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South East Europe: Regional Gasification Study

Draft Final Report: Serbia Market Report

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1 Physical, Demographic and Political Profile

The Republic of Serbia (Serbia- hereafter), is a landlocked country bordering Hungary to the north, Romania and Bulgaria to the east, Albania and the Republic of Macedonia to the south, and Montenegro, Croatia and Bosnia and Herzegovina to the west. Serbia has a population of 7.5 million people with the major cities being, Belgrade (1.6 million), Novi Sad (0.3 million), Nis (0.3 million) and Kragujevac (0.2 million)¹.

Serbia was part of the Socialist Federal Republic of Yugoslavia from 1945 to 1992, the Federal Republic of Yugoslavia from 1992 to 2003, and the State Union Serbia and Montenegro from 2003 to 2006. After Montenegro voted to leave the State Union, Serbia officially proclaimed its independence on June 5, 2006, as the successor state to the State Union of Serbia and Montenegro. Figure 1 shows a country map for Serbia.

Figure 1 Serbia map



Source: CIA World Factbook

Following Montenegro's secession in May 2006, Serbia became a stand-alone state for the first time since the adoption of the 1835 constitution. After suffering from

¹ <http://www.srbija.sr.gov.yu/pages/article.php?id=6>

economic sanctions imposed throughout the 1990s, Serbia has started the long road to membership in the European Union by signing a Stability and Association Agreement. However, membership talks have been jeopardized by the failure of Serbian authorities to hand over indicted war criminal Ratko Mladic, and investor confidence is likely to remain stagnant until Mladic is captured. Serbia's exports include manufactured goods, machinery and transport equipment, and foodstuffs

2 Economy

Serbia's economy is based mostly on various services (57.9%), industry (25.5%) and agriculture (16.6%). It is the largest of the Balkan economies and now that there is peace is sometimes referred to as the Balkan Tiger. It is estimated that Serbia's GDP will reach US\$54 billion for 2007¹ which is around US\$7, 234 per capita. This is the latest data from the most recent world economic outlook published by the IMF.

The picture is mixed though in that reasonable economic growth has been accompanied with high inflation (12.7%) and an increasing current account deficit, although exports of goods during 2006 did grow by 30%.

The World Bank has recognised Serbia's efforts and performance by putting Serbia twice at the top of "Doing Business Report" (In 2005 out of 155 countries and in 2006 out of 175 countries) as the fastest-reforming country in the world.

The European Bank for Reconstruction and Development (EBRD) in its successive reports of 2005 and 2006 has put Serbia on top of the list as the fastest changing economy out of 27 countries which their portfolio covered.

3 Energy Sector

3.1 Energy Resources

Serbia principally has lignite reserves amounting to 2.6 Mtoe that are considered recoverable, however its oil and gas reserves are negligible and therefore is highly dependent on imported energy².

Serbia is not particularly rich in energy resources. At the current level of production which meets only 25% of the country's needs, Serbia (excluding Kosovo) will have a supply of coal for the next 55 years and oil and gas for 20 years. The current hydroelectric power capacity is 10,200 GWh per year, while potential capacity is estimated at 14,200 GWh per year.

¹ Quoted by IMF at PPP

² <http://www.energyagency.at/enercee/sr/energysupply.htm>

3.2 Energy Usage

There was no gas usage in Montenegro when it was part of State Union of Serbia and Montenegro, therefore the only gas policy that was to be found for Serbia and Montenegro was in fact only applicable to Serbia.

While the gas sector in Serbia did not sustain any damage during the bombing campaign of 1999, much of the maintenance of the system was deferred during this period. Investment in the natural gas network within the country has been at low levels for at least the last 10 years.

There are large disparities between gasification levels of different regions of the country. While Northern Serbia is fully gasified, Western and Central Serbia are only partly gasified and the gasification of Southern Serbia has barely begun.

Serbia has been producing its own natural gas for half a century, although it has always been a net importer of gas.

While in terms of primary energy, Serbia has a high degree of self-sufficiency compared to many EU accession countries. Serbia produces around 97% of solid fuel requirements. However it is dependent on imports for 70% of its liquid fuel requirements and 75% of its natural gas requirements.

The Government of Serbia estimates that in the future by 2010, the overall degree of import dependency will increase moderately from 37% to 39.4%.¹ The Serbian Government hopes this *moderate* increase will essentially result from improved exploration, which will to a certain degree compensate the increase in demand for oil derivatives and for natural gas.

The strongest increase in import dependency will be for natural gas. The Serbian Government is concerned that the overall level reached is already exposing the country to the impacts of longer lasting international oil price increases. Electricity import dependency could become an issue around 2010, unless additional supply measures are taken to substitute electricity by other energy carriers, or to reduce its consumption by a more efficient use.

Inadequate investments in the energy infrastructure during the last decade resulted in an ill-adjusted energy system, with high-share of electricity in final energy consumption (around 30%) in the household sector, mostly for heating.

While further development of the renewables option could clearly reduce the pressure to import electricity or to build new power plants at an early stage, natural gas is expected to be the primary substitute for electric-based heating either through district heating in densely populated areas, or individual boilers in the rest of the country.

¹ Source: Ministry of Mining and Energy of Serbia

3.3 Energy Development Plans

There is an Energy Development Strategy document that highlights the following areas as priorities for future development:

- Assessment of production and consumption constraints
- Forecasts of energy needs up to 2015
- Priority development programs of particular energy sectors up to 2015 , measures and potential investments developed on the basis of five priorities with an assessment of positive effects regarding energy increasing of production / energy decreasing of consumption
- Long-term- development and regionally strategic priority: Programs of intensive capital investments into new sources/objects and the participation in strategic (regional/ Pan-European) energy infrastructure projects
- Proposal for monitoring and evaluation system and harmonization of Priorities.

4 Gas Sector

4.1 Policy and Legal Framework

Serbian Energy Policy sets out three crucial elements of sustainable development:

- Competitive energy markets
- Environment protection
- Energy efficiency and use of renewables

In order to further these goals, the Energy Law was passed in July 2004 and regulates the entire energy sector of Serbia and established the Energy Regulatory Agency of Serbia (AERS). AERS is responsible for enhancing and directing the energy market development on the principles of non-discrimination and effective competition, monitoring the implementation of regulations and energy systems operation codes¹. AERS covers electricity, gas, oil and district heating sub-sectors.

¹ www.seenergy.org, www.aers.org.yu

4.2 Regulatory Bodies

After its legal establishment in June 2005, AERS became fully operational in January 2006.

The Council (managing body of AERS) consists of a President and four members, with staggered terms of office (5, 4 and 3 years), elected by the National Assembly.

AERS' main tasks are price regulation, licensing, approval of network codes and market rules, dispute settlement (TPA, connection to networks), setting the eligibility threshold, determining eligibility criteria and market monitoring.

AERS' operation during the first two years (2005-2007) has been enabled through a grant of the EU (CARDS Programme), whereupon the operation of AERS will be provided from revenues obtained from license fees and use-of-system charges. In the natural gas sector the responsibilities of AERS mainly cover;

- Issuing pricing methodologies and tariff systems
- Issuing methodologies for connection charges
- Preparation of Transportation and Distribution Operation Codes
- Preparation of the Implementation Program of the Energy Sector Development Strategy of the Republic of Serbia

4.3 Institutional Framework

The new energy law underpins the institutional framework and environment existing in Serbia today. Serbia's regulatory body is well established and also has a fully operational website¹.

Serbia has been so concerned about its competitive situation with regards to energy production and consumption that it has empowered an energy efficiency agency. The Energy Efficiency Agency of the Republic of Serbia (SEEA) was also formed by the new Energy Law.

Public enterprise "Srbijagas" started its operation in October 2005, performing transport, distribution, system operation and trade of natural gas. Srbijagas is also the sole wholesale supplier for tariff customers in Serbia.

There are 28 privately owned distribution companies responsible for distribution and supply of natural gas in the northern part of Serbia

¹ <http://www.aers.org.yu/IndexEng.asp>

4.4 Fuel prices

Studies for Serbia and Montenegro (2001-2003) have indicated that relative gas prices between customer types in Serbia need to be adjusted to reflect costs. Comparison with import prices shows that absolute price levels need to be increased, particularly for small customers with high seasonal swing¹.

In 2005, the average price for residential consumers was 6,63\$/GJ (US\$ 250 per mcm)².

After Serbia's separation from Montenegro, and the establishment of the Energy Agency of Serbia, it is the latter's role now to set the tariffs for natural gas. In July 2006, the Council of the Energy Agency of Serbia approved methodologies for setting electricity and gas prices for tariff customers, for electricity generation, transmission and distribution as well as for distribution and transport of natural gas and transport of oil and oil derivatives. In particular it approved:

- ❑ Methodology for setting tariff elements for calculating prices for access and use of system for natural gas transport
- ❑ Methodology for setting tariff elements for calculating prices for access and use of system for natural gas distribution
- ❑ Methodology for setting tariff elements for calculating prices of natural gas for tariff customers

These Methodologies will enable transparency in the activities of all regulated energy entities in the area of price setting and unbundling so that cross-subsidies are prevented.

4.5 EC Gas Commitments

Serbia is committed to meeting the basic EU requirements with regards to developing a competitive energy market. The key issues currently being dealt with are as follows:

- ❑ Issuing pricing methodologies and tariff systems
- ❑ Issuing methodologies for connection charges

¹ Estimates used by OCHA indicated that the industrial and residential sector pay around \$65 per tcm whilst the power sector pays slightly less at \$60 per tcm. However large industrial customers are reported to be paying \$155/tcm, indicating an element of cross-subsidy in gas prices. Based on a purchase price of \$130 per tcm, OCHA indicated that to supply to the non-power sector would require an annual subsidy of \$113 million. To supply to all sectors would require an annual subsidy of \$177 million.

² www.seenergy.org

- ❑ Preparation of Transportation and Distribution Operation Codes
- ❑ Preparation of the Implementation Program of the Energy Sector Development Strategy of the Republic of Serbia

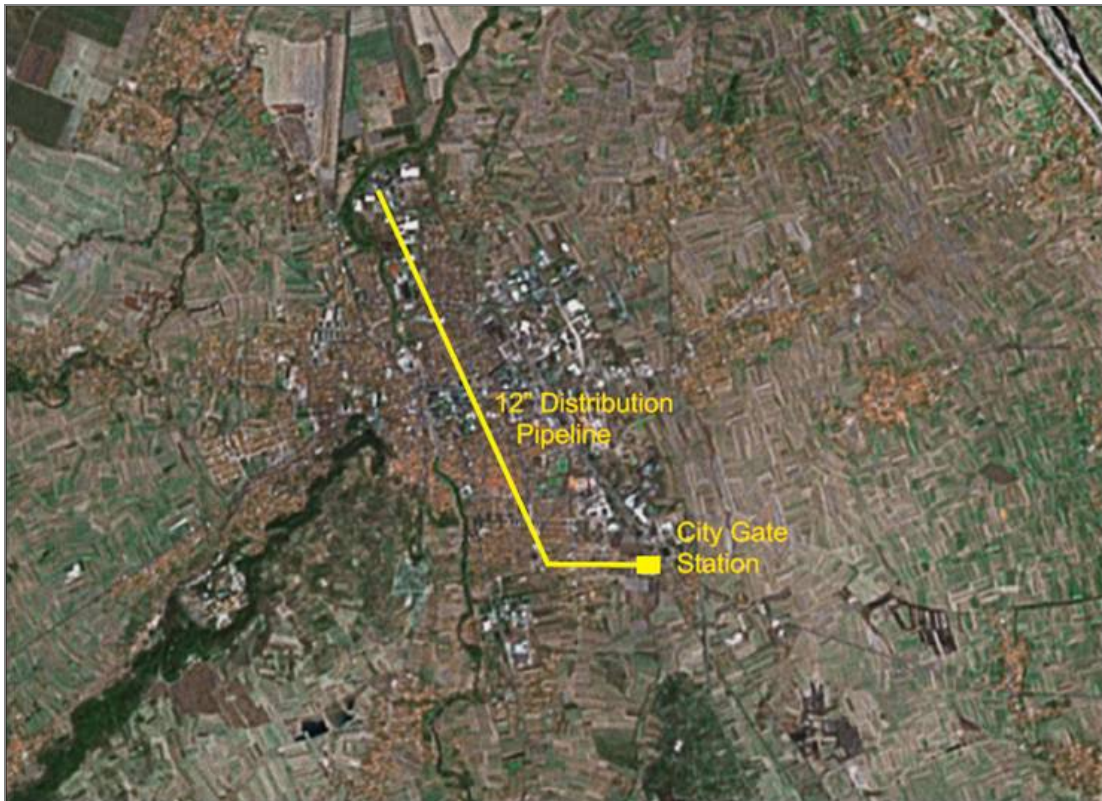
There is already an initial eligibility threshold set by the Energy Law, which is 50 mmcm/year (potentially 50% market opening).

4.6 City Distribution Demand Studies

Leskovac

Leskovac is a town with a population of approximately 78,030. It is made up of a Residential and Commercial area of around 5.3 km² and 0.6 km² Industrial. This gives a population density of 14,723 per km². Figure 2 shows a map of Leskovac with the associated section of the EC Ring pipeline.

Figure 2 Leskovac distribution map



Data provided shows a total number of households to be 26,010 estimated to comprise 19,508 apartments and 6,503 houses. Based upon an annual estimated consumption of 15,240 kWh and peak consumption of 3m³/hr per residential customer, residential demand is estimated at 396,392 MWh per annum, with a peak hour demand of 58,523m³/hr.

Using the sectoral demand assumptions set out above results in the following potential demand estimates as shown in Table 1.

Table 1 Potential demand		
Sector	Annual demand	Peak hour demand
	MWh	Cu.m/hr
Residential	396,392	58,523
Commercial	165,164	7,289
Industrial	99,098	3,644
Total	660,654	69,455

It is suggested that gas would be supplied to the city from the proposed Energy Community (EC) Ring via a 30km / 14in. diameter spur line, which will transport gas to a City Gate Station located to the south east of the city. Gas would be metered and the pressure reduced to 16bar for supply to a 4.km / 12in diameter high-pressure steel distribution system.

The high-pressure distribution system would supply the 4bar medium pressure network, which would in turn supply customers.

Estimated capital costs for the gas supply system are shown in Table 2.

Table 2 Estimated capital costs	
Item	Total Cost
	US\$ million
EC Ring Connection	5.0
Spur Line	11.2
City Gate Station	4.0
HP Distribution System (16bar Steel)	1.7
MP Distribution System (4bar PE)	5.2
Residential Connections	21.1
Residential Installations	6.2
Industrial and Commercial Connections	2.9
Total	57.4

Uzice

Uzice is a town with a population of approximately 55,025. It is made up of a Residential and Commercial area of around 2.7km² and 0.3km² Industrial. This gives a population density of 20,380 per km².

Figure 3 Uzice distribution map



Data provided shows a total number of households to be 18,342 estimated to comprise 13,756 apartments and 4,585 houses. Based upon an annual estimated consumption of 15,240 kWh and peak consumption of 3m³/hr per residential customer, residential demand is estimated at 279,527MWh per annum, with a peak hour demand of 41,269m³/hr.

Using the sectoral demand assumptions set out above results in the potential demand estimates shown in Table 3.

Table 3 Potential demand

Sector	Annual demand	Peak hour demand
	MWh	Cu.m/hr
Residential	279,527	41,269
Commercial	116,470	5,140
Industrial	69,882	2,570

Total	465,878	48,978
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It is suggested that gas would be supplied to the city from the proposed EC Ring via a 90km / 8in. diameter spur line, which will transport gas to a City Gate Station located to the north of the city. Gas would be metered and the pressure reduced to 16bar for supply to a 3.8km / 10in diameter high-pressure steel distribution system.

The high-pressure distribution system would supply the 4bar medium pressure network, which would in turn supply customers.

Estimated capital costs for the gas supply system are shown in Table 4.

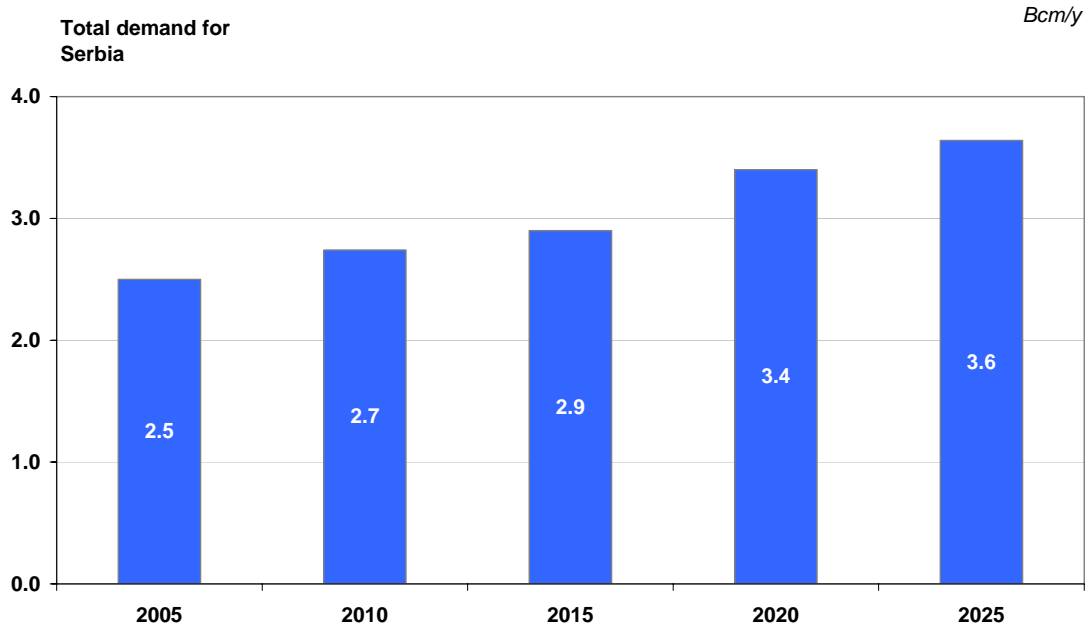
Table 4 Estimated capital costs

Item	Total Cost
	US\$ million
EC ring Connection	5.0
Spur Line	18.4
City Gate Station	4.0
HP Distribution System (16bar Steel)	1.2
MP Distribution System (4bar PE)	3.7
Residential Connections	14.9
Residential Installations	4.4
Industrial and Commercial Connections	2.1
Total	53.6

4.7 Overall Demand for Gas

The historical trend for gas demand in Serbia is quite erratic with a number of well-known geopolitical factors contributing to the trend. Since 2002, demand has stabilised and is now on a growth projection. Figure 4 shows projected gas demand up to 2025.

Figure 4 Gas demand to 2025



Gas demand is forecast to reach 3 bcm per annum by 2015 and 3.5 bcm by 2025.

Since 1996, production of natural gas has averaged around 0.7 bcm per annum. Serbia currently produces 0.2 bcm per annum of natural gas from its own fields¹. Gas is produced from fields in the Vojvodina autonomous province and used mostly in the immediate area for district heating.

The remainder of the gas requirements are purchased from Russia. The volume of gas imported varied, but has generally fallen within the range 1.5-3.0 bcm per year over recent years. It was 2.3 bcm in 2005².

Gas-fired power plants consumed 0.09 bcm in 2005. Overall, consumption was 2.5 bcm in 2005³. Gas is used in Serbia to make fertiliser and synthetic rubber, by power plants and district heating plants.

Table 5 shows the forecast of the Government of Serbia for natural gas. The results for total demand are reasonably close to the projection using the time series regression approach.

¹ www.seenergy.org

² www.seenergy.org

³ www.seenergy.org

Table 5 Forecasts by Government of Serbia for Natural gas Sector (mmcm)

Year	2006	2010	2014
Total Demand	2,594	3,060	3,363
Natutar gas Import	2,292	2,742	2,963

Source: Ministry of Mining and Energy of Serbia

4.8 Current Gas Supplies

The natural gas pipeline infrastructure is most developed in the Northern area of Serbia, where an extensive transmission and distribution system has been established. Further South gas transmission has been established to Kraljevo and Nis. The total length of the transmission system is 2,135km, and ranges in size from 6 inches to 30 inches. The transmission system has a maximum capacity of 6.1 bcm, and has a maximum operational pressure of 50 bar. The average age of the pipeline system is 25 years.

Figure 5 shows a diagram of the main transmission pipeline network.

Figure 5 Serbia gas transmission



Table 6 shows the transit volumes for the consumers as well as the maximum capacity.

Table 6 Gas transit volumes

Country	Volume (bcm/y)	Capacity ¹ (bcm/y)
Hungary (Import)	2.15 ²	4.99
Bosnia - Herzegovina (Export)	0.16 ³	0.74

As a result of the Balkans wars in the 1990s significant damage was caused to Serbia's energy infrastructure, with the oil sector suffering heavy damage. Although the natural gas sector did not sustain war damage, the lack of upkeep of the gas system during this period has resulted in major maintenance needs.

4.9 Anchor Loads

There are currently no known large consumers planned.

4.10 Future Gas Supply Options

In July 2006, the Serbian Government announced a project to build a 400km cross-country gas pipeline together with Russia's Gazprom, a project worth more than US\$800 million⁴. In this context Serbian relations with Russia, more specifically, Gazprom, take a greater, and once again, strategic importance. It is noted that Serbia has a very favourably priced gas contract with Gazprom. However, during the winter 2005-2006, Serbia experienced severe shortages of imported gas from Russia, when Gazprom cut Serbia's gas supplies by 25 percent due to rising demand in Russia.

There are many indications that 2007 will be a year of significant and structural changes in the natural gas sector. An important issue is the completion of the underground gas storage facility in Banatski Dvor, and prior to that, diversifying gas supply routes by adding pipelines from Bulgaria (Dimitrovgrad - Niš) and Romania (Arad - Mokrin) to the one that is already pumping natural gas from Hungary.

There are also preparations for another, less publicised project, the construction of a natural gas pipeline connecting Serbia and Croatia. A Memorandum on Cooperation signed in May 2006 documents a strategy for connecting the natural gas infrastructure of these two countries. It was agreed on the same occasion that the connection be established between Mokrin (in Banat), Arad (in Romania), while

¹ Gas Transmission Europe Maps and Data

² BP World Statistical Review

³ Energy Information Administration

⁴ www.balkanpeace.org

Romanian Transgas experts, along those of Srbijagas, have been instructed to draw a draft plan for this project's implementation¹.

The current gas supply contract with Hungary does not provide sufficient capacity to meet peak seasonal demand². Additionally, increased overall demand coupled with declining domestic production (Serbia's current gas production rate is 0.31 bcm) has exacerbated this situation. In order to alleviate this, Srbijagas (the sole company responsible for gas transmission within Serbia) has initiated a number programmes:

- ❑ Gas Storage - Construction of a gas storage facility, whereby the excess import gas capacity during the summer months is stored for consumption during the winter.
- ❑ Additional Import Capacity - A number of pipelines are currently either in the planning stages or are in construction. These include:
 - ❑ Bulgaria Pipeline: Dimitrovgrad - Nis, Capacity 1.8bcm
 - ❑ Romania Pipeline: Arias - Mokrin, Capacity 1.6bcm
 - ❑ Macedonia Pipeline: Kriva Palanka - Nis, Capacity 0.5bcm

In addition, Srbijagas is also planning a number of transit routes. These include:

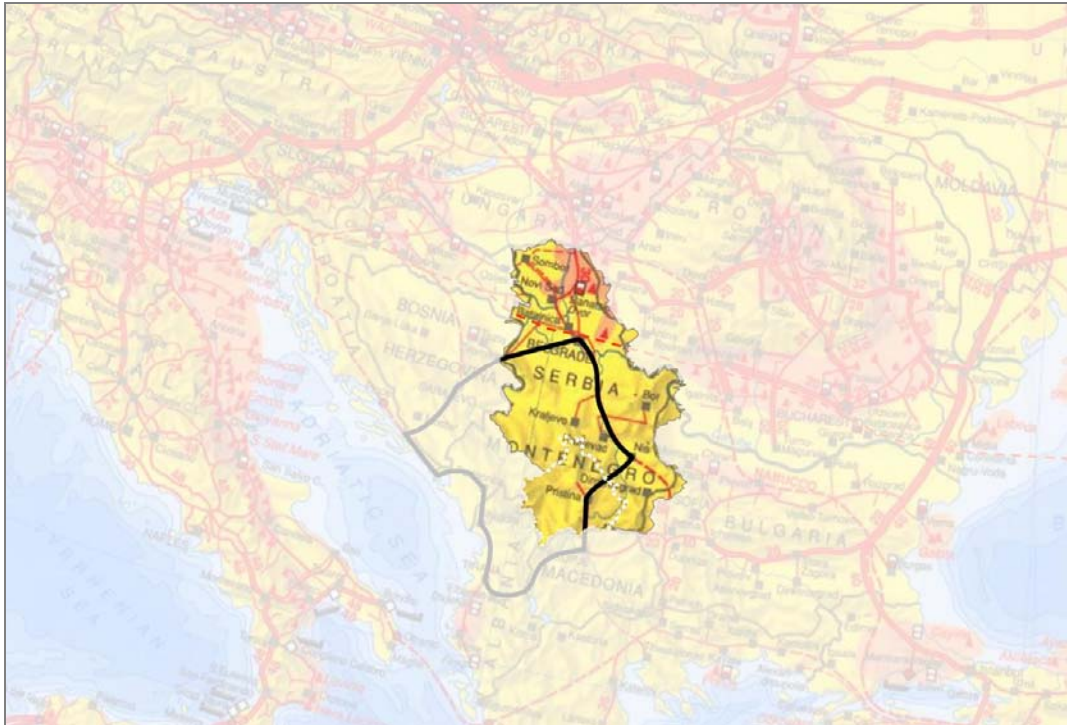
- ❑ Connection to the Croatian pipeline system. Three connection points are proposed, these include:
 - ❑ Sombor - Osijek
 - ❑ Backa Palanka - Llok
 - ❑ Sid - Vinkovci
- ❑ Additional transit pipeline to Bosnia - Herzegovina (Sava Project). Capacity 1.2 bcm.
- ❑ Transit pipeline to Pristina, Kosovo. Capacity TBC

Figure 6 shows the EC Ring from the perspective of Serbia. A major proportion of Ring lies in the territory of Serbia.

¹ www.b92.net; July 6, 2006, "Investments are coming"

² Serbia: Gasification Study, ECA.

Figure 6 EC Ring – Serbia



Reinforcement of the Belgrade-Sarajevo pipeline would make possible increased deliveries of gas to Bosnia and Herzegovina. A pipeline connection from Nis to Pristina would make possible the transportation of gas to Kosovo. When developed, both of these pipeline connections should be built at constant diameter along their length with a view to their eventually forming a part of the Energy Community gas transmission ring. Such a ring would make possible the regional trading of gas between Serbia and Greece, the FYR of Macedonia, Albania, Montenegro and Bosnia and Herzegovina and Croatia.

5 Conclusion

One of the key issues for Serbia is the rehabilitation of the energy sector, which needs to achieve three basic objectives that together should help ensure a more secure energy supply at least in the short-term. These are:

- ❑ Developing sustainable institutions and good governance in the energy sector.
- ❑ Developing sound economic mechanisms related to energy supply and demand.
- ❑ Basic improvements in the system's technical capabilities and institutional structures.

Natural gas is expected to increasingly meet Serbia's energy requirements because of price and environmental considerations. To enable this, major new investments in pipeline improvements are required, which can best be met through private

sector participation. Substantial new investment in distribution networks will be required to meet space-heating needs as electricity prices are adjusted. The priority investments in gas sector are: main gas pipeline Nis-Dimitrovgrad and underground Gas Storage Banatski Dvor

Thus there are two key issues in natural gas sector that the Government intends to achieve: increased gasification (with increased gas storage capacity) and increased options for importing gas.

The existing Hungarian import contract does not provide sufficient capacity to meet peak winter demand. This situation will worsen with increasing demand and declining domestic production. However, most of the import capacity is unused for most of the year, because of the very high seasonal demand swing.

It has been almost two years since the Law on Energy was adopted (August 1, 2004), and more than a year since the founding of the Energy Agency (June 16, 2005). The latter has been criticised lately in the press for being late in adopting many documents crucial to enabling faster development of the energy, and in particular natural gas, sectors. Criticism has also been heard with regards to slowness in dismantling monopolies, conducting reforms, establishing the domestic energy market, and finally in realising potential investments¹.

The priorities for the Serbian natural gas sector are:

- ❑ Increase gas prices to economic levels and reduce connection costs to economic levels to make the gas industry financially viable and facilitate increased gasification
- ❑ Develop storage to:
 - ❑ relieve the seasonal import capacity constraint (providing sufficient capacity from the existing Hungarian transit contract for Serbia's demand until 2010~2015)
 - ❑ provide a reliability reserve for the system
- ❑ Commence discussions with the relevant authorities about supplying gas via Serbia to Montenegro, Croatia, Bosnia and Herzegovina, Albania and Macedonia
- ❑ Enter discussions with the Nabucco consortium to take gas via a new pipeline

¹ www.b92.net; July 6, 2006, "Investments are coming"