

**The Government wants to create two integrated companies on the Romanian electricity market. A bad solution, thinks Ana Otilia Nuțu**

# ROMANIA'S TURNAROUND IN THE ENERGY SECTOR



The saga of the energy sector restructuring continues, this time with an idea that is even worse than the previous proposal of the Tăriceanu government. If at that time the government proposed one energy behemoth, now we would be blessed with two. They would include mining and gas, wrapped together in a uniquely non-transparent, inefficient structure.

The new strategy published on the website of the Ministry of Economy proposes again a restructuring in the electricity sector. Unlike last year, there will be two companies instead of one:

- **the first one (S1)** would include the 3 energy complexes (Turceni, Rovinari, Craiova); two units from Hidroelectrică (Vâlcea, Slatina); nuclear (Units 1 and 2 Cernavodă); the lignite company (SNLO); and a part of Electrica. Its structure consists of 34% nuclear, 10% hydro, the remaining thermal and would represent 48% of the electricity generation in Romania;
- **the second (S2)** will comprise the largest part of Termoelectrică (Deva, Paroșeni, ELCEN); the part of Hidroelectrică not contained in S1 (Iron Gates; SH Sebeș, Buzău, Târgu Jiu, Caransebeș, Hațeg, Argeș, Cluj,

Bistrița, Sibiu); the hard coal company (CNH); ROMGAZ; the remaining from Electrica. Its production structure would be 38% hydro, the rest thermal, and the company would have 44% of the generation market.

The Ministry expects that by 2013 the market shares of the two companies would decrease to 41% and 34%, respectively, as additional generation capacities from private investments would become operational. PETROM would have then 10% (Brazi plant, 860 MW); ENEL would also have 9%.

There are several reasons why we are just as worried about the new approach in reorganizing the energy sector as we were last year about the creation of a "national champion" <sup>1</sup>:

1. **The objectives of the strategy are fundamentally wrong:** the promotion of energy independence, the sponsorship of a "national energy identity", the sustainable development of the national energy sector by environment and new technology investments, the creation of strong companies on the regional market, the optimal coverage of the consumption peak-low curve, sector capitalization, maintaining the jobs in the mining sector – all seem reasonable goals, but they are not the key priority of an energy strategy. In addition, some of these goals are inconsistent with each other.

The main objective of an energy strategy is **securing the energy supply at competitive prices**. All the other goals are secondary to this key objective. One cannot achieve two incompatible goals with only one public policy measure. For example, it is virtually impossible to increase the funding (capitalize) the sector (by private investments on the market,

which require profit maximization) and at the same time to keep the jobs in loss-making sectors, such as mining. Not to mention that consumer prices are generally lower (more competitive) when the supply is more fragmented, so concentrating the market in "large, strong companies" would defeat this objective (Fig. 1).

2. Last year we complained that the creation of a national champion would raise serious issues of non-transparency. In the revised strategy, **the new holdings would contain also important shares of other sectors (mining, gas), and our concerns about transparency are even greater**. One could easily hide subsidies to the bankrupt mining sector, even though the state aid for hard coal should be discontinued in 2010, according to what we negotiated for EU accession. The state has always been a poor manager of the mining sector, and the new approach would simply



Source: Eurostat, 2008

<sup>1</sup> Don't reverse the reforms in the energy sector, SAR Policy Brief No. 33, August 2008, <http://www.sar.org.ro/files/Policy%20memo33-en.pdf>

create the temptation to divert funds from Hidroelectrica and ROMGAZ to cover the losses in the mining sector. The National Hard Coal Company CNH owes 3 billion RON to the state, including penalties. No wonder it pressures the government for debt rescheduling and the extension of the subsidies until 2014-2018.

In addition, funds would probably be redirected from Hidroelectrica to Turceni and Rovinari, in a desperate attempt to save them from closure, even though this is very likely no longer justified in economic terms. ENEL, EON, CEZ, PETROM are all interested in investing in generation capacities, and they bring new technologies that would turn the energy complexes in S1 inefficient. Turceni and Rovinari would probably have to be gradually closed in the following years, as they were not upgraded timely to meet the environmental standards agreed with EU during negotiations. To finish these works in time, they should have started in 2004-2005 and, as no money was available from the budget, the only viable option would have been to privatize them. However, the populist temptation to "maintain state control in a strategic sector" was too strong.

Meanwhile, Hidroelectrica is chronically underfinanced, because the prices at which it sells electricity (the so-called "cheap hydro power") are too low to cover the rehabilitation needs for power plants and dams. It is very likely that in the new two-holding structure Hidroelectrica would cross-subsidize the mining and thermal sectors – or fall prey to other impractical ideas that occur to political leaders<sup>2</sup>. Also, the much-needed funding for the construction

of Units 3 and 4 Cernavodă (which the state intends to keep for energy security reasons) could be directed to covering losses in the lignite company in S1.

Curiously, the Ministry of Economy does not even try to conceal its intentions: one of the publicly stated objectives of the strategy is "maintaining the jobs in the mining and thermal power sector", instead of focusing on improving the sectors' efficiency and to cut the perfusions with monies from the state budget.

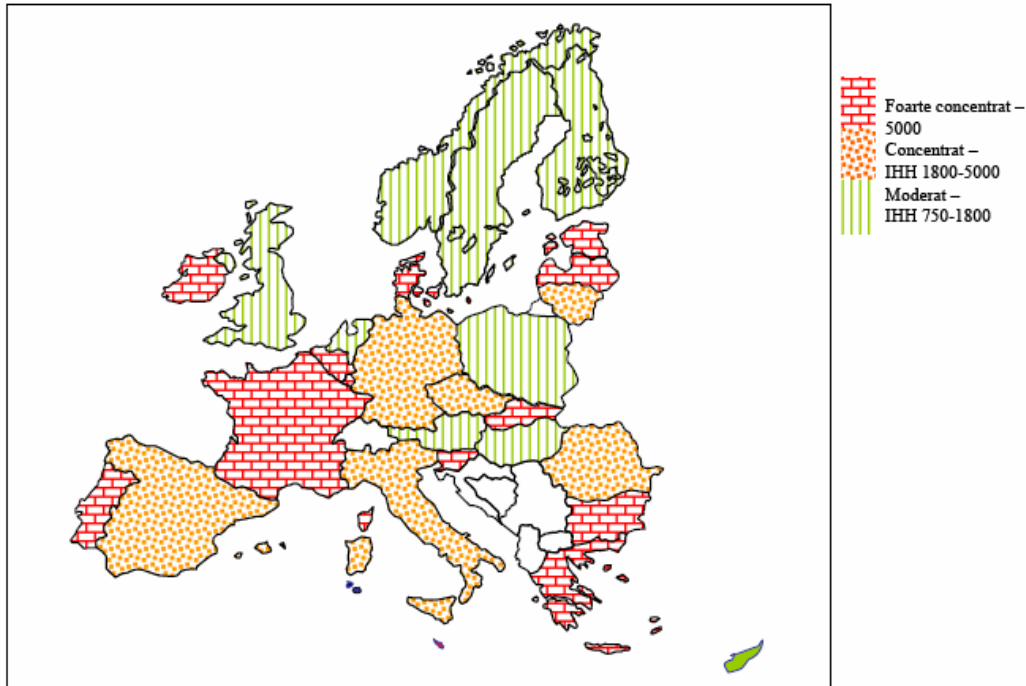
3. Last year we mentioned that state-owned companies which sell or buy energy are required by law to do so on OPCOM, but these companies are individually nominated in a list attached to the law. No matter how the new entities would be grouped, **there is a risk that, until the list is updated to include the new companies, there would be a time interval in which they would be exempted from the requirement to trade on OPCOM.**

The new entities might be able to conclude contracts outside the transparent, competitive market. We were saying in August 2008 that the liberalization of the energy market has stabilized at around 50%, but after a rapid growth from 10% in 2001 to 50% in 2007 the market opening has stalled. The segment of bilateral contracts concluded outside the competitive market has not declined, and the share of "cheap electricity" from Nuclearelectrica sold outside OPCOM has even increased.

4. **We do not understand why the mix of thermal, hydro and nuclear generation must be created by administrative fiat.** Also, it is not clear what the benefits from the vertical integration of distribution and generation are, when the management skills needed for the two types of operations are different. The proposed strategy of the Ministry does not clarify these

<sup>2</sup> For example, according to an anti-crisis plan announced a few days ago by the PSD leader, the "cheap hydro electricity" should be used to provide additional subsidies for irrigations, which are already partly subsidized by the government.

Fig. 2. Market concentration in the EU



Source: EC, 2008

aspects, but takes them for granted and builds its arguments on them.

In reality, hydro, thermal and nuclear power plants can enter a direct competition and the consumers, on a competitive market, would purchase an energy mix, to diversify their sources and minimize the potential losses caused by a draught season, for example (when hydro and nuclear electricity are not produced). In their turn, producers can invest in different generation capacities, depending also on what they consider to be more profitable and less risky. This is the manner in which the companies from other European countries that the Ministry gives as examples have constructed their generation mix. These have built their diversified production structure based on mergers and acquisitions, not by a Minister's administrative decision.

In addition, the "cheap electricity" that the "smart guys" allegedly obtain from Hidroelectrica is a result of preferential contracts and trading outside the competitive market

OPCOM (where there would be transparent competition among consumers). These "special" prices do not cover the much needed future investments in Hidroelectrica, hence the illusion of the very cheap electricity generated by hydro. On a well-functioning, competitive market, the equilibrium prices would adequately reflect risks and preferences of market participants.

5. **The concentration on the electricity market, while slightly below EU average, is still above the level that the EU targets (Fig. 2).** There are only 8 member states where the concentration is average, close to European Commission targets (HHI 750-1800); 6 members with a high concentration (HHI 1800-5000, among which Romania), and 13 countries with very high market concentration (IHH above 5000); see Fig. 2. Grouping any entities in large companies with generation mix increases the market concentration, against the EU trend.

6. **The cancellation of CNH and Termoelectrica's debts to the state, by transforming them into public debt, perpetuates inefficient practices incompatible with the market economy.** CNH owes almost 3 billion RON to the state budget, whereas Termoelectrica more than half a billion. The possibility of canceling these debts was discussed and appeared in the media, even though it is not mentioned in the strategy presentation on the Ministry of Economy's website. Canceling such debts is however a return to past, wasteful practices of soft budget constraints from the early '90s. It would not stimulate efficiency in the ways these companies operate and would be immediately sanctioned by the European Commission as unjustified state aid. At the same time, such measures could block the trenches from the IMF / World Bank / EC / EBRD / EIB 20 billion EUR loan. To a certain extent, the Ministry seems to be aware of these risks, and promised in the media to consult the EC and the IMF before a final decision.
7. **Paradoxically, the state control would be more effective on an atomized market, with competing, private generation units, than on a market controlled by big state owned companies.** Where the market power is shared among a large number of competitors, independent from the Ministry (which prepares the energy strategy and could maintain ownership in several "strategic" units) and from the regulator (ANRE), the opportunities for a single player to control the market are limited. Also, the state can supervise much more effectively the well functioning of the market through its regulatory agencies – ANRE (well-regarded in the region for its technical competencies) and the Competition Council. The competing companies would complain immediately if one of the players (private or state-owned) breaks the rules, which reduces the corruption risks. If, however, the market is shared among one or two state owned companies, they would be controlled by the Ministry with little supervision from other stakeholders. This reduces accountability and increases the chances for new "smart guys" to appear.
8. **Merging the companies in the proposed structure would not reach the stated objectives of the strategy.** Just like in the case of the national energy champion, creating these new structures changes absolutely nothing in the real sector, as it is simply an accounting trick. The Ministry argues that the proposed restructuring contributes to the country's energy security and the reduction of import dependency. However, we see no reason why the companies in the structure from today cannot purchase gas, lignite and hard coal from ROMGAZ, SNLO, and CNH, respectively, if the prices are justified in economic terms. The Ministry also states that the new structures would invest in technology improvements to increase energy efficiency and protect the environment; there is no reason why these investments cannot be made today or, what is more, they would be better sustained financially from privatization proceeds of state owned companies for which there is demand from investors even during the crisis.
- Regarding the regional competition, as we said last year, this depends much more on whether transmission networks are interconnected and on whether a regional market functions well (OPCOM). By simply merging the companies, one does not match better the supply with peaks in consumption. This matching can be improved only if new investments are made, and not by simply reorganizing the accounting of existing units. The harmonization of

the investment programs in gas, coal and electricity generation would be equally possible in the existing structure, as the state is even today the only shareholder. Additional capitalization is possible only if new financial resources are tapped, preferably by privatizations with strategic investors. The option considered by the Ministry of Economy (to sell shares in the newly established companies on the stock exchange) would encounter the same problems that we highlighted in our previous paper: the crisis does not allow substantial gains from the stock exchange, and the listed companies must show a past track of a minimum 3 years of good financial and economic performance, which is not the case (if we consider only the losses incurred by Termoelectrica, SNLO and CNH).

#### What we recommend

- As urgent funding is needed to upgrade some existing capacities, **private competition must be allowed in the generation units and in the remaining state-owned distribution.** State-owned generation should be divided into smaller units and then sold to strategic investors. These investors would also have competencies to improve the efficiency in the mining sector, where the state has had more than one occasion to show its management skills. We recommend that the Electrica privatizations continue (particularly because the 5 privatizations completed so far were a big success); we also support the privatization of mining operations that are viable and the closure of the loss-making ones. Turceni, Rovinari and Craiova must be put for sale (hoping there is still any interest in them from the private sector); and the micro hydro power plants. The state can use the sale proceeds to invest in Units 3 and 4 from Cernavodă, if it wants to keep a

strategic interest in these companies; whereas Electrica, by selling its shares in the three distribution companies in state ownership can invest in generation.

- **The practice of preparing new strategies without proper consideration of their impact must be abandoned.** A major obstacle for private investments has been the volatility of strategic vision and the perception that new actors playing by different rules might appear (state monopolies with preferential conditions). The Road Map 2003-2013, agreed with EU during accession negotiations, and the energy strategy prepared in 2007 (except for the much-contested paragraph regarding the national energy champion) must be implemented.
- **All energy transactions of the state owned companies should take place on OPCOM,** to increase their transparency and avoid suspicions of corruption, to create a real competition among producers and among consumers, and to ensure transparency of the real energy costs and prices.
- **We recommend that units be kept separate.** There is no reason why the objectives proposed by the Ministry of Economy cannot be attained in the existing structure, since the "state" is even today the shareholder in all the companies. Nothing changes for the better in the proposed option, while the current structure ensures at least transparency in the relationships among companies.

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