The Energy Sector

Poland: The Outlook for 2004 and Beyond

Adamów Lignite-Fired Power Plant in Western Poland

A Summary Survey
prepared by

Pan EurAsian Enterprises

Poland, Energy Sector – 2004 and Beyond©

Retrospective

Pan EurAsian takes a brief look at what we believe is in store for Poland in '04, what will be the priorities, and where may lie some opportunities in the power sector. As always, Pan EurAsian stands ready to assist clients develop more specific analyses and market development plans.

As Poland sits virtually on the eve of accession to the European Union (set for May), a good way to start may be to take a look at what has been accomplished in the energy sectors since the collapse of the Warsaw Pact and the fall of Communism.

The last 14 years have seen Poland change a lot, with some changes occurring in the power sector, but perhaps showing less dramatic changes than in other sectors of the economy. The State still owns over 50% of the means of generating electricity, although the sector has been "commercialized." In terms of fuel efficiencies, Poland continues to lag behind the EU-15. In terms of price, Poland's electricity is still cheap compared to consumer prices in the EU-15. In terms of environmental compliance with EU rules, it still has a ways to go.

Some forecasters are suggesting that Poland will have to modernize its energy infrastructure at a more rapid pace than in the past once it joins the EU. Our view is that accession to the EU will not change the basic social and economic resistance to modernization any more than did the fall of Communism. The government does not have the money to invest itself in the sector and the low prices are a deterrent to self-supporting investment on a massive scale. The resistance to increasing the price of electricity to consumers will not diminish simply because Poland becomes a member of the EU. In the minds of many, there is still the temptation to want the "free lunch."

The Polish economy is slowly emerging from a period of low growth and high unemployment. It seems that growth is returning, but the high unemployment figures, near 20% at times, seems to be a persistent problem. High social costs (medical, pensions, education), exacerbated by inefficiency in the deliver systems, weigh down the national budget and limit the government's ability to invest in the improvements necessary to upright the economy and modernize the country. The coal sector continues to be a particularly difficult problem. Hopes are that EU accession and aid will give the government the additional resources it needs to dig its way out.

Our previous summary report, *Polish Power Sector Privatization* from December 2002, is available on the Pan EurAsian website archives, which are open without charge.

Privatization

Oil, Gas and Coal: The natural gas and coal industries remain state-owned and control despite periodic declarations of intent to privatize. Polish Oil & Gas Company ("PGNiG") has been the subject of many studies and plans to break it up and sell it off, but none of these plans have yet come to fruition. At present, the government is, again, talking about selling off parts of PGNiG, but the national pipeline system and the management of gas imports (Poland is heavily dependent upon imported gas) will remain state-owned activities. Local gas distribution may become privatized.

The oil sector, on the other hand, is already mostly out of state hands. The largest refinery, PKN Orlen (Płock), has been largely sold off by the government and is listed on the Warsaw Stock Exchange. The second largest refinery, Gdańsk, was the subject of a multi-year privatization process that ended in failure. The government has decided to create a second refining and marketing group, Lotus, with Gdańsk Refinery at the center, which will also be subject of an eventual IPO. Retail marketing of gasoline is fairly fragmented with stations owned by Orlen (the largest network), Lotus, Shell, BP, and others.

The coal sector has been an enormous headache for the Polish government since 1989. The sector loses money. Poland is heavily dependent on coal for power generation (over 95% of electricity is coal-generated). Social pressures to keep coal and electricity prices low have limited the government's ability to price coal on a cost-recovery basis. Strong union presence has further limited the government's ability to rationalize the coal mining industry.

That being said, remarkable progress was made during the 1990s to reduce employment in the coal mining industry. The problem was simply bigger than could be dealt with quickly.

Various past initiatives to privatize the coal industry have failed. Pan EurAsian doubts that the industry could be truly privatized, especially if foreign capital were involved, without substantial government warranties on pension, health (Black Lung), and subsidence costs. The government has been unwilling to date to consider warranties.

<u>Power Generation:</u> The decade of the 1990s brought an explosion of multinational investment in power generation, transmission and distribution. Poland saw some of that, but not anywhere near as much of it as it could have. Nonetheless, some large foreign investors made inroads into Poland during that decade with interest tapering off in 2001 and 2002. The largest foreign investors in the power sector are:

- Vattenfall
    - Warsaw Heat and Power Company (EcW) (six heat and power plants serving the capital city)
    - Upper Silesian Electricity Distribution Company (GZE)
- Électricité de France (EdF)
    - Ec. Kraków (heat and power plant serving Kraków)
    - El. Rybnik (large system power plant)
    - A number of smaller district heating plants
- RWE Plus, the Warsaw electricity distribution company (STOEN);
- Electrabel (formerly Tractebel), "Połaniec" power generating company and some smaller assets;
- PSEG Global
    - Ec. Chorzów (heat and power plant near Katowice)
    - Ec. Skawina (heat and power plant serving Kraków)
- Enron, an industrial cogeneration plant at Nowa Sarzyna, Poland.

In addition, some smaller investors have participated such as Dalkia, SNET and Rolls-Royce Power Ventures.

Some other majors such as ENDESA, Iberdrola, AES, Southern, NRG, National Power, PowerGen and others made efforts to participate, found it difficult, and withdrew (except for AES that has kept on with development of Zarnowiec in the north of Poland).

A more complete report on privatization in the Polish power sector can be found at www.paneurasian.com/recap11.pdf

The problems that have suppressed investment are:

- A lack of consistent implementation of general policies to privatize the sector;
- Ineffective implementation of a free market structure for electricity;
- Social resistance to privatization of the power sector;
- Unrealistic expectations in both the government and on the part of investors;
- Pricing distortions in the fuels market caused by government support of the coal mining sector.

None of that has changed. What has changed is that the "feeding frenzy" for investors in the power sector is over. Many of the potential investors that were interested in Poland have withdrawn from the business of foreign development. This is especially true of US and UK based, shareholder-owned companies. But, even the notorious, state-owned EdF with its seemingly unlimited resources of cheap capital has found itself somewhat over-extended. If the Polish government had a plan at this point to privatize the rest of the power sector on a fast-track, with clear and transparent procedures, it would find few takers. The government need not bother to try, and it knows that. It has missed the boat.

New Government Strategy

As a result of the problems with privatizing the power generation and coal mining sectors, there is a new government strategy for these sectors based on the creation of home-grown Polish energy conglomerates. The first such company is Południowy Koncern Energetyczny S.A. In effect, what the Polish government has found too difficult to privatize, it has re-packaged. PKE, as it is known, is a harbinger of the future. There will be more conglomerates.

The conglomerate idea addresses directly very strong political and social concerns:

- Resistance to sale of the "family silver" to foreigners;
- Control of Polish entities by foreign entities that do not embrace Polish social policies;
- Lack of Polish "national champions" to offset those from large EU countries;
- Worry about how Polish consumers will be treated after accession.

Most importantly, the conglomerates take on the task of restructuring over-staffed and inefficient state-owned enterprises that the government by itself would find politically difficult to do, even though the conglomerates themselves are state-owned. The government can blame the conglomerates who operate "independently." At the same time, the government is not criticized for turning the task over to foreigners. The prospect of Poles throwing Poles onto the bread-lines may be more acceptable politically than foreigners doing the same thing. (This sentiment is not unique to Poland but can be seen to operate in pretty much any country in the world.)

Actually, PKE has committed itself to very generous social and redundancy policies. It may be that the regulator, URE, finds it easier to give rate relief for such costs to domestically owned companies than if they are foreign owned.

The conglomerates, like PKE, will be regionally oriented, and will be vertically integrated to include coal mines, power generation, and distribution. [The national grid system, operated by the Polish Power Grid Company ("PSE") will not be broken up, and may eventually be offered as an IPO.]

At present, PKE belongs entirely to the State Treasury. The longer term plan is for an IPO on the Warsaw Stock Exchange at a time when there is enough liquidity in the market to support a major IPO.

PKE started from the nucleus of the Jaworzno power complex (plants one, two and three, of which one has been decommissioned). It now consists of 8 formerly independent power generating companies with a total available capacity of 5,055 MW. In addition, PKE is adding coal mines and possibly electricity distribution to its structure. The idea is to create Polish companies large enough to compare favorably (but not claim equality) with the giants of western Europe. (For more information see their website: www.pke.pl)

The Polish government has announced that more conglomerates are to come. The next one planned is based on the gigantic (4,320 MW) Bełchatów lignite-fired, mine mouth power plant plus another lignite-fired plant (Turów) and the hard coal plant, Opole. The government has also considered forming another group based on the Kozienice power plant (Poland's largest hard coal-fired plant) combined with the Bogdanka coal mine, purportedly the lowest cost hard coal mine in Poland. However, present thinking seems to be favoring the addition of Kozienice to PKE. A final decision on Kozienice is promised for 2004. (The government attempted to privatize Kozienice in 2003, but there was not sufficient investor interest and the tender was cancelled.)

Foreign sector investors, strategic investors, are not seen as an element of the conglomerate program. Foreign financial investors, of course, will be able to participate when these conglomerates go public on the Warsaw Stock Exchange.

Electricity Distribution

Electricity distribution has progressed even more slowly than power generation. There have been two, albeit large, privatizations in the power distribution business: STOEN and GZE. STOEN is the distribution company serving the city of Warsaw. GZE serves the region around Katowice in the south of Poland. STOEN is now in the hands of RWE Plus; GZE is in the hands of Vattenfall. Privatization of the "Group of Eight" (eight distribution companies in the western portion of Poland, bundled together, but not merged, to be sold to one bidder) is a long-running drama in Poland. Presently, Kulczyk Holdings has exclusivity on the Group of Eight and may close the transaction in 2004. If not, it will probably be withdrawn and the pieces put into one or more of the conglomerates.

Looking Ahead

What are the wild cards for 2004 in Poland? A friend of ours once remarked about forecasts in the energy business that the only thing consistent about them is that they are always wrong. One reason for this is the unexpected. One can only speculate about the unexpected, and where it could come from. We call these the wild cards. The energy business is full of them.

Despite the recent unpleasant proceedings in Brussels over the voting rights of new members, especially Poland, Poland will join the EU in May. We don't see any wild cards, any major discontinuities, in Poland's accession or in the early days of membership. There may be a lot of squabbling over money, but this should not affect the energy sector very much.

Looking East

The wild cards are more to the east than to the west. As Poland pursues its conglomerate policy, there may be opportunities for foreign investors to "cooperate." We see one company – UESR – the Russian electricity giant (155,000 MW_e) as watching and waiting for opportunities to move into the Polish market. For UESR, Poland is the most logical and necessary stepping stone for Russia to eventually integrate European Russia into the European electricity markets. Although any participation in the Polish electricity sector by UESR would face strong political and public relations problems in Poland, we do not write it off completely. It is, indeed, a wild card. Russian electricity represents "cheap fuel-by-wire" for EU industry. That attraction is not easy to write off.

Oil Transit: The oil pipelines, unlike the natural gas pipelines, that serve and transit Poland seem to have a fairly low profile. We expect that the importance of that oil pipeline infrastructure will increase in importance and visibility during 2004 and beyond.

The production of crude oil in Russia and the Caspian has been growing fast. Both, however, are export capacity constrained. The Russian oil industry is especially constrained as to pipelines and ports. Recently, the Russian national oil pipeline operator Transneft, has increased substantially the capacity of the port of Primorsk (near St. Petersburg). But, Primorsk is not an ice-free port. Gdańsk, on the other hand, is an ice-free port. PERN, the Polish operator of the Friendship Pipeline system (Druzhba) fragment in Poland, has also embarked on a program to increase substantially its ability to bring crude oil to Gdańsk for export. Naftaport, the operator of the oil terminal at Gdańsk, has also upgraded its capacity and facilities recently. We expect to see exports of Russian crude through Gdańsk increase substantially in the next two years.

Poland also interjected itself in 2003 into the intense debate over the "Odessa-Brody" pipeline dispute. Odessa-Brody (actually serving the port of Yuzhniy, or Pivdenny, in Ukraine) is a new, and as of yet unused, pipeline that connects the Black Sea maritime infrastructure to the southern branch of the Friendship Pipeline system transiting Ukraine towards south-central Europe. The intended flow was Caspian crude to European markets (southern Germany, Slovakia, Hungary and Czech Republic). But, those markets turned out to be well served by Urals blends and resisted shifting to Caspian crudes, at least until now.

In 2003, Russia, especially TNK, pressed the Ukrainian government to reverse the intended direction of flow of Odessa-Brody in order to carry Russian (Urals) crude to the Black Sea. This debate became intensely political and is yet unresolved.

Poland has, from time to time, suggested that Odessa-Brody be extended from Brody to Płock in Poland, thus connecting Odessa-Brody into the northern branch of the Friendship Pipeline system to serve Polish refineries and refineries in northern Germany. This suggestion reached ministerial agreement levels in 2003, although whether or not this turns into a commercial reality still remains a question.

Political Changes Ahead

Another wild card, always present in Poland, is a major change in government. The present SLD (Social Democratic party) government is fast losing popularity in Poland. Rising to take its place is the conservative "Citizens' Platform." If there were to be a change of that sort in the government, along with supporting changes in the parliament, the conglomerate idea in the power sector might get scrapped in favor of a more fragmented and competitive market structure.

Long Term Contracts

Finally, a word on the long term electricity supply contracts issue. During the 1990s the Polish Power Grid Company, in its role as the single buyer and operator of the national grid system, let out a number of long term power contracts to power plants that served as collateral for loans to modernize. The amount of power moving under those contracts has reached about 70% of all electricity sold in Poland. This has put dampers on government plans to create a "free market" in trading electricity. For the last three years, the Polish government has been trying to find a way to cancel those contracts so it can do away with the single buyer model. So far, their plans have met strong resistance from the banks (some domestic, some foreign) that made the loans to proposals from the Polish government. The banks have not backed down despite some veiled threats by the government to re-nationalize any plants with the contracts that refuse to accept the government's terms. The problem of canceling the long term contracts seems no closer to resolution in December of 2003 than it did a year ago.

The present path being pursued is cancellation of the contracts and "monetizing" of the debts. The individual borrowers would be released from their debt obligations by means of a payoff of the debts. The monies to pay off the debts would come from a bond offering backed by a general levy on electricity sales. The objective is to dismantle the single buyer system and go to an open, free market system for electricity trading. Our main concern with this approach is the distortion in cost structures this approach would create between plants whose debts were forgiven (essentially a free gift of assets) versus those plants that found other ways to finance capital improvements and are not eligible to participate in the debt-forgiveness program.

However, we also think that the question is fast resolving itself. Many of the long term contracts will expire by their original terms in the next year or two. The total amount of electricity moving under long term contracts will soon drop to levels that will allow sustainable trading to coexist with power sold under long term contracts. One of the lessons of California is that long term contracts are not an evil, but are a benefit and need to be a part of the portfolio. We expect Poland will accept that duality and the issue will go away by itself. Implementing such a duality, however, would require very different approaches to the problem than the government has pursued thus far.

Renewables and Green Energy

In an attempt to follow EU regulations Poland has introduced incentives for renewables and "green" energy. Some investors may find opportunities in waste-to-energy, methane recovery, wind and other projects of this nature. If the long term contract problem is resolved finally, the electricity trading business may finally emerge as a viable business.

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