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USAID ROMANIA
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PROPOSED PRIVATIZATION STRATEGY POLICY FRAMEWORK FOR THE ROMANIAN POWER GENERATION SECTOR

PRESENTATION TO THE ROMANIAN ENERGY POLICY ASSOCIATION/APER

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Background and Introduction

- The Government of Romania is presently in the process of privatizing its electric distribution system, and is preparing to privatize the power generation sector in accordance with the Medium-Term National Strategy for Energy Development covering the period 2001-2004
- This plan calls for the privatizing 25-40 percent of Termoelectrica's thermal power assets by 2004, as well as encouraging investors to complete the construction of several unfinished hydro sites on a BOT basis
- The U.S. Agency for International Development has provided a major technical assistance package to the Ministry of Industry and Resources to develop further the privatization strategy, and the international law firm Hunton & Williams was selected to assist MIR to develop a proposed generation privatization strategy for consideration by the Government of Romania

Key Drivers for Privatization of the Generation Sector

1) A desire to attain European accession which requires accelerated economic growth, market reforms, and environmental emission compliance for the generation sector as a whole
2) The fiscal discipline mandated by the IMF and World Bank which imposes sector spending ceilings and limits on new debt
3) The lack of sufficient investment capital to modernize the power generation sector so that it will be both more efficient and environmentally compliant in the longer run

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Re-Statement of the Government of Romania's Privatization Objectives

- Progress towards achieving EU accession in terms of environmental compliance, utility restructuring, and market liberalization
- Introduction of private owners/operators and increased competition in the generation sector
- Encouragement of improved plant operating efficiency and maintenance practices
- Expansion of reliable and secure supplies of electricity for the people of Romania
- Provision of lower cost electricity over the loner term than might otherwise have been possible with the status quo

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Re-Statement of the Government of Romania's Privatization Objectives (Continued)

- Leveraging of private investment capital for plant modernization, upgrades, and even replacement of outmoded facilities over time
- Generation of revenue for the State Treasury from the initial sale proceeds, as well as increased tax revenues from these newly profitable plants in the longer run
- Future revenue generation from the increased value of shares still held by Government in these newly privatized companies
- Attainment of specialized skills and knowledge regarding both integrated European utility market operations and electricity export markets
- Minimization or mitigation of the likely near-term social and employment disruptions from privatization of this sector

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Attainment of Selected Privatization Goals and Objectives by Privatization Method

Privatization Objectives	Concession Method	BOT Contracts	Auctions	Capitalization & Public Sale	Trade Sales Grouping
Progress towards EU accession requirements			●	●	●
Introduction of private operators & competition		●	●		●
Improved plant operating efficiencies	●	●	●		●
Expansion of reliable, low cost energy	●	●			●
Provision of lower cost electricity in long term		●	●		●
Leveraging of new investment capital		●		●	●
Generation of revenue for the State Treasury			●	●	●
Future revenue from increased value of shares				●	●
Expertise on European market operations	●				●
Mitigation of social disruptions and impacts			●	●	●

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Hallmarks of a Sound Privatization Strategy

- The potential capacity offered must exceed 2,000 MW in available capacity to be considered credible and attractive
- Assets being offered must be free of burdensome debt
- The strategic investor must have full corporate and operational control of the transferred assets
- The generation assets being offered must be comprised of both thermal and hydro assets so as to insure a cost competitive asset bundle from the outset
- Mitigation of social disruptions brought on by work force adjustments
- Foster greater energy supply security for the country as a whole
- Increased financial viability of the remaining public sector generation entities
- Create a truly competitive electricity sector so that longer-term tariffs will be lower than they might otherwise have occurred

Romanian Generating Capacity Available for Privatization

- While Romania currently has an overall installed electric generating capacity of 19,596 MW, when planned transfers to other jurisdictions and strategic assets are subtracted, the remaining available capacity for potential privatization is about 15,873 MW as indicated in the table below:

Overview of Romanian Generating Capacity Available for Privatization

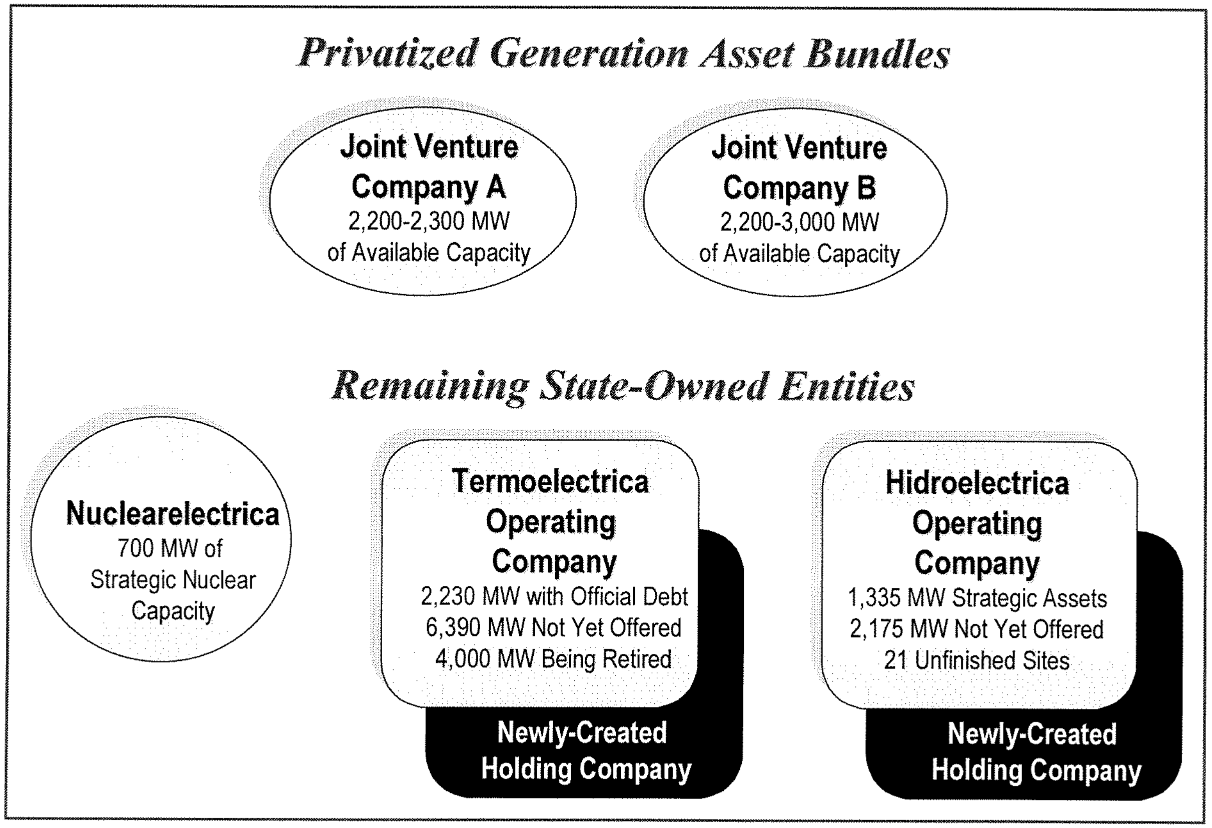
Plant Type	Current Installed Capacity	Less Strategic or Transferred Asset	Net Capacity Available
Large Thermal Plants	11,303 MW	0	11,303 MW
Smaller CHPs	1,688 MW	1,688 MW	0
Hydro Cascades	5,905 MW	1,335 MW	4,570 MW
Nuclear Station	700 MW	700 MW	0
Total	**19,596 MW**	**3,723 MW**	**15,873 MW**

The Case for Re-Bundling Thermal and Hydro Units

- The asset ownership side of the Romanian electricity sector has undergone profound changes over the past several years, not all for the better.
- The division of generation into thermal and hydro entities hinders competition in the sector, and seriously harms the thermal generation owner -- at a time when Termoelectrica needs significant capital infusions for plant modernization and environmental retrofit programs
- To stimulate increased competition in the electricity sector, while at the same time leverage private capital to undertake necessary plant modernizations and environmental retrofits, generation assets must be bundled to create viable national players, without regard to asset type

Illustration of Suggested Market Structure Organization in 2004

SUGGESTED MARKET STRUCTURE IN 2004



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Suggested Romanian Electricity Market Structure by the Year 2004

- If the Government of Romania adopts and implements the proposed Hunton & Williams privatization strategy, then the electricity market structure by the year 2004 will be comprised of the following components:

➢ Two privately owned asset bundles of approximately 2,200–2,300 MW each in available capacity structured as joint venture companies with both Termoelectrica and Hidroelectrica owning not greater than 39.99 percent

➢ Nuclearelectrica with approximately 700 MW in installed nuclear capacity

➢ Hidroelectrica with 1,335 MW in strategic assets and approximately 2,175 MW in available hydro capacity assets that have not yet been offered for privatization, for a total remaining installed capacity of 3,510 MW

➢ Termoelectrica with approximately 2,230 MW in currently available capacity from Deva, Bucharest South, and Braila, plus approximately 6,390 MW in installed capacity which has not yet been offered for privatization, including about 4,000 MW in aging and obsolete capacity that will be in the process of being retired over time according to an agreed upon schedule

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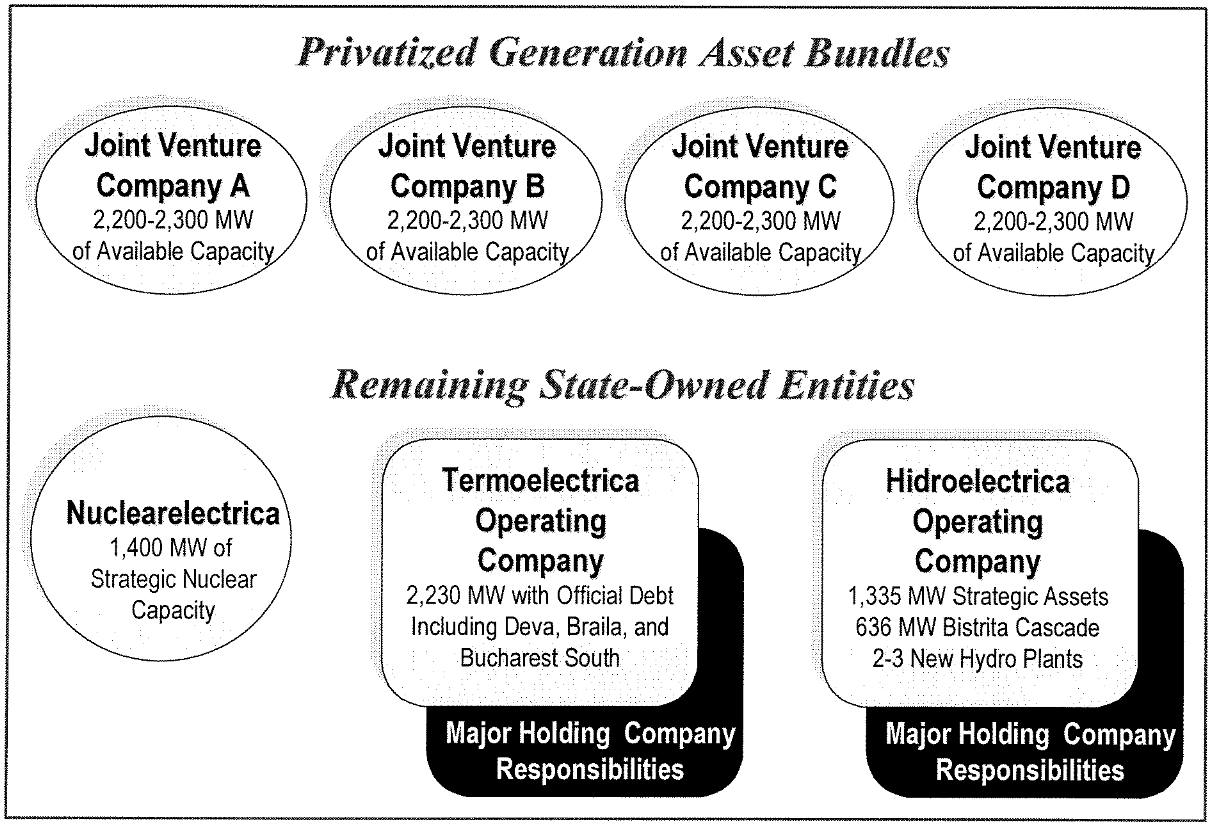
Illustration of Suggested Market Structure Organization in 2007

SUGGESTED MARKET STRUCTURE IN 2007



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Ultimate Romanian Electricity Market Structure Within Five Years

- If the Government of Romania continues to implement the proposed Hunton & Williams privatization strategy over the longer term, then by the year 2007 the Romanian electricity market will encompass:

➢ Four privately owned asset bundles of approximately 2,200–2,300 MW each in available capacity structured as joint venture companies with both Termoelectrica and Hidroelectrica owning not greater than 39.99 percent

➢ Nuclearelectrica with approximately 1,400 MW in installed nuclear capacity, assuming that Cernavoda Unit 2 is completed as scheduled

➢ Hidroelectrica will still remain with 1,335 MW in strategic assets from Iron Gates I & II and 636 MW from the Bistrita Cascade that was not made available for privatization due to age, advanced reservoir silting, and potential structural problems

➢ Termoelectrica will still remain with approximately 2,230 MW in currently available capacity from Deva, Bucharest South, and Brail, which are some of the most competitive and recently upgraded thermal plants in the country

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Specific Characteristics of the Proposed Hunton & Williams Privatization Strategy

- The initial privatization phase offering will consist of two 2,200-2,300 MW bundles of combined thermal and hydro available capacity, with one being anchored by a major coal or lignite-fired power station and the other being anchored by a major hydro cascade
- Each generation asset bundle will be offered preferably debt free or at a minimum, without burdensome debts
- The assets of each generation bundle will be owned by a Romanian joint venture company, with 60.01 percent of the shares held by the strategic investor and 39.01 percent of the shares held collectively by Termoelectrica and Hidroelectrica; the strategic investors will be permitted to exercise full management and operating control over all aspects of these enterprises
- The strategic investor will acquire his shares for cash at terms and conditions to be agreed upon with the Government of Romania

Specific Characteristics of the Proposed Hunton & Williams Privatization Strategy (Continued)

- The share split between Termoelectrica and Hidroelectrica will be proportional to the average electricity production in GWh over the previous two years from the respective generating units being contributed
- The Government, through its thermal power asset management agent, Termoelectrica, must agree to retire approximately 4,000 MW in aging and obsolete installed capacity over an agreed upon period of time
- So that these generation asset purchases can be financed on a project finance basis, ANRE will insure that an adequate number of annual portfolio contracts with Electrica and/or any newly privatized electric distribution companies are assigned to the joint venture company sufficient to cover principal and interest on loans, fixed O & M expenses, and an adequate return to investors

Specific Characteristics of the Proposed Hunton & Williams Privatization Strategy (Continued)

- The new joint venture company must agree to maintain minimum available capacity limits over time as specified in the tender documents and determined by ANRE, but strategic investors should not be required to upgrade or refurbish any specific plants or facilities in their generation asset bundle -- they must have the flexibility to meet these capability obligations in any manner they deem most cost effective
- Each new joint venture company must also agree to meet all legally required EU emission standards, whether by the retrofitting of existing available capacity, retirement and subsequent construction of new capacity, fuel switching, the use of carbon emission credits, or some combination of the above, with appropriate penalties for failure to comply

Specific Characteristics of the Proposed Hunton & Williams Privatization Strategy (Continued)

- A USD50-75 million fund will be created out of funds received by the Ministry of Public Finances from either the privatization sales to be applied to mitigate the potential social impacts and workforce dislocations that are likely to occur as a result of privatization, primarily by funding job placement and retraining programs for displaced workers, early retirement buy-outs for older employees, and depending on seniority, up to 24 months of base salary for severance payments to assist the worker and his family to transition to a new job or field of endeavor
- In addition, the fund manager and trustees will be empowered collectively to make investments in qualified acceptable securities thereby helping to mature local capital markets

Preliminary Financing Plan for the First Indicative Generation Asset Bundle

- It is assumed that the total amount of financing to be raised for this asset bundle through a project financing is 500 million U.S. Dollars, and that the new owner of these assets will be a Romanian joint venture company whose outstanding shares are held as follows: 60.01 percent by the private strategic investor, and the remaining 39.99 percent by both Termoelectrica and Hidroelectrica
- It is understood that the Government of Romania may not be providing any performance undertakings or sovereign guarantees for this project financing
- A 70/30 debt-to-equity ratio appears to be an appropriate level of gearing for this proposed $500 million generation acquisition and planned modernization program for the first indicative asset bundle on a project finance basis, especially given the high caliber of strategic investors that have already expressed interest in such a transaction

Achievement of Important Policy Goals

- From an overall national political perspective, the proposed generation privatization strategy achieves several important policy goals and objectives:
  - It addresses all major European Union accession requirements for the power generation sector in a timely and forthright manner, including resolution of all key issues raised during negotiations on the Energy, Market Reform, and Environment Chapters
  - It will result in a more highly competitive electricity sector over time
  - It raises considerable revenues for the Treasury that can to be used for high priority policy initiatives on a national scale in the power generation, district heating or other sectors
  - It provides a built-in solution for fairly and equitably dealing with displaced workers and their families by creating a temporary disposition fund to serve as a social safety net during this transition period