# Polish Power Sector Privatization

*Dreams and Realities*

Twelve years have now passed since a series of post-Communist Polish governments made consistent plans to privatize the Polish power generation sector; and still very little has happened. The reasons to look back are to be constructive, not to carp. For one, the task still lies ahead, so examination of the problems will help investors to recognize the pitfalls and to respond when real progress to fix the problems is being made. Secondly, many of the problems plague other countries, like Russia, which are just beginning the process. Forewarned is forearmed.

The plans of Poland's Ministry of Industry and Trade, dating from 1991 and 1992, were clear and ambitious. A commitment was made by the Ministry to The World Bank that power generation and distribution would be converted from government bureaucracies to commercial enterprises, and would be privatized. It would all be done by 1996.

Foreign governments responded favorably with provision of transitional funding and expertise. Multilateral institutions, like The World Bank, supported much of the early efforts to restructure with grants and loans. Private investors from the sector responded with great enthusiasm.

By the end of 2002, twelve years after the process was started, what has happened?

- Two of the fourteen large, system power plants (Rybnik and Połaniec) have been sold to foreign investors;
- Two large electric distribution company (GZE and STOEN) (of 33 in total) have been sold to a foreign company;
- Many of the local, or district, heating plants have been sold off to foreign investors.

But, even this is not as good as it sounds. By "sold off" we do not mean completely sold off. The government has retained some shares in all these companies, usually more than 50%. Investors do not have a truly free hand to manage as they might wish.

Polish investors into their own country's power sector have fared even worse than foreigners. The troubled conglomerate, Elektrim, acquired 38% of the second largest lignite-fueled, power generation complex in Poland (PAK) and has the right to manage the company. But, Elektrim is teetering on the brink of bankruptcy and finds it cannot comply with the investment commitments it made when it acquired the shares in PAK from the Polish government.

Very troubling to investors have been the numerous false starts and tortuous paths leading to little or no result at all. The sale of Rybnik power plant was a saga of difficulties and tribulations. Negotiations with NRG, the American company first awarded exclusivity by the government, dragged on endlessly, and disastrously, because the government and NRG were negotiating at cross purposes. Similarly, the starts and stops in the sale of eight electricity distribution companies (the "Group of Eight") could fill a book. That privatization is still in progress, and appears destined to collapse. The program to sell shares in STOEN (the electricity distribution company serving the city of Warsaw) nearly collapsed over political objections to selling an 85% share to a foreign company (RWE)[1]. The sale of STOEN, incidentally, marks the first major acquisition of an essential, infrastructure asset to a German company. For historical reasons, that marks an important landmark in German-Polish relations.

The Polish government has long given the impression that it either does not understand or care that investors expend considerable amounts of management resources and money on bidding processes. When these bidding processes end up being cancelled or restarted, as they have been many times in Poland, investors re-evaluate their interest in taking part. The government seems insensitive to this issue and surprised when investors withdraw.

Due to a present paucity of potential bidders knocking at the door and to nationalistic political pressures, the Polish government's latest strategy for 'privatization' is to merge companies it owns with other companies it owns, creating a few vertically integrated entities in the electricity sector (amongst others). (See comments below on the program of "Consolidation.")

Looking back over the past 12 years we would ask, was any of this really privatization at all? Privatization implies more than a government selling off assets. It implies moving the entire sector into a state of vigorous competition populated by companies and managements with experience and demonstrated ability to run competitive, efficient and modern enterprises.

But, in fact, who have been the leading successful buyers of Polish power assets? They have been:

- Électricité de France (EdF), the state-owned monopoly in France;
- Tractebel (Electrabel), a protected oligopolist in the Belgian market;
- Vattenfall, the Swedish state-owned company, also a protected oligopolist in Sweden.

Buying up the smaller heat and power plants were also Gaz de France (a monopolist), SNET (a state-owned and financed French company), and Dalkia (connected to EdF).

What did Poland get from these privatizations? It got some money for its treasury but precious little assistance for transforming the sector into the vibrant, free market economy that it said it sought.

**How did all this happen, and why?**

As the title of this paper implies, there were dreams, and there were realities. This applies as much to the western governments that advised and encouraged the Polish governments as it does to a succession of Polish governments themselves. Often, the dreams could not find their way to reality, and often old realities were hard to put down. What were these realities?

> The power sector is a special sector, along with some others. Lenin, in one of his last speeches to the Party Congress, characterized the heavy industries, including

[1] Transaction was conditionally closed just before Christmas. Ministry of Interior approvals are still required.

power plants and coal mines, as the "commanding heights" of the economy. If the government controlled those commanding heights, it controlled everything. Thus, the people who led those entities in the commanding heights became the industrial elite of society; the best and the brightest. They were respected by the government; they commanded attention and got it.

When the much-admired Shock Therapy program was implemented in Poland, the commanding heights were left pretty much alone. Although those entities underwent some structural changes, those changes were quite superficial in effect. The managers during Communist times continued as managers in post-Communist times. Electricity prices continued to be set for social reasons along with heat and coal prices. Throughout the 1990s, these state-owned enterprises continued to spend money the way they had spent it before, based on technical and social parameters, not on economic ones. The concept that capital had a cost remained strange and foreign.

Society at large had accepted the Communist line that heavy industry, such as power generation, was one of the success stories of Communism. Enterprises on the commanding heights became known as 'the family silver.' The "man in the street" had little or no sympathy with selling off these assets, especially if that sale were to foreign investors.

More powerful than the man in the street were the unions. The labor unions, even when not in the government, have enormous power in Poland. The unions have virtual veto power over any privatization. They can, and have often, delayed or even stopped privatization of enterprises. This is evidenced in Poland by the necessity for buyers of state companies to sign a "social package" with the unions as a precondition to final negotiations with the State. The unions have used this leverage to stop privatizations they don't like, and to extract from buyers expensive commitments not to reduce employment for a given period of time plus the payment of a "privatization bonus" for the workers.

Privatization of electricity generation and distribution assets was also a social problem in Poland. In the United Kingdom, the exciting model for privatization and restructuring in the 1990s, the principal political benefit of privatization was lower prices for gas and electricity. But in Poland, where prices had been artificially set by the Ministry of Finance based on social criteria with little respect to economic costs, the impact of privatization and restructuring would be higher prices. The politicians knew this and dreaded being responsible for it.

Western governments, and the advisors they hired to help the Polish government, either ignored these realities or were unaware of them. Their dream was of a New Age Poland, a free market economy on the doorstep of the old Soviet Union. They urged Poland on to divest itself of its power plants, distribution companies and coal mines. In hindsight, the well-meaning advice of foreigners to the Polish government was often worse than it seemed at the time. Very few foreign advisors seemed to have had the courage to tell the government what it needed to hear rather than what it wanted to hear. Foreign advisors seemed insensitive to the array of embedded interests against the whole privatization process and failed to take that into account.

But, there were dreams in Poland too. There were reformers who dreamed that Poland would become a New Age Poland, that (in the words of one) Poland would not follow the British Model, or the Scandinavian Model, or the American Model, it would follow the Polish Model. It would go almost without hesitation from a command and control structure to a consumer choice structure for electricity without passing through any of the stages that the US and the UK had passed through to approach consumer choice. This dream, however, was a 'dream too far' for those who controlled the commanding heights of power generation.

The easiest way out of this contradiction between dreams and realities was for the Polish government to do nothing while appearing to be hard at work doing something. Hence, a number of plans, strategies, and tenders were announced, processed, and forgotten. The government had the luxury of an overcapacity in the generation of electricity that meant there was no urgency to making technical repairs, adding capacity, or improving efficiency. As long as the government could keep the price of fuel (coal) at a low level, through back-door subsidization of the coal industry, there was little or no stress on the system.

Enough happened with privatization to keep western investors tantalized for a while. This state of affairs persisted throughout the 1990s. But, since the emergence of serious problems in South America, the United Kingdom and the United States, most notable being the California crisis and the Enron collapse, shareholder-owned investors have all but disappeared from the Polish market.

As a result, the Polish government is struggling with a fall in privatization revenues and a power sector that is woefully unprepared to take on integration with Western Europe. These circumstances make it nearly impossible for the government to implement any kind of fast track program, even if the political will was there, to catch up with where it should be in the process on the eve of entering the EU.

<u>Consolidation</u>

The political fix for this problem has been to redirect its strategic focus on consolidation of the industry. Using the excuse that Poland needs a few "national champions" to stand up to champions from Western Europe after accession to the EU, the government has implemented a program to create a small number of vertically integrated regional power companies, a program called "Consolidation."

The model for the consolidated enterprise is the state-owned company PKE (Southern Energy Consortium). Built around the Jaworzno power generation complex, PKE has undertaken a program of 'acquiring' other power companies and even some coal mines. It has hopes to add electricity distribution to its list of acquisitions.

The government has suggested that the gigantic Bełchatów lignite mine and power generation complex (the largest of its kind in all of Europe) could be the nucleus for a second grouping. The government's recent attempt to privatize the Kozienice power plant (the largest hard coal fired power station in Poland) seems to be floundering on union preferences to join a consortium.

What is the attraction of these consortia to the unions? They avoid sale of family silver because the state retains ownership. They allow the unions to negotiate generous (in the case of PKE outrageously generous) "social packages" and they trigger payment of a privatization bonus. In the end, however, the owner remains the State, an owner the unions are comfortable with because they know how to manipulate that owner to their own ends. This is truly "shuffling the deck chairs on the Titanic."

The government likes consortia because it allows the pretense of restructuring and privatization without actually losing control of the commanding heights.

Other Realities

The foregoing explanation ignores some of the less complimentary realities that hindered the privatization process. Corruption has played a small part in that story, but by emerging market standards Poland is relatively clean (but getting worse). Incompetence is another matter.

Poland does not have, as of yet, an effective, experienced and knowledgeable core of civil servants. The political appointment process invades deeply into both the managements of state-owned enterprises and the government bureaucracies themselves. The intrusion of political appointees on the scene worsened as the 1990s progressed. It has had a devastating effect on the management of the sector itself and on the implementation of government plans and policies.

In our view, the tender process itself, by which assets were offered and sold, was deeply flawed. The criteria by which bids were evaluated were not published. For example, the financial proposal often consisted of two major components: the immediate price paid to the State for the shares taken by the investor, and the (firm) commitment the investor made for subsequent investments to improve the asset itself.

On one hand it would have been easy to see that the imperatives of the State were budgetary, and that the State (cash starved like all others on earth) would take the attitude that cash in hand was far preferable to the promise of future improvements to the sector.

On the other hand, many made the argument (including some of those in the Ministry of the State Treasury) that the government was not so short sighted as to prefer present cash over future effectiveness. The point, they said, was to bring expertise and efficiency to the benefit of society as a whole, and that it was the government's responsibility to make sure securing improvements would be preferred over immediate cash. Believing this line was the surest way to lose the bid.

There were no published criteria for who was an acceptable bidder, and who was not. Two recent cases illustrate this problem very well. Both are on-going situations, dragging on largely due to a lack of clear understanding on the part of the government as to who constitutes an acceptable bidder.

One case is the "Group of Eight" electricity distribution companies in which the government lost the better part of a year in negotiations with a Polish businessman who simply did not have the resources to pay to the government the price he had offered.

The other case is the saga of privatizing the Gdańsk Refinery. After numerous false starts at privatizing this, the second largest oil refinery in Poland, the government finally found itself negotiating with a British investor. This investor lacked the financial resources and the in-house technical expertise needed to modernize, develop and operate a large oil refinery. In the end, the British investor could only satisfy the technical and financial requirements, which had not ever been expressed up front in the tender documents, by bringing in a large foreign owner and operator of refineries. But, that too floundered when the Polish government suddenly and latterly raised objections over the nationality of the foreigner refiner (Russian Lukoil).

Now, it would seem that another consolidation is inevitable; the British investor has had to throw in with the largest Polish refining company, essentially resulting in the largest and second largest (and together totally dominating) refineries being merged. In short, as in the electricity sector, an inefficient and unrestructured national champion will be created. One critic has referred to this process as "The Return of the Dinosaurs."

In summary, the privatization process to date could be characterized as amateurish and political. This impression, coupled with the difficulties being experienced by western companies in their home markets leaves Poland with few potential bidders for any future privatization process.

**What are the lessons for other emerging market countries?**

Countries like Russia, which is now starting its process of restructuring and privatizing the power generation sectors, should take note. All the same dynamics apply to Russia that applied to Poland with an extra measure of xenophobia.

The lessons also apply to the countries of south-central Europe that are also just starting their restructuring and privatization processes, mostly delayed by the region's turmoil. Also, the Ukraine should take note, although parallels between the situation in Ukraine and in Poland should be drawn with great caution, and then sparingly.

Our impression is that the present Russian government underestimates the social resistance to real privatization and commercialization of RAO UES. As in Poland, imposition of real prices and commercial conditions will result in much higher prices for electricity, prices the public can not easily afford. Bringing foreign investors in to own and operate power generation assets in Russia will be even more difficult, politically, than in Poland. The ongoing efforts of RAO UES to restructure itself, being strongly opposed by both politicians and other business interests, show all the signs of the same 'realities' that have hampered efforts in Poland for 12 years.

The foregoing discussion has not addressed the dynamics in Poland of the coal industry itself, or the parallel situation in Russia with Gazprom. This, however, is the weak link in the attempt to maintain the social, rather than economic, structure of power generation. In Poland the government is running out of capacity to keep its coal industry going at the present level of indirect subsidies. The same is true in Russia for Gazprom.

The present Polish government is maneuvering to avoid a costly coal miners' strike; in Russia the rumors are circulating of a possible bankruptcy of Gazprom. While it is likely that neither will occur, both show that the governments' abilities to maintain expensive social subsidies of fuel prices are nearing an end. This is the key. When real reform occurs in the fuel sectors (gas in Russia, coal in Poland), real restructuring in the power generation sectors will, of necessity, follow.