

**Deloitte &
Touche**



CZECH AND SLOVAK FEDERAL REPUBLIC
ENERGY AND TELECOMMUNICATIONS SECTOR ASSISTANCE
FOR MINISTRY OF ECONOMIC POLICY AND DEVELOPMENT
PHASE I

**Enterprise Restructuring and Privatization Project
for Central and Eastern Europe (180-0014)**

Contract # EUR-0014-I-00-1056-00
Delivery Order #4
Prepared for EUR/RME/ER/ED

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**CZECH REPUBLIC MINISTRY OF
ECONOMIC POLICY AND DEVELOPMENT**

**Energy and Telecommunications Privatization
USAID Contract EUR-0014-I-00-1056-00
Delivery Order No. 04**

**Work Plan
Submitted by:**

Deloitte & Touche

November 1, 1991

DRT Czechoslovakia



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November 1, 1991

Ms. Lee Roussel
Local Representative
U.S. Agency for International Development
U.S. Embassy
Trziste 15
Praha 1

Dear Ms. Roussel:

Deloitte & Touche is pleased to submit this work plan outlining the approach we will take to complete U.S. AID Project No. EUR-0014-I-00-1056-00, Delivery Order No. 4. This workplan is the culmination of our Phase I efforts under the terms of this contract.

Our work plan is divided into two parts. Part I describes our general approach without reference to specific sectors or enterprises. Part II lays out the sector- and enterprise-specific efforts required.

We have assembled a team and laid out an approach that utilizes the highest quality technical resources available, including significant involvement from DRT's Prague-based professionals.

We are excited by this project and we look forward to working with the Czech Republic Ministry of Economic Policy and Development at this important time in the Republic's history. If you have any questions, please contact Art Warman in Washington DC or Phil Burton in Prague.

Sincerely,

Robin J.F. McPhail
Partner

Enclosure

Part I - GENERAL APPROACH AND PROJECT BACKGROUND

Introduction

This document is the work plan for Fuels and Energy and Telecommunications sector privatization which is required to be produced as the deliverable under Phase I of this USAID contract.

The document sets out the work plan for Phases II and III of the contract. Phase II comprises strategic studies of both the fuels and energy and telecommunications sectors, while Phase III focuses on specific enterprise privatization plans.

Background

The Czech Republic Ministry of Economic Policy and Development (MHPR) is responsible for privatization plans prepared for enterprises in the fuels and energy and telecommunication sectors. The Ministry has the responsibility of ensuring that the privatization plans are prepared in accordance with the procedures set out by the government. In practice this generally amounts to approving a plan prepared by the enterprise itself.

Privatization is being organised in two waves:

The first wave is for non-strategic, low risk state enterprises, which includes certain non-core activities to be spun off from core state enterprises in both the energy and telecommunications sectors. This first wave is expected to be largely complete this autumn.

The second wave is to cover the core activities of large state enterprises. Privatization plans have to be submitted to the Czech Republic Ministry of Privatization by May 30, 1992.

The proceeds of privatization sales are to be paid to the Republic's National Property Fund.

It is apparent that the enterprises may have different objectives in the privatization process from those of the Ministries, as the Ministries have wider public objectives to take into account. The Ministries may therefore need their own independent advisers at all stages.

Our work plan has been constructed in the light of this background.

Phase I Workplan Development Activities

Over the past two weeks, senior practitioners from the United States, United Kingdom and Czechoslovakia convened in Prague to prepare this workplan. During this two-week period, we met with officials from relevant Federal and Czech Republic Ministries and enterprises to understand their needs, so we could tailor our approach accordingly. In this inquiry phase, we met with the following officials:

Ing. K. Dyba	Minister	MHPR
Ing. J. Michalicka	Energy Advisor	MHPR
Ing. L. Chrudina	Deputy Minister	MHPR
Ing. O. Sedlacek	Director of Telecoms	MHPR
Ing. L. Stary	Deputy Director of Telecoms	MHPR
Ing. H. Strnad	Director of Privatization	MHPR
Ing. P. Knizek	Director of Energy Policy	MHPR
M. T. Gheyselinck	Advisor to Minister	MHPR
Ing. Kucera	Director of Electricity	MHPR
Ing. J. Holecek	Ministerial Director	MHPR
Ing. V. Holy	Advisor	MHPR
Ing. F. Hesoun	Director of State Policy	F e d e r a l Ministry of Telecoms (FMS)
Ing. L. Matejka Jr.	Head of Communications	FMS
Ing. J. Holobradý	Technical Assistance Unit	FMS
Sr. De Bonis	Advisor to Deputy Minister	FMS
Ing. Ivo Martinec	Coordinator of For. Assist.	F e d e r a l Ministry of Economy
Ing. V. Stephan	Director of Economics	CPP
Mrs. M. Ptackova	Head of Finance	CPP
Ing. J. Kodr	Deputy Technical Director	SRP
Ing. M. Curin	Deputy Finance Director	SRP
Ing. L. Matejka	Deputy Finance Director	SPT Praha
Ing. P. Paska	Head of IT Department	SPT Praha
Mr. C. Dumas	Chief Executive Officer (US)	J.P. Morgan
Mr. N. Walsh	Advisor to SPT Praha	J.P. Morgan
Mr. O. Fehily	Advisor to SPT Praha	ETCO

Revised Scope for Phases II and III

Based on our discussions it is our understanding that:

1. In both Phases II and III, in some cases we have been asked to review existing plans and make recommendations, whereas the terms of reference indicate that we were to develop these same plans without reference to an existing document.
2. Three additional tasks have been added to the Phase II effort in the fuels and energy sector. They are:

- A review of Republic energy policy

- A review of existing laws relating to the fuels and energy sector
 - A review of the regulatory framework
3. Thusfar, we have determined that: (1) the following enterprises desire our assistance in Phase III, or (2) MHPR desires our help in review of enterprise plans or the preparation of alternate plans:

SR Praha (radio and television transmission)
 TransGas operations of CPP (gas transmission)
 CEZ (electric power and district heating)

In the case of SR Praha, we have been asked to assist in preparing a privatization plan "from scratch". In the case of TransGas, we have been asked to develop recommendations on several key elements of an overall privatization plan. In the case of CEZ, we have been asked by the Ministry to review CEZ's existing privatization plan and make recommendations. MHPR has also indicated they may require assistance in preparing an alternative privatization plan for CEZ.

3. Several Phase III tasks will require modifying the November 30 completion date. Our TransGas work (which will be partially funded by TransGas) is scheduled for completion by December 15, 1991. As TransGas will provide partial funding, this extension will not require additional USAID funds or effort under this contract. CRMHPR has indicated that they may in the near future request our assistance developing an alternative plan for CEZ; this work would also extend beyond November 30.

The scope modifications described above do not significantly increase or reduce our overall level of effort authorized under this contract. While some modifications have been scope reductions (i.e. number of enterprises in Phase III), others have expanded our scope (i.e. additional Phase II work in energy).

General Approach

The philosophy we adopted in developing our approach is that it is critical to demonstrate to Ministry and enterprise officials an analytical approach and method of inquiry that is based on the fundamental laws of free market economics and business dynamics. Should we find in the course of our work that sufficient data is not available to support a conclusion, we will lay out a course of action for enterprise and Ministry officials that provides an appreciation for how to attack complex business decisions and arrive a solution that is supportable by Western standards.

In accordance with our terms of reference, our work is to proceed at two levels, the sector and the enterprise. At the

sector level, the fundamental questions our workplan is designed to answer are:

- What would be the best way to privatise the enterprises in the sector?
- What broad sector goals targets appear achievable over the next 5 to 10 years?
- What options exist to achieve these goals?
- What obstacles and risks exist which may prevent the sector from achieving the desired level of performance?
- What course of action should be taken?

At the enterprise level, our fundamental approach is similar - to assist the enterprises in the sector to prepare the best possible privatisation projects to facilitate their privatization. In addition to facilitating the process of privatization, we aim to assist each enterprise in articulating a set of long-term performance targets, and laying out an action

plan to achieve them. Enterprise-specific performance targets must not only harmonise with overall sectoral goals as far as possible, but also encourage the creation of a commercially viable, efficient and competitive business.

Project Schedule and Performance Milestones

The attached GANTT chart shows our proposed project schedule. This schedule is contingent on our ability to meet with Ministry and enterprise officials in a timely manner, and to receive prompt replies from these officials to our data requests. As shown in the GANTT chart, submittal dates are as follows:

Fuels and energy sector strategies	November 29
Telecoms sector strategy	November 25
SR Praha enterprise plan	November 30
TransGas enterprise plan	December 15
CEZ enterprise plan review	November 29

Staffing

Given the critical importance of this effort to the Republic's overall privatization program, we will devote a team of our most senior and experienced professionals to carry out the workplan described herein. The GANTT chart shows our proposed staffing by task by function. Our staffing plan assumes that each enterprise will allocate a full-time liaison person to our project team, to respond to our inquiries for data, interviews, etc. It also assumes that Ministry and enterprise officials will respond in a timely manner to requests for data, interviews, etc.

Mr. Robin McPhail (Washington, DC) will have overall responsibility for this project. Mr. Phil Burton (Prague) will serve as day-to-day project manager and be responsible external communications with Ministry officials and USAID.

Table of Contents

	<u>Page</u>
Part I - General Approach and Project Background	
Introduction	1
Background	1
Phase I Work Plan Development Activities	1
Revised Scope for Phases II and III.	2
General Approach	3
Project Schedule and Performance Milestones.	4
Staffing	4
Part II - Sector- and Enterprise-Specific Efforts	
Telecommunications	
Phase II	
Introduction	
Work Steps	6
Staffing	6
Work Products	7
	8
Phase III	
Introduction	
Work Steps	9
Staffing	9
Work Products	10
	11
Fuels and Energy	
Phase II	
Energy Policy Review	
Privatization Strategies Review	12
Review of Laws	15
Regulatory Framework	19
	21
Phase III	
CEZ Plan Review	
TransGas Plan Development	24
CEZ Plan Development	26
Coal Plan Development.	27
	28

Key subject matter experts assigned to this project include the following. All of these individuals are classified as Financial Planners except for the legal experts. Subcontractors are identified by a tilde (-).

Fuels and Energy Sector Personnel

- Charles Mann
- John Schuster
- Ted Breton
- Leonard Crook

Telecommunications Sector Personnel

Nicholas Garthwaite

Business Planning and Strategy Personnel

Amy Snyder

Legal Personnel

- S. Marcuss
- C. Ryder

In addition, this project team will be supported by dedicated in-country translators, the global library information services of DRT International, in-country secretarial services, and the collective expertise of audit, tax and consulting practitioners throughout the worldwide DRTI firm.

Part II - SECTOR-SPECIFIC APPROACH

Telecommunications and Posts

PHASE II TASK

REVIEW OF TELECOMMUNICATIONS PRIVATIZATION STRATEGY

1. Introduction

Background: The Ministry of Economic Policy and Development (MHPR) has prepared a strategy document on telecommunications denationalization and privatization in the Czech Republic. This document was written with the help of the Federal Ministry of Telecommunications (FMS) and the two telecommunications enterprises in the Czech Republic, SPT Praha and SR Praha. We have been advised that parts of the document represent a compromise between the sometimes conflicting policy considerations of the different parties involved.

Purpose: Provide assistance to the Ministry for change or refinement of its strategy document.

Approach: Review and provide comments and suggestions on the draft policy. Draw on knowledge of the Czech situation and of telecommunications policies and practices adopted in other countries.

2. Work steps

Step 1: Team Meeting

The team will meet to generate comments and constructive criticisms of the strategy document, and to work out some of the implications in more detail, as appropriate. The meeting will result in a list of points for further analysis.

Step 2: Analysis of Points Arising

Team members will analyse individual points arising.

Step 3: Meeting with MHPR

The team will meet with MHPR and present initial thoughts on the strategy document and test possible alternative ideas.

Step 4: Review of Telecommunications Laws

The legal members of the team will review the existing federal Telecommunications Law of 1964 and such information as is available about the federal government's proposed new telecommunications law. Comments will be made on any provisions which seem undesirable, as well as on provisions which are likely to be necessary or desirable for privatization but which appear to be lacking. Comment will also be made on any provisions which seem obscure or difficult to enforce, as these might give rise to doubts in the minds of potential foreign investors in the privatization of Czech telecommunications enterprises.

The legal review will also examine other laws which may have a bearing on privatization of telecommunications enterprises in the Czech Republic, such as employee and company legislation.

Step 5: Regulatory Framework

This would be similar to Task 4 in the energy section. We have extensive material on telecommunications regulation already to hand, as a result of our recent assignments on telecommunications regulatory issues in the United States, the United Kingdom, Singapore, New Zealand, Australia, Korea and South America.

The special features of telecommunications regulation will be given full weight. These will include such questions as the control of the frequency spectrum and the use of standards to regulate the type of equipment which may be connected to the public network. International telephone calls pose particular regulatory problems, especially with the onset of competition between carriers either in the Czech market or in countries abroad: we have recently performed a study of these issues for an OECD government and participated in the recent ad hoc group of experts on international telecommunications accounting issues which met under OECD auspices.

Step 6: Synthesis

In this step, the team will pull together the analyses they have made and synthesise a coherent view of the strategy document. To the extent that the team considers alternative approaches preferable and feasible, the team will prepare an outline of what they would involve and what the implications would be. A brief appraisal will be made of the two telecommunications enterprises.

This work will culminate in a report and presentation to the MHPR, reviewing the strategy document and, if appropriate, outlining options for other strategies.

3. Staffing

Small team of senior telecommunications experts, including specialists in policy development, regulatory law and practice, telecommunications economics and finance.

4. **Work Products (Deliverables)**

Discussion of preliminary conclusions with MHPR in week of November 11.

Report and presentation to MHPR of conclusions on the regulatory framework and on the strategy document in week of November 18.

Report on the review of telecommunications laws by November 25.

Continued advice and comment in last week of November as necessary.

PHASE III TASK

PREPARE PRELIMINARY PRIVATIZATION PLAN OF SR PRAHA

1. Introduction

Background: SR Praha has as yet made no preparations for the privatization of its core activities in the second wave of privatizations, although non-core peripheral activities are the subject of privatization projects in the first wave. SR Praha has no foreign privatization consultants to advise them and therefore welcomes the offer of help in preliminary planning for privatization from DRT under the USAID contract.

The preliminary privatization plan of SR Praha is due to be submitted to the Federal Ministry of Posts and Telecommunications (FMS), its founding Ministry, by November 30. The final version will be due by May 30, 1992.

SR Praha has advised us that it will not be necessary to secure the consent of FMS to the assistance which is to be granted under this contract. MHPR is content for the assistance available under this contract to be used in this way, even though it is not (since August) the Founding Ministry of SR Praha.

Purpose: The purpose is to assist the privatization of entities providing telecommunications services in the Czech Republic.

2. Work Steps

Step 1: Information Gathering

The information we will need will mostly be available from within SR Praha. The data will have to be collected and presented in a concise format. The data required will include accounting and other data which will need to be analysed so as to produce summary statements of income, cost, profits and employee numbers for each major activity of SR Praha. The relative importance to SR Praha of each of its customers will need to be assessed.

We will also collect whatever data is available on analogous enterprises in other countries.

This step will also include discussions with SR Praha about its strategic objectives, both generally and in regard to privatization. The team will want to assess how SR Praha views its future, where it considers that its strengths and weaknesses may lie, and what quantification can be attached

to these views.

Step 2: Generation of Strategic Business Options

The team will generate strategic options for SR Praha to consider, in order to further its general business objectives and its particular privatization objectives. We would outline the positive and negative implications of each option in the light of the various possible ways in which the telecommunications market in the Czech Republic might develop.

Key questions at this stage will include:

- The relationship between SR Praha's two major activities - distribution and transmission of radio and TV broadcasts, and providing a microwave backbone network for SPT Praha.
- The relationship between SR Praha and SPT Praha, which is to be privatised at the same time.
- What new types of activity might be permitted to SR Praha and to potential competitors by a new regulatory regime for telecommunications, and which enterprises would be best placed to exploit these opportunities.

Step 3: Option Refinement

The team will meet with SR Praha and discuss which of the options are worth pursuing further.

Step 4: Business Planning

In this step, the team will compile an outline business plan in accordance with one or more of SR Praha's preferred privatization options. This should if possible include illustrative financial projections, including turnover, costs and profit for each major activity in both existing and new markets. The plan will also include statements of enterprise scope, plans and priorities for action and investment, possible risks, and assessments of where the enterprise's long term competitive advantage may lie.

Step 5: Privatization Planning

In the light of the business plan, the team will help SR Praha write the preliminary privatization plan which must be submitted to FMS by November 30.

3. Staffing

Team of senior telecommunications experts, including specialists in privatization, strategic planning, market analysis, regulatory law and practice, telecommunications

cost structures, finance and accounting.

4. **Work Products (Deliverables)**

Discussion of outline draft of the preliminary privatization plan with SR Praha in mid-November.

Assistance in the presentation of the preliminary privatization plan by SR Praha to FMS by the deadline of November 30. This will probably involve writing the major portion of the plan.

Fuels and Energy

PHASE II TASKS

TASK 1 - REVIEW OF CZECH REPUBLIC ENERGY POLICY

1. Introduction

Background: The Ministry of Economic Policy and Development (MHPR) is preparing an energy policy statement for the Czech Republic (CR). This energy policy statement is intended to provide guidance for the development of energy programs in the Czech Republic and for the privatization of the energy sector. The policy statement addresses many important questions such as the transition to market pricing, problems in the sources of energy and reduction of pollution from use of coal. A CSFR energy policy statement is also being developed, with which the Czech Republic policy should be consistent.

Purpose: Provide assistance to the Ministry for refinement of the draft policy.

Approach: Review and provide comments and suggestions on the draft policy. Draw on knowledge of Czech situation and energy planning of other countries. Perform a limited analysis of some aspects of the energy situation and implications of the plan.

2. Work Steps

The work under this task is to be performed over a short period. In fact, the first comments to the MHPR were provided on October 21. As a result of the short time frame, only a little analysis is to be performed under this task. The work steps are:

Step 1: Gather Information

The sources of information to be gathered and digested are: the draft energy strategy, the draft sector privatization strategies, published reports (particularly of the World Bank), laws on privatization and environmental regulations and interviews with members of the MHPR staff.

Step 2: Analysis of Energy Policy:

This step will include critical review of energy policy documents. The review will address these aspects of policy document:

- Statement of current energy situation as basis for the policy.
- Scope of policy in guiding all energy areas at right level of generality.
- Kinds of legislation which will be needed to implement the policy
- Economically sound balance of market competition and regulation.
- Consistency of policy with national strategic goals.
- Explanation of the implications of the policy.

Step 3: Energy Balance

Supporting analysis will be done of a preliminary energy balance. This will be based on estimates in the World Bank report, feedback from interviews and the MHPR estimates in the privatization strategies.

Step 4: Implications of Environmental Policies

We will consider the energy implications of the proposed air pollution control program. The main concerns are the extent of reduction in coal use versus additional pollution control installations.

Step 5: Macroeconomic Implications

Finally, we will make an assessment of the macro-economic effects of the energy policy. These include the effects of energy price increases on perceived inflation, the effects on competitiveness of industry in local and world markets, and the employment and investment effects.

3. Staffing

Small team of senior energy experts, including specialist in policy development, regulatory law, economics and finance.

4. Work Products (Deliverables)

- a) Preliminary comments on first draft were delivered Oct 21.
- b) Briefing on preliminary comments Nov. 1
- c) Report and briefing of comments on second draft on Nov. 15.

- d) Continuing assistance and review of second draft plan in November if needed.

TASK 2 - REVIEW OF ENERGY PRIVATIZATION STRATEGIES FOR
ELECTRIC POWER, GAS AND COAL

1. Introduction

Background: The MHPR has prepared drafts of privatization strategies for the electric power, gas and coal industries. These privatization strategies combine an overall energy plan (production, markets, major investments) with a description of the proposed structure of the privatized companies and the method of privatization. The strategies are intended to provide guidance to the enterprises in the preparation of their privatization plans.

Purpose: The purpose of this task is to assist the MHPR in the development of their sectoral privatization strategies. This includes:

- Provide recommendations for the refinement of privatization strategies for electric power, gas and coal; including a recommended "roadmap" for strategy implementation. The review will include policy, economic, regulatory, financial and management aspects.
- Provide analysis of how the sector strategies fit together for into a balanced Czech Republic energy sector privatization plan.

2. Work Steps

Step 1: Information Gathering

The sources of information are those mentioned in Task 1, plus interviews with members of the MHPR, the Federal Energy Department, and with personnel of the companies in the three sectors. Also, in order to prepare better information on energy demand, contacts will be made with major energy consumers such as the steel industry. Assistance will also be sought from Czech Republic research institutes and other entities familiar with the energy sector.

Step 2 : Analysis of Energy Planning Issues

Based on the sources mentioned above we will identify the main energy planning issues. Among these are the trade-offs among fuels, the possibility of a large reduction in energy consumption, possible limitations on availability or reliability of oil and gas supply from Russia, and the difficulty of the transition to higher prices for energy. The main analytical tool will be an energy balance, to be expanded upon from the initial one prepared in Task 1. As part of this effort research will be done on the prospects for both near term (1-3 year) and longer term changes in

industrial output and energy efficiency.

Step 3: Review of the Privatization Strategy Reports

Based on the information and analysis discussed above, we will perform a critical review of the privatization strategies. For each sector or aspect of the strategies we will provide a critique of the limitations of the existing draft document and suggestions for improvement including additional analysis to be performed. The questions to be asked are:

- The proposed sectoral structure: does the structure provide for competition where practical? Are the enterprises sized appropriately to achieve economies of scale? Are all of the necessary functional areas assigned in order for each enterprise to meet its goals? Do and should enterprises contain both regulated and unregulated elements?
- Conformance with energy policy: does the privatization strategy establish goals for the enterprises that are in accord with the energy policy? Will the resources of the organization (especially financial resources) be adequate to carry out the energy policy goals?
- Development of least cost plan: do the specific program elements (e.g. major investments planned) reflect a least cost comparison of available options?
- Financial structure and projections: would the proposed privatization method, considering likely costs and investment requirements, result in financially self-sufficient enterprises?
- Options considered: recommend additional structural and program options to be considered in the privatization strategies.
- Analytical methods and data. To the extent that the privatization strategies include specific recommendations for major investments and changes in fuel use patterns, has the analysis of these options been carried out in the appropriate way?
- Documentation and presentation: does the draft strategy provide sufficient explanation and documentation for the conclusions?
- Adequacy of detail as a privatization "roadmap": is the privatization strategy in sufficient detail to provide adequate guidance for the preparation of enterprise specific privatization plans?

Based on our current understanding, the following are some

of the major issues to be considered in each of the three sectors:

★ Electric Power:

- Demand prospects and possible surplus capacity
- Completion of two nuclear power units
- Approach for reducing SO₂ emissions
- Phase in of price increases for small consumers
- Organizational structure of the industry to promote competition and efficiency
- Contract relations with electric power distributors and fuel suppliers
- Development of energy efficiency programs

★ Gas

- Structure of the transit pipeline
- Longer term prospects for gas supply and prices from Russia
- Reductions in gas use at industrial customers
- Extent of vertical integration of the gas industry
- Measures to diversify gas sources

★ Coal

- Cost-competitiveness of coal mining domestically and internationally. Opportunities for cost reduction
- Demand for coal in both electric power and other sectors
- (Structural and privation method issues will not be considered at this stage).

STEP 4: Evaluate Energy/Economic Integration of Strategies and Competition and Fuel Substitution:

The purpose of this step is to assess how the coal, electricity and gas sectors will fit together in the uncertain national energy economy. This analysis will extend the energy balance analysis by a more extensive economic evaluation. The economic evaluation will compare the range of long-term costs for the various energy forms in the applications of power generation, industrial heat and steam, district heat and residential heat and hot water. These economic comparisons will be at the level of "back-of-the-envelope" cost comparisons. The objective is to identify energy projections used at a basis for the privatization strategies which are uncertain. It is likely that the comparative economics of the three fuels may be quite close in some applications. Should this prove to be true, greater ranges of uncertainty should be anticipated and reflected in the plans.

A specific policy issue posed by the current draft plans is the tradeoff between electricity, gas and coal from a

national strategy viewpoint. While gas has major environmental and ease-of-use advantages, the Czech Republic is almost entirely dependent on imports from Russia (via the Ukraine). Domestic coal resources are plentiful and probably much of the coal production is or could be inexpensive. On the other hand, as presently used the coal is very dirty. Major policy decisions and investments are being made which depend on the balance between these alternatives. Therefore we will examine this particular trade-off considering comparative economics, investment, regulatory and other aspects.

Step 5: Analysis of Macroeconomic Effects:

The purpose of this step is to estimate the extent of economic dislocations which could occur under several privatization options. These effects would be increases in prices, declines in employment in energy enterprises, and increases or decreases in hard currency trade. This part of the study will provide rough quantitative estimates of these effects for privatization options in each sector. From this analysis we will develop suggestions for problems which should be addressed in the privatization strategies:

3. Staffing

The staff for this task will be a team of financial planners and economists that are experts in electricity, natural gas and coal industries. They will be assisted by accounting staff.

4. Work Products

- Preliminary report on strategies on November 15. This report will include preliminary results of Steps 1, 2 and 3. These results will include (1) summaries of the results of our energy market analysis and (2) item-by-item review of the sector strategies (see Step 3). The report will be in briefing format.

This report will contain recommendations for additional options to be examined in the strategies, and our recommendations of needed changes.

- Final report on strategies on November 30. This report will be in the form a narrative with a summary in briefing format. This report will expand on the preliminary report and include the results of Steps 4 and 5.
- Continuing verbal exchange of comments throughout the project, including meetings at approximately weekly intervals.

TASK 3 - REVIEW OF FUELS AND ENERGY SECTOR LAWS

1. Introduction

Background: The federal government has proposed laws addressing the privatization of electricity, natural gas, coal and district heating.

Purpose:

- A. To evaluate the impact of the proposed laws on fuels and energy sector policy and privatization strategies.
- B. To recommend modifications and/or additional laws as necessary to provide adequate guidance for the privatization and on-going operation of fuel and energy sector enterprises.

2. Work Steps

Step 1: Review of Draft Laws for consistency with Energy Policy and Privatization Strategy

In this step we will read through the draft laws and summarize the areas they cover. The intent of the laws will then be compared with the principles of the energy policy and the main points of the privatization strategies. We will identify inconsistencies and provide suggestions (in general terms, not specific language) for revisions.

Step 2: Identify Requirements for Legislation

The coverage of these laws will then be compared to the areas of necessary legislation identified in Task 1. Based on this outline and our knowledge of the aspects of energy which may be regulated by law, we will suggest a list of additional topics which may require legislation. The ranges of topics could include:

- Franchise rights and service obligations of regulated monopoly energy companies. Franchise rights may include eminent domain power.
- Licensing and siting control of energy facilities construction and operation.
- Health and safety regulations of energy, such as pipeline safety.

- ### 3. Staffing: Small team of lawyers and senior economists.

4. Work Products:

- Draft report on draft laws on November 10.
- Final report on November 30.

TASK 4 - REGULATORY FRAMEWORK STUDY

1. Introduction

Background: The MHPR has asked that a study be prepared of the method for economic regulation of "natural monopolies" in the energy sector, anticipating that privatized electric and gas utilities will have elements which have market power or possibly an exclusive franchise. No such regulatory laws or institutions exist today. Energy prices have been set directly by the political leadership of the Ministries to which they report. The profitability and financial self-sufficiency of these entities will depend heavily on the kind of regulation which is put in place. Therefore the development of privatization strategies will have to proceed in parallel and link with the study of regulation.

The MHPR has also solicited proposals for the preparation of an independent and possibly more detailed study on the issue of regulation. The MHPR has agreed that if such a study is contracted, this study will serve as the starting point for further refinement. In any case, the additional study will not be completed in time to serve for the development of the privatization strategies.

Purpose:

- Assess range of regulatory options including rate of return, price cap, cost sharing, marginal cost with taxation of rents. Based on economic theory and US and W. Europe experience. Provide recommended approach along with comparison of alternatives.
- Provide policy paper and outline of new law for regulatory structure selected by MHPR.

2. Work Steps

Step 1: Gathering of Background Information:

In this task we will gather information from public sources, Ministry and many contacts with energy enterprises on the current legal framework which may affect regulation (e.g. law on competition), and on views of the parties on possible schemes of regulation.

We will assemble information (much of which is already in our hands) on the basic concepts of regulation of monopoly utilities and on the regulatory methods used in those countries which have private utility companies (e.g. the US, UK, FRG, Spain, and Japan).

Step 2: Summary and Analysis of Regulatory Approaches

The information mentioned above will be summarized, to outline the main alternative regulatory methods and the theoretical economic thinking behind them. This will address the advantages and disadvantages of the main methods. At this moment more and more thinking around the world is being given to methods to provide efficiency incentives to regulated companies like those driving unregulated competitive companies and to create competitive forces where possible. For this reason particular attention will be paid to the opportunity to create competition in the generation of electric power and the production and transmission of natural gas, which may not be pure natural monopolies.

The advantages and disadvantages to be considered include:

- Incentives for efficiency
- Protection of consumers interest
- Complexity of regulation
- Potential for effective public participation in the process
- Financial risk to the regulated enterprise and implications for access to capital markets
- Mechanism for reconciling social and financial goals
- Mechanism to provide incentives for energy company to encourage conservation (which entails lost sales)
- Mechanism for reconciling service obligation/reliability concerns with least cost
- Responsiveness to Czech Republic energy policy objectives (e.g. fuel diversity and security) and to popular concerns

Step 3: Analysis of Options from viewpoint of Czech Republic Needs and Recommendation of Preferred Regulatory Structure

In this step we will place the comparison of the regulatory alternatives in the context of the Czech Republic energy industry and structure alternatives -- tying into the privatization strategies. The structure of the industry and the type of regulation relate mostly strongly where there is a possibility of creating or limiting competition through structural choices. The other areas where Czech Republic-specific features are important are the need for creation

of brand-new institutions (so that complex regulation should probably be avoided), the possibility of a bid drop in energy use and the need to strongly encourage energy conservation, the potential for very large improvements in efficiency of operation of energy enterprises, the lack of a capital market, and the need to major pollution control investments.

Based on this analysis we will recommend a regulatory plan for the monopoly sectors of electric power, gas and district heat.

Step 4: Review with the MHPR

The recommended regulatory approach will be reviewed with MHPR. MHPR will select a preferred regulatory approach.

Step 5: Drafting Outline of Law on Regulation of Monopolies in Energy Sector

The last step will be to draft an outline of the main provisions of a law on regulation. This outline will specify the intent of each section and the key definitions and concepts.

3. **Staffing:** small team of senior economists and lawyers.
4. **Work Products**
 - Draft report on regulatory policy on November 11.
 - Meeting to decide on recommended policy November 15.
 - Final report on regulatory policy and outline of law on November 29.

TASK 1 - REVIEW OF THE CEZ PRIVATIZATION PLAN

1. Introduction

Background: The Czech Republic electric utility, the CEZ, is submitting an optional early privatization plan in the first wave of proposals due October 31, 1991. This plan was not prepared in cooperation with the MHPR. The MHPR has requested that we review and comment on this privatization plan. The privatization plan will, of course, raise many issues of structure, finance, regulation, business focus and priorities and energy plan.

Purpose: The purpose of this task is to assist the MHPR to evaluate the advantages and disadvantages of the CEZ privatization plan and to determine what recommendation or response the MHPR should make to the CEZ and the Ministry of Privatization.

2. Work Steps

Step 1: Review of the CEZ Plan

The first step is the review of the CEZ plan. This review will consist of an analysis of the structure and financing initiatives proposed by CEZ compared to the requirements of the energy policy and privatization strategy. We will also review the economic and financial analyses prepared by the enterprise and perform sundry other steps as necessary so as necessary to enable us to advise MHPR as to the viability of the filed plan.

Step 2: Present Comments to MHPR

We will present our comments to MHPR in a briefing style report and meeting. We will suggest options for responses to the CEZ plan.

Step 3: Preparation of Report of Comments

We will also formalize our comments on the CEZ plan in a memorandum report.

3. Staffing

The task will be staffed by the same team of financial and economic planners and lawyers. We will use the same individuals who will work on the electric power sector privatization strategy as well as specialists in business planning.

4. Work Product

- Comments in briefing meeting to CEZ on November 15.
- Formal report of comments -- November 29, 1991.

TASK 2 - PRIVATIZATION OF THE TRANSIT PIPELINE

1. Introduction

Background: The privatization of the Transit Pipeline, which is a subsidiary of the CPP (the Czech Republic gas company) has been studied and debated for at least a year. The transit pipeline moves gas from Russia to Europe and also supplied CR needs. At present the pipeline is highly profitable. The pipeline is considered joint property of the CR and SR, but is technically owned by the CPP. The issue has very important political implications between the Czech Republic and the SR. The MHRP recently issued a public tender requesting assistance with the analysis of privatization strategies.

Purpose: To develop the principles of privatization plan which will be acceptable to all parties. This will combine financial plans with acceptable measures on gas service and prices for the Czech Republic.

2. Approach:

DRT International, with ICF Resources, has submitted a proposal to the MHRP to perform this study, with the suggestion that the work might be jointly funded by the CPP and US AID, should AID approve. The project falls clearly within the scope of privatization planning in Phase III of this project. The funding mechanism supplements AID funding one-for-one with Czech funding.

The proposal submitted to MHRP is attached.

TASK 3 - PREPARATION OF CEZ PRIVATIZATION PLAN

1. Introduction

Background: The Ministry of Economic Policy and Development does not have the direct ability to "veto" energy sector privatization plan that it considers contrary to the Republic's fuel and energy policies. Therefore, it may seek to develop its own privatization plan for CEZ, if it is not satisfied with CEZ's submission and is unable to influence CEZ to revise its filing.

Purpose: To prepare a "competitive" privatization plan for CEZ that would be submitted to the Ministry for Privatization as a recommended alternative to the plan filed by CEZ.

2. Approach: The "competitive" plan would build on those elements of the CEZ plan are useful. Without full cooperation of CEZ the information base for the plan will necessarily be limited. The approach will therefore be to "mark up" the CEZ plan in those areas where changes would make it more consistent with the Energy Policy and the Privatization strategy for the electric power sector. This task will also build on the critique of the plan performed in Task 1 of Phase III.

3. Staffing The staff is expected to include financial planners, and lawyers who have participated in the other electric power sector tasks, with the addition of business strategy expertise.

Task 4 -- PREPARATION OF COAL SECTOR PRIVATIZATION PLAN

1. Introduction

Background: The coal sector is likely to be privatized in some way. At the moment privatization plans are on hold. Minister Dyba has appointed Mr. J. Gheyselinck to act informally as operational director of the coal sector, reporting directly to him. He plans to start privatization planning in about March of 1992. Mr. Gheyselinck has requested specific Phase II activities in support of his planning. These include a study of coal demand and an estimate of long-term mining costs assuming Czech enterprises can achieve "western standards" of performance. He does not plan to build up a large staff, and has request our assistance under this contract.

2. Approach

The privatization planning approach for coal will be similar to that described for other sectors, except that there may be more consideration given to foreign ownership in some activities. Also, the privatization plan is expected to be driven to a greater extent by the projected profitability of the sector in a market price environment.

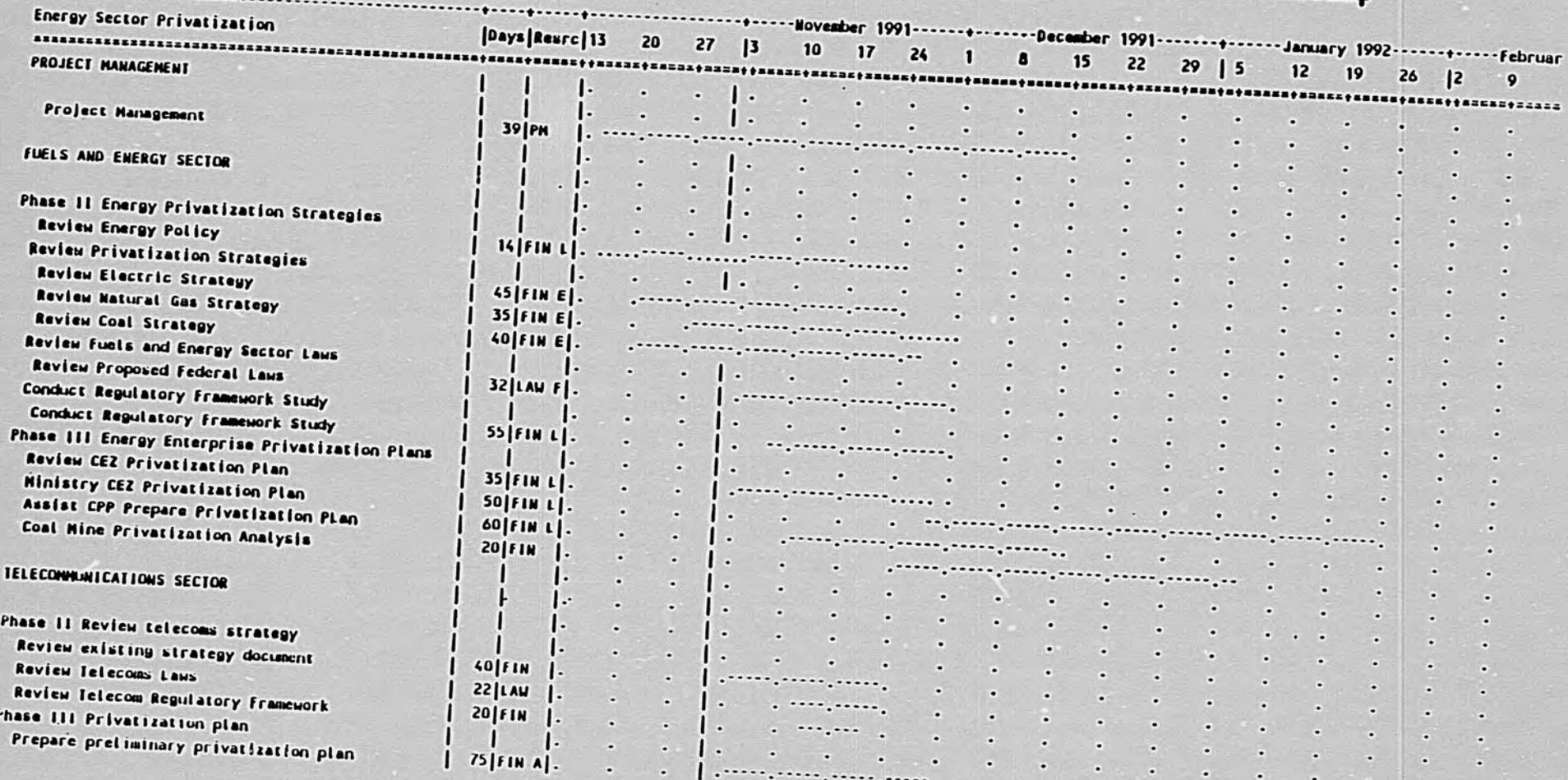
3. Staffing The team will include financial planners, and lawyers who have participated in the other coal sector tasks.

31 OCT 91

GANTT CHART

PAGE 1

Energy Sector Privatisation



29

31 OCT 91

GANTT CHART

PAGE 2

Energy Sector Privatization

	Days	Resrc	13	20	27	3	10	17	24	1	8	15	22	29	5	12	19	26	2	9	
	November 1991						December 1991						January 1992				February				
Energy Sector Privatization																					
Resource summary																					
Utilization																					
Project Manager	6.0	PM	4.0	4.8	4.8	4.8	4.5	4.2	4.2	4.2	3.5										
Financial Planner	120.0	FIN		6.2	5.8	71.9	98.2	88.8	38.9	16.6	14.6	6.6	6.6	6.6	4.6	3.6	3.0				
Lawyer	36.0	LAW				8.1	22.1	30.3	16.3	3.0	4.2	1.2	1.2	1.2	1.2	1.2	1.0				
Economist	12.0	ECOM					10.2	9.8													
Accountant	12.0	ACCT				7.8	13.0	14.0	12.8	4.2	1.2	1.2	1.2	1.2	1.2	1.2	1.0				
Total days			4.0	11.0	10.6	92.6	148.0	147.1	72.2	28.0	23.5	9.0	9.0	9.0	7.0	6.0	5.0				

119



T r a n s G a s

Proposal for professional
services

DRT Czechoslovakia



Revised: 11/10/91
11/10/91

Telephone: (420) 224 11 11
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31 October 1991

RNDr. K r a u s , CSc.
Deputy to Minister
Ministry for Economic Policy and Development
Vrsovicka 65
101 60 Praha 10

Dear Dr. Kraus,

DRT Czechoslovakia, in conjunction with ICF Resources Incorporated, is pleased to respond to CPP's request for assistance in addressing issues concerning TransGas.

This proposal is organized in four sections. In the Background section, we describe our understanding of the situation facing TransGas and the key issues to be addressed in our scope of work. The Approach and Deliverables section that follows lays out the work steps we will undertake to address these issues. The third section, Timing and Staffing, provides engagement details. The last section, Project Cost and Sources of Funds, proposes how we might use the resources provided by our U.S. AID contract to reduce the overall cost of this project for CPP.

DRT International is the third largest professional services firm in the world, and we believe our approach represents an unsurpassed blend of talents, resources and skills that is unique to our firm. Attached, we have provided a Statement of Qualification from DRT Europe Services which describes DRT's energy sector capabilities in Central and Eastern Europe.

ICF Resources, a member of DRT's consortium, is one of the United States' largest energy consulting firms. ICF Resources' strength in gas planning arises from fifteen years of experience in assisting gas pipeline companies and gas distributors in market and supply planning. ICF Resources has advised international oil and gas firms such as Statoil and also the Government of Argentina.

Background

TransGas operates the major gas transportation pipeline which moves gas from the Soviet Union to customer markets in Western Europe and supplies CPP with gas for distribution to the Czech Republic.

There are several important issues facing the Czech Republic and the CPP arising from the privatization of TransGas. These issues are made more complex by the fact that public policy goals (low long-term gas prices) may conflict with the interests of future TransGas shareholders (profit maximization). These issues are:

1. Creating an equitable ownership structure that balances the interests of the Czech and Slovak Republics and is at the same time politically acceptable and maximizes the value of the enterprise.
2. Developing an assured and reasonably priced long-term gas supply.
3. Structuring the privatized TransGas operations in a realistic way that recognizes the uncertain nature of Soviet supplies and the relative negotiating power likely to be enjoyed by both sides in the future (CSFR vs. Soviets). Ideally, one goal of TransGas' privatization plan should be to preserve or even enhance the negotiating power enjoyed by the CSFR in its relations with the Soviet Union.

The approach which we propose below is designed to address each of these issues.

Approach and Deliverables

Our approach will comprise three distinct phases of work, as described below. We have designed this approach to meet CPP's needs in the most efficient and cost effective manner possible.

Data Acquisition and Analysis

First, we propose to hold a "kickoff" meeting with key officials of CPP and TransGas. At this meeting, we would: (1) identify any relevant studies, data, or independent recommendations that may be useful; (2) work with you to outline the competing political, economic and social interests involved in privatization of TransGas.

Over the next weeks, we would analyze data we obtained, meet with Czech and Slovak Ministry officials

to obtain their views, and work with TransGas officials to build the "fact set" that describes TransGas' current situation and its business, financial and social obligations.

Option Generation and Refinement

Once we have built the "fact base," we would generate options that may be viable as solutions to the three issues described above.

For each issue, we would outline viable options and describe the positive and negative implications of each. For example, one option which addresses issue #3 might be to build a loop into the existing pipeline (a relatively inexpensive way to increase its capacity). TransGas might then be able to offer this additional capacity to Western markets, thereby forming a direct relationship with potential customers and bypassing the USSR. This would obviously increase your negotiating power with the Soviets in other areas.

Other options to be addressed are: (1) contract structures between privatized TransGas and CPP, (2) payments from TransGas to the Republic governments, (3) oversight role in TransGas of CPP and SPP, and (4) linkage of transit tariffs and gas pricing.

Option Selection and Consensus-Building

Once options are identified and described in enough detail, we would hold a series of meetings with officials at CPP, TransGas, and relevant Ministries. The purpose of these meetings would be to debate the positive and negative aspects of each option and arrive at an overall consensus on the appropriate course of action.

Deliverables

Our deliverables based on the approach described above will be:

1. A series of options for each issue described above
2. An assessment of the positive and negative aspects of each option
3. Facilitation of a series of consensus-building meetings where these options are discussed and debated by Ministry and CPP officials



Staffing and Timing

We recognize that this project is critical to the successful privatization of TransGas, and we have assembled an experienced, senior-level team of professionals who we believe can provide the high quality advisory services you expect.

Mr. John Mandak will have ultimate responsibility for this project. Mr. Mandak is Partner-in-Charge of DRT Czechoslovakia. Mr. Phil Burton will be project manager, responsible for carrying out the day-to-day tasks described herein. Mr. William Hederman and Mr. Leonard Crook will be the principal consultants on the project. Resumes of principal team members are attached.

Project Costs and Sources of Funds

The total estimated cost for this project will be \$131,000. The costs to the Ministry of Economic Policy should be as low as \$65,500 with U.S. AID support. DRT is seeking the approval of U.S. AID for funding under Deloitte & Touche's ongoing contract with the Ministry for Economic Policy and Development (Deloitte & Touche is the U.S. member firm of DRT International). Assistance that DRT would provide to the Ministry under this project falls within the scope of upcoming work under Phase III of the U.S. AID privatization project.

As shown in the attached table, the total level of effort for this project is 120 labor days. Given the proposed U.S. AID support, the total cost to the ministry would be \$65,500.

Detail on Project Costs and Source of Funds

<u>Expense</u>	<u>Labor Days</u>	<u>Rate (\$/Day)</u>	<u>Cost (U.S \$)</u>
Labor	120	950	\$114,000
plus: Air Travel (6 trips, \$2,500/trip)			15,000
Other Costs			2,000
Total	120	950	\$131,000
less AID Support	60	950	65,500
TOTAL	60	950	\$ 65,500

We would again like to thank you for the opportunity to submit this proposal and to be considered for this

DRT
Czechoslovakia

assignment. If you have any questions regarding any matters described in this letter, please do not hesitate to contact Phil Burton or John Mandak, on (02) 231 1584 or (02) 231 0872 by telephone, or (02) 231 1732 by telefax.

Yours faithfully,

DRT Czechoslovakia

DRT Czechoslovakia

Signed by: Carl Tausch

