RAO UES – A Practical Plan?

The announcement on November 15th by Sergei Dubynin, Deputy Chief Executive Officer of RAO UES of new restructuring plans certainly precipitated a firestorm of controversy. (See http://www.rao-ees.ru/en/reform/show.cgi?pr141102dubinin.htm)

The restructuring ideas include two controversial suggestions:

- Sale of some generating assets to investors, foreign or domestic;
- Negotiating management contracts with utility operators for two of the eight generating subsidiaries (Energos).

Both ideas were strongly criticized by minority investors present at the Boston conference, as well as by an advisor to President Putin (Andrei Illaryonov).

It seems that at the bottom of the opposition was distrust of UES management and its real intentions. Also of concern to the minority investors (notably and vocally Hermitage and Prosperity funds) was the issue of loss of value to them. They seem to feel strongly that these two new ideas were just another attempt to strip assets from UES leaving the shareholders will less and less.

But, in principle, Pan EurAsian believes that the management contract idea could have merit for the company and the shareholders *if* implemented well. It should also receive warm response from sector experts. The reasons, in brief, are:

- The number of potential, well-qualified bidders to acquire assets of this sort anywhere in the world has shrunken down to a mere handful;
- Conditions are not right to sell generating assets in Russia at the moment, even if there were qualified bidders eagerly waiting in the wings.

For the first reason we also believe that the idea of UES to sell generating assets at the moment is not viable. The objections of minority shareholders about valuations of assets could also be valid in the case of selling assets in the present market.

<u>The case for management contracts</u>

The experience over the last ten years in Central Europe has taught us some valuable lessons.

1. Basic infrastructure assets like power generation, transmission and distribution are publicly perceived as part of the "family silver." There is simply very little public sympathy for selling them off, let alone selling them off to foreign investors. The "man in the street" opposes such privatization attempts. In short, the political benefits of such actions are minimal at best, and probably negative on the whole. Implementing a program of contract management, keeping asset ownership in Russian hands, would avoid such opposition.
2. Power generation facilities were generally used during Socialist times as massive full employment vehicles. A lot of workers could be hired by power plants, way beyond what a modern, well-managed facility would need. Sale to a private investor means layoffs in the minds of the workers. Even agreements to a "social

package" do not fully protect the workers from the restructuring any private sector owner with a duty to shareholders to generate a return on investment would need to undertake. In short, the workers will oppose sale of such plants to investors, especially foreign investors. The negative social implications of improved management and more efficient operations can be mitigated in the way the management contracts are constructed.

3. Restructuring a power generation business is difficult for a private investor if that business is sandwiched between government run entities. Fuel constitutes over half of the cost of a normal power plant. In the case of UES, most of its plants are gas-fired. Presently, it purchases most of its gas from Gazprom at prices well below $20 per thousand cubic meters (versus about $100 to export customers). Gazprom claims (we believe correctly) that it is losing money at this price level, but is forced by the Federal Energy Commission to keep their domestic prices low for social reasons. Nonetheless, we believe it highly likely that any private owner, especially a foreign owner, would be pressed to pay "market" prices for gas, thus increasing costs substantially. On the other hand, the price that UES sells electricity for is also artificially low for social reasons. This is also controlled at present. However, foreign owner would get little sympathy politically for raising electricity prices to cover any increase in the cost of gas because of the impact these cost increases would have on the local market. Even if electricity prices are released to be set by the market, the overcapacity in the Russian system would keep prices near present levels and preclude one operator (with less than 20% of the total generating capacity in the country) from increasing prices to reflect increased costs. Thus, the investor would be caught in what Pan EurAsian terms the "privatization sandwich." A properly structured management contract would avoid this problem. The cost of properly compensating the management would not necessarily have to be recovered directly and totally by the assets being managed.

4. Without long term contracts covering adequately the cost of fuel on one side and the price (and volume) of electricity to be sold on the other side, no investor would get adequate project financing either to make the acquisition or to raise funds for the necessary modernization of an owned asset. Lenders, after Enron's collapse, are far more risk averse than they were before. Merchant power plants are hard, if not impossible, to finance today even in the best established markets, let alone in a market being restructured. Very few, if any, investors today would be able or willing to undertake a major acquisition and modernization program in Russia funded entirely with equity. Very few potential investors at present have the borrowing capacity to make an acquisition such as UES might offer using on-balance sheet debt. The bad experience in Central Europe has raised the risk profile of such deals to the point where any investor's management would be severely criticized in the market even for suggesting such an acquisition based on a balance sheet transaction. A proper management contract, with safeguards to protect returns on investment and properly structured, would probably be bankable.

In addition, many of the qualified, potential bidders who might acquire assets are recovering from a period of excess and have to restructure their own finances. This leaves too few qualified companies who could consider bidding for Russian assets. The bidding process would become too much of a "fire sale." But we believe that many companies that could not acquire assets at present would bid on management by contract opportunities.

For all these reasons, it is apparent to us that sale of assets is not appropriate at the present time, but that management contracts could be made to work.

There are two compelling reasons in emerging economies to privatize power generation assets. One is to attract capital that the government cannot afford to devote to those assets. The second is to bring in expertise to improve the effectiveness of those assets financially and socially.

In our view, the use of management contracts could achieve both objectives. Given the problems with simply selling off the assets noted above, we think that awarding management contracts is a sensible and practical way to accelerate the effectiveness, efficiency and sustainability of the electricity generating assets in Russia.

The biggest problems facing the UES generating assets are the age and inefficiency of the plants. According to one estimate provided by UES, the average efficiency of UES fossil-fueled generation assets is about 25%, or well below the level they could achieve with modern equipment and better management. Improving that efficiency can, of course, be used to absorb some increases in the price of natural gas. Given its present production constraints, it should be that Gazprom would welcome any improvement a contract manager could achieve, and should be willing to work with them to make it mutually beneficial.

Such improvements would also cushion the impact on electricity prices of rationalization of generating assets. Thus, UES could begin the painful transition from socially set prices to those which are economically sustainable.

In summary, we believe that the idea of management contracts is potentially a very good one. The "devil will be in the details," however.

Pan EurAsian's position

Pan EurAsian Enterprises, Ltd. ("PEEL") in cooperation with the Russian energy experts, RPI Inc., are advisors to foreign investors and other potential investors in the Russian power sector. We suggest that investors who spend some time and resources now, when the development of rationalization and restructuring plans at UES are still underway, can achieve a better result by working with UES, its shareholders and the government to reach consensus on the final plan. PEEL and RPI invite interest investors to contact us at russia@paneurasian.com to develop a plan of action.

Background – RAO UES

RAO UES is the largest, by far, generator, transmitter, and distributor of electricity in Russia. It generates approximately 70% of the electricity in Russia. It owns fossil fuel plants and hydro-electric facility. It covers almost the entire country.

RAO UES thinks of itself as a privately owned company, even though the largest shareholder is the Russian government. Its shares are traded on the Moscow stock exchange (EESR.RTS) as well as in Germany (UES) and in the US (USERY.PK).

Basic data about RAO UES are found in the table below.

RAO UES Basic Facts

Physical	units	amount	share of Russian market
Total Installed capacity	MWe	155,100	73%
fossil-fueled	MWe	121,300	
hydro-electric	MWe	33,800	
Production 2000	GWh	623	
Heat production in 2000	Gcal	473	33%
Coal consumed	'000 tonnes	120,083	
Gas consumed	billion cubic meters	127	
Average number of employees		668,200	
Financial results for 2001 in millions of Roubles			**approx. USD equivalent, millions**
Total revenues		400,054	$14,288
electricity		296,127	10,576
heat		72,258	2,581
transmission fees		1,194	43
governmental assistance		3,297	118
other		27,178	971
			0
Net income		41,696	1,489

Source: www.rao-ees.ru