

PN-ABR-109  
12/12/91

**Deloitte &  
Touche**

IN ASSOCIATION WITH:



**DRT CZECHOSLOVAKIA  
ICF RESOURCES, INC.**

---

**ENERGY AND TELECOMMUNICATIONS SECTOR ASSISTANCE  
FOR MINISTRY OF ECONOMIC POLICY AND DEVELOPMENT  
OF THE CZECH REPUBLIC**

---

**COMMENTS ON CEZ PRIVATIZATION PLAN**

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

**DECEMBER 1991**

**COMMENTS ON THE CEZ PLAN AND PROPOSAL FOR FIRST WAVE  
PRIVATIZATION**

**1. Proposed Corporate Structure**

The proposed privatized CEZ will consist of the following main elements:

- Nearly all of the electric generating plants which are now part of CEZ

- The Most power and district heating plant (CEZ-SCT)

- Three companies engaged in supporting activities to CEZ:

- Energovod
- Energotechnika
- ORGREZ

The following companies will be privatized as separate joint-stock companies:

Heat Distribution Companies

- CEZ-KE Ostrava
- CEZ-EPR Praha
- CEZ-EJM Brno

The Kolin area system of EPR Praha will be split off as a new company.

Manufacturing, Construction and Maintenance Companies

- CEZ-TEŠ Teplice
- CEZ-ESB Brno
- CEZ-EGD Velke Mezirici
- CEZ-EGM Liberic (partly tranfered to Electromont, which is not a part of CEZ)
- CEZ Energostrojirny Pardubice

Thus, out of one company will come 10.

**2. Privatization method**

The privatization method for most of the companies is by the coupon method, for 30%, with 3% restitution and 67% state ownership. For the heat distribution systems, 30% ownership by the home town of each company is proposed. No specific plan for foreign capital is presented. The CEZ plan discusses some general ideas for foreign ownership in the future.

No provision for employee ownership of shares is made.

### **3. Justification for the proposed corporate structure**

Very little explanation is provided for the overall structure. The three heat distribution companies are to be separated because their activities are local. The manufacturing companies are to be separated because they could sell to other customers besides CEZ and are not part of the main business. No discussion is provided of why Energovod, Energotechnika and ORGREZ are different in this regard from the companies which are being separated. Also, the status of the CEZ-EGO Chvaletice energy machinery works is not covered by the documents we have.

### **4. Logical Consistency of the Proposed Structure**

The proposed structure is possibly inconsistent. Some supporting activities are split off, some are not. Several of the heat distribution networks are split off, but not all. Several of the new heat distribution companies contain systems which are in different towns, but the Praha system is split so that the Kolin town system will become a separate company. If there are reasons for these inconsistencies, they do not seem to be explained.

### **5. The CEZ Structure Compared to Alternatives**

The CEZ proposes a single republic-wide electricity generating and transmission company, selling to independent distribution companies. An alternative model, which we believe deserves serious consideration, is the possibility of several generating companies and a single transmission company. Multiple generating companies could create a competitive market in bulk power.

The CEZ proposes that the heat distribution companies will contain combined-heat-and-power plants. Possibly, these plants could be separated from the heat distribution functions of these systems. Even keeping the operation of these generating plants as part of CEZ would be an option. The CEZ plan also combines several local heat distribution systems into a single company. Possibly, each system could be a separate company, to provide rates which accurately reflect local costs.

### **6. Quality of the Privatization Plans**

Based on a very cursory review, it is evident that the quality of the 10 plans in the CEZ package varies widely. At least one of these companies looks quite likely to fail, based on the information in the plan.

The plans do not discuss in any meaningful way the necessary transition of prices and the expected form of regulation.

The formation of capital for the privatized manufacturing companies is not treated at all well.

The plans do not address the further organizational and ownership development of the companies, after the initial privatization step.

#### 7. CEZ's Argument on the Need for First Wave Privatization

CEZ argues that privatization in the first wave is important because they are urgently trying to negotiate with foreign investors. They assert that these investors do not want to do business with a state-owned company because the management of a state-owned company is not in control. This argument has several flaws:

- CEZ is proposing that the CR retain 67% ownership. The CR ownership is specifically so that the CR may be sure that the CEZ carries out the direction of the government. So, who is running the company after privatization, the management or the owners? It may not be any more clear to a foreign company after this type of privatization that the CEZ management is more in control than it is now.
- The CR government can solve this problem by clear and open policy guidance to the CEZ. Particularly if a policy on foreign participation is worked out at the political level, foreign investors can know the rules.
- The greatest concern of a foreign investor is the risk of the investment. This risk will depend mainly on the prices and profitability of CEZ. CEZ prices will be set according to a regulatory law and agency which are yet to be established. Privatization as proposed by the CEZ does not help to solve this problem.
- Further, the description provided by CEZ of capital needs says that it is probably too early to tell whether CEZ will need capital from foreign companies.

#### 8. Advantages and Disadvantages of First Wave Privatization

**Advantages:** Privatization now begins some of the needed structural change (such as splitting off manufacturing activities). As a privatized company, the CEZ may have more management discretion than it has now. The extent of real change in this regard will depend on how much the MHPR changes its relationship with the CEZ.

**Disadvantages:** Privatization according to the CEZ proposal may result in some organization changes which the MHPR may later wish to alter. Possibly even the basic form of privatization, such as the amount of shares sold through the coupon method will be different from what the MHPR desires, depending on the kind of price and financial regulation which is imposed. For some of the manufacturing organizations, privatization according to the structure and quality of plan now proposed may lead to financial disaster.

## 9. Recommendation

The privatization of CEZ should be postponed to the second wave. The CEZ plan should be viewed as an excellent starting point for a refined second wave plan. The MHPR should make an effort to solve CEZ's concern about the degree of management discretion and the right to negotiate with foreign companies.

The reasons for this recommendation are:

- First wave privatization is premature, considering the lack of an established legal and regulatory basis for the energy industry.
- The CEZ plan supposes an organization of the electric power and heat distribution industries which on further study by the MHPR, may well not be recommended.
- Certain portions of the CEZ plans could benefit from time for improvement, particularly in the business planning aspects.
- In summary, more bad than good is likely to result from privatization in the first wave.