Liberalization in Franz Kafka's Wonderland

Tomáš Dzurilla & Jan Pravda, Pravda Capital

The most topical issue in the Czech energy market is the rise in electricity and natural gas prices. Despite ongoing liberalization, which was designed to bring competition and lower end-user prices, the opposite seems to be the case. Much of this can be attributed to the continued monopolies in both the power and gas markets.

After an unsuccessful privatization in 2002, the Czech government opted to build "SuperCEZ", allowing the incumbent, controlling over 70% of the country's power production, to acquire five out of eight distributors. The lack of competition in the gas sector is even more apparent. RWE Transgas is the exclusive importer of natural gas in the country, owns the transmission network and controls underground storage as well as six out of eight distributors.

To underline the problem, the country's largest gas consumers, who became eligible last year, experienced price increases of up to 40%, leading 13 of them to file a complaint with the Energy Regulatory Office (ERU). ERU ruled that the prices were too high, as a result of which the antimonopoly office (UOHS) has intervened. Apart from the obvious reasons for price increases such as oil-indexed take-or-pay contracts, steeply rising deregulated prices may be RWE's attempt to recover the extremely high price it paid for the company in 2002 – a common problem associated with privatizations of large monopolies.

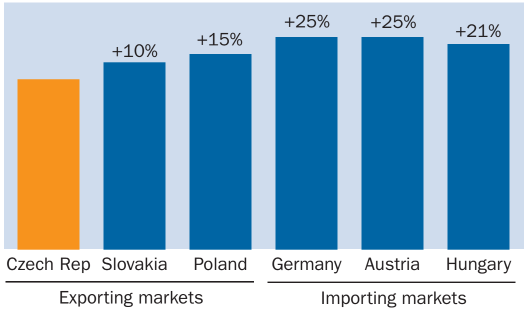
Though both electricity and gas markets are theoretically open, the lack of suppliers is obstructing competition and until new players enter the markets final customers will not reap the benefits. This, in turn, will not happen until prices reach an attractive level. Such reasoning leads to a seemingly contradictory conclusion that there will be no effective competition until prices increase.

Although prices of both electricity and gas in the neighbouring countries create upward pressures on domestic prices, market inefficiencies including limited cross-border transmission capacity or destination clauses embedded in long-term take-or-pay gas supply contracts help to slow the pace of growth. Should these obstacles be removed, prices should converge immediately.

While we remain a proponent of SuperCEZ, we believe that more cross-border capacity would benefit everyone including CEZ over the long run. Similarly, cancellation of destination clauses (although very unlikely to happen) would benefit gas market participants.

CO_2 emission trading has become one of the most pronounced factors contributing to rising electricity prices in Europe. CEZ, for instance, also blames higher prices on allowances. We do not dispute CEZ CEO Martin Roman's argument that if production costs plus the CO_2 allowance price exceed power prices in the local market the company is motivated to decrease production and sell unused allowances. We can not, however, ignore the fact that CEZ received its allocation free of charge.

Comparison of wholesale electricity prices in 2004



Source: CEZ

Through the above-described mechanism, carbon trading provides arbitrage opportunities helping to reduce price differentials without need for physically increasing cross-border connectivity as well as improve the seller's cashflow. Despite operating only coal-to-nuclear switching capacity which does not depend on producer's discretion but on nuclear plant reliability, CEZ can reduce carbon emissions through increasing nuclear output by improving utilisation of its new nuclear plant Temelín. This further improves asset utilization in the region.

M&A activity

The expectation of growing prices creates incentives for acquisitions. Despite the dominance of CEZ, RWE and Eon, the Czech-Slovak financial group J&T acquired the heat and power producer United Energy and the wholesale electricity trader První energetická last year. These assets, however, even when combined with J&T's stake in the Prague distributor PRE, cannot be considered a threat to the dominance of CEZ but rather a sideshow riding on the wave of price increases.

Since CEZ controls sites suitable for new build development, investment projects to build new capacity are limited for other players. Nonetheless, investment opportunities for new capacity exist for large industrial companies, which already own some easy-to-extend production capacity.

With respect to CEZ's investment decision regarding thermal plants, last year's most important domestic transaction was the acquisition by CEZ of the brown coal producer Severoceske Doly (SD) for K9.05 billion (€312 million). The transaction was a practical solution reflecting the fact that SD is CEZ's most important coal supplier and, CEZ is SD's most important customer.

Ironically, CEZ's former CEO, Jaroslav Mîl was officially fired because of CEZ's participation in the first tender for the sale of SD in 2003.

Following its unsuccessful bid to buy Slovakia's dominant power producer Slovenske Elektrárne, which was sold to Italy's Enel, CEZ acquired a majority stake in Romanian regional distributor Electrica Oltenia expanding its foreign portfolio of three regional distributors in Bulgaria. The company is currently participating in several other tenders for generation and distribution assets in the Balkans and Poland. Indeed, while CEZ's acquisition list may seem quite ambitious, it is in line with the government's approved strategy of creating a leading energy group in central and southeastern Europe.

As a consequence of this strategy and CEZ's outstanding share price performance, the general sentiment is slowly leaning toward a privatisation of CEZ via the public equity markets. We believe that, over the long term, such a solution will increase competition and secure SuperCEZ's position as one of Europe's leading players.

Pravda Capital is a leading Prague based M&A advisory firm and broker of CO_2 allowances. www.pravda.cz.