

Things are never as good, or as bad, as they seem at the time.

A letter from the managing director of Pan EurAsian Enterprises, Ltd. to friends, clients and interested colleagues:

For a number of reasons it seems like a good time to take stock, to take a look back and a look ahead, to try to make some sense of it all and gather up some new directions.

This letter is presented in two sections: Looking Back and Looking Ahead. For those who wish only to Look Ahead, you can jump to that section with a [simple click](#) of the mouse. Were real life so easy!

Looking Back

Energy in general.

Pan EurAsian was established in 1991 to undertake some special projects in Central Europe. Since then, it has broadened its scope, but stayed focused on Central and Eastern Europe. My own experience with the energy industry, which is the main focus of this letter, dates back to the Oil Shock of 1974. There have been a few ups and downs since then. A colleague of mine likes to say that the lesson of the last 25 years has been that there is only one thing sure about energy forecasts; they will be wrong.

From 1974 to about 1980, the accepted wisdom was that oil reserves were depleted, that oil prices were destined to rise (“\$90 by ‘90”). Britain’s National Coal Board was issuing dramatic forecasts about “doubling and trebling of coal use and production in the U.K.” It all turned out to be nonsense. Margaret Thatcher turned the NCB on its ear, putting coal into the background with the “dash to gas.”

In the US, the Clean Air Act of 1977 and the Public Utilities Regulatory Policy Act of 1978 (“PURPA”) laid the groundwork for a complete restructuring of the industry there, some of which has taken place, and some of which has not. [I note in passing that some analysts have laid a lot of blame for the severity of the 1929 stock market crash on the electric utility pyramid schemes and massive debt problems. It seems history is repeating itself. The industry appears to have a knack for getting itself into trouble.]

By 1990, the growing wisdom was that the marketplace would solve all problems. Simply deregulate, and all problems would go away. Post Reagan US and post Thatcher UK were convinced. Or mostly convinced.

The time was right, in some ways, for this restructuring. Electricity generating capacity in the US had stopped growing after the Oil Shock of 1974. Reserve generating margins were adequate, even excessive. President Reagan refused to re-enact the Clean Air Act, which meant that no one who could avoid it would take the chance on building a power plant that might be rendered useless by a new clean air act. The backlog of needs started to grow. It was not until 1990 that the Bush administration and Congress had agreed to a new Clean Air Act.

The regulated electric utility companies in the US made matters worse by resisting every change. When the Clean Air Act was first enacted, I prepared a survey of electric utility companies in the US. We asked them to describe their compliance strategy, and a surprisingly high percentage of surveyed CEOs answered our questions. We gave them a number of choices regarding how they would, in general, deal with the requirements to clean up their emissions. One of those choices was “litigate” which meant that they would fight it

every step of the way. It was the overwhelming choice selected by those who responded. The refusal of the Reagan administration to initiate re-enactment of the Clean Air Act (which had sunset provisions when originally enacted) was a direct result of this attitude.

The “dam finally burst” in the 1990s, most notably in the UK, and in some parts of the US. Independent power generation, which had been struggling since the concept of “qualifying facilities” had been established in the early 1980s, suddenly took off. At the same time, developers, banks and others discovered the magic of non-recourse project financing. The feast began.

In the early 1970s I worked in the Financial Counseling and Utilities departments of the Irving Trust Company in New York City. Under the leadership of John Childs these departments were prominent nationally in advising clients, especially regulated public utility companies, on matters such as capital structure, issuance of securities, and policies on dividends and relationships with the rating agencies. The general policy of electric utility companies, in order to maintain at least A ratings, was to keep long term debt to no more than 35% of total capital structure.

With project financing, however, companies were building portfolios of power generation assets that were leveraged as much as 90%. What had changed; were the Newtonian rules of gravity finally revoked? Although I worked diligently on a number of such project finance structures, that question nagged at me from the back of my mind. That nagging thought got worse as the projects themselves went from fairly safe long term contract-supported frameworks to “merchant plant” configurations. Although there are few, if any, pure merchant plants with 90% debt structures, the universe of projects was getting riskier and riskier, and the high level of leverage continued largely unabated.

I am not referring here to the out and out fraud that has become apparent since the Enron collapse. These structures were undertaken openly and honestly in most cases. But, they were risky, and I wondered why that worked then and hadn’t worked before.

With the advantage of present hindsight, of course, it is clear that the structures were too risky. The stock market has rendered that verdict by trashing the stocks of many power developers whose only sin was that they used project financing to run up huge amounts of debt. In some cases, the companies were scrupulously careful in providing information to the analysts and shareholders. This doesn’t save them. As I write this in August of 2002, it is clear that the independent power industry and much of the electric utility industry of the US and the UK, let alone within more risky country environments, are virtually foreclosed from the capital markets. The party is over. A period of triage, retrenchment, consolidation, rationalization, call it what you will, has begun. I will deal with what I think this creates in the way of opportunity, and it creates a lot of opportunity, in the Looking Ahead section.

Central and Eastern Europe.

President Ronald Reagan will be long remembered for his leadership in bringing about the final collapse of the Soviet Union and the evaporation of the Iron Curtain. The countries of Central and Eastern Europe shed their repressive, Communist governments and sought to rejoin the free world. In some respects, they couldn’t have picked a better time; or worse.

It was a good time in that the “west” was moving into a period of great prosperity giving it the resources to be helpful. It was a bad time for reasons I will elaborate.

In general, the peoples of Central and Eastern Europe were truly shocked to see the difference in standards of living between the “west” and the “east.” Although this caused some resentment, the more common reaction seemed to have been acceptance that “anyone with a

briefcase and a room at the Marriot” (in the words of Lech Walesa) was a millionaire genius who could put everything right. The region became flooded with “advisors” and “experts.”

What the people of the region did not fully appreciate was that the western countries were themselves in a period of fundamental restructuring and that a lot of the proposed solutions were entirely theoretical and unproven. The liberalization of the electricity (and other) markets in the UK (for example) that became a template for other countries to emulate was itself new and untried. In the end, the first British model was scrapped and replaced by the “New Energy Trading Arrangements” that corrected some of the earlier errors, and introduced some new ones. The development process in this regard is still in early days.

But, there was a financial cushion in the west that the transition economies did not have. The mistakes would be far more expensive for them than for the west.

Worse than that, some of the “experts” who flooded the region with advice were simply unqualified, and were simply taking advantage of an exciting, profitable, new business called “advisor.” Universities, “beltway bandit” firms, and government bureaucracies all got in on the game. In fairness, a lot of good also came from the work of these experts, not all of whom were unqualified. But, I ascribe a lot of the present economic problems in countries like Poland to those advisors who found complicated and elaborate ways to tell the governments of the region just what they wanted to hear, not what they should hear. Honesty (intellectual) was not their best policy. As always, it is the few rotten apples that spoil the barrel. Government-sponsored advice programs had real quality control problems.

In my view, the so-called “Shock Therapy” program had a lot in its favor. Contrary to the opinion of some, I believe that it was not implemented deeply enough. Too many exemptions for “strategic reasons” were tolerated. As a result the region is, twelve years after the restructuring started, no further along at solving the problems of the “dinosaurs” than it was twelve years ago. That may seem a bit extreme, but in essence I believe it to be true.

By “dinosaurs” I refer to the “rust belt” industries of the region such as primary steel making, coal mining, certain chemical plants, automobile manufacturing plants, and others. Some of the more outrageous examples got shut down, perhaps, but many are still kept alive. They still produce products with outmoded technologies, still pollute the air and water, and still employ thousands of workers at sub-standard wages. Almost without exception, they still belong to their governments and divert tax revenues through front and back door subsidies into non-productive uses in a cycle of ever-worsening results. Even today, however, “offset programs” from western countries are offering to keep them alive a little longer. The “west” is complicit in the crime.

I am not going to make this letter a political treatise, as tempting as that might be to do. Suffice it to say, my observation is that the ‘full-employment at any cost’ philosophies of the region will not, cannot, work. The budget deficits and prospects for worse budget deficits in the region are sufficient testimony. Many in the region live with the dream that all will be magically made better by membership in the EU, as if Brussels were a fountain of money fed by a magic spring that never runs out. The reality is quite different.

Moving to a more specific topic, I would like to comment on the privatization of the energy sector in Poland. In general, it could be characterized as a colossal failure.

In around 1997 there was a conference in Warsaw on “public-private partnerships.” It was an notable example of giving good advice. Attendees were high level government officials from all over the region, as well as those from western countries. Much of the advice given was “straight from the shoulder” and quite sensible. It was, generally, not what the governments

of Central Europe wanted to hear, but was what they should hear. The Polish government (except for the Finance Minister, Leszek Balcerowicz, who had been a strong force in sponsoring the conference) showed its interest in receiving such advice by staying away.

A lot of the conference focused on transparency, clarity, and effectiveness. These are all things that the privatization process in Poland totally lacked and continues to lack.

For example, in no privatization bid request document that I have read from the Polish government have I ever seen anything that established:

- The weighted criteria by which the offer would be ranked;
- The criteria establishing whether or not a bidder was qualified to bid;
- Any ground rules for ownership of the bidder, be it another State or a private enterprise;
- A clear explanation of payment terms acceptable or not acceptable to the Polish government;
- A clear statement of government regarding the negotiation of the “social package” including the payment of the infamous “privatization bribe” to the workers (who have effective veto rights on any privatization action the government might undertake);
- Any indication on the government side that they realized just how bad the condition of the assets being offered really are, and a willingness to let the buyer deal with those problems (such as long standing unpaid bills by state companies to state companies).

Beyond that, very few privatization processes in the energy sector have stuck to any kind of schedule. In some cases bidders were either promoted or rejected for unstated, but obviously political reasons.

In addition, the whole process has been tainted by the general public impression that the government was “giving away the family silver.” Nothing could have been further from the truth, but no government minister ever showed the courage or the integrity to say so, with the possible exception of Emil Wąsacz, who surprised everyone and defied critics by staying on the job longer than expected and taking initiatives no one expected. His refreshing rationale for accelerating the privatization of “dinosaurs” was “we can’t manage them, and someone has to.” His reward was finally to be dismissed.

At present the privatization process has come to all but a halt, with the few ongoing processes (in energy) marred by uncertainty, political favoritism, and a total lack of realistic objectives.

The present situation in Poland can be characterized as follows. The present government is made up of “ex-Communists” who seem to hold to the idea that running a tight bureaucracy and spending freely will solve all problems. The problems are fast becoming more and more intractable. They include:

- A rising budget deficit that exceeds 5% of GDP;
- Already high taxes and social charges that leave little, probably no, room for increasing taxes to cover the deficit;
- A declining economy, rising unemployment, decreasing standard of living;
- A failure of the “responsible right” leaving the door open to nationalistic, populist, politicians (observation of President Kwaśniewski in a recent, published interview);
- A population that doesn’t know what to think, and yearns for some real leadership.

Privatization has come to a virtual standstill because:

- The “man in the street” believes the family silver is being given away;
- Political gamesmanship and insider deals reminiscent of Yeltsin era Russia seem to be flourishing;
- The honest conviction of the present Minister of the State Treasury that privatization revenues should not be used for filling budget holes and supporting on-going programs as was the case under the previous government, but with no idea how to fill the holes otherwise;
- The change in economic circumstances of western companies that were coming to Poland, but no longer are;
- There is no government conviction to solve the problem of the “dinosaurs” other than to continue hoping they can be magically restored to profitability.

The driving forces that led me, and many others, to judge that Central Europe was a good market for those in the energy business still persist. They include:

- An old, outdated, inefficient plant that needs replacing or modernizing;
- New environmental standards that the present plant does not meet;
- Approaching membership in the EU where less avoidance of issues will be possible.

The problem is, everyone admits the problem, but no one does anything about it. The *status quo* is not sufficiently uncomfortable for governments, and the population at large, to embrace the uncertainty of action. Inaction is too easy, and has been for the last 12 years. For the moment, inaction persists.

Looking Ahead

Energy in general.

As difficult as it may seem, I believe that what is happening now is healthy. In general, the 90s mentality embraced the “greed is good” motto with a vengeance, taking it to the point of “excessive greed is excessively good.” As long as you made money, there was no bad, and if you made a lot of money, all was forgiven. Such is the rationale of the bank robber as well.

As with all things of this nature, it seems, the beginning was innocent enough. Where there are large capital flows, there are opportunities to make a lot of money, and fair enough.

I have seen enough of the good over the past few years to be encouraged that more can come. I have also seen enough distortions of that good to believe that some “Herculean” cleaning is in order. Sadly, the falling tide lowers all ships. Out of it, I am sure, a stronger energy industry will emerge. The process is not pretty, but the result will be good.

The task is not complete. In the US there are still spots of energy needs that will require investors and new plants. The cleanup task in Central Europe, and more especially Eastern Europe, has barely gotten started. There remains a huge amount of investment to be made in the region, and this means opportunity.

I believe that the issues of debt versus equity, the management and allocation of risk, and the real cost of capital (debt and equity) will be re-assessed in light of the present situation. There have been dire predictions recently in the press of imminent bankruptcy of energy companies. Some have even felt it necessary to assure the public that they are not faced with bankruptcy. Some will indeed become bankrupt. This creates new opportunities.

What is hard for me to tell, and I suspect the low prices of energy companies reflects analysts' frustrations with this issue, is the degree to which the present risk of default on project debt falls on the energy companies, and to which degree on the lenders. How much of this lending was "non-recourse" and to what degree was the "non" indeed penetrable? The detailed answer to that question is buried in thousands of pages of complex legal agreements underpinning each of hundreds of projects, and there is no general rule. Given the complexity and uncertainty, is it any wonder that some companies are selling for considerably less than 10 times earnings?

But, there will be survivors. In the interim, it will be the lucky energy company that has access to the capital markets at any cost, let alone at reasonable cost. Other ways of doing business will need to be developed. This creates new opportunities.

There are, of course, some energy companies that have kept "their powder dry." John Childs was fond of saying that the good CFO earns his entire life's earnings once. That is when he is able to arrange financing for a blockbuster deal for his company when everyone else in his industry has run out of capacity. The next few years in the energy industry will show just how right John was. Some signs of this are already emerging. Warren Buffett has kept his powder very dry.

For Pan EurAsian it is a time of opportunity. I have been through this before. In the aftermath of the "coal boom" a number of companies, mainly big oil companies, that rushed into the coal business "at any price" got out "regardless of cost." This will happen now with power developers. It is starting, with sellers valiantly trying to hold firm on price. In the end, the prices will tumble, and those who hold out the longest against the inevitable will get hurt worse than those who recognize the reality and free up their capital early.

It reminds me of the traditional "open to buy" technique in retail merchandising. Buyers are given an allotted amount of capital to deal with. The buyer who sits on his inventory and is reluctant to liquidate does worse, generally, than the one who quickly liquidates slow moving stuff, and redeploys capital into more lucrative lines.

So, I have been there, done that, and am confident it will happen again as it has in the past. A healthy industry will emerge, shareholders will regain their confidence, and the survivors will again have access to the capital markets. But, some will fail. That's the process, and overall it is healthy.

Central and Eastern Europe.

This process is more brutal, more dramatic, and finally more effective in the US than in Europe, especially Central and Eastern. The very persistence of the "dinosaurs" is evidence of a total lack of faith in this process of "natural selection."

While it is not entirely obvious that the solution to the problems of the energy sector in the region is privatization, I believe it to be the case. The governments of the region simply do not have the financial or management resources (and both are important) to carry out the restructuring, modernization, and repowering that is needed. The French seem to get away with it (but, do they, really?) because they have a government with large financial resources, and a technical and educational infrastructure that can provide considerable management resources. Also, the French do not face such a task as is faced in the Central and Eastern regions. And still, they also appear to be struggling with a "government solution" to the problem.

I believed Ronald Reagan was right when he said, "Government is not the solution, government is the problem."

The future in the region is really quite bright, in my view. Coming back to Poland, for example, it is quite clear to me that, somehow not immediately apparent at the moment, the Poles will find their way to solutions of problems that now seem daunting. Poland's population presently struggles on with GDP per capita of ¼ of the EU average, clearly a situation they will not wish to tolerate for very long. The rest of Central Europe is in about the same situation. This process of catching up will create a lot of opportunity yet to come.

Poland still has a massive amount of installed power capacity that will have to be modernized or replaced. They can postpone or delay the inevitable, but they cannot avoid it. EU membership will most likely increase pressure on the region to replace old capacity. Ignoring environmental legislation (like "litigation") as a compliance strategy may work in the short run, but not in the long run.

Most encouraging, there are distinct signs in the press that the quiet tolerance for corruption, corruption that has flourished under this tolerance, is coming to an end. Extinction of corruption can only happen, I firmly believe, when society in general comes to realize that it loses more than it gains by tolerating corruption. If Poland can achieve that attitude, many things will change for the better.

The present leadership vacuum in Poland cannot go on forever. Much as with the situation in Russia, when it seemed hopeless, a leader emerged. Putin's "white paper," published on the Russian government web site at the time of his assumption of the presidency, was a stark and realistic assessment of where Russia was, and what it needed to do. More remarkably, despite all doubts and criticisms, it seems as if he is slowly, but surely, carrying out the steps he articulated in his paper ("Russia at the Turn of the Millennium"). The views stated in that paper were not what Russians wanted to hear, but were very much what they needed to hear.

I am convinced leadership will finally emerge in all the countries of Central Europe. The Ukraine is probably the most difficult case, but it too will find a way out or risk being seriously isolated and marginalized.

When will this happen? I cannot say. Is it better not just to wait and take advantage of it when, and if (the cynics will add), this happens? My experience is no. The western investors who have done the best in Poland are the ones who took the plunge when no one else was ready or willing. Those who waited found that it took too long for them to come up the learning curve, develop contacts, and understand the country and its risks well enough to satisfy a board of directors. In the end, those who waited got little, nothing, or dregs.

Again, this is good for me and for Pan EurAsian. We have been in the region for 12 years, and we want to stay. We believe we understand it, and can help our clients to understand it and the deals that will be coming their way.

Just because this is not a good time for investors does not mean that good opportunities will not come along or, more importantly, that they will wait for better times.

Conclusion

I guess I am an optimist in bad times and somewhat of a pessimist in good times. *Things are never as good, or as bad, as they seem at the time.*

Zachariah Allen
Managing Director