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PRIVATIZATION PROJECT DISCUSSION PAPER

**NIS Institutional Based Services Under the Energy
Efficiency and Market Reform Project
Contract No CCN-Q-00-93-00152-00**

Electric Power Sector Restructuring and Privatization

Delivery Order No 1

Presentation

Prepared for

U S Agency for International Development
Bureau for Europe and NIS
Office of Environment, Energy and Urban Development
Energy and Infrastructure Division

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Privatization Project Discussion Paper

For The Russian Electric Power Sector Privatization And Restructuring Task
Of The USAID Project Russian Energy Sector Institutional Reform

**Presentation Of The Status Of Phase I Of The Privatization Project
And Initial Suggestions For Phase II At A Review Meeting With Mr.
Ron Leasburg, USAID, Moscow**

RCG/Hagler, Bailly, Inc.
August, 1994

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▶ What Are The Goals Of The Program?

□ Overall goal design and implementation of a program to privatize the electric power sector where competition is a key variable in the equation

□ Specific goals of Phase I

▶ Learn about Russian power sector

- I People
- I Politics
- I Basic information on existing system

Ongoing, slower than expected due to culture

Doing well

▶ Build relationships and establish trust

- I Working groups and use of consensus process
- I Delivering products as promised

- General acceptance of structure
- Slow progress on legal
- Slow progress on financial management
- Steady progress on investment promotion

▶ Design a framework for the privatized electric power system that meets the needs of Russia, recognizing the constraints and opportunities facing Russia

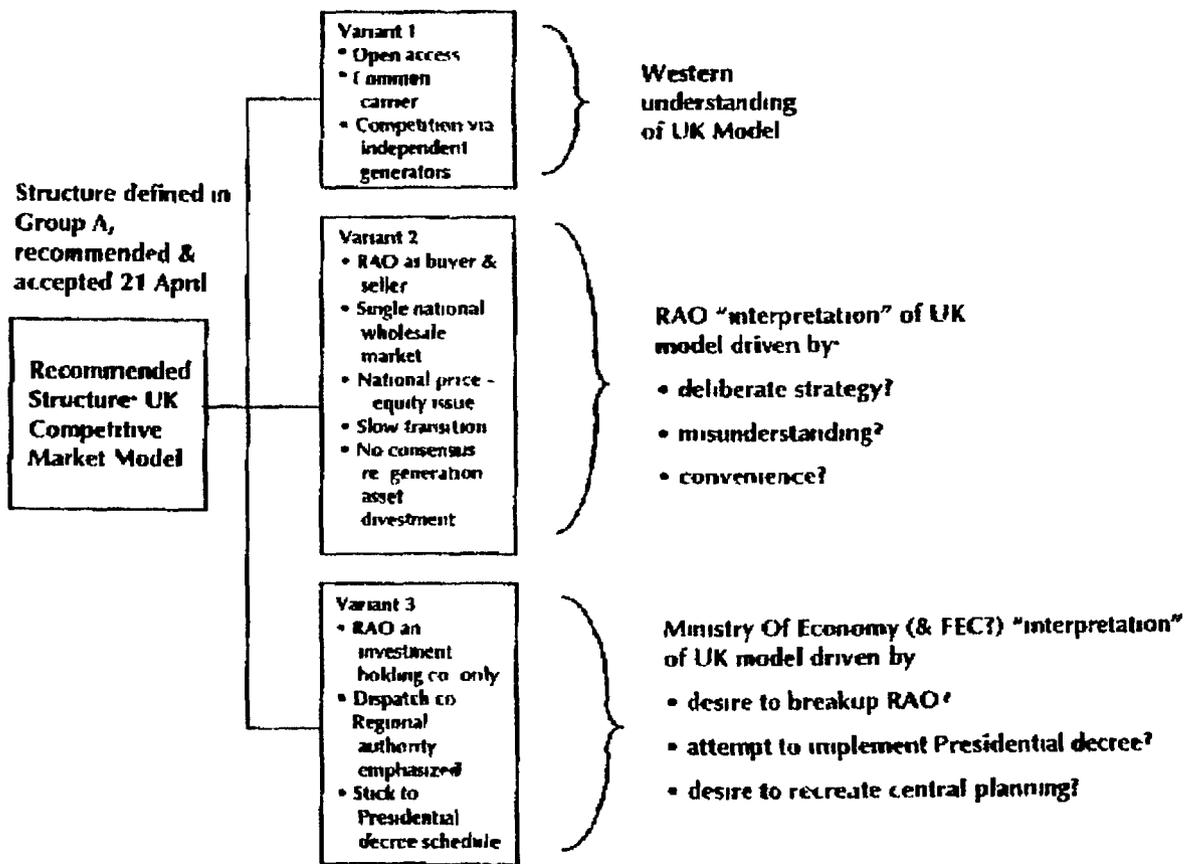
▶ Plan for Phase II (implementation) that is accepted by Russian and American sides



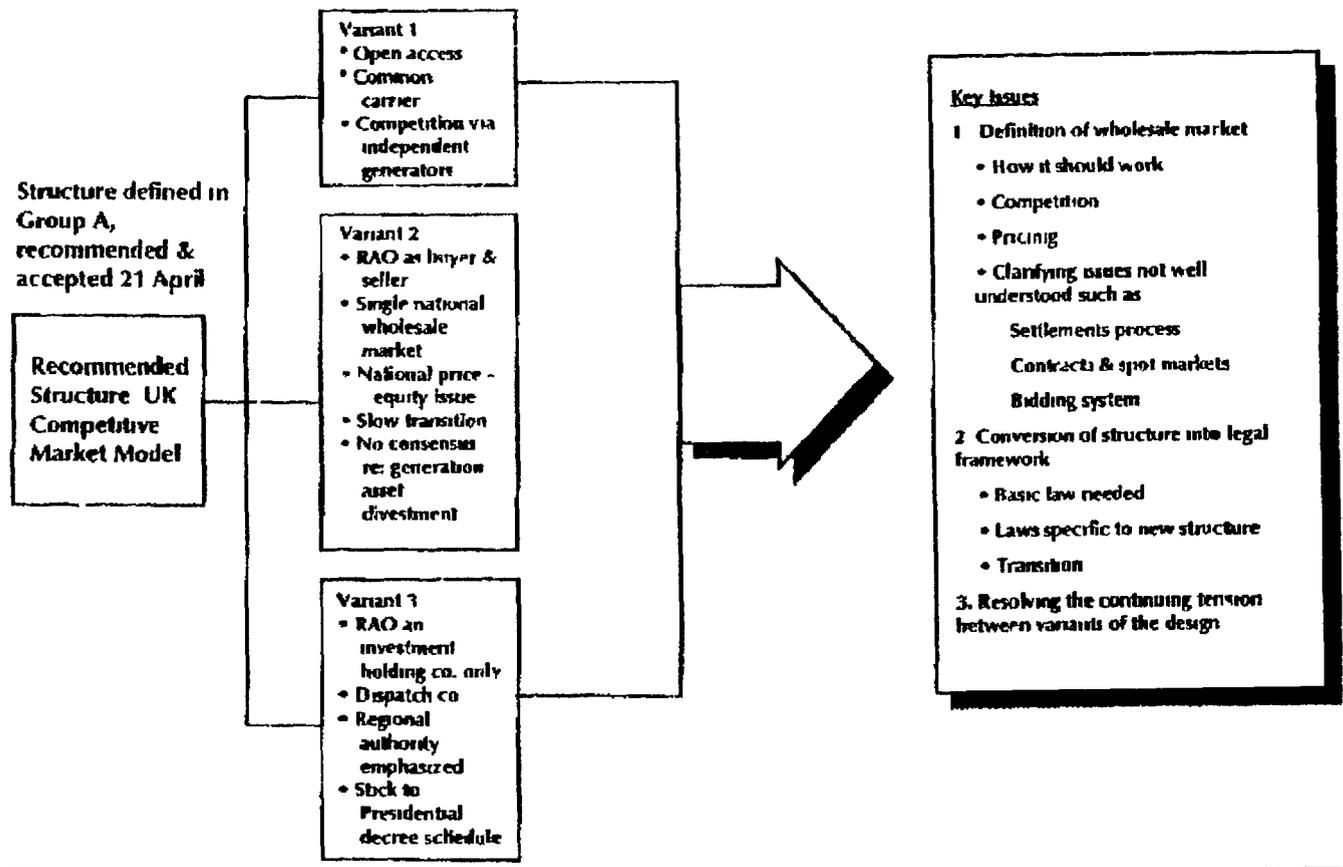
Where Is The Program Heading?

- Comprehensive design for the privatization of the Russian electric power sector**
- A model based on competition but assuming a transitional period is necessary to implement it**
- Financial and investment strategy for the electric power sector**

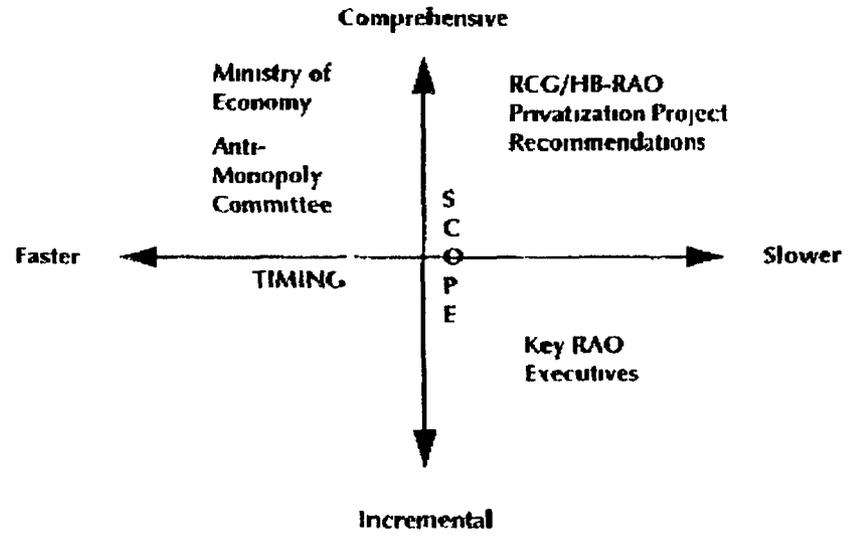
Present Focus Of The Project Is On Clarifying Key Issues Pertaining To Structure



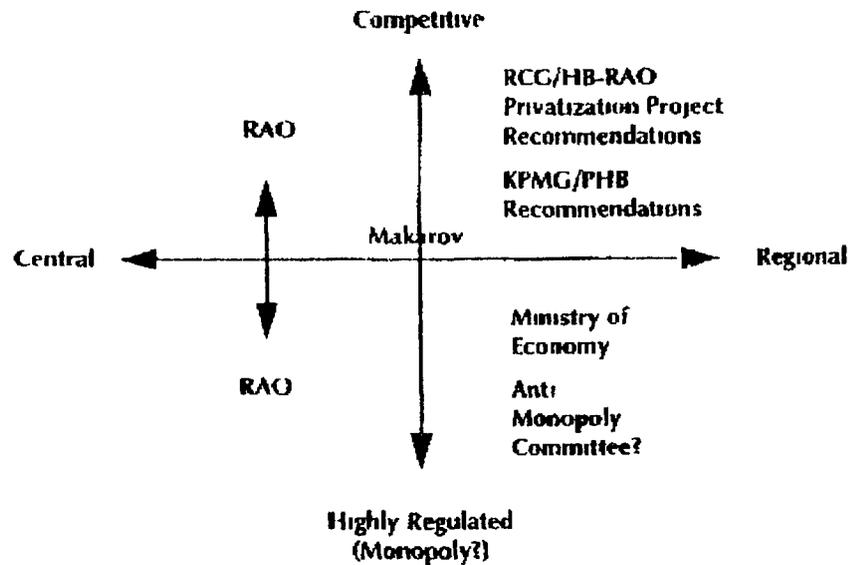
▶ Key Issues Concern Matters Of Pace, Level Of Competition, And Bureaucratic Politics



▶ There Appear To Be Differing Views Among Key Russian Institutional Leaders Regarding The Timing Of Power Sector Privatization & Restructuring

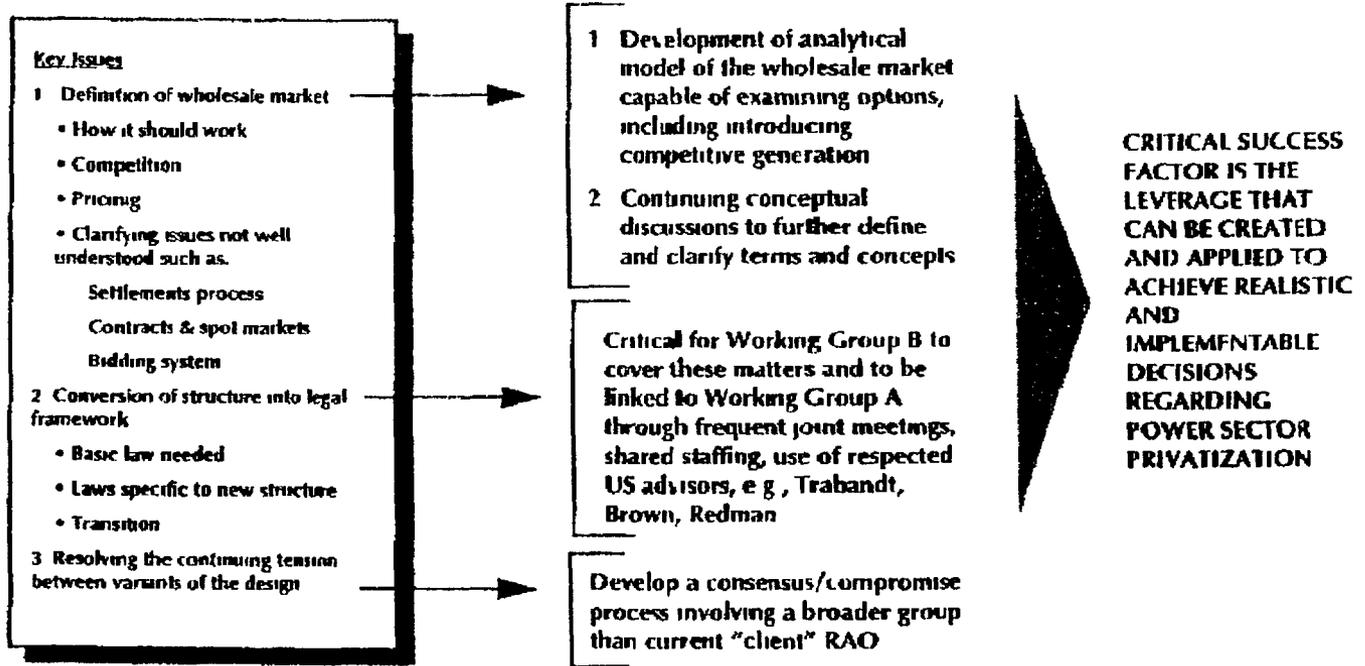


▶ **There Also Appears To Be Divergent Views On The Role Of Competition In The Privatization Of The Power Sector**



▶ Many Of These Issues May Be Resolved Through Understanding Gained From Further Analysis

STEPS TO BE TAKEN TO ADDRESS ISSUES



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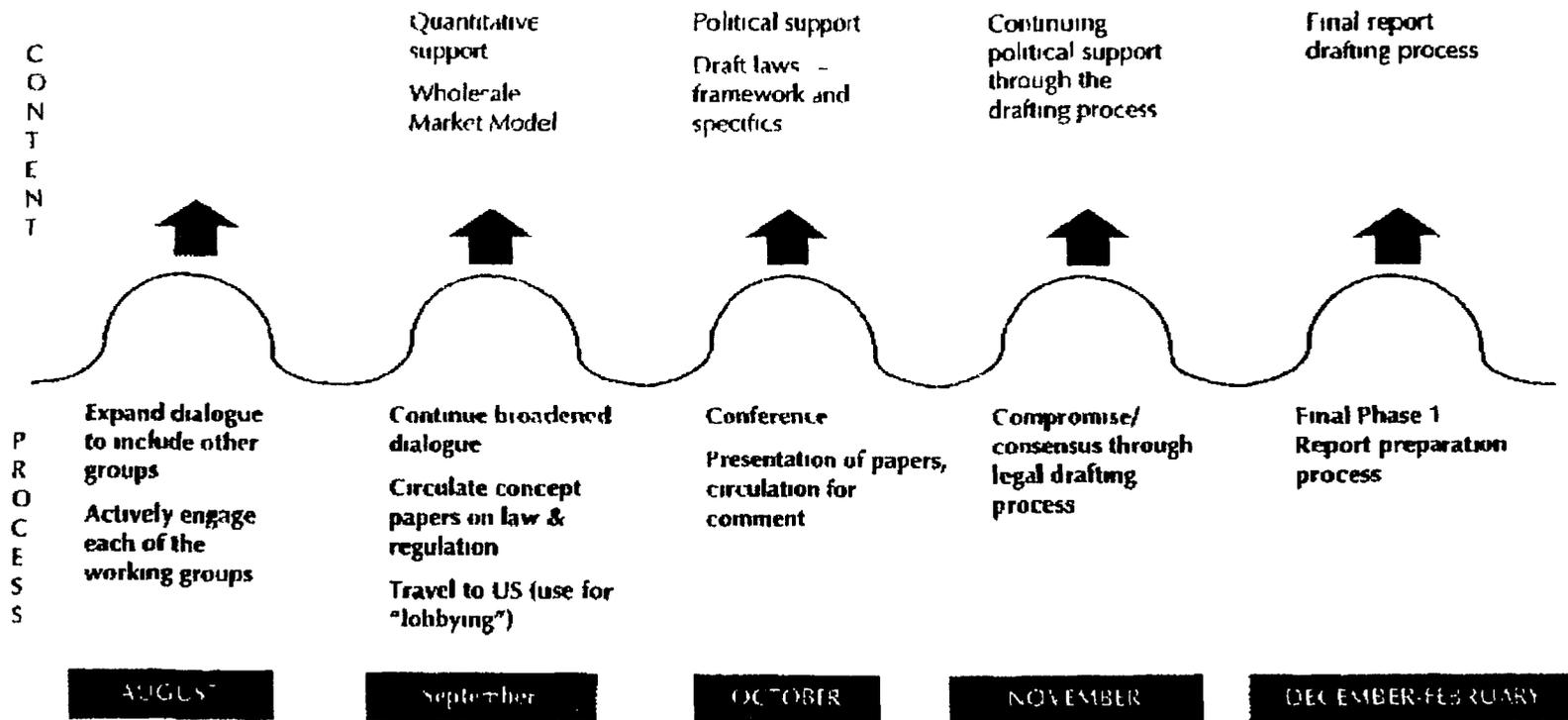
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▶ **There Are Several Possible Leverage Points That Can Be Used To Facilitate Decision-Making**

- Define an acceptable compromise position that brings variant positions together**
 - ▶ **Role of a joint paper with Energy Research Institute requested by Baranovsky, in process of development now**
 - ▶ **Role of the 17 October conference and post-conference discussions, papers, etc**
- Broaden the participants in the project to include key influentials from various Ministries, regions, generating companies, industrial interests**
 - ▶ **Role of the 17 October conference**
 - ▶ **Important role for USAID in encouraging an opening of the dialogue**
- Amplify the message that investment requires clear restructuring process, action being taken sooner than later**
 - ▶ **Role of the World Bank loan process**
 - ▶ **Absence of private investors until their criteria can be met**
- Use the analytical process of the project to further define and articulate structure**
 - ▶ **Wholesale market model**
 - ▶ **Retail pricing methodology**
 - ▶ **Design and development of legal and regulatory framework**

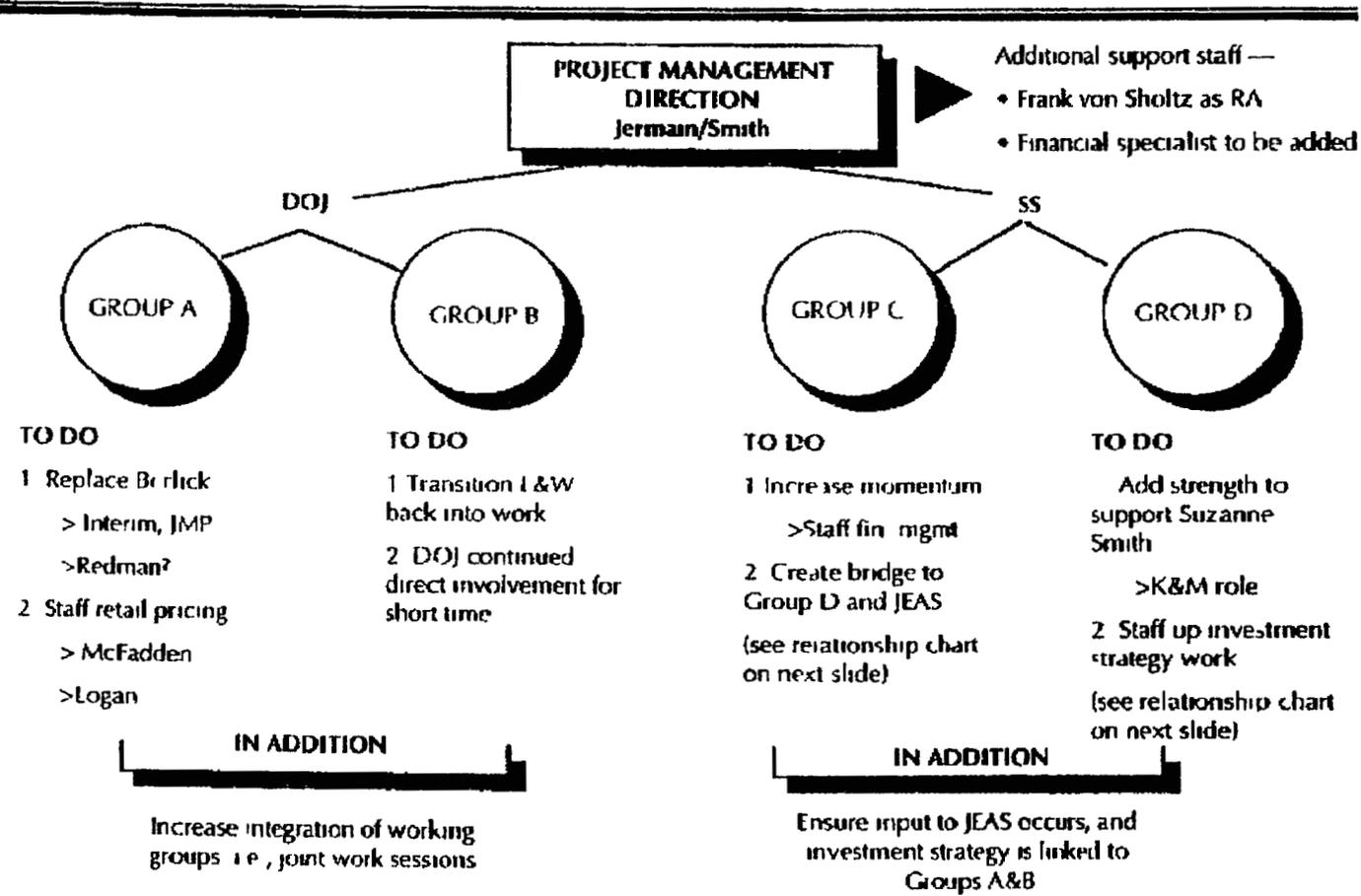
▶ In Order To Bring Phase I Design To Closure, Momentum Must Be Increased And Leverage Applied Over The Next Three To Four Months



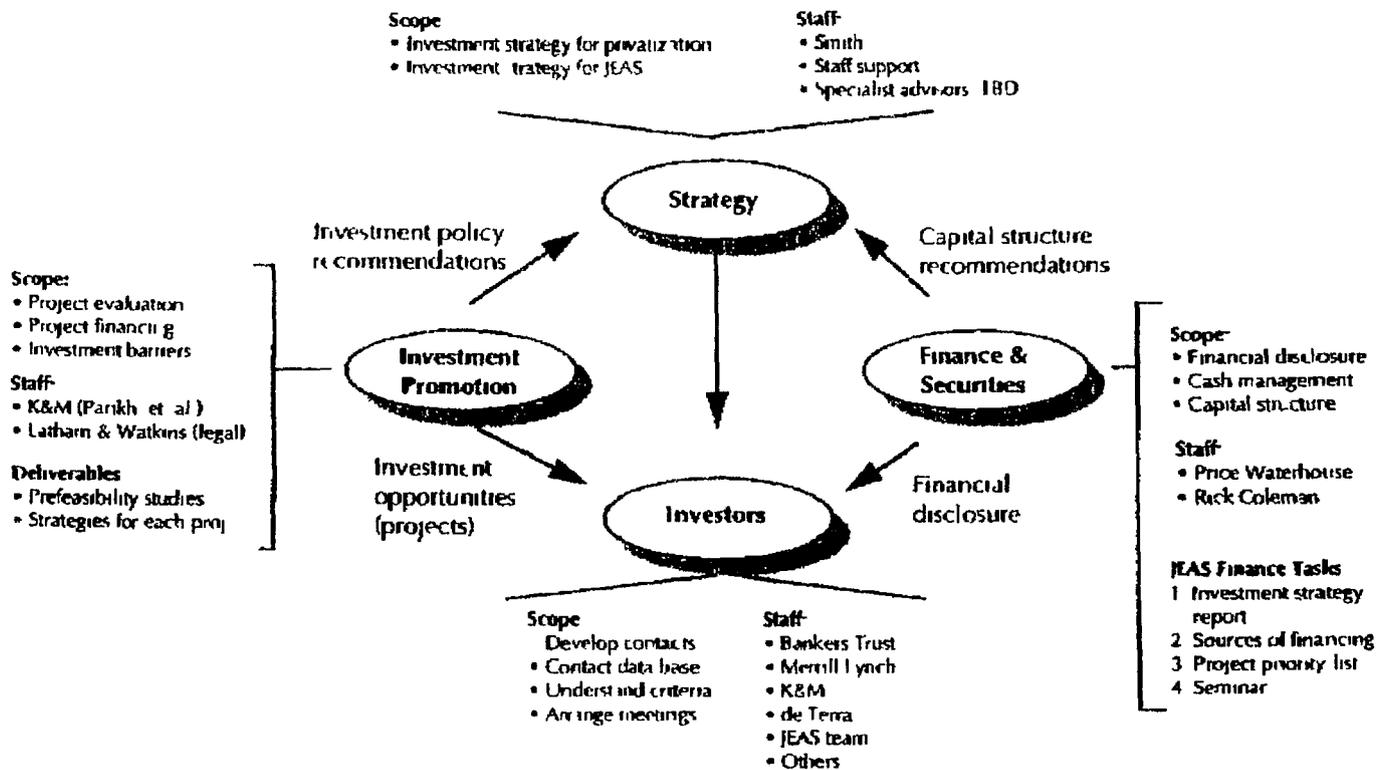
▶ A Critical Focal Point Is The 17 October Conference

- Agenda should include
 - ▶ Review of structure and its refinements based on analysis of implications of various wholesale market options
 - ▶ Presentation of the legal and regulatory framework with an overview of the laws to be drafted to implement it
 - ▶ Review of the investment strategy for the electric power sector
 - ▶ Discussion of the transition plan and its organization, including key milestones that will trigger "next steps" in transition (leverages presentation by Makarov at the 21 April conference)
- Invitation of participants is a key factor
 - ▶ Other ministries
 - ▶ Regional and Genco interests
 - ▶ Industrial interests
 - ▶ US advisors
- USAID should be involved in the agenda setting process

▶ As We Enter The Fall, And Build Momentum, Staffing Will Be Ramped Up To Ensure Smooth Management Of The Project



Investment Strategy Is Of Increasing Importance And Needs To Be Better Integrated Within And Between Projects (Privatization & JEAS)



**▶ Further, Investment Strategy Is Emerging From Privatization
Project Groups C & D, And This Will Help The JEAS**

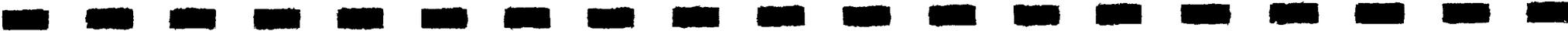
- Project pre-feasibility studies are focusing on specific project issues**
 - ▶ Project selection criteria**
 - ▶ What can be financed and how**
- Financial management efforts are key to investment as well**
 - ▶ Financial disclosure requirements and standards**
 - ▶ Cash management and capital budgeting**
- A focus on immediate problems is helping to define an investment strategy**
 - ▶ Share value questions**
 - ▶ Accounts receivable problems**

▶ What Will Be Accomplished In Phase I?

| | September | October | November | Dec /Jan | February |
|-----------------------------------|---|--|---|---|-------------------------|
| Travel | US tour | London & Paris | Hong Kong, Tokyo | | |
| Reports | <ul style="list-style-type: none"> Five K&M reports Draft law concept paper Investment planning report Securities report Public affairs role | <ul style="list-style-type: none"> Details on wholesale market Retail pricing methods Investment strategy Initial draft laws | <ul style="list-style-type: none"> Transition plan recom Detailed draft laws Cash mgmt recom Profile of RAO for investors | <ul style="list-style-type: none"> Conference on implementation program reports Delivery of libraries re regulation financial structure | Final report on Phase I |
| Seminars & Conferences | <ul style="list-style-type: none"> PW Acctg & Finance Kutovoy regulatory seminar Ad hoc group on arrears All WG heads (DC during tour?) | <ul style="list-style-type: none"> All working groups at Conference JEAS seminar | <ul style="list-style-type: none"> DOE conference | <ul style="list-style-type: none"> Implementation conference | |

▶ What Will Be Delivered In Phase I?

- Consensus/Compromise on power sector structure**
- Draft legal framework and laws**
- Financial and investment strategy**
 - ▶ Specific projects for financing**
 - ▶ Financing framework**
- Organization and plan for transition and transition management**



► Where Are We And What Is Left In The Workplan?

- The next slides summarize the time line for Phase 1, what has been accomplished and what remains to be done

▶ Schedule Of Ongoing Activities Of Group A: Privatization And Pricing

| Working Group A Privatization | January 1994-June 1994 <i>Work Completed</i> | July 1994-September 1994 <i>Ongoing Work</i> | October 1994-December 1994 <i>To Be Scheduled</i> |
|---|---|--|---|
| Tasks | | | |
| Background Research | Continues throughout the year | | Conduct site visits to regional power companies |
| Industry Models | Progress Report on Power Sector Restructuring and Privatization " presented at the Privatization Seminar in Moscow on April 21 1994 | Restructuring proposal now being reviewed within RAO and at other Ministries. Finalize proposal and present at next privatization seminar currently planned for last week of September | Schedule visits to UK and/or US on industry structure model. Visits to US interconnected power pools (FERC) |
| Wholesale Power Market | | Ongoing work on wholesale power market model data collection and customizing the model to reflect the Russian power sector | Prepare a report on alternatives for creating competitive generation markets and on alternatives for setting wholesale prices |
| Retail Pricing Methodology | | Initiating a task to develop retail pricing methodology based on the recommendations from the April 21 seminar | Workshop in Moscow to discuss retail pricing and to choose regulatory methodologies for further development. Produce a final report incorporating the results of the workshop discussions and decisions |
| Comprehensive Proposal Implementation Plan Support for Plan | | | Produce a comprehensive description of the long term organization and a plan to manage the transition from the current state to the long-term state. Distribute proposal to implement plan to outside government agencies for comment, modify the plan as appropriate |

Schedule Of Ongoing Activities Of Group B: Legislation And Regulation

| Working Group B Legislation | January 1994-June 1994 Work Completed | July 1994-September 1994 Ongoing Work | October 1994-December 1994 To Be Scheduled |
|---|---|--|---|
| Tasks | | | |
| Background Research | Continues throughout the year | | |
| Legal Support for Models | "Privatization And Economic Regulation In The Russian Electric Power Sector," by Latham & Watkins | Develop a system of laws based on the work of Working Group A Present results to a conference to be held the last week of September | |
| Wholesale Power Market Support | | Define the legal and regulatory system for governing the wholesale market | |
| Retail Pricing Regulation | | Define the legal and regulatory system for governing retail pricing | |
| Comprehensive Proposal, Implementation Plan, Support for Plan | | | Produce a comprehensive description of the long-term organization and a plan to manage the transition from the current state to the long-term state. Distribute proposal to implement plan to outside government agencies for comment, modify the plan as appropriate |

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Schedule Of Ongoing Activities Of Group C: Securities And Finance

| Working Group C: Securities | January 1994-June 1994 Work Completed | July 1994-September 1994 Ongoing Work | October 1994-December 1994 To Be Scheduled |
|------------------------------------|---|--|--|
| Tasks | | | |
| Accounting Tasks | Conversion of financial statements into western standards | Presentation of results of financial statements task to RAO in a seminar in early September | |
| Asset Management | | Review current capital structure financing arrangements and cash management policies and procedures for RAO. Recommend appropriate cash management policies, procedures, and organization structures for RAO. Provide advice on the "arrears problem." | Prepare an overview of the use of internal and external auditors for use by RAO in determining appropriate policies for the Russian power sector. |
| Securities Markets | | Prepare an overview of RAO for discussion with domestic and foreign investors. Prepare an overview of Western capital markets and their operations vis a vis the power sector. Recommend a strategy for securities management in a market economy. | Visit key financial intermediaries and power sector investors in Moscow, New York, London, Paris & Frankfurt and discuss the review of RAO. Recommend a program for integrating Russia's power sector into both national and international financial markets including steps, a schedule, and budget for implementation. |
| Training | | Develop a library of appropriate financial literature for RAO. | Prepare and present a seminar on the operations of Western debt and equity markets. Prepare and present a seminar in shareholder relations/corporate governance issues. |

► Schedule Of Ongoing Activities Of Group D: Investment Promotion

| Working Group D: Invest. Promote | January 1994-June 1994 Work Completed | July 1994-September 1994 Ongoing Work | October 1994-December 1994 To Be Scheduled |
|---|--|--|---|
| Tasks | | | |
| Power Sector Investments | <p>Collected and submitted reference materials and examples of investment incentives that have been used in recent power sector project investments</p> <p>Prepared materials for a working group meeting on "Investment Options in the Power Sector" and completed this seminar</p> | <p>Develop recommendations and options for changes and modifications of existing laws on foreign investments in the power sector</p> <p>Preparing a concept paper on "Recommended Options on Investment in the Power Sector"</p> <p>Preparing legislative recommendations to be submitted to Group B</p> | |
| Planning & Evaluation | <p>Transfer available materials on methodologies, guidelines and techniques for evaluating and appraising investment proposals. Be certain to include methodologies that account for inflation</p> | <p>Provide an overview of state-of-the-art methodologies and techniques on policies and planning for investment and capital expenditures. Develop recommendations for modifications to RAO investment planning procedures and policies. Deliverable will be a "Memorandum on Options and Recommendations."</p> | <p>Conduct a seminar on "Evaluation of Power Sector Investment Projects" to be held in Moscow</p> <p>Conduct a seminar on "Investment Policy and Planning in a Market Economy" to be held in the US</p> |
| Project Development | | <p>Begin the development of four investment projects including a new thermal power plant, the Beloporogeskaya Hydro Power Plant, the rehabilitation of an existing thermal power plant, and an inter-utility transmission line project</p> | <p>Complete investment projects and prepare them for review by prospective investors (see financial market promotional programs in Group C)</p> |
| Investor Relations | <p>Develop relationships with investor groups. This will be done in coordination with the Securities and Financial Markets Working Group. This is ongoing</p> | | |



What Is Phase II?

- Implementation of design**
- The next slides suggest some areas of possible focus for Phase II**
- Caveats**
 - ▶ Initial thinking on Phase II is represented and does not include input from Working Groups, either from the American side or the Russian side**
 - ▶ Russian contributions to possible Phase II projects are expected within the month of August**
 - ▶ The inventory presented is for discussion purposes only and does not constitute RCG/Hagler, Bailly's recommendations for Phase II**

**▶ An Agenda For Phase II: Implementation Of Structural, Legal
And Regulatory Measures**

□ Structural change implementation

- ▶ Facilitating breakout of remaining pieces of RAO and conversion of RAO into a transmission company**
- ▶ Contracting and licensing of generators and distributors**
- ▶ Wholesale market set up, financial settlements system for RAO**
- ▶ SCADA systems and their role in the wholesale market**
- ▶ IPP project financing — actual demonstration project**
- ▶ Retail distribution and customer services — development of energy service programs at the AO Energo level**

□ Legal and regulatory

- ▶ Implementation of recommended laws, support for legislative process**
- ▶ Federal Energy Commission staffing and IRP**
- ▶ Tax policy**

An Agenda For Phase II: Implementation Of Securities And Finance And Investment Promotion Programs

Securities and finance

- ▶ **Create a working capital revolving credit line using commodity backing, e.g., gold**
- ▶ **Listing of securities on international capital markets**
- ▶ **Financial information systems to support new financial management tools**
- ▶ **Capital budgeting and resource allocation**
- ▶ **Economic development programs**
- ▶ **Banking institutions and investment program for the power sector**

Investment promotion

- ▶ **From pre-feasibility through actual financing of projects**
- ▶ **Creative financing measures**
 - ▶ **Gold backed bonds**
 - ▶ **Equity investment by IPPs in existing plants to refurbish them**

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An Agenda For Phase II: Implementation Of A Regional Level Program Of Privatization

- Regional implementation**
 - ▶ **Regional commission development**
 - ▶ **Regional legal infrastructure**
 - ▶ **Regional management consulting support — financial and management systems for ENERGOs**

- Management training**
 - ▶ **General business management -- key managers to MBA programs and mid-career programs in the US**
 - ▶ **Contracting and bidding actual implementation of international bidding systems**

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An Agenda For Phase II: Implementation — Managing Social Costs

- **Social cost issues and system rationalization**
 - ▶ **Dealing with social costs of plant shutdowns, i.e , what to do with social infrastructure supporting the plant**
 - ▶ **Actual development of a proto-type safety net program**



► Conclusions

- Momentum needs to be built to move to decisions this fall**
- There are some key areas where enhanced understanding and/or "creative compromise" are needed to bring Phase I to closure**
- USAID will have an important role to play in helping facilitate decision-making in the months ahead**