not cause any direct costs to the state, there are substantial risks for that to happen in the near future, if no adequate reforms are carried out. Apart from the already existing problems with liquidity, there is a growth in operating expenses due to increased imports of electricity (about 18 billion dinars) and negative impact of the flood on the cash flows due to the cost of rehabilitation of facilities (about 12 billion dinars) in 2014. Besides the growth of expenses, income from electricity sales could be slightly lower in 2014. In fact, during the flood, and shortly after, about 110,000 customers were left without electricity, and the priority of EPS in the crisis situation was urgent reconnection of these consumers to the electricity network, often without proper power meters. In this way, a large part of the consumed electricity in the affected areas during May was not charged, and according to the estimates, it is necessary to install approximately 22,000 power meter in order to reduce these non-technical losses during the rest of the year. Liquidity risks EPS due to the costs for remedying the consequences of the floods are twofold - possible delay in the payment of obligations to the state (VAT, contributions and other charges) that could reduce the public revenues by several billion dinars and/or approval of new government-guaranteed borrowings for EPS which would directly increase the public debt. However, due to the extremely difficult fiscal position of Serbia, the probability that the cost of rehabilitation will affect the budget needs to be reduced to a minimum. The Fiscal Council considers that the emergency costs could be financed from the received national and international donations, while funds for repair of other damages should be provided by EPS through its internal rationalization: improvement of accounts receivable collection, rationalization of employment and wage policy, adjustment of the electricity price and tariff systems, and other measures of reorganization aimed at increasing the overall and cost-efficiency of the largest domestic electricity company.

3.2. Srbijagas (Gas Company)

Losses of Srbijagas in 2012 and 2013 were extremely high. The loss in 2012 was in the amount of about 37 billion dinars, and in 2013 almost 50 billion dinars. Three years before that (2009-2011), Srbijagas had not generated any loss, although in the period before 2012 there were some business moves that have shattered the foundations of the enterprise in the long term. This conclusion arises from the fact that the losses in 2012 and 2013 are primarily due to extremely high “other expenses” in those two years (reaching 50 billion dinars in 2013, which is 40 percent of the total expenses and almost equal to the costs for purchase of gas). These expenses are the result of ineffective takeovers of other loss-making enterprises and uncollected receivables from other enterprises (in accounting terms: write-off of receivables and equity participations) including Azotara, Petrohemija, Metanolsko-sirćetni kompleks, GP Rad, Agroživ, Srpska fabrika stakla, municipal heating plants and another subsidiaries, related entities and independent enterprises.⁴² The causes are the previous policy of taking over poor performing companies (through acquisition of the majority package of shares and conversion of receivables into equity) and a low level of actual debt collection related to delivered gas (for example, only about 60 percent of the receivables for deliveries made in 2012 are collected) - both channels have led to the above mentioned huge write-off of debts in 2012 and 2013 and, consequently, a very large loss.⁴³

⁴² At the end of 2013 gross receivables reached the amount of over 100 billion dinars, and the largest debtors were Azotara (over 30 billion dinars), Petrohemija (20 billion dinars), GP Rad (5 billion dinars), Beogradske elektrane (5 billion dinars).

⁴³ At the end of 2013, Srbijagas had eight subsidiaries (with equity participation of 100 percent and greater than 51 percent), 5 related entities (share of 25 percent to 50 percent) and equity participation in 8 other enterprises

Losses have eroded the capital of the enterprise in only two years. Accumulated losses of Srbijagas in 2013 exceeded the value of its equity (27 billion dinars; in 2011 the value of equity was about 40 billion dinars) so the enterprise was fully financed with borrowed funds. Losses have, therefore, jeopardized the financial health and survival of the enterprise.⁴⁴

The operating result dynamics differs from the overall result. In 2012 the operating loss of Srbijagas amounted to 13 billion dinars (compared to the total loss of 37 billion dinars), and in 2013 the enterprise incurred a loss of (only) 90 million (total loss of 50 billion dinars). The change in the business result (less loss) arises from the larger adjustment of the selling with the purchase prices of natural gas starting from the last quarter of 2013. On the other hand, as already mentioned, primarily the explosion of other expenses (write-off of debts) resulted in a record-breaking total loss. These facts show that the poor performance of Srbijagas, despite the problems in the core business - low prices in comparison to the (high) purchase price until 2013, was also a consequence of the low level of collection of receivables for gas supplied to enterprises, heating plants and citizens.

However, it should be noted that the operating result is not appropriate as well, since in the past three years Srbijagas recorded an operating loss. Operating expenses were, in fact, greater than operating income, so that even without the big shock with the aforementioned write-off of receivables and equity participations, Srbijagas operated at a loss. Generally, income was (except in 2012) a couple of billion dinars (7 billion dinars in 2013) higher than the cost of goods, but it failed to cover other operating expenses (salaries, depreciation, supplies, etc.). This in contrary to the possible and desired situation Srbijagas to make relatively high profit in order to finance investment (Južni Tok, etc.). By 2008 the price of gas was determined by the decisions of the Management Board of Srbijagas, and from October 2008 the selling price of gas is determined based on specific methodology of the Energy Agency. After 2008 there is no adjustment of prices (selling prices are lower than the purchase prices) and the problems escalate: losses, indebtedness and insolvency of Srbijagas.⁴⁵ If the price was fully adjusted to the methodology, it is estimated that losses of Srbijagas in the period 2008-2012 would have been about 40 billion dinars less, resulting in smaller loss of Srbijagas in the last few years.⁴⁶ In general, it could be said that the inadequate pricing of gas is directly responsible for about 40 percent of the financial problems (losses and debts) of Srbijagas. In addition, there is the question of adequacy of the (too high) import prices, and not just (too low) selling prices. There are indications that the purchase prices of the gas from Russia were higher for Serbia than for the other comparable countries (which is discussed further in the text).

Interest costs are increasing and that is a result of the intensive growth of debt. Financial expenses rise. They have doubled in two years, and in 2013 reached over 12 billion dinars (10 percent of total expenses in this year and 18 percent of operating income). In 2014 more than 7 billion dinars were paid just for interest expenses to the banks. Foreign exchange losses are also high financial cost (about 1.5 billion dinars in 2013), and it is mostly a consequence of the inability to collect the receivables of the enterprise within the required period.⁴⁷ At the end of 2013 the debt of the enterprise towards the banks reached almost 100

and banks.

⁴⁴ If it were not a public company, Srbijagas would actually be in bankruptcy.

⁴⁵ Qualified buyers pay the market price of gas, whereas tariff customers and distribution privileged (lower than the market) price. The difference between the market price and privileged price ranged up to 66 percent (in 2012; it shows how much market price was higher than privileged price). Nearly 80 percent of the gas is supplied at privileged prices.

⁴⁶ Energy Agency has analyzed the direct losses due to inadequate price for the period from 2008 to 2012, and the estimate amounts nearly 300 million dollars. This effect should be added to the indirect effects - the repayment of a loan which Srbijagas took due to lack of income and proceeds. Estimates of losses due to the low selling price of the gas of Srbijagas are higher and amount to about EUR 500 million for the period 2008-2013, as well as further estimated interest expenses of EUR 165 million.

⁴⁷ Liabilities of Srbijagas for gas and loans are expressed in dollars and euros, while the collection of receivables

billion dinars (fully guaranteed loans), while the total liabilities amounted to about 160 billion dinars. The trade payables in the amount of about 45 billion at the end of 2013 (more than 20 billion dinars towards NIS), account for a large part of the total liabilities. At the same time, it is not only the liabilities that are alarming, but also their dynamics, as compared to 2011, the increase in loans and other liabilities amounted to about 20 percent (compared to 2009, total liabilities were tripled).

Matured liabilities towards the banks in 2013 reached about 17 billion dinars. Out of that, 10 billion dinars relate to principal payment and about 7 billion dinars to interest payment. In 2013 the state directly paid about 5 billion dinars for activated guaranteed debts, which Srbijagas was unable to pay by itself, while through the new guarantees in the amount of 4.5 billion dinars it indirectly ensured the enterprise's liquidity. It is anticipated that in 2014 the overall loan principal due will be paid from the budget, and it is an amount of about 17 billion dinars. In addition, the budget also provides for a guarantee concerning a new borrowing for liquidity, worth about 20 billion dinars (200 million dollars). This should provide funds to settle the liabilities (loans and trade payables) of Srbijagas in 2014, where it is clear that the fiscal effects are very bad - budget expenditures are directly increased by the amount of the liabilities taken over (17 billion dinars), while the new guarantees increase the public debt and future expenditures of the budget.

High level of receivables, despite large write-offs in the previous period, is a result of continuing low collection percentage. The total amount of receivables of Srbijagas at the end of 2013 was more than 100 billion dinars. It is important to emphasize that three-quarters of the receivables were written-off, and the net amount of receivables amounted to 26 billion dinars. The biggest debtors of Srbijagas are Azotara and Petrohemija (half of the total gross receivables), GP Rad in bankruptcy, JKP Beogradske Elektrane, Novi Sad Gas, Železara Smederevo and other enterprises. About three-quarters of the receivables are related to enterprises in restructuring, while the rest to the remote heating systems, health care facilities etc. So, most of the problems associated with the receivables and equity participation originated from the fact that enterprises in restructuring and the subsidiaries of Srbijagas did not pay for the gas supplied. At the same time, we should point out that the largest debtors are also the biggest buyers of gas, so a possible suspension of gas supply would affect the sale and income of Srbijagas. The largest debtors at the local government level are Beogradske Elektrane and Novosadska Toplana (total of 7 billion dinars in gross receivables). There should be a mechanism of conditional transfers from the Republic to the local self-government to ensure that users of gas under the jurisdiction of the local self-government pay for the gas supplied.

The takeover of loss-making enterprises contributed to the accumulation of losses of Srbijagas (by reducing the value of their equity participation). The problem of bad debts was not resolved through the process of taking over some loss-making enterprises (Azotara, MSK, etc.) by Srbijagas. Through the conversion of bad debts in equity participation in these companies, the recognition of loss was only delayed and in the accounting it was shown on another item. When reducing the value of equity - the loss is recognized in accounting as well. The case of Srbijagas is a proof of the wrong policy of the Government to try to save ("keep alive") other loss-makers through an enterprise that is a loss-maker itself. So, Srbijagas, in addition to the enterprises from which it could not collect its receivables for delivered gas, it also took over an enterprise that has nothing to do with sale of gas - Agroživ.

Still not written-off part of equity in the subsidiaries amounts to about 10 billion dinars. Besides the receivables, there is a possibility of (new) write-off of value and, consequently, increase in expenses, as well as in the equity investment. Compared to the end

for delivered gas in dinars. In circumstances where the receivables would be collected in due time, this exchange rate exposure could be reduced by an appropriate hedging, which is actually impossible if the receivables are not collected.

of 2012, equity investment in the subsidiaries and related entities and other types of investments is less by 25 billion, which means that most of the poor “investments” from the past is already written off.

Increasing efficiency in business operations is necessary, but it should be taken into consideration that this only partially solves the basic problems of the enterprise. The State Audit Institution points out the following weaknesses in the business operations of Srbijagas: irregularities in public procurement procedures, accounting policies, documents related to the ownership of real estate, long-term financial investments and sponsorships, providing guarantees and pledges to other enterprises, payment of profit share to the employees, payment of salaries, making decisions without the consent of the Government.⁴⁸ The weaknesses have resulted in inefficient use of funds, but also inadequate financial statements and performance evaluation (profitability, liquidity, solvency, etc.) of the enterprise. On the other hand, an objective assessment of the potential savings and the impact on public finances implies that the elimination of weaknesses in the business operations of Srbijagas cannot remove the largest causes of loss and over indebtedness. Salaries and other operating expenses (materials, production services, intangibles) were highest in 2012 and amounted to about 8 billion dinars.⁴⁹ Within those expenses, the salary costs, compensations and other staff expenses are approximately 2 billion dinars per annum.⁵⁰ Srbijagas’ dominant operating expenses are the costs of purchased gas. Given the fact that the expenses of salaries, materials, services and other operating expenses make up about 7 percent of the operating expenses (where salaries, benefits, etc. amount to 2 percent), the required savings cannot be achieved only by reducing these positions, although there should be savings on them as well. It is possible to rationalize the costs of Srbijagas (including the wage bill), but it would not solve the core problems - price disparities and bad debts and investments.

Srbijagas is insolvent, and the liquidity and settlement of current liabilities are maintained due to budgetary resources and new government-guaranteed borrowings. Srbijagas does not generate positive cash flows from operating activities (there is a negative balance of 2.6 billion dinars in 2013), while the investment outflows (9 billion dinars in 2013) further deepen the negative cash balance. These deficits are covered by positive net borrowings, whereas it is clear that the increasing financial outflows, without fundamental changes in the business operations, can be covered only by new and increasing guaranteed loans. The abovementioned government support in 2014 (17 billion dinars budget expenditure for the activated guaranteed loans and 20 billion dinars for the new guarantees issued) is a consequence of the described mechanism. The insolvency of the enterprise is also evident through the extremely low standard liquidity indicators, so at the end of 2013 the ratio of current assets to current liabilities while 59 percent, the value of net working capital was negative by 32 billion dinars, and the cash can cover only 1.5 percent of the short-term liabilities.

The low collection percentage and the unchanged business operations of Srbijagas could lead to issuance of new guarantees and unplanned increase in public debt in 2014 as well. The 2014 budget provides issuing state guarantees for borrowings of Srbijagas (for its current liquidity) in the amount of 200 million dollars. At the same time, in the Fiscal Strategy for 2014 the Government states that there will be no new guarantees issued, and this situation requires a serious and fundamental change in the business operations of Srbijagas and in the attitude of the state towards the energy sector. If in the second half of the year there is no increase in the percentage of collection of delivered gas receivables

⁴⁸ Concerning the different weaknesses in the business operations, see the report of the State Audit Institution for the year 2011.

⁴⁹ At the consolidated level (including subsidiaries) the expenses in 2012 amounted to 10 billion dinars. Other operating expenses were particularly high in 2012, primarily due to the cost of transportation services, as a consequence of changes in posting transportation of gas to enterprises abroad.

⁵⁰ Total number of employees at the consolidated level is 3,200, of which 1,180 are employed in the parent company.

(general illiquidity could even decrease the current low level of collection) and if no other necessary changes are implemented, there is a serious risk that the end of the year a pressure will arise again for Srbijagas to take new state-guaranteed borrowings (in the amount of 50 to 100 million). The negative consequences of these developments would be multiple. First, the public debt would further increase by the amount of unplanned guarantees, which would deteriorate the credibility and sustainability of the public finances of Serbia, and possibly increase the cost of borrowing of both the public and the private sector. Secondly, there would be even larger demands for cuts in public spending and savings measures in the short term. Third, in the following years in which the guaranteed loans are still not due for payment, an opportunity for payment of the debts of Srbijagas would be created, which means that the reduction of other expenses must be planned in the medium and long term. Fourth, once again (after 2013) the Government itself would breach the principle and obligation specified in the Fiscal Strategy, that, apart from the previously budgeted guarantee, it will not issue additional guarantees for borrowings of Srbijagas, which undermines the credibility of the economic policy and the country on the domestic and international financial market.

If Srbijagas does not undertake restructuring, the state will most likely - just on the basis of already activated guarantees - pay EUR 180 million per annum (about 20 billion dinars) in the next three years, whereas this amount may even be higher, around 30 billion dinars per annum. The total fiscal cost may be even higher if the approval of new guarantees continues. For the purpose of achieving the intention of the Government specified in the Fiscal Strategy - that it will not issue any new guarantees – it is necessary to change the way Srbijagas carries out its business operations. If it does not improve its collection percentage, the liquidity will continue to be affected by the ordinary business activities, regardless of the established favorable ratio between selling and market prices (the income posted in accounting does not mean that the delivered gas receivables are collected). The solution to this problem is lays in resolving the fate of the enterprises in restructuring, because the biggest non-payers for delivered gas are in this group of enterprises. Therefore, the financial improvement of Srbijagas on this basis, can probably be expected only after implementation of the plan for the enterprises in restructuring, i.e., their privatization or bankruptcy. The dynamics of other expenses cannot be disadvantageous as in 2013, since receivables and equity investments are largely written off (the write-off in 2013 amounted to 50 billion dinars, while the remaining balance at the end of this year amounted to about 35 billion dinars). On the other hand, the high level of debt and liabilities will cause increase in the financial obligations and it will represent a significant burden for the liquidity of Srbijagas. It should be taken into account that most of the loans bear floating interest rate, so an increase in the reference rates of the banks would affect the increase in loan repayment of Srbijagas. The largest single problem are the liabilities towards NIS (over 20 billion dinars in 2013), and the way this problem will be resolved. In addition, the planned investments (Južni Tok, etc.) also pose risks in the way of funding and the possible implications on the public finances. Taking everything into account, we estimate that the unchanged way of carrying out business operations and activation of various obligations that the state would have to fund, would mean an annual budget expenditure of about 30 billion dinars in the next three years.

In contrast to the previous scenario, the restructure of Srbijagas could reduce the annual budget expenditures to about 10 billion dinars, and possible debt rescheduling could further reduce pressure on public finances. Through a process of restructuring, Srbijagas could earn operating profit and positive cash flows of about 10 billion dinars per annum, which would create conditions the enterprise to pay half of the activated government guarantees. Thus, instead of the annual budget expenditures of 30 billion dinars, the budget expenditures for Srbijagas would amount to about 10 billion per annum. It means that in three years there will be savings of about EUR 500 million. Restructuring involves much higher percentage of collection of receivables (at least 90 percent of the receivables for delivered gas) and decrease in operating expenses. When taking a step further, and the debts of Srbijagas are rescheduled, then the fiscal cost would be even less than 10 billion dinars. If a

reform in this area is implemented, then Srbijagas would later be able to pay for the loans that the state guaranteed and now repays them.

An important part of the financial restructuring of Srbijagas is the import price of gas, since Serbia is among the countries with the most expensive import price. When analyzing the import price of gas, a few facts should be kept in mind. First, the price of gas depends on the type of agreement - if the importer guarantees certain minimum import volume, the price of the gas should be lower compared to the option when such guarantee does not exist. Second, the import price depends on the volume - the price could be lower if there are more imports. Third, the price depends on the cost of transportation, including transit through other countries. Fourth, it is important to point out that the price often deviates from the objective and quantifiable factors and it is determined by direct agreement between two countries.⁵¹ The details of the agreement on gas imports from Russia to Serbia are not known, but few comparisons show that the price of gas paid by Serbia is high.⁵² The unfavorable position is determined by these two factors in the structure of the price: high purchase price of gas and high transport costs through Hungary. Therefore, improvement of the financial position of Srbijagas would follow after negotiations on the purchase price of gas and transit fees. There are strong arguments that these costs should be lower.⁵³ It is necessary to examine the role of intermediaries in the sale of gas and whether it is possible for Srbijagas to import gas directly, at a lower price.

It is not possible to deal with price, receivables and purchase costs separately. In order for Srbijagas to be able to operate without new guaranteed loans (to be liquid), we estimate that the percentage of collected receivables should be 90 percent (an increase from the current 60 percent) and assuming that the selling prices are adjusted in full compliance with the methodology. However, the increase in collected receivables is possible only if Srbijagas suspends the supply of gas to insolvent customers, and in particular to its subsidiaries and enterprises in restructuring.

Little is known about the possibility of reducing the volume of imported gas. Suspension of gas supply to non-paying customers would mean lower gas delivery, and thus less demand for gas imports. The minimum guaranteed volumes of gas imports are not known. It is possible that the reduction of gas supply would not be followed by spending cuts in the same extent, with respect to certain import volumes that according to the current agreement must be imported regardless of whether the gas can be sold or not. So, if the existing agreements on import volumes and prices remain, the suspension of gas supply to insolvent customers would not equally improve the operating results and liquidity of the enterprise. Therefore, it is necessary, along with the negotiations on the price of gas, to determine appropriate (lower) minimum import volumes. Therefore, it is important to emphasize that continuation of the practice of supplying gas to insolvent customers will prolong the current manner of carrying out the business operations of Srbijagas - generating part of income without its collection and, therefore, illiquidity. The solution would therefore be that, along with reductions in gas supply, to reduce without any penalties the import volumes, which possibly means changes in the gas import agreement.

⁵¹ See prices of gas at the site <http://izvestia.ru/news/544100> and the article "Why Gazprom Is In Trouble In One Chart" on the site http://www.forbes.com/sites/markadomanis/2013/02/19/why-gazprom-is-in-trouble-in-one-chart/#/?_suid=139938130730802367104047615145. These sources indicate that the price of gas that Russia supplies does not depend on economic and political factors, and that, in fact, the methodology or the manner of determining the price of the Russian gas cannot be determined. The data show, contrary to expectations, that a country which is not in friendly political relations with Russia and which buys small quantities of gas can have a lower price of gas.

⁵² In addition to these reports on prices, this conclusion is made from the data of the Energy Agency (data for 2012). Bulgaria and Greece buy more expensive gas, whereas Romania, Slovakia, Hungary and other countries of Europe, buy cheaper gas.

⁵³ In this respect, there is the fact that losses and debts of Srbijagas would have been lower if the import price over the past few years was lower - and because of this it is, after all, difficult to precisely distinguish the causes of the poor financial condition of Srbijagas.

Sale of the equity participation of Srbijagas in its subsidiaries and related entities should be one of the strategic directions. This would relieve the enterprise of the non-core business operations, the management would be focused on the core business, bad investments and receivables would be reduced and, in general, it would improve the liquidity and solvency.

Rescheduling of liabilities and receivables should relax the enterprise (and the country) from the obligation to repay major principals and interests over the next few years, on the one hand, and higher percentage of receivables collection, on the other hand. During this period, the enterprise would be restructured, the income to expenses ratio would be better, so conditions would be created for the rescheduled debt to be mainly paid off by Srbijagas (and not by the state).

Reduction of operating expenses cannot solve the basic problems of Srbijagas, but increase in the efficiency should certainly be one of the priorities. This requires a review of the wage policy and number of employees.

The financial difficulties and the burden transferred to the budget require selection of **priorities for investment** of this enterprise. This means to suspend the plans for investment in subsidiaries (as already said, it is necessary to sell them and not to continue to invest in them), and then select investment priorities for Srbijagas. The document of the Ministry of Energy, Development and Environmental Protection points out the following needs: measuring equipment, Južni Tok, repair of the transport system, Nis-Dimitrovgrad gas pipeline and two other gas pipelines and several reorganization projects.⁵⁴ According to some earlier information, the value of “Južni Tok” project through Serbia amounts to EUR 1.7 billion, and it is planned 30 percent of the amount to be financed from the equity, and 70 percent with loans. The participation of Serbia, therefore, is about EUR 250 million in equity and EUR 600 million in loan. The fiscal impact will depend on the method of financing. If the loan is approved with a state guarantee, then the public debt of Serbia, according to the gross concept (which is usually used) could be increased by about EUR 850 million (2.5 percent of GDP).⁵⁵ If the loan does not require government guarantees, then the fiscal cost would be only the participation of EUR 250 million. On the other hand, income from transit fees would represent an important source of funds for Srbijagas and Serbia.⁵⁶ Additional effects could result from lower purchase prices of gas and lower transportation costs.

The debt towards NIS, which according to some information reaches EUR 240 million in 2014, would be best solved by converting receivables into equity of subsidiaries. This would also solve the issue of liabilities, and a new owner of the non-core business operations would be found. Alternatively, the liabilities should be rescheduled, without government guarantees or taking over the liabilities into public debt.

Organizational issues include deciding on ownership or legal unbundling of the enterprise. The ownership principle was supported by the Ministry of Energy of the previous government, whereas the legal principle by Srbijagas. Basically, the point is that in the legal unbundling a greater degree of connection of the components of the system will be retained (the holding would manage the development and determine the business policy), whereas in the ownership unbundling there will be separate companies for transport and storage and for distribution and trade. Corporatization, which would mean a change in the form from a public company into a joint stock company, could take place after solving some of the relations between the parts of the enterprise, financial restructuring, as well as resolving the property-related issues between Srbijagas and other independent companies (NIS as well).

⁵⁴ “Baselines for the restructuring with reorganization of JP” Srbijagas”, “Novi Sad”, April 2013.

⁵⁵ The fact that it is planned to pay off the loan from the proceeds of the pipeline does not change the fact that public debt would be increased by the amount of loan that would be disbursed prior to that.

⁵⁶ An amount of EUR 200 million per annum has been mentioned in the public.

3.3. Železnice Srbije (Railways)

The situation in Železnice Srbije is unsustainable - with a high fiscal cost, the railway transport is at extremely low level. Železnice Srbije needs government assistance of almost 20 billion dinars per annum, but there are no investments, and as a result of that the infrastructure is gradually deteriorating; there is no increase in the quality of railway transport, and at the same time, there isn't any essential restructuring of the company. Comparisons with other national systems are not adequate, since the subsidies in other countries are, by rule, used to improve the railway system and contribute to the development of the economy, while in Serbia costly government interventions only maintain a system that is more and more falling behind and losing the ability to be restructured rationally and in a regulated manner.

Despite extensive government subsidies, each year Železnica Srbije records an operating loss. In the last five years, Železnice⁵⁷ records an operating loss of about 4-5 billion dinars per annum, since the total income (including government subsidies) is not sufficient to cover the operating expenses. The total profit, which is obtained after adding financial and other results, is even higher (amounts up to 17 billion dinars), whereas the accumulated loss at the end of 2013 amounted to about 146 billion dinars and reduced the value of the capital to a half.

Income that Železnica Srbije earns independently is sufficient to cover only one-third of the operating expenses. In the last five years, income, excluding subsidies, amounts to about 10-11 billion dinars, while the operating expenses around 30 billion dinars. Therefore, if it had not been for the government subsidies amounting to about 14 billion dinars per annum, net loss from operations would have amounted to 20 billion. Operating income is insufficient to cover the salaries, since salaries amount to around 15 billion dinars per annum. All amounts listed are fairly stable over the past five years, which indicates that there is no change and progress in the business model and the results. The 2014 business plan also estimates, basically, unchanged dynamics and structure of income, expenses and net result. Therefore, if income categories are stable (own and subsidies), then expense categories are stable too - salaries, thus, amount to between 15 and 16 billion dinars in the entire reporting period. Number of employees at the end of 2013 is approximately 18,000 and during the five-year period it has been reduced by about 1,500 people (the largest downsizing was in 2010; in 2014 it is planned to decrease only by the number of employees who will retire).

Income is not nearly sufficient to pay for maintenance and consumables. Železnice estimate that they need about 4 billion dinars in 2014 for maintenance of the infrastructure and about 8.5 billion to maintain its railway transportation vehicles, procurement of consumables, spare parts, etc. This means that income from services rendered is not nearly enough to pay for the maintenance of fixed assets and consumables. One of the devastating facts is that the lack of funds for the fees that Železnice have to pay for international traffic has led to a drop in the number of international railway lines which generate higher net income than the domestic lines.

As a consequence of these results, the overall investments are financed using loans. The government either issues guarantees for borrowings of Železnice or is directly indebted for the needs of Železnice. Železnice have received loans from the Development Fund as well. Guaranteed and granted loans to Železnice amount to around EUR 300 million, while granted (but not disbursed) loans amount to total of about EUR 750 million. Setting priorities for investments (and borrowings) arises from the fact that the budget will continue to fund these expenditures in the future.

⁵⁷ From May 2011, Železnice Srbije is no longer a public company, but a joint stock company owned by the state. Železnice has seven subsidiaries.

The direct annual budget expenditures (subsidies and paid guaranteed loans) for Železnice amount to 18 billion dinars. Železnice are the largest recipient of subsidies from the state budget, with about 13 billion dinars per annum. The subsidies were higher (15.5 billion in 2011), and gradually reduced in the period 2012-2014. Nominal decrease in subsidies with growth of GDP led to a decline in the relative importance of subsidies (in GDP), taking into account that the mild reduction of subsidies resulted from budgetary problems, and not from restructuring and cost savings in salaries in Železnice. In other words, there is a risk that the reduction in subsidies would result in a redirection of other expenses into salaries, less expenses on maintenance, etc., which would further worsen the situation in the railway transport. Subsidies from the budget supplement the operating income, being used to cover part of the operating expenses (they are less than the annual wage bill) and are not used for maintenance or new investments. In addition to the subsidies, the state pays off the activated guaranteed loans instead of Železnice. For the period 2014-2016 this amount is projected to more than 5 billion dinars per annum (out of around 6 billion dinars of total loan liabilities in 2014).

The main problems of Železnice arise from the ordinary course of business, and not from the debts. The biggest imbalances of the enterprise result from operating loss. Operating loss determines the lack of funds for maintenance and investments and, consequently, indebtedness of the enterprise. However, the standard debt indicators are not alarming yet (for example, debt to equity ratio is about one-quarter). Liquidity is not very good (current assets are about one-quarter of current liabilities), and it is due to the low level of receivables (about 2 billion dinars), but also moderately high current liabilities (primarily trade payables, about 11 billion dinars). This means that the way to improve results is based on resolving the cause of the problem – operating income and expenses.

Price regulation is one of the causes of low income. The fact that the prices in the rail freight transport have not been changed since 2008, and in the passenger transport since 2010, shows that the controlled prices disrupted the performance of Železnice. Here as well, low selling prices have been maintained at a low level, and the goal was neither to improve the operational efficiency nor to reduce the costs. The consequence is dilapidated railway transport. Significant increase in price with the current quality of service would probably not be justified. Therefore, first of all, cancelation of privileges and adjustment of tariff zones should be considered in order to increase the income.

The railway transport in Serbia significantly falls behind the European average. Several indicators of the railway transport have a value of only one-quarter of the European average.⁵⁸ It refers to the transportation of goods and passengers per kilometer of railway track or employee productivity. Low indicators mean higher unit costs of maintenance. Although the number of employees in the last fifteen years was largely reduced, the productivity (transportation of goods and passengers per employee) has not improved satisfactorily. At the beginning of 2000, Železnice had nearly 33,000 employees, and then by 2005 this number was quickly reduced to 22,000 (voluntary employment termination with severance pay), and then at a slower pace up to the present 18,000 employees.

Railway infrastructure and rail cars are in very poor condition. The average speed on the railway tracks in Serbia is around 40 kilometers per hour, and due to lack of maintenance, each year the number of kilometers of tracks on which full speed is allowed, decreases. Over 55 percent of the tracks were built in the 19th century, and the length of repaired tracks continuously decreases. For the purpose of meeting the requirements of the timetable, there is a lack of locomotives, freight and passenger cars (in the period from 2008 to 2012 there was a lack of at least 25 percent of each category). The largest number of rail cars is more than 30 years old.

⁵⁸ Analysis by the World Bank in 2011, “Railway Reform in South East Europe and Turkey: On the Right Track” (author Carolina Monsalve).

Subsidies and state policy must relate to specific targets. Given the situation in Železnice Srbije, a significant decrease in the value of subsidies cannot be expected. The problem is that, unlike other countries, Serbia does not subsidize modern railway but a survival of an outdated system. The strategy for the development of the railways should take this into consideration, and the aim is using approximately equal means to achieve significantly greater effects for Železnice and the Serbian economy.

The current system of nontransparent subsidies and passive role of the state should be changed. The state as an owner, especially in view of the generous subsidies and difficult position of the public finances, has an obligation, together with the management, to determine measurable objectives. Such are, for example, a decrease in operating expenses (including the number of employees and salary costs), reducing the railway network, precise investment horizon, separation of core and non-core activities. It is necessary to determine the criteria: how many passengers are required in order to keep the line, which is the optimal frequency of traffic, when it is more cost-effective to replace an asset instead of maintaining it, which is the optimal number of employees by department. A detailed review of the financial and operational criteria of the business operations is recommended. They would be used by the management and all stakeholders to commit to continuous efforts and responsibility in the business operations. Local self-government could be included in selecting and financing priority lines. Certainly, the focus should be on modernization of the railway traffic on the main route (Corridor 10, Belgrade-Bar railway line, etc.), which would be possible by reducing railway network, cutting the most unprofitable lines (for at least one-third).

3.4. Železara Smederevo (Steelworks)

Železara Smederevo records losses each year, and survives thanks to government assistance in the amount of about EUR 60 million. The basic problem in the business operations of Železara is the very low value added product and, on the other hand, imports of the main input, which is why it can be profitable only at a time when the global market is close to a maximum capacity. However, Železara, regardless of the level of capacity utilization, prices at the world market and the owner, generates losses (about 11-12 billion dinars is the operating loss in the period 2009-2012⁵⁹). After the private owner left (US Steel, at the beginning of 2012), by the end of 2013 in order to maintain the production in Železara the state approved, through the Development Fund, 2.2 billion dinars in loans and bank guarantees (through the Development Fund and government guarantees worth of almost EUR 100 million). In 2014 the budget provided for a government guarantee for borrowing of Železara in the amount of EUR 30 million. Since monthly maintenance of production costs between EUR 5 and 10 million (depending on the prices and engaged facilities), there is a serious risk that in the second half of the year additional funds will be needed for the functioning of Železara.

Regardless of whether Železara is funded through the Development Fund or government-guaranteed borrowings, it eventually turns into a fiscal cost, which means that the cost is paid by the citizens of Serbia, the taxpayers. The Development Fund is owned by the state, and thus the guarantees issued by the Development Fund, under the law, are guaranteed by the state, so this kind of assistance directly increases the public debt. Eventually, government guarantees also increase the public debt and the budget expenditures when the debt becomes due. For payment of the guarantees approved by the end of 2013, the government in 2014 will pay 1.7 billion dinars from the budget, and in the next two years 7 billion dinars cumulatively.

⁵⁹ Foreign exchange gains reduced losses, and the net result in 2012 was lower than the business loss.

Indirect expenses (outstanding liabilities) of Železara are also very large and affect the budget. Železara does not pay for energy sources (gas and electricity), so the claims of Srbijagas and EPS towards Železara at the end of 2013 reached an amount of 2.5 billion dinars (primarily towards Srbijagas). The debts of Železara thus reflect in the poor financial position of the public enterprises, which then have to borrow (usually with a government guarantee), and therefore this effect as well spills over to the public debt and budget expenditures.

The current manner of carrying out the business operations of Železara has to change. The experience from the last two years shows that maintenance of Železara is a large cost to the state, and that separation of Železara from the budget is one of the prerequisites for recovery of the public finances of Serbia. The best option is to find a new strategic partner, and the other is severance pays and bankruptcy of the enterprise. It is necessary to provide for a period of finding a strategic partner, and then, if it fails, the funds intended for subsidies to be redirected for severance pays and/or subsidies for opening new (healthy) enterprises in Smederevo.

3.5. Galenika (Pharmaceuticals)

Since 2010 Galenika⁶⁰ has been facing serious problems in its performance - operating income falls drastically, the losses are piling up and eroded the capital in 2012, while the debt of the enterprise grows manifold. Operating income of the enterprise nominally fell by 55 percent in 2013 compared to 2009.⁶¹ In 2010 the enterprise became a loss-maker, and since then it has accumulated losses of about 25 billion dinars⁶² and in 2012 the losses eroded the capital – if it were not a state-owned enterprise, it would have gone bankrupt. Almost half of the accumulated loss is a result of operating losses in the previous four years, while the other half is due to debt write-offs, of which the most important was the one-time write-off in 2011 of about 10 billion dinars.⁶³ Due to the significant lack of funding as a result of non-collected receivables the enterprise takes short-term negative (expensive) borrowings, which in the reporting period, increased threefold. In 2012, the Republic of Serbia issued guarantees for EUR 85 million of long-term loans with high interest rates, which relaxed the need for significant short-term borrowings in order to survive. However, the enterprise is still illiquid and insolvent, although in 2013 there was a sign of improvement of the performance.

There is a risk that insolvency and illiquidity of Galenika will result in a fiscal cost in 2014 of about 3 to 4 billion dinars, due to the activation of guarantees or a need for issuance of new guarantees. Although Galenika, after many years, for the first time in 2013 had a positive net cash flow from operating activities, and had no significant inflow from additional borrowings (a slight recovery can be noticed), it still lacks resources to repay the matured loans and interest (mostly guaranteed). In 2013 the Republic of Serbia (Public Debt Administration) paid the interest on long-term loans of about 650 million dinars. This further implies a possibility that most of the matured long-term loans and interest, of approximately 3 billion dinars, will become a fiscal cost, either in a form of new guarantees for borrowings, or in a form of direct payments of the activated guarantees. In 2014 the enterprise will need another 1 billion dinars to repay the short-term loans and the related

⁶⁰ Galenika a.d. is a closed joint stock company for manufacturing pharmaceutical products, owned by the Republic of Serbia. It has a status of enterprise in restructuring.

⁶¹ The enterprise had about 10 billion dinars of operating income, earned in 2009 and 2010, but then dramatically dropped to about 5 billion dinars of operating income in 2011, and it is how much it earned in the next two years as well.

⁶² More than half of the accumulated loss (of about 13.5 billion dinars) generated in 2011.

⁶³ Most of the written off receivables refer to pharmaceutical companies BG Pharm, Velefarm VFB d.o.o., Velefarm PROLEX d.o.o. and Velefarm BG a.d.

interest. It should be noted that the liabilities of the enterprise of about 4 billion dinars are becoming due, an amount almost equal to the annual income from sale. Thus, it is questionable how will the enterprise pay for the matured financial obligations of about 4 billion dinars.

The question is how an enterprise (Galenika) that operates in the pharmaceutical industry, regarded as one of the most profitable industries everywhere in the world and in Serbia as well, could generate so many losses. In the case of Galenika, it is certain that more than half of the losses (the problems) are due to mismanagement. Inadequate business decisions of the enterprise's management have led to a situation that the entire annual operating income (from the period when the enterprise performed well - 10 billion dinars), was practically donated to certain companies that never paid for the goods delivered. Part of the problems are certainly due to overstaffing, since after the fall of income by over 50 percent (which was never recovered), practically that much employees became surplus. In 2010, when the problems in the performance became visible, the enterprise employed less than 3,000 workers, and in 2013 this number was reduced to 2,000. However, bearing in mind that the volume of operations (operating income) declined by more than 50 percent, there is probably still a surplus of about 500 employees. Since the state, in more instances, proved to be not very good manager (owner) of the enterprises operating in the commercial sectors, privatization of Galenika seems like the most desirable solution.

3.6. Resavica (Coal Mines)

The annual cost for the Republic of Serbia concerning Resavica is 4-5 billion dinars. This is another enterprise in restructuring. The fact is that the enterprise for years back generates losses and survives thanks to the direct and indirect state subsidies, since the income from sale of products is not even sufficient to cover the salary costs for about 4,000 employees (about 4.5 billion dinars). Direct subsidies until 2011 amounted to just over 2 billion dinars per annum, whereas from 2012 they are between 3 and 4 billion dinars. Indirect subsidies in the form of non-payment of taxes and contributions in 2011 and 2012 amounted cumulatively to about 3.5 billion dinars. During 2013, there were indirect subsidies, since Resavica began to pay taxes and contributions. However, the cumulative amount of unpaid taxes and contributions from previous years, reaches an amount of about 8 billion dinars.⁶⁴

Resavica's fate will be known after the release of the plan for enterprises in restructuring - there are announcements about finding a strategic partner. Privatization, which would probably be accompanied by closure of most of the mines, and consequently laying off a large number of employees, according the announcements so far, as well as closing the enterprise down, are not an option. The reason is primarily of a social nature, since the complex of nine mines is located in the territory of the eight most undeveloped (the poorest) municipalities. Closure of these mines would mean that most of the families will be left without any income. However, there has not been any consideration of whether there is an interest in providing severance pays. According to our estimates, part of the funds available to Resavica through subsidies, and which have a function of government assistance, could support the this program. Each year the employees will be given an opportunity to leave the enterprise with severance pay of EUR 10,000 per employee (funds that would stimulate development of self-employment activities), whereby the funds that would not be used for severance pay, and are budgeted, will be sufficient to pay salaries to the workers who remain employed. This would have probably reduced the number of employees in Resavica in the last few years, with continued activities in the mines, new business activities would have been developed and would have reduced the pressure on the public finances.

⁶⁴ It should be noted that the enterprise owes more than one billion dinars to EPS for electricity delivered.

There is a large number of staff employed in administration. According to some estimates, around two thirds of employees are miners, and thus it means that there is a room for rationalization of staff in administration and other “non-mining” jobs. Rationalization of the number of employees is likely possible among the miners too, since in several mines there is almost no coal exploitation. This type of voluntary work separation of a certain number of employees would certainly facilitate the process of finding a strategic partner.

The previous Ministry of Energy announced that there are ongoing negotiations for finding a strategic partner. The investor, in addition to the core activities (excavation of underground coal) and increasing the technological level of the mine, should build power plants. The state investment would be in giving rights to coal mining, as well as in natural resources. Closing an agreement with a strategic partner and increasing the business volume and sales could complete cease the direct and indirect state subsidies, or at least reduce them.

3.7. Telekom Srbija (Telecommunications)

Telekom Srbija is still makes profit, but according to many parameters it does not operate successfully. Telekom Srbija is a joint stock company in which the state owns the majority stake (the remaining shares belong to citizens of Serbia and employees of the company). This enterprise operates in the profitable telecommunications services industry, and has a strong competition in the largest part of its business (mobile telephony for a longer period of time, and recently in the fixed telephony as well). Operating results of Telekom and market trends in the last years indicate, however, that the company is losing the race against its competitors, that its operating results are deteriorating, and the market value decreases. Thus, we believe that privatization of this company is economically viable, and that it should have been conducted much earlier.

Telekom generates an annual net income of EUR 100 to 200 million. Net income of Telekom in 2012 amounted to 11.3 billion dinars, and it was significantly lower than in the previous years, 15.5 billion dinars in 2009 and 22.3 billion dinars in 2011. Since the net income of the company depends on many parameters and some of them, such as exchange rate differences, are temporary - we believe that it is more relevant to conduct business analysis of Telekom on the basis of available market, and not just financial data.

In 2012, the number of fixed and mobile telephony users in Telekom decreased, while the number of internet and multimedia users increased. The latest available data for 2012 indicate a decline in fixed telephony, as compared to 2011, by 1.3 percent as a result of a long-lasting and broader trend of decline in this type of telecommunications services, at the expense of increase in the mobile and internet communications. However, it is surprising that in 2012 Telekom lost a large number of its mobile users, about 9 percent.⁶⁵ In the internet market, in 2012 Telekom continued to increase the number of ADSL service users by about 3 percent, while the IPTV (Internet Protocol Television) service which was relatively new in 2012, had a high growth of 48 percent (from a low basis).

Telekom Srbija records a large drop in market share (by number of users), as well as in the total mobile telephony income share. In the past five years, the most profitable and the most important segment of the business operations of Telekom was the mobile telephony. In this part of the business, Telekom has strong competition from Telenor and VIP-in. Comparison of results achieved by Telekom with the competing companies reveals a very worrying trend. Operating income of Telekom from mobile telephony is constantly decreasing each year and in 2012 amounted to only 5.2 billion dinars. In comparison, Telenor in 2012 earned twice larger income which amounted to over 10 billion dinars. Market indicators show that Telekom Srbija has a very rapid decline in market share in

⁶⁵ Mainly the less profitable prepaid users, but it retained, even slightly increased, the number of business and postpaid users.

terms of the total number of users, from about 59 percent in 2008 to about 46 percent in 2012. The reason for this decline in the number of users of Telekom cannot be only the emergence and market expansion of the youngest competitor (VIP), because in the same reporting period (2008-2012) the third competitor, Telenor, not only that it retained its market share but it slightly increased it.⁶⁶ It is interesting to note that despite having (still) the largest market share by number of users, Telekom fails to earn the highest income from mobile telephony. In 2012 with 45.8 percent of mobile phone users, Telekom earned only 38.1 percent of the income, and Telenor with 33.9 percent of users accounts for 42.4 percent of the total income. Telekom share in the total income from mobile telephony, as well as the share by number of users, strongly decreases each year.

The management by the state is probably one of the most important reasons for decline in market share. State ownership and management is a major burden for the performance of Telekom. So far the profit has been shared between the state budget and the company, and the profit that remains in Telekom is further distributed to the employees (thirteenth salary), so there is not much left for investments.⁶⁷ In addition, Telekom also implicitly finances a large number of state initiatives and projects (sponsorship of events, sports clubs, etc.), which probably does not contribute much to the performance of the company. Also, there are indications that there is still some surplus of employees who are not made redundant. Telekom has almost the same total operating income as Telenor, VIP and SBB together, but it operates with over three times larger number of employees than the number of employees of its three major competitors together. None of the competitors of Telekom has such kind of obligations to the state, nor in its operations is guided by political, social and trade union interests, but they invest their funds into the growth and development - which eventually reflects in the success of the company.

The privatization of Telekom Srbija in the upcoming year would be justified on several grounds. Telekom needs restructuring, which would prevent further decline in market share and would recover part of what is lost. It would require, in addition to the operational rationalization (reduction in number of employees and salary costs, reduction in unreasonable costs) and serious efforts in marketing activities, especially improvement of the quality and number of services. Taking into account the seriousness of the problems in the operations of other public and state-owned enterprises, as well as the significant fiscal cost they create, the question is whether the state has sufficient (in terms of required time and attention), adequate and apolitical (professionals) resources for the implementation of sensitive restructuring of Telekom. This leads to the conclusion that it would be more effective to let the private sector operate commercial activities, such as telecommunications, and all the efforts and energy of the state to be focused on preventing further increase in the fiscal cost resulting from deterioration of the performance of enterprises of strategic interest. The estimated selling price of about EUR 2-2.5 billion for 100 percent of the shares of Telekom, from few years ago, with the current trend of drop in the mobile telephony market share, is certainly not feasible. In addition, upcoming emergence of serious competition in the fixed telephony segment is expected, where Telekom has so far been the dominant player in the market, which will further diminish the value of the company in the future. Therefore, the privatization of Telekom should not be delayed, that is, it should be conducted in the next year. Privatization of Telekom in this period would enable the proceeds from its sale to be used for reducing the public debt and/or financing part of the record-breaking fiscal deficit.

⁶⁶ Source: RATEL "Overview of Telecommunications in the Republic of Serbia for 2012," 2013.

⁶⁷ This practice was formally often changed, but in the essence it remained the same. Thus, the earlier owner of the shares of Telekom Srbija was the enterprise Pošte Srbije, so the dividends came to the state in the second round and indirectly. While Greek OTE was the owner of 20 percent of Telekom, they were also involved in decision-making and distribution of the dividends. The latest practice, since December 2013, is the determined dividends to be paid to the state, but also to citizens and employees of Telekom in accordance with the number of shares they hold.

3.8. Dunav osiguranje (Insurance)

Increase in the number of employees by 50 percent, and actually unchanged total premium (2007-2012), are the reason for mainly modest income of Dunav osiguranje, which have become a loss of about 1.5 billion dinars in 2012.⁶⁸ Through comparison of the fourth quarter of 2007 to the same quarter in 2012, it can be seen that Dunav did not achieve real growth in total premium (business volume), while the number of employees increased by more than 50 percent in the reporting period. Thus, the main reason for lack of good results in this period⁶⁹ and the loss in 2012 is high and rising salary costs - resulting from a significant increase in the number of employees. Gross operating result (as difference between operating income and expenses) grew much more slowly than the costs for providing original services (which include salary costs, advertising, sponsorships, etc.) - increased from about 5 billion dinars in 2007/2008 to around 8 billion dinars in 2012 - which resulted in a net loss of approximately 1.5 billion dinars.

The largest item of the rising operational expenses is the salary costs for employees and management, but also the costs of advertising and sponsorship. The consequence of the modest net profit in the period 2007-2011, is practically overflow of gross operating income into the costs for providing original services - almost constant gross operating result was no longer sufficient to cover the rising costs for providing original services in the insurance business, due to which Dunav generated a net loss in 2012. The highest item of these expenses is salary costs for employees and management, which since 2007 increased from less than 2 billion dinars to nearly 4 billion dinars in 2012. The increase in salary costs was mainly due to the increase in the number of employees, from 2,049 to 3,120.⁷⁰ Costs of advertising and sponsorships increased almost fivefold, from about 0.3 billion dinars to about 1.5 billion dinars in the reporting period.

Necessary rationalization of salary costs, primarily through reduction of the number of employees, with consideration of offers for privatization of Dunav osiguranje. It is indisputable that the reasons for the modest income and losses in 2012 are the high and rising salary costs (i.e., number of employees), as well as fivefold increased costs of advertising and sponsorship, with actually unchanged gross premium (business volume). In order to prevent generation of net losses in the upcoming years, as well as to “enable” the enterprise to generate significant net income, it is necessary to eliminate the aforementioned irrationalities. In the case of Dunav osiguranje as well, the question is whether the state should focus all its energy and resources available to solve the serious problems in the operations of other public and state-owned enterprises (which generate significant fiscal cost and operate in strategic sectors), while leaving the enterprises that operate in commercial activities to the private sector.(?) Rationalization of the number of employees, with reassessment of the salary levels must be conducted as soon as possible, and the solution to this problem would certainly enable rapid and successful privatization of Dunav osiguranje.

⁶⁸ In the analysis of the performance of Dunav osiguranje, the last available data for the year 2013 will not be used due to unreliable results (the statements are not audited). Following a significant revision of the net result for the year 2012 (70 million dinars in income and 1.5 billion dinars in loss), in the analysis of the business performance of Dunav osiguranje year 2012 will be used as the last year, since there is a risk that the modest income of around 160 million dinars in 2013, after the audit will again slip back into loss.

⁶⁹ In the period from 2007 to 2011, Dunav earned modest income of 150-400 million dinars, except in 2008 when it earned a significant income, slightly less than 2 billion dinars.

⁷⁰ In 2008 alone, about 500 new workers were employed, while another significant increase in the staff, about 300 employees, took place in 2011.

3.9. GSP (Belgrade public transport) and Other Public Utilities

GSP generates both operating and total loss, despite growing subsidies of the City of Belgrade, which in 2013 amounted to 7.5 billion dinars. In the period 2010 to 2013, the enterprise constantly generated operating loss, which declined from 3 to about 1 billion dinars. The main reason for the drop in the operating loss was the increase of subsidies of the City of Belgrade from 4 to 7.5 billion dinars in 2013, which actually means that the problems did not decrease, but increased. The City of Belgrade, in addition to current subsidies for public transport, allocates certain funds for capital subsidies to GSP.⁷¹ On the other hand, there is no improvement in the collection of receivables from sold tickets and stamps, since the income from sale has slightly increased from 5 to 5.7 billion dinars. Income generated from sale is insufficient to cover the salary costs for about 6,000 employees, which amount to 7 billion dinars⁷², as well as the total operating expenses in the amount of 12-14 billion dinars per annum. Also, GSP has liabilities of about 1.3 billion dinars towards the funds of the compulsory social insurance (pension and health) and the Tax Administration. Operating losses resulted in a total loss of 1.5 to 3 billion dinars and contributed to an accumulated loss of about 20 billion dinars in 2013.

The main problem is the low collection percentage, but also the generous system for the privileged categories of users of the public transport. The collection of receivables for tickets sold has not improved after 2012 as well, when the new system of “Bus-plus” was implemented – income from sale has stagnated since 2011, at an amount of about 5.7 billion dinars. The new billing system operates on the principle that the company Apex Solution Technology is responsible for collection and sale of cards and stamps, and the overall income earned is paid to the Public Transport Directorate, which then transfers about 70 percent of the monthly income from sale of tickets and stamps to GSP. Insufficient collection is the reason for the announced reevaluation of the “Bus-plus” system, and possible termination of the agreement with Apex. One of the proposals for solving the problem of collection, within the study⁷³ of the World Bank, was introduction of controller in each individual vehicle, instead of periodic controls in randomly selected vehicles, as well as stipulating higher penalties for non-payers, as well as greater powers for the controllers. Also, the same study finds that the City of Belgrade gives the largest discounts for privileged categories, in addition to the existing low prices, compared to the major cities of Europe and the neighboring countries. For example, an annual ticket for retirees in Belgrade costs 400 dinars, regardless of the amount of the pension. In some European cities, the prices of prepaid tickets for retirees depend on the amount of the pension. For example, in Zagreb tickets at reduced prices are granted only to individuals with lower income (pensions) and social welfare. Furthermore, Belgrade is the only one in the region, probably in Europe as well, where elementary school children and pregnant women use the transport free of charge. Therefore, one of the solutions to the problem of low income from sale, in addition to improving the collection system, could be a review of the amount of discount for certain privileged categories, which is planned, according to the recent statements given by the Administration of the City – collection of sale of tickets and control shall be carried out by GSP, while Apex will only maintain the system, and the prepaid tickets price for students and retirees will increase.

⁷¹ The City of Belgrade is not a direct guarantor for the loan of EUR 65 million approved by the EBRD for the purchase of buses. However, the City is required to ensure that the income of GSP will be sufficient for this enterprise to service the debt.

⁷² The reason for the high salary costs, as explained by GSP, is that the collective agreement stipulates a relatively short working day, due to which the enterprise paid a large amount of overtime.

⁷³ “Review of finances and local self-government expenditures”, April 2013, World Bank.

It is estimated that a quarter of the budget of the local self-governments goes to the local public enterprises that employ nearly half of all employees at the local level (77,000).⁷⁴ The total number of local public enterprises is about 720, and among them 650 have a formal status of public enterprises, while the remaining are budget users. The most important group of local public enterprises is a group of 350 utilities, which employ more than 56,000 people. These enterprises modestly contribute to the economy (2.4 percent of GDP is their added value), are illiquid, each year there are more loss-makers among them, and are generating and increasing losses despite the significant direct and indirect subsidies.⁷⁵ In addition, the utilities often receive indirect subsidies through “inflated” invoices for services delivered to the municipalities.

There are many sources of inefficiency of the public utilities, but the largest most irrational expense is the staff costs (surplus of employees and average salaries higher than those in the private sector). During the period 2002 – 2013, the average salaries in the utilities were higher than the average salary in the Republic, as well as compared to the average in the private sector, and were constantly on the rise. It is estimated that personnel costs of public utilities account for almost 1 percent of GDP per annum. Also, the inefficient operation of the public enterprises is a result of the lack of financial and managerial control of the local self-government over the enterprises; low rates that sometimes do not cover even the operating costs, let alone the cost of investment and maintenance of infrastructure; unsolved property-related issues between utilities and local self-governments. Due to the lack of control and pressure for better performance, the utilities use loopholes in employment and salary determination, do not adequately take care of the property and infrastructure, rates are determined selectively and arbitrarily (often are significantly higher for businesses than for citizens), do not publish annual business programs, etc.

There is a considerable room for reducing inefficiencies and achieving savings in utilities, which would improve the fiscal position of the local self-governments, and thus the public finances of the state. The fastest and probably the largest savings would be achieved by rationalizing costs for employees in the utilities - the reduction of salaries and number of employees. There is no reason that employees of the public utilities, on average, receive higher salaries than those in the private sector, since their business does not require much different qualifications and expertise of employees. Moreover, according to the comparative analyzes, in a number of public utilities there is a surplus of employees, measured by the size of the municipality in which they provide services. It is essential that local self-governments, as owners of the utilities, begin to systematically and substantially control and take care of them, primarily through introduction of operational objectives, monitoring the implementation of these objectives, and adequate sanctions for not meeting the established objectives.⁷⁶ At the end, it is necessary to establish a systematic framework for determining the appropriate amount of utility rates since the rates are currently arbitrarily and selectively determined, among different municipalities and within the municipalities among different users (for example, legal entities as opposed to individuals).

⁷⁴ The estimates in this section are based on the study of the World Bank, June 2014: *Municipal Public Finance Review: Options for Efficiency Gains, Republic of Serbia*. Our estimate on the number of employees in the local public enterprises, in the previous part of the text (of 60,000) is based on the insight into individual companies whose financial statements are published by the Agency for Business Registers. We have no information on the scope of the World Bank. It is possible that the difference originates from indirect budget users.

⁷⁵ Utilities receive current subsidies and capital subsidies. Most of the funds set aside by the City of Belgrade are intended for the utilities - one-third of its budget.

⁷⁶ The implementation of these measures, however, is unlikely as long as the actual local self-governments are not organized. Therefore, the only practical solution would be by reducing the transfer (in fact by penalties), the local self-governments to be forced to rationalize themselves in financial and operational terms, and then the utilities they own.

IV. Enterprises in Restructuring

There are more than 160 enterprises in restructuring, with 56,000 employees, left in the portfolio of the Privatization Agency. The World Bank estimates have indicated a direct and indirect cost to the state for maintenance of the enterprises in restructuring, in the amount of EUR 200-300 million per annum. These enterprises operate very unproductively and have been so far kept alive by giving them subsidies for salaries and tolerating non-payment of their liabilities to the public enterprises and the government. In addition, the Development Fund too in several occasions has financed the survival of some of the enterprises in restructuring. The problem of the enterprises in restructuring, therefore, has been largely dislocated and hidden from view, given the fact that they received indirect subsidies (tolerating unsettled liabilities and market-unjustified investments of the Development Fund), so those losses and debts were piling up elsewhere, in the public enterprises that actually bore the burden of the enterprises in restructuring (EPS and Srbijagas primarily). Eventually, it all spilled over to the budget since the state now has to help its unsuccessful public enterprises. Resolving the fate of the enterprises in restructuring is therefore significant multiple ways. Not only that it would reduce the direct fiscal costs of their business operations, but also the business and financial restructuring of the large loss-making public enterprises (Srbijagas and some others) is impossible without a solution to this problem.

The elections postponed the planned process of solving the problems of the enterprises in restructuring, in May the amendments to the Law on Privatization extended the deadline until the end of 2014, and it is planned this problem to be solved in accordance with the new law. According to the plans of the previous Ministry of Economy, in 2014 the employees in the enterprises in restructuring were supposed to receive the unpaid salaries and severance pays, and then the state to claim these funds after the completion of the privatization or bankruptcy of the enterprise. The process was supposed to be completed by the end of the first half of 2014. An additional time limitation for resolving the fate of these enterprises was posed by the decision of the Constitutional Court on termination of the protection of the enterprises in restructuring made in mid-May 2014, which opened a possibility for the creditors to make their claims and to initiate bankruptcy proceedings for probably most of these enterprises. Amendments to the Law on Privatization in May 2014, however, impeded this outcome since they prescribed procedures that should take another five months. Namely, the amendments to the Law on Privatization provided for the creditors of an enterprise in restructuring to register their claims, and afterwards the Privatization Agency to record and determine the amount of claims, which could not be completed before the end of this year. In meantime, however, a new Law on Privatization (hereinafter the Law) was proposed which should become new and amended basis for a permanent solution to the problems of the enterprises in restructuring.

The new Law on Privatization introduces a new concept, but also an extension of the deadline for completion of the privatization process and solution to the problems of the enterprises in restructuring. The new law brings a different vision about resolving the fate of the enterprises in restructuring, introducing additional flexibility - different methods, models and measures of privatization, which facilitates the process of finding strategic partners and interested buyers of (minority or majority) equity interest, purchase of assets, etc. The law extends the deadline for completion of the privatization of certain enterprises by the end of 2015, which may carry some additional risks and costs.

The fate of the majority of enterprises in restructuring should be known by the end of 2014. With the implementation of the new law, the fate of the majority of enterprises in restructuring should be known by the end of 2014 (which of them will go into bankruptcy or liquidation, and which will continue the process of privatization through some of the

stipulated models), as well as the potential fiscal costs. It is planned within 60 days after the new law enters into force, to specify the enterprises in restructuring for which there are potential customers or strategic partners identified. Since the law stipulates that in the first 30 days of the adoption of the law, the Privatization Agency shall announce a public call for expressions of interest, as well as additional 30 days for submission of the interest, only then it would be clear which enterprises in restructuring continue with the privatization process, while for the remaining a basis will be created for initiation of bankruptcy proceedings or liquidation.⁷⁷ After expiry of this period, within additional 45 days the Agency shall propose to the Ministry of Economy a method, model and measures for privatization of the entity and an initial price, and after that the Ministry of Economy shall make a decision within further 30 days. Afterwards, on the basis of the accepted methods, models and measures, the possible fiscal costs would be also clearer. Thus, over a period of 135 days (four months and a half) after the law enters into effect, it should be known which enterprises and under what conditions qualify for privatization, and what are the possible direct and indirect fiscal costs of the enterprise in restructuring on that basis: severance pay, bridging of employees' service periods, debt write-off, possible taking over of debts by the state, or investing in strategically important enterprises.

The measures for preparing and relieving the entity, subject to privatization, of its liabilities should further increase the interest of buyers. In addition to various models and methods, there are also stipulated measures to support privatization. The criteria for the measures are quite general and practically enable the Government to support a large number of enterprises. The criteria, such as strategic importance for the region, volume of assets, number of employees, amount of income, an market potential – are not, therefore, quantified nor specific. The intention is to retain the ability, if necessary, on a case-by-case basis, to support the privatization and to clear the enterprise, before selling it, of liabilities towards government creditors. Thus, the buyers and investors could get a company with less debts (debts towards private creditors will not be relieved).

The first measure is to write off the debt of the enterprise in privatization, and the other involves conversion of debts into state-owned equity. The government may make a decision for the state creditors to write off the debt of the entity. This measure would reduce the claims of state creditors, and thus the possibility of collection of at least a portion of the non-collected public revenues will be lost (as would be the case of the alternative – bankruptcy of the enterprise). Since it is stipulated that the public enterprises are also in the group of government creditors, write-off of their claims against the enterprises in restructuring would further compromise the results of business operations and manifest in deterioration of the financial position of the public enterprises. This might result in increased demands for direct and indirect subsidies and guaranteed loans, which would be a channel for transferring the anticipated measures into the public finances of the Republic. A negative effect of the debt write-off is also a lost opportunity for the state to collect at least a portion of the non-collected public revenues (as would be the case with a bankruptcy proceeding) - the value being not large, but there is a question of moral hazard, since it will turn out that some enterprises did not pay their obligations towards the state for many years without any consequence. Another measure of support to the privatization is conversion of the state creditors' claims into equity - in fact this also means that the debts of entities in privatization are forgiven, where the state converts the debt into equity and still generates income in the process of sale of capital or adds a value to the company that will operate after capital increase. It should be taken into account that the capital increase, as a model of privatization, means that the state remains co-owner of the enterprise, and that it is a basis for future generation of rights and obligations (income and expenses) from the functioning of the enterprise. Therefore, this measure should

⁷⁷ Along with this process, the enterprises in restructuring have 45 days after the law enters into effect, to perform an inventory and assessment of the fair market value of all assets, liabilities and equity, and submit that to the Privatization Agency.

be limited to enterprises that have a perspective, and not to be applied only in order to avoid bankruptcy of state-owned enterprises.

The opinion of the Fiscal Council is that the process of solving the problems of the enterprises in restructuring must be completed as soon as possible and with minimal fiscal costs. The new law provides for a legal basis for initiating a bankruptcy procedure in enterprises that have no perspective or interested buyers, within 60 days after the law enters into effect, and therefore any further delay will no longer be justified. In addition, by the end of the year, through the implementation of the law, the plans for the enterprises that continue the privatization process will be known, as well as the potential fiscal costs of implementing such plans, which we will more accurately assess. The fiscal costs are likely to exceed the amount currently allocated for solving the problems of the enterprises in restructuring in the amount of 17 billion dinars, but they must not, by any means, be much higher. Additional risks and fiscal costs concerning this group of enterprises result also from the announcement that the government intends to remain the owner of some of the enterprises - but the Fiscal Council, taking into account their performance so far, could hardly support that.