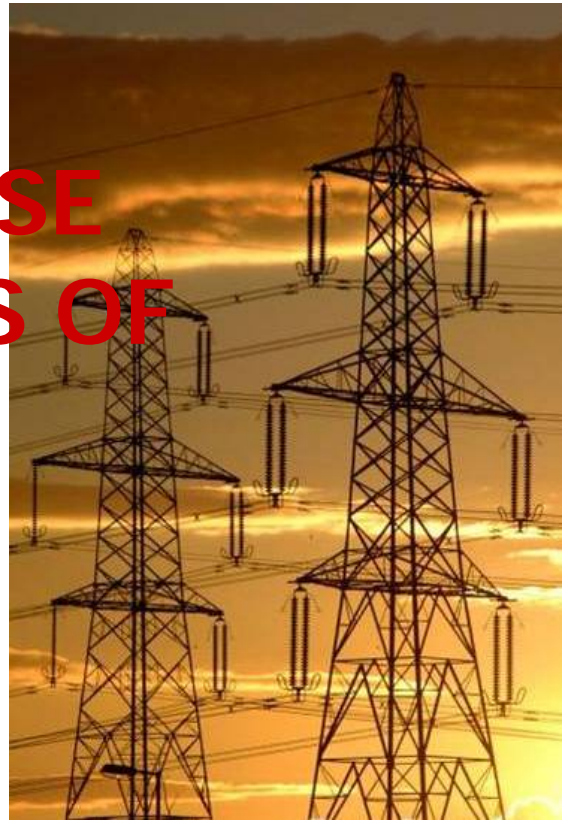


A national champion on the Romanian electricity market? A bad idea of the government, says SAR

DON'T REVERSE THE REFORMS OF THE ENERGY SECTOR



The government intends to set up a public electricity behemoth by merging distribution and generation units (hydro and thermal), covering half of the market. The Social-Democrats oppose the measure vocally, but incoherently, mixing up pro-liberalization and populist arguments. PD-L, the other large opposition party, is silent, with no capacity to react on policy issues. In this report SAR explains what is at stake here and why the measure would be at odds with the Lisbon Agenda and the reforms made in the sector over the past decade.

About a year ago the cabinet in Bucharest has begun toying with the idea of creating a state energy super-company, by including the three branches of Electrica distributor not privatized yet (Muntenia Nord, Transilvania Nord and Transilvania Sud), the hydro generation (all Hidroelectrica) and the thermal plants (Turceni, Rovinari). Possibly, also Tarnița, a provider of ancillary services.

The whole structure would be managed by Electrica, which would invest the proceeds of previous privatizations of distribution companies into generation units. The new holding would be created by transferring Hidroelectrica to AVAS and increasing the share capital of Electrica through the transfer of state-owned shares in Hidroelectrica, Turceni and Rovinari to Electrica.

The holding, subordinated to AVAS, would own cca. 60% of the electricity generation and would become the dominant player on a market which is today relatively competitive. The company would publish consolidated financial statements. As Electrica would own the generation units, in theory the parent

company could use the privatization proceeds collected so far in order to invest public money in generation capacities and by-pass the legislation on state aid. In the future, the company would be privatized (or so the government says) on the stock exchange by the sale of shares.

Since other political parties, including PD-L, do not seem to have the capacity to formulate a position on this, the Social Democrats were the only ones who reacted (vehemently), by threatening the cabinet with a no-confidence motion in Parliament. Unfortunately their arguments are somehow contradictory, mixing up valid points (such as the criticism that the government's plan marks a step back on the energy market liberalization, and that the

Romania is one of the most advanced EU members on energy market liberalization; setting up a national electricity holding, cumbersome and opaque, runs against these reforms

resulting dominant operator would be difficult to supervise after privatization) with populist ones (claiming for example that the population should get cheap energy produced by the hydro power plants; if this happens, it would signal the reversal of the reforms carried out over

the past decade, partly by PSD itself, aimed at terminating cross-subsidies to households in the energy sector). Nevertheless, beyond the political rhetoric, such a move by the state does indeed raise a number of serious concerns.

- There will be a serious **lack of transparency in operations** within and among the companies of this holding. It has been argued that the state should maintain public ownership of certain generation units for energy security purposes and in order to gain regional weight. This can be achieved without the merger of the units in a holding. The units can be kept as separate companies in which the Ministry of Economy and Finance may own shares. The companies would maintain separate accounts and publish individual financial statements, which would ensure the transparency of operations and transactions undertaken by these companies. Otherwise, in a merged company, the decision makers would always be tempted to cover the losses of

some generators with the profits of others (cross-subsidization).

The lack of transparency always leads to rumors, recriminations and makes fertile ground for corruption. If the goal is to make Romania a significant player on the regional electricity market, this would be better served by accelerating the expansion of the trading platform of OPCOM¹. This is likely to become the only regional energy exchange in Central and Eastern Europe, providing services to Romania, Hungary and Austria – a fact that is little known or discussed in our country.

Moreover, if the integrated company is indeed established, the competition on OPCOM would disappear automatically because of the dominant position of this company. And, in the structure that is under discussion today, the owner of the holding would be AVAS, which is in charge with privatizations, and not MEF, which would have in theory the competence to manage issues related to the energy security. The government intends anyway to privatize this company, which offsets any possible argument related to state-controlled energy security.

- The plan to create such a national champion is clearly **clashing with the government's commitments on the Lisbon Agenda**. True, Romania would not be the only culprit in this respect: France and Germany are regularly lambasted by the Commission for their obstinate refusal to unbundle energy generation and distribution and open up the national markets; the EU on average fares worse in 2007 compared with 2002 in terms of telecom & utilities liberalization, which is a crucial component of the Lisbon process².

¹ "Commercial Operator", or the exchange on which energy contracts are traded competitively. It consists mainly of the day-ahead market (PZU, i.e. electricity supply contracts for the next day), the market of bilateral negotiated contracts (PCCB, i.e. long-term supply contracts), and the green certificates trading.

² See general trends and country scores in *The Lisbon Scorecard VIII: is Europe Ready for an*

- If so, the move will mark a **reversal of reforms** made over the past ten years in the electricity sector in Romania, reforms that have been pursued to meet the requirements of European Directives in the electricity sector. These regulations impose the unbundling of generation from transmission and distribution, and the liberalization of the energy market in order to stimulate competition and provide more freedom of choice to the end-consumer.

Even if the new company would formally meet the requirements of the EU Directives, one could argue that the market would never be competitive again as long as one dominant player controls over 60% of the it (generation). Such a company could simply keep out any potential new entrant, by simply manipulating the price. Eventually, this would be an odd move indeed: Romania is currently among the

most advanced EU members on energy market liberalization and vertical and horizontal unbundling of the generation, transmission and distribution, far ahead of old members such as France, Germany or Italy. It is hard to understand such a process reversal, once the country has finally emerged – almost unnoticed – as a serious European competitor in a crucial economic sector. Today there is a real chance to be ahead of the curve on some European policies and abandon, at least in one sector, our well-known position as country which must be permanently monitored, shown the way forward and offered technical assistance.

- The privatization proceeds would be used for investments in **generation and ancillary services**, or so the government says. In the initial scenario, Electrica, the owner of the eight distribution companies

Electricity market and state monopoly in Hungary

The electricity sector in Hungary is dominated by a state-owned company (MVM) which owns nuclear generation, the transmission grid, and a monopoly on the wholesale electricity market. Even though the structure of this state monopoly is different from the one the Romanian government has in mind – particularly the ownership of the transmission grid –, several interesting conclusions can be drawn from this case:

1. Hungary had two major conflicts with the European Commission regarding the competition on the energy market, which are still on-going. The first one is related to the fact that the transmission grid is in the same holding with one of the generators (nuclear), which is a conflict of interest affecting competition. In short, a company that owns both generation and transmission grid can simply block the access of a rival producer to the grid. The second one is related to MVM's monopoly on the wholesale market: all generators, private or public, are obliged to sell to MVM at a set price a certain energy quantity and can sell on the free market only what they produce on top of this quota. The contracts with MVM are on a very long term, some of them until 2024, at prices which are unfavorable to MVM (there are allegations of corruption). The contracts prompted the reaction of the Commission on grounds of unjustified state aid – that is, hidden subsidy from MVM to private generators. In both cases, the Commission has threatened with very heavy sanctions, and the threat was credible.
2. Following the two conflicts and despite the opposition of those who benefited the existing situation, the Hungarian government is currently pressured to rethink the energy market structure and prepares a strategy to further liberalize and unbundle the sector.

What are the lessons learned for Romania? The European Commission is very strict regarding the free market competition in the energy sector and has the necessary leverage to push for the market liberalization, in the benefit of the end-consumer. Any measure with a significant impact on the competition in the energy market should be discussed and agreed with the Commission before its actual implementation.

before privatization, was supposed to be dissolved at the end of the privatization process after transferring the proceeds to AVAS. However, in the new company, Electrica would invest these amounts in generation. Why is the merger of all these units in one holding necessary to make such investments?

The proceeds from the privatization of the *discoms* have started to pour in from 2004, but so far there was no attempt to find any means to use the money for state investments in generation capacities. It is

Why create a huge new dominant player which will behave like a monopolist after privatization?

not clear why these funds were kept for so long into an opaque off-budget public company slated initially for phasing out when privatization is completed, instead of being transferred into the National

Development Fund, created exactly for the purpose of investing transparently in strategic infrastructure. There is a distinct possibility that part of them may have syphoned off through unwise procurement, as it happened at various points in the past³.

The reason may have been the restrictions regarding the state aid, which could indeed be an issue if the investments in generation come from the government instead of Electrica as parent company. However, the European Commission would most likely accept that MEF invests in generation after a preliminary agreement regarding the state aid, than consent to the merger of the energy companies in a dominant player on the market.

This idea has already been harshly criticized by the Energy Commissioner, Andris Piebalgs, in December 2007. In addition, if the state invests in environment protection in the generation units, these are not considered state aid, which would allow such expenditure even without the merger of companies under Electrica.

- The privatization of generation units is vital to **keep alive the thermal power plants** which provide an important share

³ Such as when Electrica bought a few years ago overpriced scuba diving bodysuits.

of the national consumption. Around 60% of the thermal generation is older than 20 years, and 8 GW (roughly one third of the Romania's available installed capacity) must be modernized or it would be closed gradually starting from 2008. Romania must meet its commitments regarding the environment to the EU, which these units do not comply with, and also considers other investments. The sector needs in total huge amount of funds in the next 5-7 years: a study done by the consulting company *Arthur D. Little* mentions 8-11 billion EUR for the environment, new generation capacities and distribution networks. If the units cannot meet its environment obligations in the next years, some of these must be phased out starting in 2008 and Romania would become net importer of electricity (currently it is a net exporter); and this would indeed raise issues of energy security.

For example, this year one of the generation units from Termocentrale Deva had to be shut down, specifically because it did not meet environmental requirements. Even if privatization proceeds from distribution companies could be used for upgrading it, only the free, competitive market could show which of the generation units are economically justified and which should be simply shut down.

Turceni and Rovinari already face this dilemma: today nobody knows whether the needed environment investments pay off in the long run. What is more: the privatization proceeds could be used for the construction of units 3 and 4 of Cernavodă, rather than for rehabilitation of hydro or thermal power plants. In the nuclear generation, the state wishes to maintain over 51% ownership rights, but with the amounts currently available in the state budget it can cover only 20% of the construction. For the rest, there is interest from the private sector, but that means the state would have to give up its objective to retain 51%.

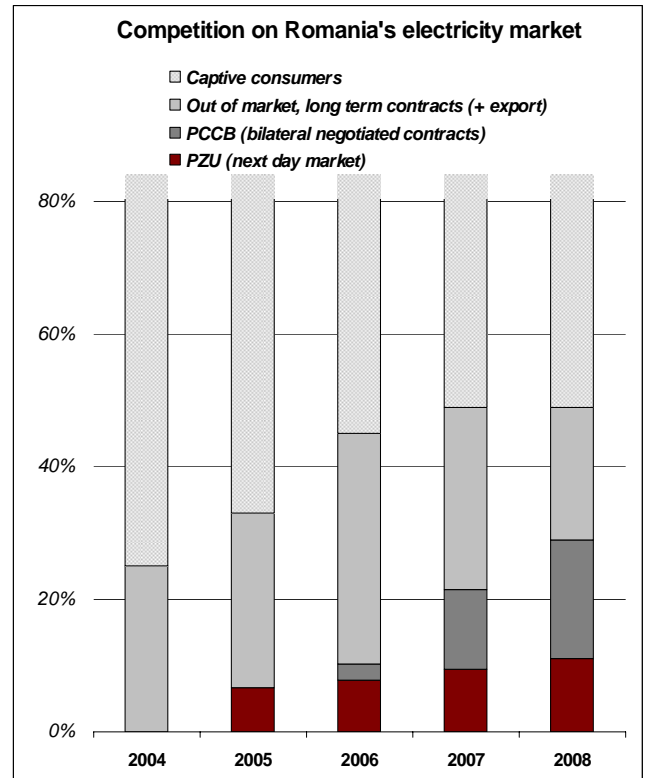
- If a **state monopoly on the market distorts the competition**, the future privatization of this giant would have consequences which are difficult to

imagine. First, the way in which the state merges these companies is different from the manner in which the private sector does it. If the state merges under the same parent company viable units with loss-making ones, the market value of the holding would go down. In addition, considering the dominant position of the company, there would be numerous debates regarding private monopolies and "excessive profits", similar to those we see today in the case of *Petrom*. And if the company would incur losses, there would be a public uproar, this time on the company's side.

- Once this holding is created, OPCOM transactions would be seriously diminished, making this market irrelevant, a situation that would perpetuate the emergence of contracts with the "smart guys" (private players suspected of involvement in corrupt transactions with the public energy sector). OPCOM is a competitive market (an energy exchange), but once a dominant player with over 50% of the market appears and influences prices through its transactions, a real competition is simply impossible.

An IFC financed consultancy – *Romania Competitiveness Report* – warns that the EU would oppose the integrated state-owned company because of the risks that it would "lower market competitiveness due to the high concentration of assets, and rise consumer vulnerability to price hikes". For Romania, the trade with electricity on the free market (currently OPCOM) is the only way to escape the "smart guys" phenomenon in the long run. It must be noted that the current legislation, from 2007, requires all state-owned electricity generators to sell on OPCOM, and the existing contracts with those accused to be rent-seekers (the contracts which have been negotiated in a non-transparent manner and without competition) can be maintained only until their expiry.

As long as OPCOM functions, state-owned companies would not be able to conclude long-term contracts except by transparent trading on the market of negotiated bilateral contracts. However, once there are signs of crisis on the market (which is very likely in case of excessive concentration) MEF would grant



exemptions from this legislation, as it has done at the beginning of 2007. OPCOM is currently one of the best energy markets in Europe and the transparent electricity trading has grown spectacularly since its birth in 2005.

The electricity market is made of "effectively" eligible consumers and effectively "captive" consumers. The liberalization of the market in Romania has stabilized around 50%, the effectively eligible consumers being those who decide to change the supplier they had before the liberalization of the market. In theory, starting from 2007, any household or industrial consumer can conclude contracts with any supplier; in practice, only 50% of them have decided to change their supplier. The 50% who chose to change their supplier trade either on OPCOM (the day-ahead market PZU or the market for bilaterally negotiated contracts PCCB), or by contracts negotiated bilaterally directly, without the market.

Debates and suspicions are centered in the latter, considering that all the generation capacity is state-owned and the sale contracts from this last category are those concluded without competition.

Once the effective liberalization has stabilized, any increase in the percentage of energy traded on the market (OPCOM) leads to a corresponding reduction in the contracts negotiated in a non-transparent manner. An excessive market concentration caused by the establishment of the integrated energy company would seriously distort the free competition on OPCOM.

- Last but not least, the uncertainties regarding the company and **the lack of transparency regarding the manner in which the decision would be finally made** affects the trust of potential investors in the Romanian energy sector. There are already such complaints from several units considered for the merger, particularly from Hidroelectrica. Until the idea of the holding was launched, these assets were earmarked for privatization as initially planned; now the confusion regarding Hidroelectrica's fate scares off potential investors and decreases the market value of its units. In addition, particularly during these years in which rehabilitation investments are vital, projects are stalling because of the government's incapacity to make a decision and the mixed signals.

Recommendations

1. First, any initiative of such magnitude must be publicly debated, in a transparent manner and without rushing things, in order to properly evaluate its consequences. Besides of a public debate and with energy specialists, a discussion with the European Commission is just as necessary, regarding the latter's position on state aids for investments in generation vs. the energy sector consolidation discussed by the government. Any initiative that would lead to the establishment of a consolidated company with a dominant position on the market must be carefully discussed. The European Commission monitors strictly the situations of market domination in the energy sector, as can be seen in the cases of France and Germany. France is currently in a dispute with the Commission for its refusal to unbundle *Electricité de France* in competitive units

and to allow the energy market liberalization. Paris risks the payment of substantial fines for its non-compliance with the principles of free competition; what is more, the Commission has initiated in September 2007 a new reform package for market liberalization as a response to situations like that of France. But maybe even more interesting for Romania is the case of Hungary, in which a state-owned company (MVM) has a dominant position on the electricity market, carefully monitored by the Commission and risking heavy fines.

2. In the meanwhile, we recommend that the entities be maintained separate. This does not prevent the government from making the desired investments in capacity rehabilitation and keeps the inter-company transactions transparent. The government can plan carefully what and how it wants to privatize, if the case, or maintain units in public ownership.
3. An independent audit should be performed at *Electrica*, tracking the privatization proceeds flowing into its coffers since 2004 and how they were used, for investments or otherwise.
4. In the long run, all the companies must be privatized, in distribution and generation. The distribution companies privatized so far have good results, and the price obtained by the Romanian government was reasonable. Investments in generation, if made by the private sector, would be channelled into assets which are economically viable. What is more, if creating a company of regional importance is economically justified, there are no reasons why the private sector would not seize the opportunity and create a holding. Certainly this would fetch a better privatization price overall, and the state would better control the risk that a company would gain a dominant position on the market.

Romanian Academic Society (SAR)
61 Eminescu, Bucharest 2
tel/fax (4021) 211 1477
office@sar.org.ro
www.sar.org.ro