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# Generating profit

26th October 2009

**The government's attempts to privatize the Polish energy sector have met with disappointing results so far. But it needs to follow through with its plan if the industry is to remain healthy**

**The government is set to generate a fair bit of cash from the sale of energy companies. But will all go as planned?**
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The bourse debut of Polska Grupa Energetyczna (PGE), scheduled for next week, will be a bellwether event. It will be the largest debut to take place in the CEE region this year, coming at a time when investor confidence in Poland is slowly reemerging, and interest in the event seems strong.

Book-building for institutional investors and subscriptions for individual investors closes this Tuesday, when the final issue price is set. PGE – which is Poland's largest energy group, generating 42 percent of the country's electric energy – is hoping to bring in zł.5.9 billion from the debut.

But this will be more than just a litmus test of investor sentiment. It will also set the tone for the government's privatization plans, which have recently suffered setbacks.

**A simple plan**

Poland's original plan for energy sector reform was fairly simple – consolidate, restructure and privatize. The first step, a horizontal consolidation process which took place over the 2006-2007 period, was designed to prepare Polish companies for the EU's open energy market and give them a competitive edge.

Four energy groups emerged from this period – Polska Grupa Energetyczna (PGE), Enea, Tauron and Energa, which together produce 65 percent of Poland's electric energy and handle 86 percent of its distribution.

The final step in the reform process was privatization, either through stock-market listings or by offering shares to strategic investors. According to the plan, the government will keep control over the two largest companies, PGE and Tauron, while divesting itself entirely of Enea and Energa.

However, this final element of the strategy is proving more difficult to put into practice than originally envisioned, partly due to the economic slowdown. Another problem is that the government hasn't exactly been a shrewd negotiator – by trumpeting that profits from the full privatizations of Enea and Energa would be used to plug its gaping budget deficit, it has tipped its hand.

**The first attempt**

The first of the energy groups to undergo privatization was Enea. The firm's IPO took place late last year, but with disappointing results. Investor interest was low, although Vattenfall spared the government humiliation when it bought an 18.7 percent stake for zł.1.6 billion.

Indeed, eyebrows were raised recently when the state chose not to offer the Swedish power giant first refusal for a controlling stake in Enea. When the Treasury Ministry broadly invited investors to late summer negotiations for 67 percent of the power group, giving them only two weeks to prepare their offers, Vattenfall balked.

RWE was the only firm to enter talks, but it was willing to pay much less than the government had expected. The Treasury wanted around zł.6.84 billion, a valuation based on Enea's quotation price, plus a bonus for the controlling stake. Meanwhile, after conducting due diligence the German company proposed a much lower bid, around 10-percent below the quotation price, arguing that Enea was overvalued on the WSE. According to some analysts, however, the firm was just bargain-hunting.

Faced with a difficult decision – sell now and get much-needed funds or wait for a possibly better price – the government opted for the latter. A new call to negotiations is expected in late November or early December. Will its second attempt prove more successful?

Marek Durski, head of law firm Cameron McKenna's energy, projects & construction department, is optimistic. In his opinion, the Enea bid could garner more interest in a couple of months as companies slowly exit the crisis.



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**Anatomy of a failure**

In hindsight, many factors contributed to the Enea debacle. Labor unions protested, only one company expressed interest and an attempt at corporate espionage may have occurred – a company hired to test Enea's IT security was investigated after it tried to access classified information. According to some sources, it could have been laying the groundwork for future information leaks.

According to Tomasz Chmal, an energy expert from the Sobieski Institute, the government exacerbated its own problems by trying to pit one investor against the other. Energy expert Filip Elżanowski, meanwhile, stressed that the government should have considered negotiating with Vattenfall first.

The situation is a setback for the privatization plan, but might be good for the company in the long run. "Privatizing Enea no matter the cost would not be beneficial for the company or the state," Janusz Śniadecki, deputy chair of one of Enea's labor unions, told Wnp.pl.

The Treasury is also undaunted by its failure. "We wanted to sell Enea this year, but one cannot call it an unfulfilled privatization plan as [we originally set a window of] 18 months. This means that we have time until mid-2010," Deputy Treasury Minister Jan Bury told *Puls Biznesu.*

**The other players**

When it comes to the two remaining energy groups, investors will have to wait a while yet. The Treasury Ministry announced on October 7 that it could sell over 20 percent of its stake in Tauron during a June 2010 IPO, raising zł.3-4 billion. As with PGE, the Treasury plans to retain control, even if its stake falls below 50 percent. Tauron produces 16 percent of Poland's electrical energy.

The final group, Energa, is also expected to undergo privatization next year. The government plans to sell an 85-percent stake to a strategic investor.

**Inflation expected**

Prices for industrial customers were liberalized at the beginning of this year, which resulted in hikes of up to 50 percent in some areas. Having already experienced a dramatic rise in energy costs, some have expressed fears that privatization will result in similar increases.
According to experts, the privatization process shouldn't have a big impact on prices. Mr Elżanowski, for example, stated that privatization is simply the result of economic mechanisms and national energy policy, and will have little impact.

And yet price hikes may still be in the offing for other reasons.

"I think that privatization has no connection with energy prices. Distribution fees are and probably always will be regulated. The energy sector is in for huge investments in the upcoming years. Someone has to pay for them and that someone will be the customer. So prices will rise anyway, regardless of whether the company is private or state-owned," said Marek Durski of Cameron McKenna.

**Henryk Zysko** from NUS Consulting, an international energy cost management consulting firm, told *WBJ* that he did not foresee a dramatic rise in energy prices immediately after privatization, but that prices would increase with production costs. "Improvement in companies' financial conditions and production increases will result in higher demand and thus higher prices," he stated.

Another, longer-term catalyst for energy price hikes was pointed out by Mr Chmal – Poland will have to start buying $CO_2$ emission rights in 2014.

**Criticizing the state**

Meanwhile, a report published at the beginning of October by the Supreme Chamber of Control (NIK), a public funds watchdog, criticized the ineptness of successive Polish governments in energy sector reform. The NIK praised Poland's authorities for managing to consolidate the industry into energy groups which achieved strong positions in the market, thereby increasing their development potential. But it criticized the state for sluggishness – the energy groups were originally due to be privatized by the end of 2008.

Delays, bad judgment, reneging on promises and constant changes to the supervisory boards of state-owned companies are among the biggest problems in the sector. Poor decisions have cost the state money, too. For example, according to the NIK, the government lost zł.2 billion when it backed out of the privatization of five co-generation power stations in 2006-2007.

Other problems include bureaucracy and truculent labor unions, which have been able to block restructuring attempts.

Mr Chmal was critical of the government's actions so far. "It would be good to decide upon a specific model for the market and the energy sector in Poland. I am under the impression that those issues are not fully defined," he told *WBJ*. He added, "The government has no vision for the sector and decisions are made without them being properly thought through."
Mr Durski disagreed, however. "In my opinion, it is clear that the government wants to sell companies from the energy sector, with the exception of PGE," he said.

"The privatization of energy sector companies is a good idea and should be continued, because with the right legal regulations and a strong regulator, energy security and a stable market will be ensured," said Mr Elżanowski. He added that allowing private entities into the sector would increase competitiveness.

Mr Chmal differed on one point here. "We are dealing with a relatively weak regulator – the head of the Energy Regulatory Office can be ousted at any time and has no clearly defined tasks," he said.

Poland's energy sector is predominantly coal-based and its distribution network is in dire need of modernization, as frequent power cuts during stormy or cold weather have proven. The investments necessary to address these issues will be pricey – the cost of upgrading the network, for example, has been estimated at €100 (zł.420) billion and could take 20 years to complete.

Without wise guidance from the state, not to mention private sector capital and know-how, the industry may not be up to the massive tasks ahead of it.