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**AN ASSESSMENT OF THE STATUS OF
PRIVATIZATION
IN THE ARMENIAN POWER SECTOR**

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I. INTRODUCTION¹

The purpose of this report is to provide an update on the status of energy sector privatization in Armenia. A similar report was prepared in late 1997 that reviewed the historic experience with privatization in Armenia and assessed the status of power sector privatization at that time.² This report is intended to provide an update on more recent events that have taken place and to outline the activities that should be the foci for the project team's ongoing efforts. The report presents:

- ◆ a listing of key privatization events to date demonstrating that the power sector is the logical next candidate for privatization;
- ◆ the legal framework supporting privatization and areas where additional improvement is desirable;
- ◆ current issues that affect power sector privatization and investor perceptions; additionally, the activities that should be pursued by the project team are described.

The report also includes several suggestions regarding possible next steps for USAID's further consideration.

II. KEY PRIVATIZATION-RELATED EVENTS TO DATE

Armenia has made substantial progress in setting the stage for energy sector privatization, despite significant obstacles over and above the usual hurdles that arise when ownership shifts from the public to the private sector.³

The following chart shows key events in a time-line format in order to illustrate the steady progress made.

¹ This report was prepared with the support of the U.S. Agency for International Development, as part of Subtask D, Task Order 3, Contract LAG-I-00-98-00005-00.

² See Hagler Bailly's report entitled *Status Assessment of Privatization and the Armenian Power Sector*, November 3, 1997.

³ Examples of these additional hurdles for Armenia include a severe economic collapse, political and military conflict and a legal and regulatory environment still under development.

Exhibit 1
Key Privatization-Related Events in Armenia

Year	Events
1991	<ul style="list-style-type: none"> ▶ Armenia's independence from Soviet Union ▶ Law on Enterprises and Entrepreneurial Activities enacted
1992	<ul style="list-style-type: none"> ▶ Law on Privatization and Denationalization enacted ▶ Bilateral Trade Agreement with the U.S. signed ▶ Land, agriculture, small enterprises are privatized
1993	<ul style="list-style-type: none"> ▶ Inter-Ministerial Privatization Commission (IMPC) established ▶ War and energy blockade consume government attention throughout 1993 and 1994
1994	<ul style="list-style-type: none"> ▶ Law on Foreign Investment
1995	<ul style="list-style-type: none"> ▶ Pledge Collateral and Bankruptcy Laws passed ▶ State-owned, vertically-integrated electric power company Armenergo broken up into generation, transmission, and distribution companies. ▶ Metzamor nuclear power plant restarted; Russia gains minority interest in return for fuel
1996	<ul style="list-style-type: none"> ▶ IMPC disbanded. Ministry of Privatization established by presidential decree ▶ Privatization program lists major energy assets as candidates for privatization ▶ Over 60 distribution companies consolidated into 11 distribution utilities, coterminous with the country's 11 political/administrative regions
1997	<ul style="list-style-type: none"> ▶ Energy Law passed by the National Assembly ▶ Energy Regulatory Commission established ▶ Small hydroelectric plants privatized (about 25 MW) ▶ International tender held to select World Bank-funded financial advisor ▶ Eleven distribution companies consolidated into four regional utilities in accordance with the project team's recommendations ▶ The national telephone company, Armentel, privatized; sold to Greek telephone company OTE through a strategic investor privatization ▶ Government Resolution 551 on Rehabilitation of the Financial Viability of the Energy Sector, calling for privatization using a strategic investor approach with at least 51% of shares offered
1998	<ul style="list-style-type: none"> ▶ Ministry of Energy publishes program for 1998 energy sector privatization ▶ Ministry of Finance/Economy sign contract with Raiffeissen Investments for distribution-sector privatization financial advice ▶ Yerevan Brandy Factory sold to Pernot Ricard in a highly controversial privatization. The National Assembly holds a special session and comes close to repudiating the deal ▶ Armenian Development Agency established to encourage investment ▶ Interministerial Commission commits to use International Accounting Standards economywide with partial implementation to begin on January 1, 1999 ▶ Government Resolution 555 calls for certain additional privatization-related tasks and establishes deadlines for their completion

As the exhibit demonstrates, to date only a small fraction of energy sector assets in Armenia have been transferred to private sector ownership (about 25 MW out of about 3,000 MW of installed capacity). Nonetheless, since the completion of the prior report in 1997, one positive development is the restructuring of the distribution companies in mid-1998. Armenia's

distribution sector was reorganized and consolidated into four regional utilities, in accordance with the project team's recommendations. This change created a smaller number of utilities of more significant scale, thus better positioning each to attract the interest of investors.⁴

Additionally, there is now consensus within the GOA that the distribution companies should be the first major energy sector assets to be privatized. The conditions in the third World Bank Structural Adjustment Credit (SAC-3) contain a timetable showing that at least the Yerevan Distribution Company should be privatized by July 1999. Essential events are taking place, such as the hiring of an investment advisors, so that distribution companies may be privatized this year, although some resistance can be expected.

There has also been considerable progress in establishing a legal and regulatory framework within which privatization may take place and a private energy sector company may operate. The Government confirmed its intention to privatization of the energy sector using a strategic investor approach through Resolution 551. The next section highlights the legislation and government resolutions that will most significantly impact the power sector privatization process.

III. THE LEGAL FRAMEWORK SUPPORTING PRIVATIZATION

III.1 Privatization Law

The Privatization Law, one of the first in the Former Soviet Union, was passed in 1992 and has been amended several times since. It establishes methods of privatization, such as open subscription, auction, domestic tender and international tender. The Law covers the voucher program (vouchers were used by holders to purchase small entities), establishes methods of valuation, and describes provisions for awarding shares to employees, pensioners, and disadvantaged citizens.

As of the date of this report, virtually all issued vouchers have been redeemed. Any future privatization transactions will be negotiated on a cash basis or some other basis not using vouchers. The voucher program worked well in that the coupons were widely distributed and were used to privatize relatively small-scale entities.

The Privatization Law allows for the use of a strategic investor approach. In fact, this approach was used to privatize a number of enterprises including the state-owned telephone enterprise Armentel. In the case of the power sector, Hagler Bailly has consistently recommended the use of a strategic investor approach as the most appropriate privatization technique for Armenia. This method allows Armenia to attract the capital and management expertise required to satisfactorily rehabilitate and operate the power sector enterprises.

⁴ The amount of due diligence and privatization preparation for a small facility can be similar to that required of a large facility. With larger assets potentially available, the investor interest level should increase.

One problem affecting the privatization of assets under the Law is the requirement that state-owned enterprises may not be sold for less than 50% of their designated minimum bid price. There is a debate among the Ministry of Energy staff over whether restated historic costs or "market value" should be used as the valuation method. If historic cost is the basis for valuation, then this 50% minimum will almost assuredly not be met. The project team should continue to provide assistance in this area to ensure that the minimum bid price is not used by opponents of privatization to hinder the privatization process.

III.2 Energy Law

The Energy Law was passed in July 1997. Arguably, its most important feature is to formalize the Energy Commission (Commission), which had been established by Presidential Decree earlier that year. Other key objectives of the law are to encourage investment, promote competition within the sector, enforce vertical unbundling of the sector, and permit open access to transmission and distribution.

One of the particular areas of relevance to potential investors concerns the level of electricity tariffs. Although the Energy Law provides for a two-year transition period to gradually increase tariffs to full cost recovery levels, the timing does not appear achievable. Recently, a special session of the National Assembly was convened due to the Energy Commission's decision to increase electricity tariff. Leaders of the opposition Hayrenik faction proposed freezing electricity rates and removing responsibility for tariff-setting from the Energy Commission. Only three votes were cast against the measure; fortunately however, the measure was defeated due to a lack of quorum. The majority Erkrapa faction did not participate in the voting. Clearly, this is a disturbing development which needs to be monitored carefully given the obvious impact such a decision could have on the investment environment. It is likely that such debates and discussion will continue through at least the first half of 1999, given the increasingly populist nature of the National Assembly membership and the upcoming Assembly elections.

A weakness of the existing Energy Law that may concern potential investors is the mechanism used for funding the Energy Commission; the Law provides that the Commission should be funded from the Government of Armenia (GOA) budget. This creates two potential problems: 1) the Commission has the potential to be underfunded and thus not be able to attract qualified staff members and ensure their professionalism; and, 2) the Commission runs the risk of funding problems should the Commission take an action that one or more political interests view negatively. In order to increase the likelihood of Commission independence, the project team is working with the Energy Commission and other interested parties in an effort to modify the Commission's funding method.⁵

⁵ The draft Memorandum of Understanding between the US Government and Government of Armenia pertaining to the \$15 power sector metering improvement program includes two reform covenants related to Energy Commission financing that should be helpful to both protect the Commission's current budget and seek introduction of a new, more independent, financing mechanism.

III.3 Privatization Plan

The Privatization Law calls for biennial plans for privatizing state-owned assets in all sectors. Each Ministry is responsible to present a proposed plan, which is then circulated, revised and approved by the Ministry of Privatization, the GOA, the Office of the President and the National Assembly.

The Ministry of Energy's proposed 1998-2000 privatization plan contains the timetable for specific assets to be privatized. A draft plan was issued in the Spring of 1998 and is the subject of continuing revision. A more recent version has not yet been released. The project team should continue to provide support to ensure that an updated privatization plan is adopted with appropriate implementation steps and timing.⁶

III.4 Resolution 551

Resolution 551, drafted by the Ministry of Finance/Economy and adopted in December 1997, introduced a financial rehabilitation and debt restructuring plan for the energy sector. Importantly, the Resolution includes the requirement that ownership of the majority shares of the electricity distribution enterprises be offered for sale to strategic investors. The Resolution stresses that all energy sector assets are to be eventually privatized with the exception of the nuclear station, Armenergo,⁷ and the Institute of Energy. The goal is to complete the privatization process before 2001.

As a result of Resolution 551, an Interministerial Privatization Commission was formed consisting of representatives from the Ministry of Energy, Ministry of Finance/Economy, Ministry of Privatization, the state enterprises, and Hagler Bailly. The Commission Chairperson ultimately prepared a draft privatization strategy that suffered from several weaknesses and was subsequently not adopted. It is likely that this draft strategy will serve as the "starting point" for the development of the new strategy as required by Resolution 555 as described below.

III.5 Resolution 555

Resolution 555 covers many of the same issues as Resolution 551. Resolution 555 provides a number of requirements, many of which directly affect the issues to be confronted and dealt with during the privatization process. For example, the Resolution requires that:

⁶ Coordination with Raiffeissen will be necessary.

⁷ At the time Resolution 551 was issued, Armenergo included the transmission and dispatch functions for the power sector. In mid-1998, the transmission function was divested from Armenergo and a new enterprise was formed – the High Voltage Electric Network Enterprise. Although privatization of dispatch is still not envisioned, there has been growing discussion regarding the role of privatization in the transmission subsector.

- ▶ Through an interministerial effort, a financial rehabilitation plan for the energy sector must be developed taking into account rehabilitation needs and costs. A method for the allocation of lost revenue resulting from nonpayment must also be determined.
- ▶ Financial recovery plans should be established for the irrigation, water supply, and district heating utilities, the first two of which are chronic nonpayers in the energy sector.
- ▶ Consumption limits for energy usage by state-owned enterprises will be set. The GOA will only ensure payment for electricity usage up to the level of the consumption limit. If the enterprise should desire usage over this amount, the GOA will not guarantee payment unless the Ministry of Finance/Economy grants permission.

Finally, Resolution 555 also requires that a draft agreement be developed for retaining the financial advisory services of Raiffeissen Investments and Ben Shahar Associates (Shahar) for the privatization of the electricity distribution sector. This agreement is now in place and work has begun. Coordination of the USAID's technical assistance efforts with Raiffeissen and Shahar will, of course, be desirable.

IV. ISSUES AFFECTING THE PRIVATIZATION PROCESS

The purpose of this section is to describe a number of issues and considerations that will need to be recognized due to their impact on the direction of the privatization process and investor perceptions.

The Role of the Energy Commission will be Closely Assessed by the Potential Investor; Some Aspects will be Viewed Positively while Others will be Seen as Risky

According to the Energy Law, an investor acquiring any energy sector assets in Armenia is subject to regulation by the Energy Commission. The two principal effects of this stipulation are that the investor will likely be subject to licensing and tariff regulation by the Commission. The Commission is charged with setting tariffs for generation, transmission, and distribution of electricity, and as such, an investor will likely be subject to tariff regulation in any of these areas.

The Energy Commission establishes tariffs using cost-based ratemaking principles. However, there is considerable pressure on the Commission to keep rates low. At the end of 1998, consumer rates were raised 12.5%, which is still significantly below the total cost of service and does not cover the level of inflation. In the process of valuing and bidding for assets, an investor will need to consider the expected tariff levels that are achievable and whether such tariffs can provide an acceptable rate of return. The Energy Commission and Ministry of Energy have expressed a willingness to endorse higher tariffs for generation in the event of privatization but whether there will be a similar willingness for distribution is still open to debate. The project team should continue to pursue this matter given its potential significance for the success of the distribution privatization process.

Another policy of the Energy Commission that has a potential impact on privatization is that in the present conditions of state ownership, financial losses from nonpayment are borne by the enterprises; tariffs do not allow for recovery of commercial losses. Although this policy provides an impetus for the distribution utility to pursue collections from consumers, the potential unwillingness of the Energy Commission to permit any commercial loss recovery will also be a factor of potential concern to investors.

Finally, as mentioned in the previous section, the Commission's independence remains threatened due to the fact that it is financed through the government budget. Furthermore, the recent attack on rates in the National Assembly is evidence that rates remain very controversial, a fact that will be closely contemplated by a potential investor.

The Ministry of Privatization is Unlikely to Play a Leadership Role; The Privatization Ministry Will Likely Defer to the Ministry of Energy

According to its charter, the Ministry of Privatization is to be involved in all privatization activities. However, with regard to the energy sector, the Ministry of Privatization relinquishes much of the responsibility for preparatory work and strategic analysis to the Ministry of Energy. Based on discussions with the Minister and Deputy Minister of Privatization, the Ministry of Privatization's role with respect to energy sector privatization will be to carry out those instructions as set forth by the Ministry of Energy. This illustrates that while the system has been designed with some degree of "checks and balances," influence over the energy sector privatization process still lies with the Ministry of Energy.

The Role of the Ministry of Energy and its Inherent Conflict as Owner/Operator and Seller of the Asset May Continue to Hinder the Privatization Process

The Ministry of Energy is the primary decision-making body with regard to energy sector privatization; at the same time, it is the *de facto* owner/manager of the assets. Unlike other countries that have something akin to a State Property Management body that serves as a trustee during the privatization process, in Armenia no such body exists. By keeping the ownership and management control of the enterprises within the Ministry of Energy, an additional barrier for the privatization process is created resulting from the obvious difficulty associated with loss of control and the financial resources that come with such control. This is one of the primary reasons for the continual delay witnessed in the privatization process.

The Ministry of Energy continues to have the majority of influence in the energy sector privatization process. One indication of the Ministry of Energy's central role may be seen through an example from the pilot privatization program of small hydroelectric projects that began in late 1996. One of the new plant owners was experiencing difficulty receiving payment for electricity by Armenergo. Despite Armenergo being corporatized, to resolve the problem, the new owner raised the issue with the Ministry of Energy rather than the Energy Regulatory Commission or the Ministry of Privatization. This concentration of political power will be an

impediment to privatization to the extent that investors do not see a strong institutional framework supplanting the role presently played by the Ministry of Energy.

The appointment of a new Minister of Energy on November 15, 1998 is expected to have policy implications for privatization. Given the Minister's prior tenure at the Ministry of Finance/Economy, there is reason to be hopeful that the process of privatization (as well as other reform steps) will accelerate.

The Ministry of Finance/Economy as well as the Minister of Economic and Structural Reform will be Important Catalysts for the Privatization Process

The Ministry of Finance/Economy continues to play an important role in the preparation for privatization. The Ministry is in a lead role at present in addressing the problems associated with the flow of financial resources in the sector. The Ministry has overseen the introduction of a new consumer payment process where consumers are now required to pay electricity bills at local banks, rather than directly to utility collectors. The Ministry is also reviewing the entire financial settlement process and considering ways to ensure better flow of funds throughout the power sector.

In the privatization of major energy assets, the Ministry of Finance/Economy will have a key negotiating role, including assessing tradeoffs regarding payment and potentially required GOA-backed financial guarantees.

During the past year, the Ministry of Finance/Economy has been more active on reform issues than the Ministry of Energy. The project team should work closely with the Ministry of Finance/Economy as a main counterpart for the privatization policy and strategy development. The Ministry of Finance/Economy's role will also be important to help overcome some of the resistance to privatization that may be witnessed within the Ministry of Energy and the enterprises.

Recent Movements at the National Assembly Threaten the Success of the Privatization Process; Nonetheless, the Reason for Some of the Opposition to the Privatization Process is Understandable

From a legal standpoint, the National Assembly should not have a major role in energy sector privatization since this branch of government has already approved the basic privatization program that includes the energy sector enterprises. However, negative public reaction to the privatization of the Yerevan Brandy Factory and Armentel may impact the degree of the National Assembly's involvement. The National Assembly recently considered, and rejected, a proposed new law that would have given the Assembly the right to ratify agreements reached between the GOA and potential investors. This post-negotiation review, if mandated, would have been viewed as a potential risk for an investor, since it would complicate the number of players and approvals required in the privatization process.

While there will always be some anti-privatization sentiment, the underlying intent of the proposal ultimately rejected by the National Assembly was intended to address a significant problem in Armenia privatization: that is, a lack of sufficient transparency in the privatization process. Both the Yerevan Brandy Factory and Armentel were privatized in a relatively secretive manner. There is no record of competing bids; there was no public involvement in the process, little pre-privatization publicity, and importantly, no significant effort to avoid the appearance of impropriety.

The transparency of the privatization process must continue to be stressed by the project team as an important objective for the success of the privatization process.

Market Rules Are Not Yet in Place; This Should be Addressed Prior to the Privatization Offering

The market rules are, of course, very critical for the potential investor to understand in order for the investor to determine the value of an asset. Critical questions such as the possibility of open access, bilateral contracts, settlements and funds administration should be resolved and a set of market rules adopted prior to the commencement of the due diligence process. At present, the Energy Commission is taking a lead role on the development of the market rules; the project team is supporting them in this effort. A World Bank condition requiring Commission approval of a set of market rules by mid-1999 should provide the impetus necessary to ensure progress in this area continues.⁸

The Lack of a Clear Government Decision on Hrazdan 5 Complicates the Privatization of Generation

The partially-completed unit 5 at the Hrazdan station will affect the privatization of generation until there is a clear GOA decision on what is to be done with the plant. If Hrazdan 5 is completed, it could be more efficient than existing fossil fired plants and could lead to little use of other existing gas-fired units. At the same time, the unit would not be as efficient as a new combined cycle facility. A new combined cycle would in turn make the completed Hrazdan 5 unit obsolete. Although the privatization of distribution can move forward without a final decision on Hrazdan, attracting private investment into the generation sector will be difficult until the GOA finally decides how it intends to handle Hrazdan 5. One option, recommended by the project team, is to consider tendering the plant in its present condition just to see what alternatives potential bidders may have for completing the station or using some of the partially completed facilities already in place. This would be relatively low cost and could yield potentially quite useful alternatives for how to capture some of the value from the partially completed unit.

⁸ A covenant in the draft US Government/Government of Armenia Memorandum of Understanding will also help encourage market rules development and codification.

There is Growing Interest in the GOA Regarding Investment Attraction in the Transmission Sector and the Role that may be Played by the Private Sector

While distribution and generation have historically been slated for privatization, recently there has been discussion of privatizing transmission as well. This is the result of the realization that significant investments, on the order of \$300 million, are needed in the transmission sector for rehabilitation and upgrade. Although transmission is considered a strategic asset, the high level of investment requirements cannot be met by the resources of the enterprise nor by the state budget; outside investment is required. The project team is supporting this review of the ways to attract investment into the transmission sector.

V. NEXT STEPS

During 1999, the main focus for privatization in Armenia (if events go as planned) will be the offering of a majority financial interest in the Yerevan Distribution Company. The GOA, the World Bank and donor organizations, such as USAID, have reached consensus that strategic investor privatization of this entity is the next major step for privatization in Armenia. Looking forward two to three years, it is anticipated that a significant portion of the energy sector in Armenia will be under the ownership and operating control of private parties.

In order to privatize Yerevan Distribution Company by July 1999, a significant amount of preparatory work must take place during the first half of the year. It is not certain that GOA officials understand the scope and need for the preparatory steps, the time frame for action, the needs of potential investors nor the appeal of the transaction.

In light of the present status of privatization, a number of steps are recommended in order to support the privatization process. These include:

- ◆ Hagler Bailly has distributed a privatization checklist to relevant Armenian government officials and has set forth an implementation plan and timetable for privatizing Yerevan Distribution Company.⁹ Discussion in this area should continue in an effort to ensure adoption of a reasonable plan and timetable.
- ◆ The project team should support the GOA request for consideration of ways to attract investment into the transmission subsector. The objective should be to gain a consensus on an investment attraction strategy for the sector.
- ◆ Given that the GOA has retained an investment advisor for distribution, the project team should focus its policy related efforts and privatization strategy development activities on the generation and transmission subsector. At the same time, the team should support the distribution investment advisor through close coordination, sharing of information and

⁹ This was initially completed as part of the privatization subtask of Delivery Order 15.

“packaging” of workproducts or other information that may be useful for the due diligence process. This could include, for instance, summarizing design features and results of the project team’s pilot metering, billing and collection program.

- ◆ A “critical path” item for the privatization process is the development and adoption of market rules. Although privatization of distribution can move forward in the absence of such codified market rules, it is much more preferable from an investor’s perspective to have the rules already in place at the time of the privatization offering.
- ◆ Asset valuation of the enterprises will continue to be a difficult area of assistance. The minimum bid requirements imposed under Armenian law could thwart the privatization unless the Ministry of Energy can be persuaded to use a low “market-based” valuation. This is an area where close coordination with Raiffeissen will be useful.
- ◆ Further, there needs to be better public communications about the privatization process. This was not the case for some recent strategic investor privatizations and as a result, in at least two instances, the transactions were almost overturned by the National Assembly.

Finally, as noted in the prior section, there has been growing political opposition to the privatization process over the past year. Given the upcoming elections, some public opposition to the privatization of distribution can be expected. This opposition can be overcome, at least in part, if the privatization occurs in an open, well-publicized manner. It will be helped further if the GOA, its Ministries and the Energy Commission take specific steps (e.g., adoption of market rules) designed to boost investor confidence and lower perceived risks thus helping to increase the likelihood of receiving credible bids from credible investors.