Energy sector privatization, Hungary (1995)

‚Lessons learned' for Ukraine

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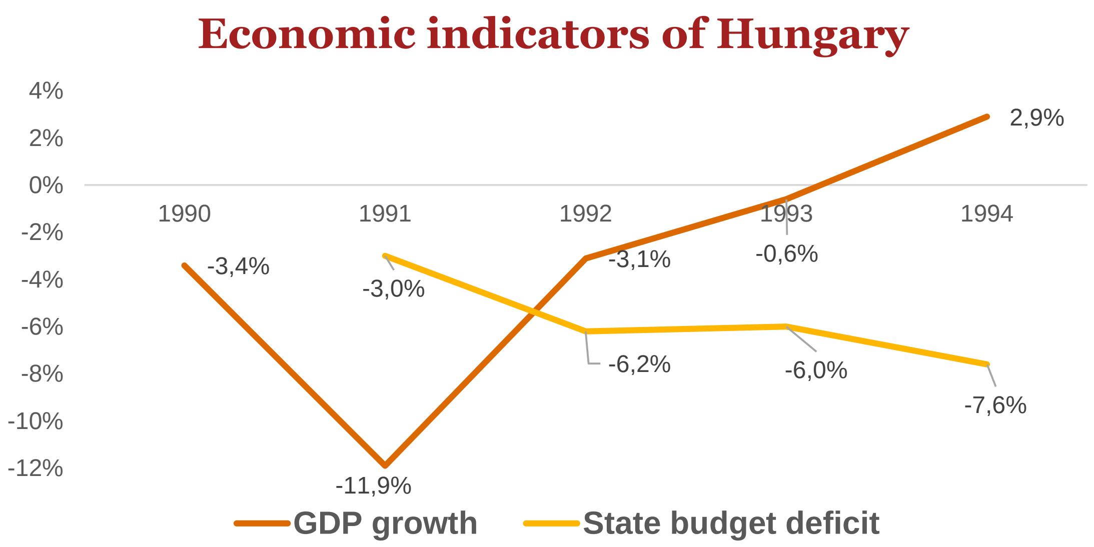
Background – economic situation of Hungary in 1994-1995



Hungary got close to bankruptcy by early 1995. The government had no other option than to introduce heavy stabilization package („Bokros package"). Energy sector privatization was an important part of the stabilization package.

1980s

Hungarian economy began to suffer, mainly due to consumer subsidies and inefficient state enterprises.

1989-1991

Change of regime in the CEE region, collapse of Hungary's main export markets (former Soviet Union and the Council for Mutual Economic Assistance countries).

Early 1990s

Cca. 18 % drop of the GDP.

Despite of the poor economic performance, Forint was artificially supported, purchasing power was also artificially increased, thus the whole economic situation was unsustainable. Therefore, government debt rose to 90% of the GDP

May, 1994

New government elected. They had to realize that Hungary is running towards bankruptcy.

Privatization process: Preparation and Background

Key milestones

1992-1993: Premature and unprepared privatization attempts

1993: Preparation of the new operational model begins

1994: Creation of a privatization strategy

December 1994 - July 1995: Government decisions on the preparation of the privatization

July 1995
Information Memorandum is finished

Background information

- Failed privatization attempts on the DSO companies (bids were well below acceptable thresholds)
- **International advisors** (Schroders) were contracted for the development of a new operational model and the privatization strategy
  - **New operational model** in the energy sector and new pricing regimes to ensure fair return on investment
- **Privatization strategy** is formalized (what to sell, how to sell, when to sell)
- **Government decision** to start privatization procedure for the natural gas and electricity DSO/supply companies and the most important power plants
  - With Schroders' support, the Information Memorandum (IM) was prepared (including description of the business and legal environment and detailed information on the assets for sale)
  - Other advisors in the privatization process on sell-side include: N.M Rotschild & Sons (natural gas sector privatization) and Stikeman Elliott as main legal counsel, ESBI as technical advisor and BIG 6 companies
  - Purchase price set for the IM (in the range of cca. 100 thousand USD)

Privatization process: sell side advisors and due diligence

Key milestones

August 1995: The IM was available for potential investors

Buy side due diligences and offer preparation (short timeframe!)

November 1995: Evaluation of offers

December 1995: Contracting

January 1996: Financial close

Background information

- As a general rule, simple, **one or two phase bidding** procedures are conducted, purchase **price in USD**, to be transferred in cash
- In some cases majority stock was to be sold, while in other cases minority stock plus option right to reach majority. At least one „**golden share**" (share with special rights) to be held by a government organization.
- Only professional investors were entitled to apply as ensuring ‚knowledge transfer' was also a goal of the privatization. In order to promote future competition, it was limited how many companies can get to one investor.
- Some guarantees required from the investor side on the further investments and prohibition of headcount reduction in the next two years
- On the other hand, **government guarantees** to reduce tax and environment pollution related risks
- Buy-side due diligences were conducted with significant time pressure, with major foreign consultant presence due to the lack of local expertise and short timeframes
- **Financial close**

Privatization in numbers

Electricity distributors: $ 1,08 billion

Company	Majority shareholder	Offer in % of book value	Offer (thousand USD)
ÉDÁSZ	EDF/Bayernwerk	123%	197 000
DÉDÁSZ	Bayernwerk	107%	108 000
ELMŰ	RWE/EVS	178%	358 000
ÉMÁSZ	RWE/EVS	154%	171 887
DÉMÁSZ	EDF	122%	155 000
TITÁSZ	ISAR Amperwerke	109%	93 000

Natural gas distributors: $ 460 million

Company	Majority shareholder	Offer in % of book value	Offer (thousand USD)
DDGÁZ Rt.	Ruhrgas/VEW	271%	52 000
DÉGÁZ Rt.	Gaz de France	206%	92 000
ÉGÁZ Rt.	Gaz de France	431%	77 000
TIGÁZ Rt.	Italgas/SNAM	282%	171 887
KÖGÁZ Rt.	Bayernwerk/EVN	282%	67 263

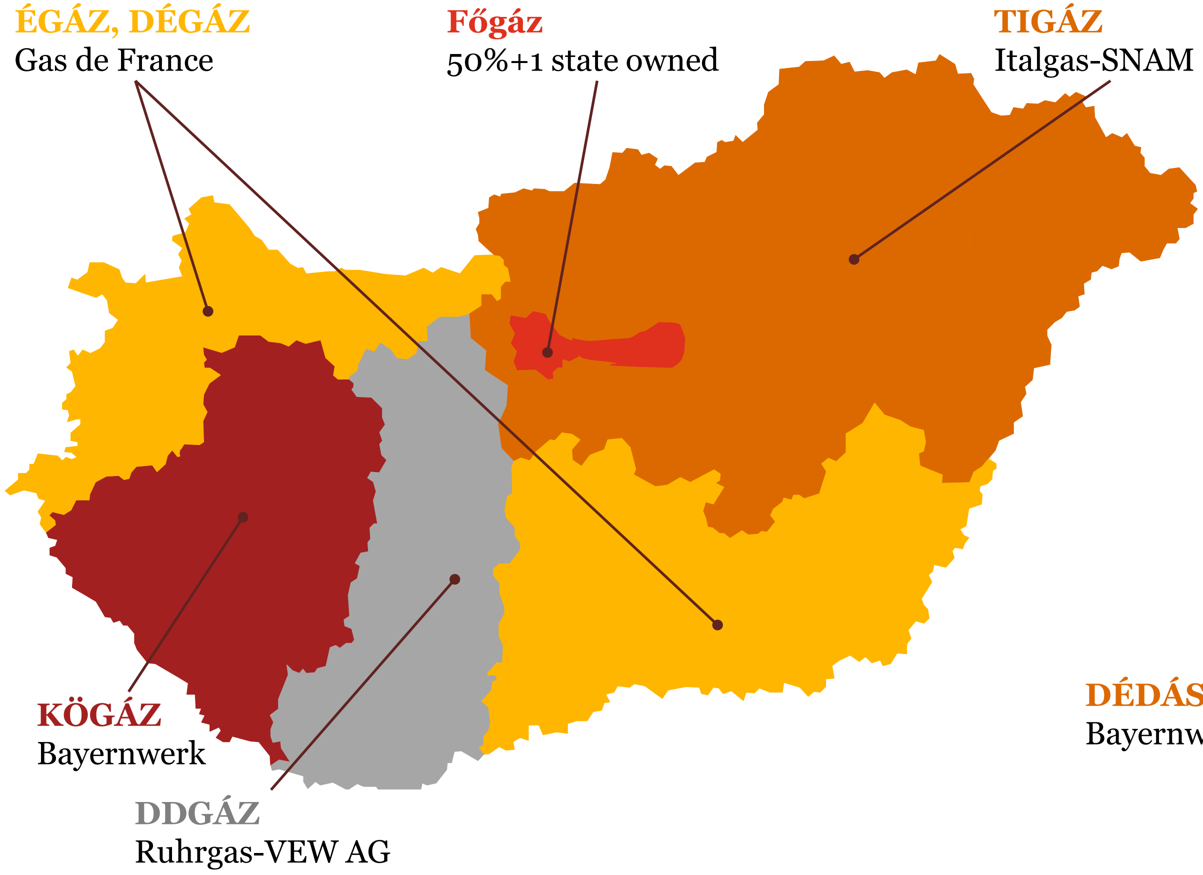
Major power plants: $ 374 million

Power Plant	Majority stakeholder	Offer (thousand USD)
Pécs	Croesus	2 000
Dunamenti	Powerfin	141 000
Budapesti	IVO/Tomen	47 000
Mátra	RWE/EVS	74 000
Tiszai	AES Summit	110 000

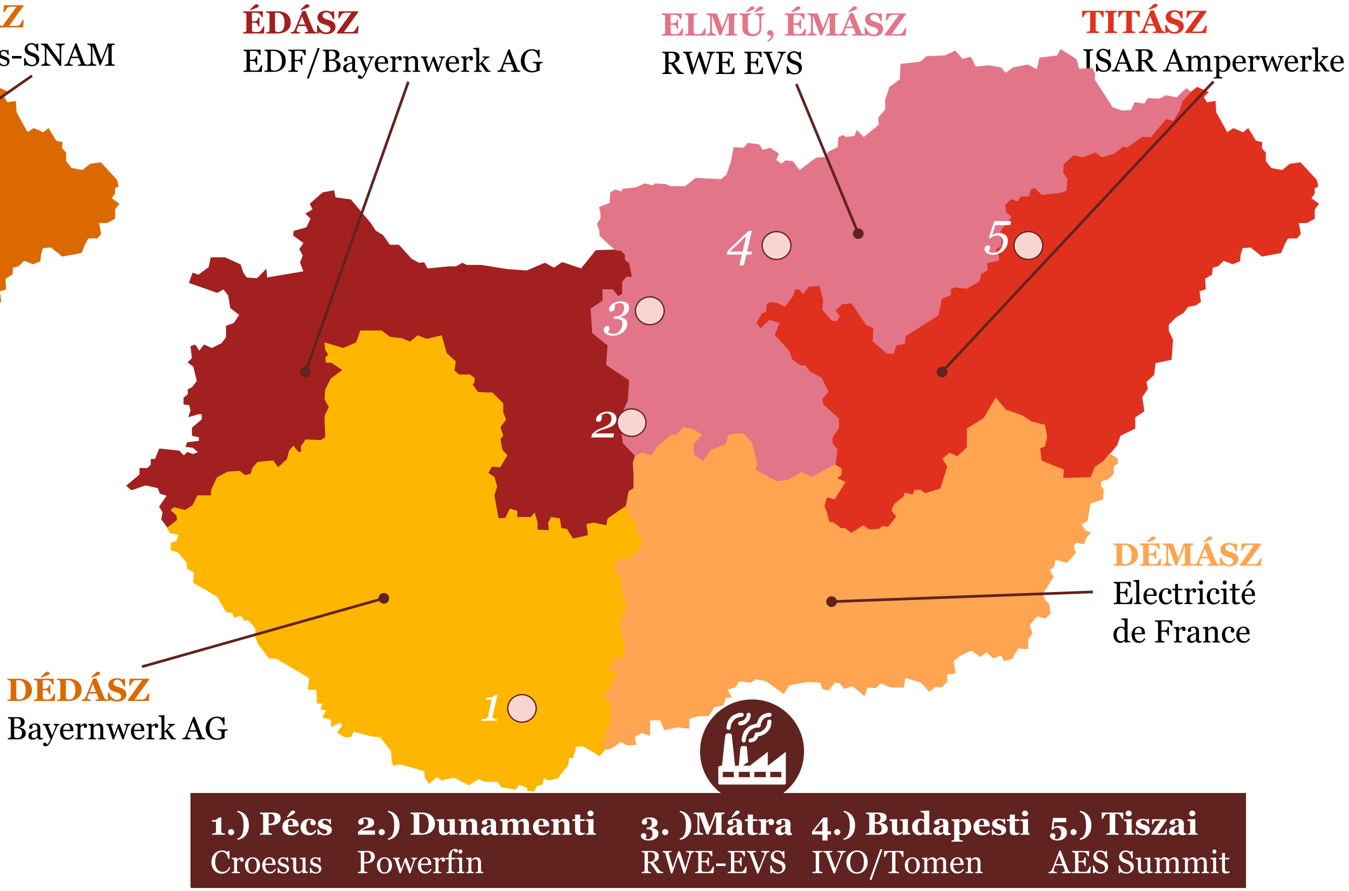
The total privatization value exceeded USD 1,8 billion (equal to USD 3 bln in 2016 prices).

Majority shareholders after privatization (before the 2000s)

Natural gas distributors and suppliers



Electricity distributors and domestic suppliers



The state maintained a majority share in Főgáz despite Ruhrgas and VEW's investments.

Some of Hungary's major power plants remained in state possession (Paks NPP, Bakony, Vértes).

General evaluation of the privatization

Next steps after 1995:

- Privatization of further power plants in the next few years, mostly for professional investors.
- New investors get majority stake of shares in the DSOs/suppliers until the end of the decade.
- MOL (Hungarian Oil and Gas Company) was privatized for financial investors via the Budapest Stock Exchange.
- MVM and Paks Nuclear Power Plant was not privatized.

Evaluation: pros

- **Successful privatization of major companies within 5 months!** HUF 250 bln (cca. USD 1,8 bln – equal to USD 3 bln in 2016 prices) revenue for the state budget which was vital to decrease government debt and to avoid bankruptcy.
- Only professional investors – most of them invested a lot in the Hungarian assets and increased the operational standards significantly. Besides the investmenst they also brought Western European know-how. In addition, they made the operation much more effective (while decreasing the headcount).

Evaluation: contras

- The privatization rush has weakened Hungary's negotiation position, thus decreasing the price.
- Hungary has lost of the owners' control over the majority of the energy sector (although the regulatory control remained at the Government).
- Significant ‚cash out' from the country through dividend payment. This profit was covered by the higher energy prices.
- Energy sector headcount reduction has increased the level of unemployment.

Interests of the Hungarian government and the potential foreign investors

Interests of the potential investors

- Attractive and safe return on investment
- Stable legal system, transparent pricing regime – Rule of Law
- Possibility for international arbitration
- Growth opportunities – country with perspectives
- Incentives for efficiency improvement – chance for higher profit if effort and money is invested to reach operational excellence

Interests of the Hungarian government

- Prompt cash revenue from the privatization
- …
- …
- …
- All the other aspects (e.g. ensuring development of the privatized assets) were far less important

Foreign investors expressed that they are ready to invest if fair ROI is ensured. Hungary's only aim was to ensure cash revenue in order to avoid bankruptcy.

Preparation for the privatization – institutional and sectoral reform

Creating investment promoting legal framework (general)

- New Companies' act (given since 1988)
- Act on the protection of foreign investments (given since 1988)
- Reliable land registry (given since the late XIX. century)
- Act on privatization (1995), establishment of the State Privatization Company Ltd. (ÁPV Ltd.)

All the relevant acts were applied in the day-to-day practice consistently.

Building ‚trust' in the potential investors has a key importance!

Creating investment promoting legal framework in the energy industry

- Creating a separate act on natural gas and act on electricity
- Setting up an independent energy regulatory authority
- Phasing out state subsides for energy
- Ensuring a fair return on investment:
  - In case of DSOs: 8 % ROE guaranteed by law
  - In case of power plants: long-term power purchase agreements with MVM (state-owned energy champion – single buyer model)

Investors were looking for an attractive return in a transparent and safe business environment. They were not willing to invest in an industry with unclear operational (especially pricing) rules.

Lessons learned – key success factors (1/2)

Create a clear national energy strategy as an overall guideline for privatization and regulatory changes

Transparent, stable legal environment, consistent law application

Consider privatization through the stock exchange (IPO)

Cost-reflective prices are unavoidable on long run. Use transparent social subsidies instead of cross subsidies.

Fair tariff setting methodology – with incentives for efficiency improvement

Efficiency improvement is vital, although headcount reduction is painful

BUILD INVESTORS' TRUST!

Lessons learned – key success factors (2/2)

Privatization revenue is just one aspect! Take into account further factors as well (e.g. willingness for a major overhaul).

Transparent tendering procedure with the involvement of external experts

The more time you have for tender preparation, negotiations and due diligences, the higher money you will get

Provide possibility for international arbitration (e.g. ICSID)

Set of guarantees provided (e.g. on tax compliance) and required (e.g. on further investments)

Do not weaken your negotiation position (e.g. do not set hard deadlines for the transaction)

BUILD INVESTORS' TRUST!

Thank you for your attention!

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