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IFC SmartLessons
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Five Keys to Power up a Private-Sector Participation Transaction: the Albanian Experience

Privatizing electricity utilities while policy and regulatory reforms are still ongoing may not always be advisable. However, IFC's experience with privatization of electricity distribution in Albania shows that when there is strong political will and commitment, when the process of privatization is well integrated with other reform initiatives, and when a fair public-private balance is maintained, it is possible to successfully introduce private-sector participation.

Albania was a net power exporter at the beginning of the economic transition in the early 1990s, but growing demand turned the country into a net importer by 1998.

Heavy reliance on hydroelectric production, the government's inability to mobilize adequate investments, mismanagement of the state-owned electricity utility, KESH,[1] and inadequate tariff levels made it impossible for the sector to keep up with the demand. Large-scale expensive imports further constrained the sector's financial stability. As a result, the country suffered from major electricity supply shortages associated with extensive and regular load sheds of 400 to 900 gigawatt hours per year.

To address the electricity sector's shortcomings, the government of Albania decided to undertake a series of initiatives that aimed to improve constraints in generation and interconnection, reduce dependence on hydroelectric production, and liberalize the electricity market. The government also decided to unbundle and privatize the electricity distribution sector and in January 2007 retained IFC as its lead advisor in the process.

Privatization of the electricity distribution sector in Albania required restructuring the state-owned electricity utility and establishing new market operators. Privatization also called for a number of policy and regulatory reforms to allow for a competitive electricity market, consistent with European Union (EU) requirements, and for a sound regulatory regime with proper energy pricing and tariff policies. Such reforms were far from being complete when the privatization process started. However, this offered an opportunity to introduce the right public-private balance in the newly drafted regulatory framework. The coordination among ongoing electricity reform initiatives and the integration of privatization with regulatory and legislative review helped structure the electricity market and the transaction in such a way as to increase potential investors' interest.

The strong political commitment and the partnership that IFC built with the government helped bring all stakeholders on board and accelerate the reform implementation process, without which the transaction would have never closed successfully.

The excellent cooperation between IFC and the World Bank also proved critical in achieving donor community consensus on major regulatory issues and in structuring an attractive transaction. The partial risk guarantee, a World Bank financial instrument designed to help governments mitigate political and regulatory risks,

1 Korporata Energjitike Shqiptare

helped to increase and maintain investors' interest in the process of privatization. Also of paramount importance to the success of the transaction were coordinating efforts by the U.S. Agency for International Development (USAID), which was heavily involved with electricity regulatory reform and market liberalization.

The transaction was completed successfully in May 2009 when the CEZ Group paid €102 million for the purchase of 76 percent of the Albanian electricity distribution company, OSSH.[2] CEZ is an electricity utility based in the Czech Republic. In the past decade CEZ has become a leader in the electricity market in Central Europe and one of the most profitable power companies in Europe, with a proven track record of turning around distressed power utilities.

Lessons Learned

1) When the optimum privatization structure is not feasible, it may be advisable to settle for second-best options.

Privatization of electricity distribution utilities in developing and transition economies is often intended to improve supply of electricity and service quality, reduce losses, and expand the distribution network by securing adequate investment that the public sector has failed to provide. However, some of the objectives of privatization may not be achieved in full when they are perceived by the private sector as unaffordable and unacceptable. In such cases, instead of striving to achieve the optimum results and risk transaction failure, second-best options should be adopted to secure a long-term partnership with a strategic investor and address all other privatization objectives.

The privatization package in Albania included the electricity public supply function, together with the distribution network, while the responsibility of securing an electricity supply to satisfy tariff customers' demands was allocated to the private sector. However, discussions with power companies that had recently privatized distribution utilities in the region made it clear that, under the current situation, the private sector would not be prepared to take on the risk of securing electricity supplies to satisfy customers' demands. All potential investors who attended privatization events in Tirana invariably confirmed that such a risk was unaffordable and unacceptable to the private sector. The uncertainties were many: volatile hydrology, fluctuating energy market prices, and doubts about the government's ability to complete the ongoing initiatives and undertake new ones to increase generation and interconnection capacities.

Under such circumstance, the second-best option was to divide the supply function into wholesale and retail. The risk of securing electricity supplies to satisfy customers' demands was allocated to the wholesale public supplier, which remained under government ownership. The retail public supplier, responsible for purchasing electricity from the wholesale public supplier at a regulated price and selling it to end consumers, was privatized, together with the distribution system operator. This model was applauded by all power companies that met with the minister of economy and the IFC team in April 2009.

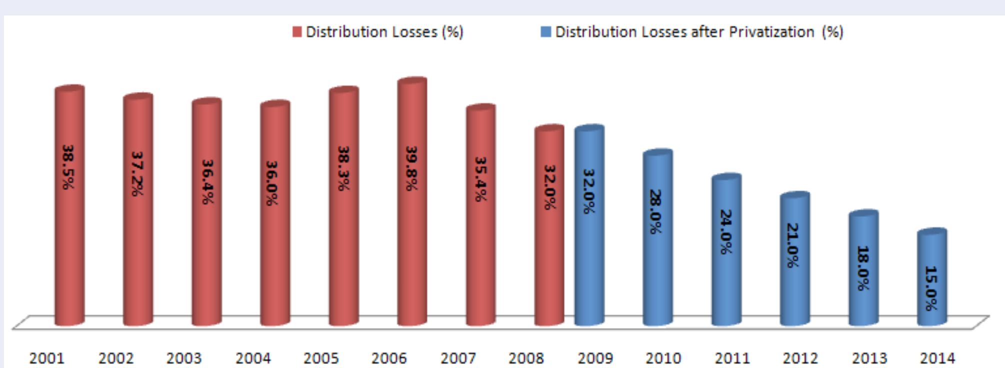
2) To ensure economic, social, and political sustainability of the transaction, a fair balance must be established between the public and private share of interest and risk.

When structuring a private-sector participation (PSP) transaction, allocation of risk among parties must be done in such a way as to ensure an increase in efficiency at the lowest possible cost. The process is not quite straightforward, as it is often difficult to determine which party can cover certain risks at the lowest costs; and occasionally portions of the same risk must be allocated to different parties. To achieve the desired increase in efficiency, the performance of the private operator is generally benchmarked against performance standards or indicators. In addition, a fair return on investment is essential in order to secure the private sector's interest in the transaction.

In the electricity distribution business, the private operator is typically expected to improve efficiencies by reducing distribution losses, expanding distribution networks, and increasing cash collections. To ensure the private sector's commitment and reduce the risk of renegotiations, reasonable performance standards must be specified in the regulatory and/or transaction documentation. Such standards must be clearly defined and easy to monitor by the regulator or contracting authority. To allow for a fair return on investment and provide further incentives to the private operator to reduce distribution losses and increase collections, the performance standards must be measured against elements of the distribution and retail tariff calculation formula.

In Albania, the new tariff methodologies, drafted under

Distribution losses before and after privatization



2 Operatori i Sistemit te Shperndarjes

the privatization framework, allow the distribution operator to make sufficient revenue to cover operating costs and investments, including the cost of energy purchased to cover technical and nontechnical distribution losses. The private operator was asked to commit to a loss reduction schedule as part of the privatization offer (see chart below).

While allowing a fair return on investment is important to attracting the private sector, the deal may prove to be both politically and economically unsustainable if tariffs are set at unaffordable levels. The adverse effect of unaffordable tariffs would also increase private-sector costs. Therefore, designing and implementing a satisfactory mechanism to protect vulnerable consumers is beneficial to all. In Albania, a deferred revenue compensation mechanism was introduced to prevent tariffs from reaching unaffordable levels.

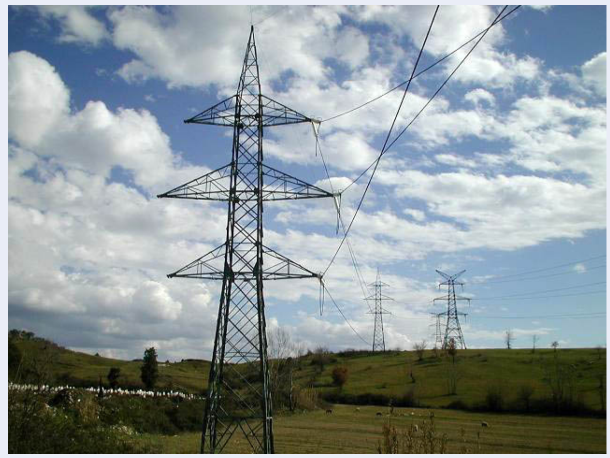
3) Restore investors' confidence by effectively mitigating the regulatory risk.

In recent years, private investors have shown reduced interest in the distribution utilities of developing countries. The number of bidders and, consequently, the degree of competition in similar transactions in the sector have been limited. The reasons for this include a weak institutional and administrative framework in the electricity sector, incomplete regulatory regimes and tariff policies, and the poor performance record of regulatory institutions.

To add to this, privatization of the electricity distribution company in Albania was initiated soon after privatization of the electricity distribution company in neighboring Macedonia. Continuous disputes over regulatory and contractual issues between the government of Macedonia and the Austrian electricity company EVN, which had recently purchased the majority of the Macedonian electricity distribution utility, increased investors' sensitivity to regulatory and political risks in the region.

To restore investors' confidence, privatization efforts in Albania focused on establishing a sound regulatory framework, with proper energy pricing and tariff policies, and effectively mitigating the regulatory risk. The latter was achieved by introducing contractual political commitment and proper dispute resolution mechanisms. To this extent, the Regulatory Statement, a document that specifies tariff calculation formulas and key performance indicators, was attached to the share purchase agreement (SPA) that was signed by the Albanian government and the winning bidder and then ratified by the Albanian Parliament. To further help mitigate the regulatory risk and backstop the government's commitment to the pre-agreed regulatory framework, the World Bank offered a partial risk guarantee (PRG).

The PRG is a financial instrument that the World Bank has designed a few years ago to help countries mitigate political and regulatory risk in order to enhance investor interest and reinforce confidence in newly established regulatory frameworks and institutions. It must be noted that the PRG can only be put in place after the signing of the privatization agreement. The process of structuring the PRG and finalizing the necessary contractual agreements among the parties involved - the World Bank, the government, the investor and the commercial bank issuing the letter of credit - may add to the time and costs of the transaction. This is why, if a PRG is needed to support the privatization of a distribution utility, it would be best if the World Bank is involved as early as possible in the process.



4) Involve the private sector early in the process of policy and regulatory reform.

Involving the private sector in the process of electricity policy and regulatory reform may help increase the chances of drafting an impartial regulation and structuring a PSP transaction that is attractive to private investors. Potential investors' feedback may be as constructive as that of any other stakeholders, and will especially help with assessing how much risk the private sector is prepared to take.

To achieve this, traditional activities used for the recruitment of potential investors, such as market sounding or pre-bid conferences, are also used to discuss and get investors' feedback on major transaction and regulatory issues. As an example, an Investors' Roundtable, sponsored by USAID and organized by IFC in April 2008, not only informed potential investors about the transaction and the process, but also presented them with the new regulatory framework and asked for their feedback on key issues and risks.

All of the comments and recommendations received during this process highlighted some of the major issues that the government and the regulator needed to address in order to improve the regulatory framework and enhance attractiveness of the transaction. The interesting fact was that comments were provided not only from the companies that later participated in the tender process, but also from those who didn't. They gave disinterested, free-of-charge advice and shared their knowledge, views, and concerns on the electricity market model and distribution tariff methodologies. Making potential investors part of the regulation review helped strengthen their confidence in a transparent and professionally run process.

5) Resist government pressure to achieve rapid closure, and focus instead on the need to address all major issues.

Governments in developing countries are often in a hurry to privatize and offload loss-making, debt-ridden electricity utilities. In addition, political pressure from upcoming elections usually adds to the governments' desire to close transactions rapidly. For this reason, it is important to constantly assess and, where possible, resist government pressure to achieve rapid closure by making it aware of the high risks associated with offering a transaction that may not be ready for the market or rushing investors to submit their proposals before they have had an opportunity to properly assess all of the issues and risks.

To comply with clients' request for rapid closure and still address all major issues, it is often necessary to implement in parallel as many processes as possible and also to use synergies with other ongoing initiatives. However, the closer you get to election day, the more difficult it becomes to find the right balance between government pressure to speed up the process and the need to address outstanding issues.

As an example, despite everybody's efforts during the privatization process in Albania, there were still outstanding issues that could not be resolved by the bid submission deadline at the end of September 2008. The government was not prepared to move the deadline because of the general elections scheduled in June 2009. To overcome this obstacle, the IFC team identified the five most critical issues and convinced the government that potential bidders be allowed to make comments on them.

Introducing changes in the process and allowing for conditional bids at that stage was quite risky, but it was the only way to maintain bidders' interest in the process and satisfy the government's request to close the bidding process by the preferred date.

Those five issues, which included the level of return on equity, the initial level of distribution losses, the purchase price adjustment mechanism, the property title, and long-term debt, were negotiated with the winning bidder and included in the SPA and the regulatory statement. Some items, such as the initial level of losses and the current level of bad debt, both of which needed extensive work and study, could not be defined during the negotiations. As a solution, the private operator was given the responsibility to complete, within the first year of operation, one study on the level of losses and one study on the age of the receivables. The two studies will be audited by independent auditors selected by both CEZ Group and the regulator.

Conclusion

IFC's experience in Albania shows that integration of the privatization process with reform implementation initiatives is of paramount importance in the effectiveness of transaction advisory work. From the beginning of an advisory mandate, it is important to obtain donor support as well as the commitment of the highest political levels in the country. This commitment and support must be maintained throughout the project to ensure successful implementation of the transaction and a long-term partnership with a strategic investor.

However, the long-term success of the privatization is still to be tested. It will take a few years before we know whether CEZ will be able to turn OSSH around. A major concern remains the regulator's ability to monitor OSSH performance effectively with regard to reduction of losses, increase of collections, and adequacy of the investment to upgrade the distribution network and improve quality of service. It is imperative that donors such as USAID and the World Bank remain involved—the former with providing assistance to the regulator in implementing the new regulatory framework, and the latter with making sure that all parties follow the terms agreed to in the regulatory framework and privatization agreement as defined in the partial risk guarantee documentation.