

## **Finding a strategic investor for AS Narva Elektriijaamad<sup>1</sup>**

### **Summary**

The Performance Audit Department of the SAO audited the first phase of the negotiation process for finding a strategic investor for AS Narva Elektriijaamad (NE) up to the signature of the Head of Terms.

The audit topic is important, because the successful completion of the said process will lead to subjecting the state-owned electricity production to management by private capital. After that the government can only regulate the economic environment in order to control and influence the service provider dominating the market.

The main targets of the National Energy Policy have been set out in the National Long-term Development Plan for Fuel and Energy Sectors. The Energy Policy primarily aims to secure the sufficient and stable supply of fuel and energy to the consumers at optimal prices and in accordance with the quality requirements. It also aims to ensure that the development of the energy sector contributes to such economic growth and balanced regional development as is necessary for EU accession. This strategic sector must also ensure the political and economic independence of the country.

The Government approved the main aspects of developing the production of energy from oil shale:

- firstly – to continue, in the long-term, the development of the production of energy from oil shale so as to avoid Estonia becoming dependent on the import of electricity or the fuel needed for its production;
- secondly – in view of the economic, social and political needs of Estonia the model of developing a uniform value chain for oil shale energy was considered to be the most appropriate model of development;
- thirdly – it was decided to include a strategic investor in developing the production of energy from oil shale and the general principles of negotiations were approved.

At a session in June 2000 the Government agreed to sell 49% of the shares of NE to NRGenerating Holdings (No. 14) B. V. (NRG). At the same session the main terms and conditions of the contracts that would regulate the future activities of NE were outlined for the purpose of the Head of Terms. On August 25, 2000 the representatives of NRG and NRG Energy Inc (guarantor of NRG), AS Eesti Energia<sup>2</sup> (EE) and NE met in the Ministry of Economic Affairs and signed the Head of Terms of contracts related to power stations.

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<sup>1</sup> Public Limited Company Narva Power Plants.

<sup>2</sup> Public Limited Company Estonian Energy.

The Head of Terms aimed to document the agreement of the parties on the following main terms and conditions:

- a) the agreement concerning the subscription of shares (agreement concerning the subscription of shares between EE, NE and NRG that requires NRG to subscribe to the shares of NE);
- b) the shareholders' agreement of NE (shareholders' agreement between EE, NE and NRG, which includes the social program and the investment program of NE);
- c) contract of purchase and sale of electricity (contract of purchase and sale of electricity between EE and NE);
- d) the shareholders' agreement of AS Eesti Põlevkivi<sup>3</sup> (EP) (EP shareholders' agreement between NE and the Republic of Estonia, which includes the social program of EP and the compendium of the negotiated extraction plan);
- e) contract of surety of NRG Energy Inc;
- f) contract of purchase and sale of thermal energy (contract of purchase and sale of thermal energy between NE, EE and AS Narva Soojus).<sup>4</sup>

The Head of Terms also sets out the activities preceding the transaction, the requirement to complete the transaction within twelve months from the signature of the Head of Terms and the insurance required from the Parties. The latter must ensure that NE and EP make an insurance contract, which enters into force simultaneously with effecting the transaction and provides insurance cover against liability towards third parties that may arise from environmental damage.

Assessment of all issues related to contracts is not the purpose of the SAO audit. Therefore the audit report addresses the problem areas that the risk analysis has pointed out with reference to the Head of Terms. The main problem areas were:

- electricity pricing;
- environmental problems related to electricity production;
- impact of the contract on the social problems of the Ida-Viru County;
- opening of the market and EU accession;
- legitimacy of the requirements of the Head of Terms.

The audit also analysed whether the Head of Terms complies with the objectives set out by the Government, how the Minister responsible for negotiations with NRG ensured achievement with the objective and whether the negotiation process was managed in accordance with the law and the principle of sound administration.

The SAO did not audit the main positions of the Government concerning the restructuring of the energy sector, since the SAO is not authorised to audit political decisions.

The SAO does not assess harmony between the Government's decisions and activities concerning the restructuring of the energy sector and the inclusion of a strategic investor

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<sup>3</sup> Public Limited Company Estonian Oil Shale.

<sup>4</sup> Public Limited Company Narva Heat.

in electricity production, on the one hand, and the Parliament's decision of december 16, 1998 to include the company to be formed on the basis of RAS Eesti Energia<sup>5</sup> and Eesti Elektriijaam<sup>6</sup> and Balti Elektriijaam<sup>7</sup> in the list of companies of strategic importance to the state, on the other hand, since legal assessments as to the compatibility between the decisions of the Government and the said decision of the Parliament differ.

## **CONCLUSIONS IN BRIEF**

### **Objectives**

The material parts of the Head of Terms of NE-related contracts signed on August 25, 2000 between EE, NE, NRG and NRG Energy Inc (guarantor of NRG) are compatible with the main positions of the Government concerning the restructuring of the energy sector and the inclusion of a strategic investor.

### **Risks related to the transaction**

The risks stemming from the Head of Terms, which the audit has pointed out, are addressed by the said agreement. Whereas the negotiations are pending and the contracts still need to be signed, the SAO cannot assess the future impact of risks related to these contracts and analyses the following important risk areas instead.

- **Role of environmental charges in electricity pricing**

The pricing principles (production capacities and the principles of formation of the producer price) and price limits (price of the raw material and maximum producer prices, also the return on investment) for the electricity to be sold according to the contract of purchase and sale of electricity under the signed Head of Terms are laid down in the contract, but the expected level of environmental charges and taxes was not known at the time of signature. This entails a risk that the economic indicators taken into account in electricity pricing do not reflect the situation in the future, when the actual amounts of voltage and energy tariffs would be specified in the contract. In this case the electricity consumer would be have to bear the financial burden resulting from legislative amendments. The SAO draws attention to the fact that the consumer price of electricity largely depends on the possible legislative amendments in the future (environmental charges and taxes), which constitutes dangerous indeterminacy, because neither the contracting parties nor the criticsers have outlined this impact.

- **Capacity of the energy market regulator**

After the finalisation of the transaction the effective protection of the interests of the consumers depends on the administrative capacity of the energy market

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<sup>5</sup> State Enterprise Estonian Energy.

<sup>6</sup> Estonian Power Station.

<sup>7</sup> Baltic Power Station.

regulator – the Energy Market Inspectorate (EMI). According to the principles set out in the Head of Terms EE can charge the increase in the producer price to the ultimate consumers within the framework of applicable legislation. EE can also control the development of the producer price and refuse any changes, if the EMI does not approve the price. Pursuant to the Energy Act and the Head of Terms the EMI shall assume overall responsibility for monitoring and approving the electricity price in the future. Since the Ministry of Economic Affairs holds the shares of EE and also governs the EMI, the SAO sees a risk to the independence of the EMI. In this context it is essential that the government is on a neutral footing when regulating the market and protecting the environment and the interests of energy consumers.

The SAO plans to audit the overall management of the EMI in order to assess, inter alia, the market regulator's ability to perform its functions.

- **Cost of remedy of environmental damage**

According to the head of terms of the agreement concerning the subscription of shares of NE neither EE, NE nor the Republic of Estonia shall guarantee the compensation of loss to NRG that has arisen out of taxes or environmental damage. The environmental risks are divided and managed as follows: NE has the responsibility to compensate for environmental damage up to the amount specified in the investment program, which is 19 million euros. The Commercial Code stipulates that EE shall remain responsible for earlier damage for a period of 5 years. This responsibility applies in cases where the claim against NE does not lead to the desired consequence; insurance is required both from NE and EP. The cost of remedy of earlier environmental damage is difficult to determine and the estimates fall between 300 and 450 million kroons. In addition, the following risks are difficult to assess: the possibility of the mine waste hills catching fire, the treatment of water used, the danger of the earth falling in and the risk of flood in the ash fields. In this context, the amount that was envisaged in the investment plan for the remedy of environmental damage might not be enough. If the planned investments in the renovation of the production units of NE are effected, the environmental situation will improve and alleviate the effects of earlier environmental damage.

- **Social problems related to the transaction**

According to the estimate of the Ministry of Social Affairs that is based on the Head of Terms the restructuring the production of oil shale and energy entails the dismissal of up to 3,400 employees in 2000–2005. Since the amounts to be paid to the social fund by NE are also available to the employees of EP and the specific solutions contained in the social plan of the County are not financially backed, there is a danger that there are not enough funds to solve the critical social problems in the Ida-Viru County. In order to ensure preparedness in the national interests comprehensive programs for the management of social risks should be

developed to give a clear picture of the number of employees released in the this labour market segment, the measures to be taken to solve the related problems and the cost of different solutions.

According to the NE social program NRG shall pay 5 million USD to the social fund over a 5-year period, whereby 80% of this amount will be used to cover the social costs of employees to be dismissed by NE or its subsidiaries (the costs exceeding the limits laid down by the law or collective agreements). 20% of the social fund will be used, inter alia, to finance regional programs. The establishment and financing of such a social fund is a positive aspect, since earlier privatisation agreements have not accomplished this. However, the non-profit association required for the management of the fund's resources has not been formed yet. Furthermore, the draft National Employment Program of Ida-Viru County does not address the consequences of changes in the employment patterns of NE and EP or link the available employment plans to one another. Neither does it reflect all the aspects of regulating employment issues or the sources of financing the funds to be established. The SAO draws attention to the fact that the social guarantees resulting from privatisation provide only short-term solutions and do not completely replace the National Regional Policy, which in principle implies the restructuring of the region's economy and the reorganisation of the business climate.

### **Opening of the electricity market**

Opening of the market in accordance with EU requirements is possible both formally and legally, but currently problematic, since it requires the resolution of the issue of market access. The provisions of the Head of Terms are not incompatible with the EU requirements related to the opening of the energy market, but create a certain market risk for EE, whose shares are owned by the state. The fact that 98% of needs of the domestic market are satisfied by one undertaking (NE) and that according to the contract of purchase and sale of electricity the minimum capacity guaranteed to EE shall be 1,350 MW until 2002 and 1,520 MW between 2003–2004 and 1,593 MW from 2005 leads to a situation where financial interests of EE are related to exports and not imports. Exporting is possible, but requires the signature of relevant trade agreements and technical solutions for the western markets. The market can be effectively opened only by means of allowing imports, which depends on the political decisions. Opening the market for the purpose of exports only jeopardises domestic competition and permitting only import poses a threat to the profitability of the planned investments of NE.

The long-term obligations to buy and sell electricity set out in the Head of Terms do not apply to the consumers of electricity. The Energy Act requires EE to transmit and distribute electricity in case the consumer buys electricity from another provider – this avoids any legal controversy between the long-term obligations and the requirements to the opening of the market. The long-term contracts are also compatible with the general competition rules of the EU and Estonia, also as regards state aid. However, the effective

competition on the domestic market or the openness of the market is determined by the relationship between the discretion criterion and the openness criterion.

Pursuant to the EU Directive 96/92/EC the electricity market must be first opened to large consumers with a minimum annual electricity consumption of 40 GWh (discretion criterion). The large consumers must account for 22–25% of the entire electricity market (openness criterion). Also the Estonian Energy Act uses the discretion criterion to define a large consumer, who, according to a Government Regulation, is an electricity consumer with a minimum annual consumption of 40 GWh. But the Estonian legislation does not specify the principles and criteria for including additional consumers on the basis of amount consumed in case the minimum level of the openness criteria is not achieved. The said EU Directive stipulates that by February 2000 the approximate value of the discretion criterion must be 20 GWh a year.

In order to accede to the EU in two years Estonia should ensure the compatibility of the domestic electricity market with the requirements of the said EU Directive by the time of accession. This requires gradual lowering of the energy consumption threshold of large consumers.

### **Process management**

The Minister of Economic Affairs, who was put in charge of the negotiations for the inclusion of a strategic investor in electricity production, has acted within the limits of the powers delegated by the Government in his efforts to comply with the main positions adopted by the Government. The powers were delegated and the decisions were made on the basis of the Foundation of and Participation in Legal Persons in Private Law by the State Act. The Government and in particular the responsible Minister shall be accountable for the quality of decisions made in the course of negotiations. The Minister of Economic Affairs has not always observed the principle of sound administration: the detailed instructions given and the decisions made during the negotiations are not adequately documented, which complicates monitoring and ignores internal control standards. In addition, this makes it difficult to determine the reasons for the course of events and the decisions later on.

### **PROPOSALS**

1. The SAO recommends the Government to considerably enhance the capacity of the EMI to monitor the prices on the energy market and to increase the credibility of the market by contributing to the opening of the electricity market (referring to a market surveillance strategy and the methods necessary for its implementation). It is essential to ensure the independence of the EMI.
2. The SAO proposes the Government to determine the priorities of solving the social issues of the Ida-Viru County and the stages of essential activities and to give an estimate of the additional expenditure required by the government.

3. The SAO draws the Government's attention to the fact that the conflict of objectives between the development of oil shale energy production, the effective opening of the electricity market and the resolution of the social problems in the region should be recognised and a politically and economically acceptable compromise should be found.
4. The SAO recommends the Government to determine the resources and time frame for developing new technical facilities for linking up with the Nordic and West-European power networks. To this end the Government should wing ways of ensuring the competitiveness of electricity exports in the future and taking account of the environmental protection obligations and the related environmental charges within the framework of European integration.
5. The SAO recommends the Government to promote the increase in the number of alternatives for electricity consumers in order to ensure greater openness of the electricity market. To this end eligibility under the discretion criterion should be reviewed.
6. The SAO proposes the Government (Prime Minister) to strengthen control over the negotiations in order to ensure the documentation of processes in the future and throughout the validity period of the contract. This includes documentation of the negotiation process and the supervision activities, the instructions given and the decisions made so as to allow monitoring the course of events and the formation of the decisions.
7. The SAO proposes the Minister of Economic Affairs to lay down, before the signature of the contract of purchase and sale, the procedure for changing the pricing rules within the value chain to allow monitoring. This procedure should clarify the calculation of the maximum rate of return on the equity capital of NE (12%) and explain the meaning of "reasonable business practice" and other similar terms.