Creating a Commercial Environment for Energy Projects –Lessons from Central and Eastern Europe

*By Robert Eric Borgström**

Introduction

Fifteen years ago, "The Wall" came down and its destruction marked both the beginning of an historic period of economic restructuring and an unprecedented commercial opportunity for which many of us were entirely unprepared.

Shortly thereafter, I had left the gas company where I was manager of economic analyses and was in Hungary, as part of a project to evaluate natural gas distribution companies for private sector investment. That fascinating project began the senior third of my career to date, which has focused almost entirely upon the development of a commercial environment for energy projects in the transitional economies, primarily in Central and Eastern Europe but also in Central and Southern Asia.

The objective of this article is to review some of the lessons that were learned through working during this historical period of transition. The points that I shall raise may seem elementary or even self-evident. Nonetheless, I believe that the broad experiences of the past fifteen years should not be assigned to the dustbin of history.

Energy Projects in Transitional Economies

To put things into perspective, when I speak of energy projects, I am speaking of big-ticket projects that will enhance and expand energy supply infrastructures. The IEA's World Energy Outlook for 2002 estimates that meeting the demand for such projects will cost $16-trillion over the first three decades of the twenty-first century. Half of this amount will be spent in developing countries and ten per cent will help to re-create Russia and the transitional economies. This means that there is roughly $50-billion to be raised each year for expenditure in those countries alone. Electricity projects should account for approximately 60% of that total, a requirement of $30-billion annually.

As countries "transit" from controlled to market economies, the public purse will be inadequate to meet the substantial capital requirements for infrastructure projects. Since these funds will need to come largely from the private sector, the State will inevitably be forced by the leverage of the new, private-sector investors to liberalize. This will mean a more efficient restructuring of business units, the hands-on involvement of owner/managers from abroad and the need for current employees to adapt to new paradigms of working or face redundancy.

Lessons Learned

We don't have the only winning paradigm.

Let me speak from the bias of an American, which I am, to say that we tend to believe so strongly in our paradigms for economic success that we fully expect that everyone, if only given access to our methodologies, will happily rush to embrace and adopt them.

However much our commercial success is admired and imitated, the rest of the world does not see its own set of encultured values as being so without merit that their national experience should be tossed into a heap while they listen to the Delphic pronouncements of a visitor from America.

This doesn't mean that we shouldn't clearly explain the parameters of our logic. On the contrary, the great challenge of doing business abroad is to establish a common basis of understanding from which meaningful negotiations can develop. However, the exportation of our commercial philosophy would be more successful if we learned to talk less and listen more; if we were more patient rather than contemptuous of the "inefficiencies" we encounter; and if we were more inclined to recognize that successful cooperation can add strength to a competitive effort.

There are fewer sound investment opportunities than "good ideas" for projects.

The "bottom line" to our business credibility can only be defined by our position on one single filter: will the project make money?

This sounds so elementary that it's hardly worth saying to an audience of energy economists, but in our zeal to pursue a business opportunity, it is sometimes easy to forget that the nature of the transitional economy is to move from doing things because it was politically appropriate to do them, to doing things because investors will benefit from them.

There are many "good ideas" for projects, but very few are worth investing in them. One will encounter no shortage of plans for new generation, the expansion of transmission systems, the betterment of distribution systems and a host of "good" things to drive the national well-being.

In the controlled economy, the merits of a proposal were weighed against socio-political objectives and, if the merits were aligned with the objectives, funds were drawn from the budget for construction. If the economy was a large enough, closed system to be self-sufficient it is possible that the bulk of the construction was without real cost.

Recovering that cost, if any, was rarely a concern since rates for energy from the new asset were typically established by fiat with the objectives of keeping citizens happy and the government in favor. Low cost – or lower-than-cost – energy was frequently a right of citizenship provided by the govern-

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ment in power.

And even if the established tariff did bear some relationship to the cost-of-service – for example, the cost of imported coal or natural gas – realization of those tariffs often reflected the ability of large consumers, state-owned enterprises and municipal systems to exempt themselves from paying their bills.

So I return to my not-so-elementary question of whether or not the project is likely to make money. I can tell you that many times I've asked that question and seen in the faces of my colleagues across the table that the question had never been considered.

Nonetheless, it is elemental that if the government's policy is to provide energy service below cost, the project passes quickly from the interest of the private investor back to the fiscal responsibility of the State. Understanding that investors who raise capital for energy projects have their own social objectives as a priority is an important lesson that many in the transitional economies must learn.

We don't always have the same objective. i.e., the Ministry isn't always on our side.

If numbers like $50-billion are to be raised each year, it is fair to assume that every Minister of Energy is interested in attracting private sector investors. However, potential investors need to know whether the State sees energy as an element of the national patrimony to be husbanded, or does it subscribe to our capitalistic notion that the market is the best guarantor of public interest. Or put another way, it is preferable for the investor to have equity in a project that will respond to signals from its customers rather than phone calls from the Prime Minister.

Today there are energy regulatory agencies in virtually all of the countries of the formerly Communist block in Central and Eastern Europe. This is an important step in moving the control of the energy sector away from political decision-making. In practice, however, many of these regulatory bodies are still in positions of political subservience. It is not unusual for the chief regulatory officer to be removed from office in an overnight political decision amid a flurry of headlines about his health or his alleged corruption.

In very few countries is there the stability that we know in the USA with our tradition of public hearings and elaborately transparent processes of impeachment. This lack of independence should raise red flags for the investor who is evaluating the possibility of equity participation in those states.

The government, through its regulatory agency, should also take leadership in explaining the costs and benefits of private sector investing to its constituents. The new project, whatever form it may take, will cause economic dislocations and public resentments. These results derive from the actions and inactions of the government and its predecessors and the defense of corrective measures cannot become the sole burden of the investor. This must be understood at the outset and be framed within the final negotiations.

The government wonders if we're on their side.

In fairness, just as serious investors should be wary of the Central Authority and its influence affecting operating conditions over the life of the project, State authorities have reason to be wary of the investor. Too many hard lessons were learned during the early days of Mass Privatization:

- large shares of capital given to management to extend their years of control;
- the overnight making of billionaires through the equally expeditious liquidation of enterprises and their assets; and
- the fund scandals that exchanged years of participatory labor for meaningless scraps of paper.

The government official may pause when considering handing-over of the national patrimony to foreign influence under a system of economic exchange that may not be understood.

From a policy perspective, the foreign investment in infrastructure must be constructive and long-term. The investor must demonstrate not only his faith in the prospective project but his wiliness to be patience to await the project's success before expecting a significant return on or of the investment. The impatient have many other more suitable opportunities in which to risk their money.

The project won't help to perpetuate the status quo.

Sadly for some, new business ventures – whether it is a privatization or a significant financial enhancement of the business – will require important changes to the "old" business approach. Utilities around the pre-transitional world tend to be over-staffed and inefficient, it is expected that new projects will bring not only an infusion of useful capital, but also an intervention by new managers, armed with new management philosophies and a focus on international best practices with respect to operations, management and staffing.

These will not be popular changes among existing employees. The inevitable redundancies will require programs for early severance and re-training, which are the fiscal responsibility of the government. It will also require a carefully developed plan to explain that the new changes are inevitabilities, brought-about by the country's economic transition. In this development, the investor should also expect the government's whole-hearted participation.

Indeed, whatever actions are taken in the course of economic reform and restructuring, these actions must take place within the context of a specific public information campaign that will inform stakeholders about the changes to take place and be persuasive about the benefits ultimately to be derived from these measures. The "good news" is that the new energy project will not only provide reliable energy at cost, it will help to fuel the nation's economic recovery and be funded by mechanisms that are fair to all stakeholders. But it will be a hard sell and the investor must have confidence that the participating government will be pro-active in promoting that sale.

(continued on page 28)