

Romanian Electricity Distribution Sector – Four Sold, Four Left To Go

by Central Europe Trust Company

Key events in 2005 • Electricity distribution sector

Overview of the power distribution privatization process

Regulatory developments

Key events in 2005

The noteworthy events that marked the Romanian electricity sector in 2005 were an advancement of the privatization process in electricity distribution, perceived stagnation of the privatization process in generation and further amendment of the legal and regulatory framework (including both primarily and secondary legislation).

Privatization

2005 was the year in which all three transactions in electricity distribution sector were closed: with Enel in spring 2005, after a long and painful negotiation process, and with E.ON Energie and CEZ in autumn 2005. Thriving on the success of these transactions and positive market sentiment the Ministry of Economy and Commerce - Office for State Ownership and Privatisation in Industry (the “Ministry”) together with Electrica SA (“Electrica”) published in the beginning of autumn 2005 the privatization announcement for Electrica Muntenia Sud (“EMS”), a step which marked the formal start of the privatization process for Electrica’s fifth distribution company.

On the other side, the privatization process in electricity generation experienced a visible stagnation and the Ministry appears to be in a stalemate as regards the strategy to be employed for the privatization of the three large generators Turceni, Rovinari and Craiova. While the privatization process concerning the three companies was so far opaque (and therefore few relevant conclusions can be drawn), it may be the case that such delay is rather a strategy employed by the Ministry in order to increase the competition: if a new entrant will win the tender for EMS, then the list of potential buyers for these generators is likely to increase to four, adding to the competitive tension of the process. If this is the case, then such strategy could prove rewarding as competition (along with stable regulatory framework) is the most important factor that drives upwards the price of such transactions.

Legal and regulatory environment

The legal and regulatory environment in the electricity sector continued to develop in 2005. The most significant development was the initiation of the consultation process for amending the Energy Law, a process which resulted in a new draft of the Energy Law that is currently undergoing the Parliamentary approval process.

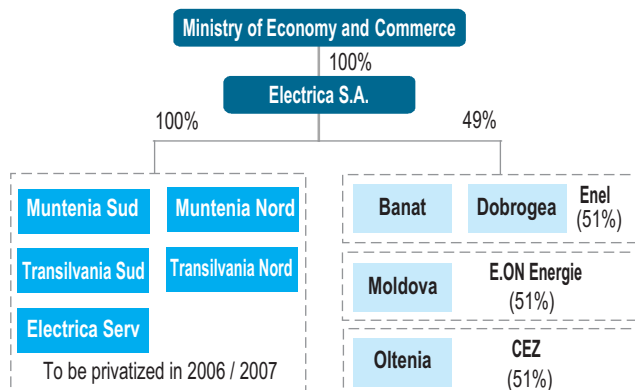
The secondary legislation was further developed: methodologies concerning electricity market, transmission, distribution and supply activities were either newly issued or amended in 2005. However, unlike previous changes of the regulatory framework, the amendments introduced in 2005 were driven to a lesser extent by the negotiations with strategic investors, being implemented in an effort to increase the clarity of the regulatory framework and to reflect the continuous challenges brought in by forthcoming liberalization.

Electricity distribution sector

Electricity distribution is currently carried in Romania through eight regional distribution companies. Prior to privatization, all eight distribution companies were wholly owned subsidiaries of Electrica SA, a holding entity which resulted following the consolidation and corporatization of 41 electricity distribution and supply branches back in February 2002. The incumbent electricity distribution company still holds interests in four regional distribution companies (Muntenia Sud,

Muntenia Nord, Transilvania Sud and Transilvania Nord) and one maintenance company (Electrica Serv), and manages the remaining 49% stakes in the four distribution companies that were already privatized.

Chart 1: Shareholding structure in the electricity distribution sector



In 2004 Electrica sold around 33,806 GWh of electricity, recording a customer based of some 8,594,248 consumers. About 24% of the total electricity sales were generated by residential consumers. This is the last year in which Electrica fully consolidated the results of all eight subsidiaries, 2005 being influenced by departure of the four privatized distribution companies.

Chart 2: Regional electricity distribution companies and sales in 2004 (GWh)

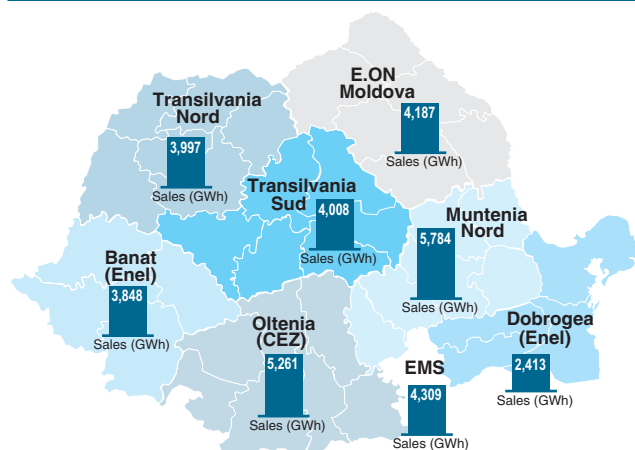


Table 1: Distribution Companies - Market position as of 2004

Subsidiary	Power sales (MWh)	Electricity sales ¹ (EUR MM)	Number of consumers	Sales/ consumer (EUR)	Residential consumption (%) ²
Muntenia North	5,784,320	329	1,236,244	266	18%
Oltenia	5,260,996	310	1,371,398	226	19%
Muntenia South	4,309,219	286	1,075,111	266	33%
Moldova	4,186,878	242	1,335,305	181	25%
Transilvania South	4,008,027	248	1,037,564	239	23%
Transilvania North	3,996,908	237	1,101,673	215	24%
Banat	3,847,753	230	837,218	274	26%
Dobrogea	2,412,773	151	599,735	251	25%
Total Electrica SA	33,806,874	2,032	8,594,248	236	24%

Notes: 1 - Includes distribution revenues. 2- Share of residential consumption (MWh) in total electricity supplied (sold) by the subsidiary. Source: Electrica SA

Overview of the power distribution privatization process

After four years from the beginning of the privatization process in electricity distribution, four regional distribution companies have been privatized with Enel (Banat and Dobrogea), E.ON Energie (Moldova) and CEZ (Oltenia)¹. The privatization announcement for the fifth regional distribution company Muntenia Sud (“EMS”) was published at the beginning of autumn 2005 with binding bids due on January 31st, 2006. As regards the last three regional distribution companies, Electrica is currently in the final stage of selecting a privatization advisor.

So far the privatization of all five regional distribution companies shared the following two characteristics:

Privatization method: Electrica privatized a 51% stake in each distribution company by (i) selling directly a 24.62% stake in the privatized company to the strategic investor who simultaneously (ii) issued a number of ordinary shares by way of a capital increase, representing 35% of the increased share capital of the company and together representing 51% of the increased share capital. Mention shall be made that in case of EMS the privatization method remained practically identical, albeit the proportion between the number of existing shares and newly issued shares was different.

Within this 51% shareholding, the investor has the right, at its own discretion, to secure the participation of the European Bank of Reconstruction and Development (“EBRD”) and/or the International Finance Corporation (“IFC”), which have expressed their interest in participating in this privatisation, with a maximum participation of 5% of the increased share capital of the companies (10% in case of EMS).

In addition to that, a 10% stake of the increased share capital of each privatized company, from the shares owned by Electrica, will be sold to the employees of the company and Electrica, through a direct sale process.

Privatisation process: the selection process included a pre-qualification stage based on Expressions of Interest submitted by investors. Pre-qualified investors were requested to submit binding bids followed generally by a request to submit improved binding bids. Based on the improved binding bids the Seller undertook negotiations and selected the winning bid. The pre-qualification criteria consisted of a combination of technical (number of end-customer utility accounts, volume of electricity sold), financial (total assets, strong credit profile) and managerial (satisfactory experience) criteria, aiming to shortlist only the

1 - For an in-depth description of these transactions see the September 2005 edition of the Romanian Business Digest.

relevant investors that would address, in Government's view, the strategic objectives of the privatization.

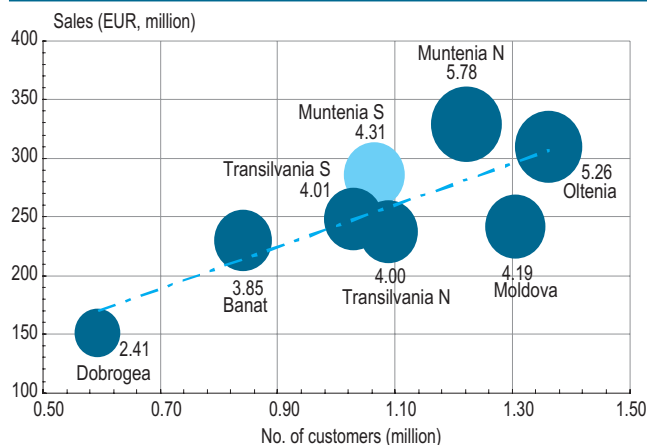
Electrica Muntenia South

With four distribution companies already sold, MEC and Electrica are looking forward to complete the privatization of Electrica's remaining four distribution companies by the end of 2007.

The most advanced in this process is EMS, which covers the capital region of Bucharest and two neighboring counties namely Giurgiu and Ilfov. The key characteristic of this distribution company is the relatively small area covered (5,350 sq km) and the high concentration of population (2.5 mn inhabitants), of which over 80% is urban. This characteristic impacts also the breakdown of consumption, EMS recording the highest share of residential consumption in total electricity sales (some 33%).

In 2004, EMS ranked 3rd in terms of electricity sales and 5th in terms of number of consumers among the eight regional electricity distribution companies.

Chart 3: EMS – Market position as of 2004



Electricity sales reached 4,309,219 MWh in 2004, down by 1.8% as compared to 2003 (4,388,271 MWh or 12% of Electrica's total sales). The decrease is due to the shifting of eligible consumers towards alternative electricity suppliers and it was recorded only on low and medium voltages. In 2003 EMS serviced about 1,069,626 consumers of which c.a. 1,020,167 residential, 47,851 small and medium and 1,608 large industrial consumers.

The privatization strategy for EMS was approved by means of Government Decision in June 2005 and the privatization announcement was published on July 28th, 2005. By September 15th ten investors have submitted Expression of Interest ("EOIs") and by October 3rd all investors submitting EOIs have been pre-qualified. The ten investors are: AES (USA), CEZ (Czech Republic), EnBW Energie AG (Germany), Enel (Italy), E.ON Energie AG (Germany), EVN AG (Austria), Gaz de France (France), Iberdrola (Spain), RWE Energy AG (Germany) and Union Fenosa International (Spain). By January 31st, 2006 eight investors submitted Binding Bids, EnBW and E.ON Energie leaving the race. The quality and quantity of the interested expressed in this privatization is by far the best seen so far in Romanian electricity privatizations and most likely will drive the price of the transaction upwards.

It is likely that the Seller will request improved binding bids shortly following the opening of the bids. The novelty in this process is the modification of the privatization strategy during the bidding phase to allow only the first ranked five investors to submit improved binding bids. The move is intended to force potential investors to bid at the upper range of their valuation (in order to make it in top five bidders allowed to submit improved binding bids) and to discourage at the same time investors to bid low and keep a certain reserve for the next stage of the binding bids. Nevertheless, it will be very interesting to review the effectiveness of such strategy employed by MEC/Electrica going forward.

As regards timing we anticipate that the large population of investors will ensure a fast and effective negotiation process. If an agreement is initiated by March 2006 then we estimate that signing could take place around May 2006 while closing will likely be in early autumn 2006.

Electrica Transilvania Sud, Transilvania Nord and Muntenia Nord

As regards the remaining three distribution companies (Transilvania Nord, Transilvania Sud and Muntenia Nord), MEC/Electrica are in the process of selecting a consultant, with the effective launch for privatization probably in the second quarter of 2006 and finalization in the third quarter of 2006.

It is likely that MEC/Electrica will be willing to sell a higher percentage (similar to EMS) and that the privatization method will be similar, most likely, to the one used for Moldova, Oltenia and EMS. While it was discussed that prior to the privatization, a 10% stake in Transilvania North and Muntenia North will be floated on the Bucharest Stock Exchange the timetable for such action is not yet clear.

Mention shall be made that a 12% stake in each of the three distribution companies will be transferred to the Restitution Fund (a fund created to compensate the individuals of stripped property during communism) leaving Electrica (post privatization) with only a residual shareholding of a little bit over 10%.

Regulatory developments

In 2005 both primary and secondary legislation was further developed: new draft of Electricity Law, methodologies concerning electricity market, transmission, distribution and supply were either newly issued or amended in 2005. However, unlike previous changes of the regulatory framework, the amendments introduced in 2005 were driven to a lesser extent by the negotiations with strategic investors, being implemented in an effort to increase the clarity of the regulatory framework and to reflect the continuous challenges brought in by forthcoming liberalization.

New draft of electricity law

Following developments in the secondary legislation and market structure, amendments to the electricity law were required in order to harmonize the provisions of the primary legislation with secondary legislation. In summer 2005 ANRE initiated the consultations on the first draft of the Energy Law with all interested parties in the sector and a draft was put forward to the Parliament in autumn 2005. As of January 2006 the law was not yet approved, although the approval process in each Parliamentary chamber is very advanced.

Among the most important provisions that were included in the draft submitted to Parliament we would mention the proposal to abolish the national uniform tariff for final captive consumers, a task which is increasingly difficult to fulfill by ANRE as the effective market opening degree continues to increase steadily.

Electricity distribution

As previously mentioned, the methodology for establishing the distribution tariffs was approved at the end of 2004 and subsequently amended in March 2005 (Order No 10/2005) following discussions with interested parties. At the end of 2005 ANRE has approved the revised distribution tariffs for 2006, after a year in which the distribution companies operated and played by the rules of the incentive-type regulation.

The specific distribution tariffs valid for 2006 are presented in the table below. Mention shall be made that in the new methodology, ANRE has reduced the number of distribution tariffs from five to three, removing the intermediary transformation tariffs. The general trend for most of the distribution companies (save for Moldova and Transilvania Sud) is to reduce as much as possible high voltage distribution tariffs (in order to balance the effect of expensive electricity and keep eligible consumers) and to increase medium and low voltage distribution tariffs.

Mention shall be made that at the end of 2005 ANRE has also issued Order No. 59/2005 which sets the maximum level of the specific distribution tariffs until the end of 2006. The limits are RON 19 /MWh for HV distribution tariffs, RON 37/MWh for MV distribution tariffs and RON 130/MWh for LV distribution tariffs.

Another important regulation passed in 2005 is the methodology for recognition of losses from receivables when establishing the electricity distribution tariffs (ANRE Order No. 58/2005). The methodology will be used for calculating such losses when establishing the electricity distribution tariffs for the first regulatory period (only the last two years - 2006 and 2007) and the second regulatory period (2008-2012).

Electricity supply

In March 2005 ANRE has issued a revised supply methodology (ANRE Order No. 11/2005) aiming to diminish the perceived risks of the distribution companies, while preserving monitoring tools in order to detect any incorrect practices that could be used by the market players. Following the passage of this methodology the tariffs to final electricity consumers were revised three time in 2005 (in March, July and December).

The evolution of the average electricity price to final consumers (both industrial and residential) since 1997 is presented in the Chart 4.

Another important piece of regulation concerning supply which was passed in 2005 is the methodology for establishing guarantees from bad captive consumers (ANRE Order No. 17/2005). The methodology is applied for contracts concluded with captive consumers and establishes the terms and conditions for creation of such guarantees in order to minimize the risk of non-payment for the supplier.

Electricity transmission

In 2005 ANRE issued Order No. 50/2005 amending the methodology for establishing the transmission tariffs (ANRE Order No. 30/2004). The amendments concern the efficiency gains from management of the losses (which will stay with the transmission operator also in the second regulatory period), adjustment of the regulatory asset base to include investments into assets qualified as public property of the state) and modification of the calculation of the working capital. Most likely the amendments were implemented in order to increase the revenues of the transmission operator and make available additional financing for network investments.

Following the last revision in December 2005 the transmission tariff amounts to RON 21.96/MWh (around EUR 6/MWh), while system services tariff amounts to RON 13.47/MWh.

Electricity wholesale market

In 2005 ANRE passed several regulations concerning electricity wholesale market. We believe that the two most important pieces of regulations are ANRE Order No. 24/2005 and ANRE Decision No. 664 /2005.

ANRE Order No. 24/2005 approved the methodology for establishing the prices and quantities of electricity sold by generators through regulated contracts and of the prices for supplying thermal energy from cogeneration units. The Methodology established, among others, the framework for setting the prices and quantities of electricity for regulated electricity sale-purchase contracts concluded between generators and suppliers for captive consumers' consumption and will be applied until full market opening in 2007.

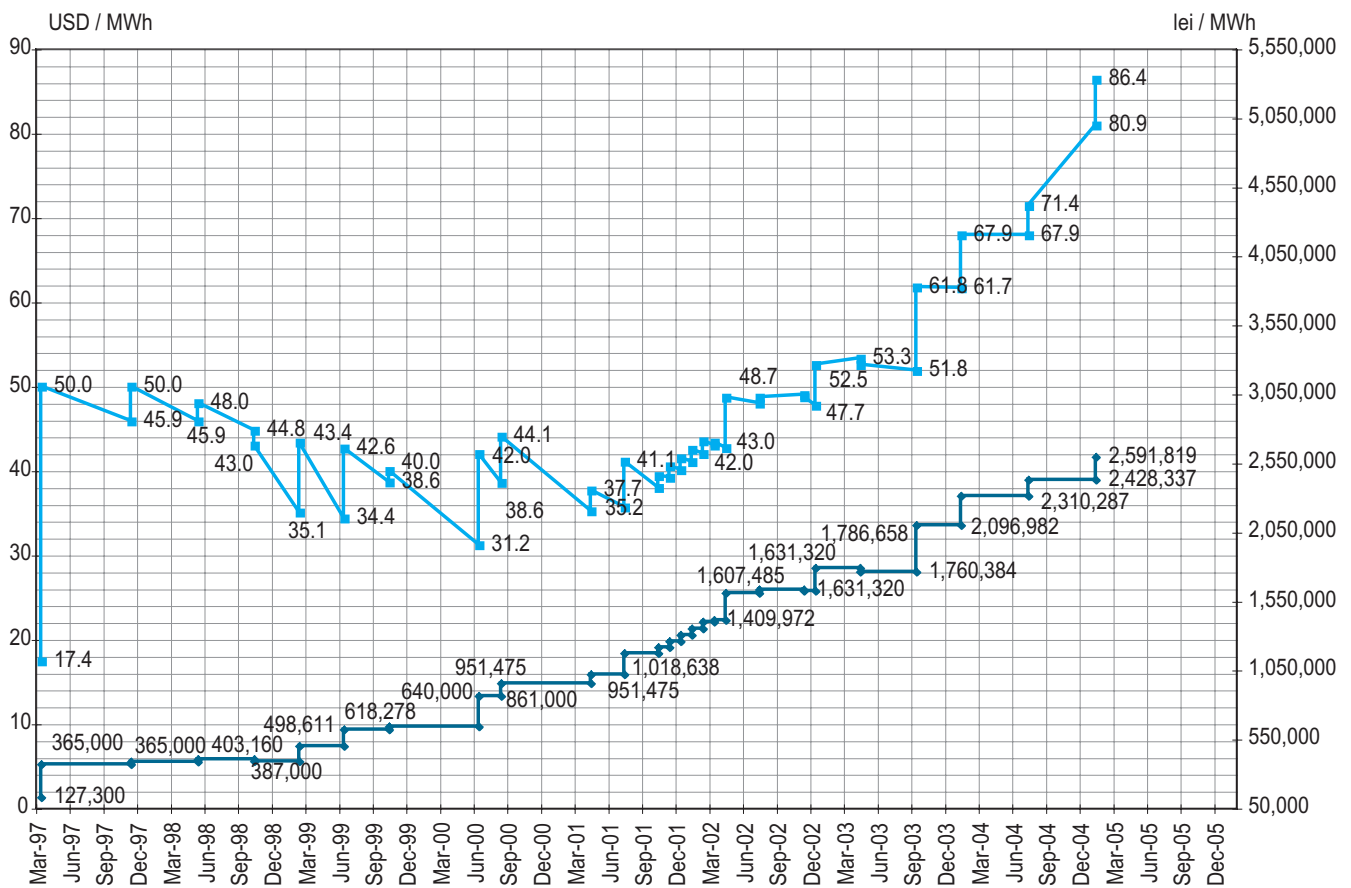
ANRE Decision No. 664 /2005 approved the procedure for modifying the electricity quantities in the electricity acquisition contracts concluded between generators and suppliers of captive consumers. The procedure establishes the framework for modifying such quantities as result of shifting of eligible consumers to another supplier or due to forecast errors. On the basis of this procedure, both (i) the quantity of electricity corresponding to regulated acquisition contracts concluded between generators and suppliers for final consumers' consumption and (ii) the quantity of electricity corresponding to regulated acquisition contracts for covering the distribution network's losses, can be modified.

Table 2: Specific distribution tariffs by distribution company valid for 2006 (RON/MWh) without VAT¹

	Banat	Dobrogea	Moldova	Oltenia	Muntenia Nord	Muntenia Sud	Transilvania Nord	Transilvania Sud
High voltage	18.39	12.42	16.38	17.09	9.95	8.27	14.40	14.01
Medium voltage	29.38	33.57	32.40	36.38	23.43	22.25	27.97	33.56
Low voltage	110.28	114.94	113.42	114.50	130.00	118.60	102.48	103.78

Note: 1 - The table presents the distribution tariffs for each voltage level e.g. a consumer connected at medium voltage will pay the sum of the HV and MV tariffs, while the LV consumer will pay the sum of all three specific tariffs. Source: ANRE Order No. 48005

Chart 4: Evolution of the average electricity sale price to end consumers (1997-2005)



Another development that is worth mentioning in 2005 is the establishment of the Centralized Market for Electricity Contracts ('CMEC'). CMEC was created following the critics regarding the transparency of the contractual relationships on the competitive wholesale market and has as objective to increase the transparency of such transactions and to create an arms-length environment where all suppliers have equal access to cheap electricity.

CMEC will be a voluntary market where generators, suppliers and eligible consumers will be able to buy/sell electricity by means of bids. While the participation is voluntary, the Ministry of Economy and Commerce has asked the main generators (that are currently under its control) to contract the electricity for 2006 on this market. Such producers include Hidroelectrica, Nuclearelectrica and the three energy complexes: Turceni, Rovinari and Craiova.

While this is an attempt to increase the transparency and provide equal access to cost effective electricity, there is a drawback that can potentially affect the objective of CMEC: certain cost effective generators may have already little electricity to offer on such market, as most of capacity it is already contracted on long term negotiated contracts with suppliers to eligible consumers.

Further regulatory amendments

Further regulatory amendments in 2006 will include the amendment of the Commercial Code, the issuance of a methodology for calculating the CPT (losses) by the electricity distribution companies and the methodology for appointing the suppliers of last resort following full market liberalization in 2007.

Central Europe Trust Company, Ltd.

Strada Aviator Petre Crețu Nr. 38, Sector 1, București
Tel.: +40 21 260 2908
Fax: +40 21 260 1628

Contact:
Adrian Rusu, Director
E-mail: adrian.rusu@cet.com.ro
Cătălin Iliescu, Senior Manager
E-mail: catalin.iliescu@cet.com.ro