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Daniela Mineva

IMPROVING THE GOVERNANCE OF STATE-OWNED ENTERPRISES IN THE ENERGY SECTOR

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Why analyse the governance of the energy sector in SEE-9?

The **energy sector has a crucial importance**, due to:

- status as a natural monopoly;
- social sensitivity of societies to any price increases (protests at the beginning of 2022; energy governance is a matter of national security);
- large investments and financial interests at stake;
- *State Capture Assessment Diagnostics* tool identifies the sector as highly vulnerable to monopolization / state capture risk.

Systematic governance problems in the energy sector

- Lack of **strategic planning** and coherent evidence based regulatory policy;
- Structural **dependency** on fossil fuels;
- Focusing state- and EU-funding in **large and non-sustainable projects**, without detailed cost-benefit analysis or long-term clear societal benefits;
- **Restricting free competition** and excluding smaller players, with **monopolization** of a few well-connected companies;
- **Financial mismanagement** (including cross-subsidisation) resulting in debts of SOEs;
- **Political appointments** in energy SOEs;
- Public procurement **corruption risks**;
- **Discrepancy** between European and national principles and practices.

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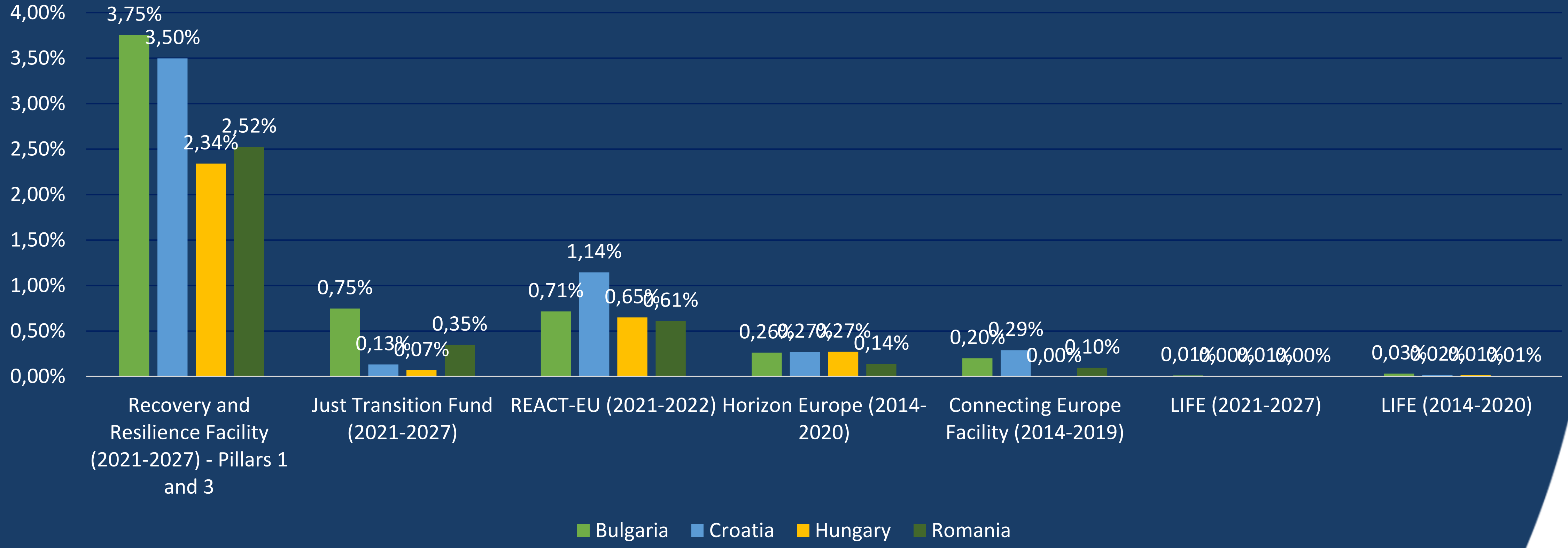
EU funding for Member States

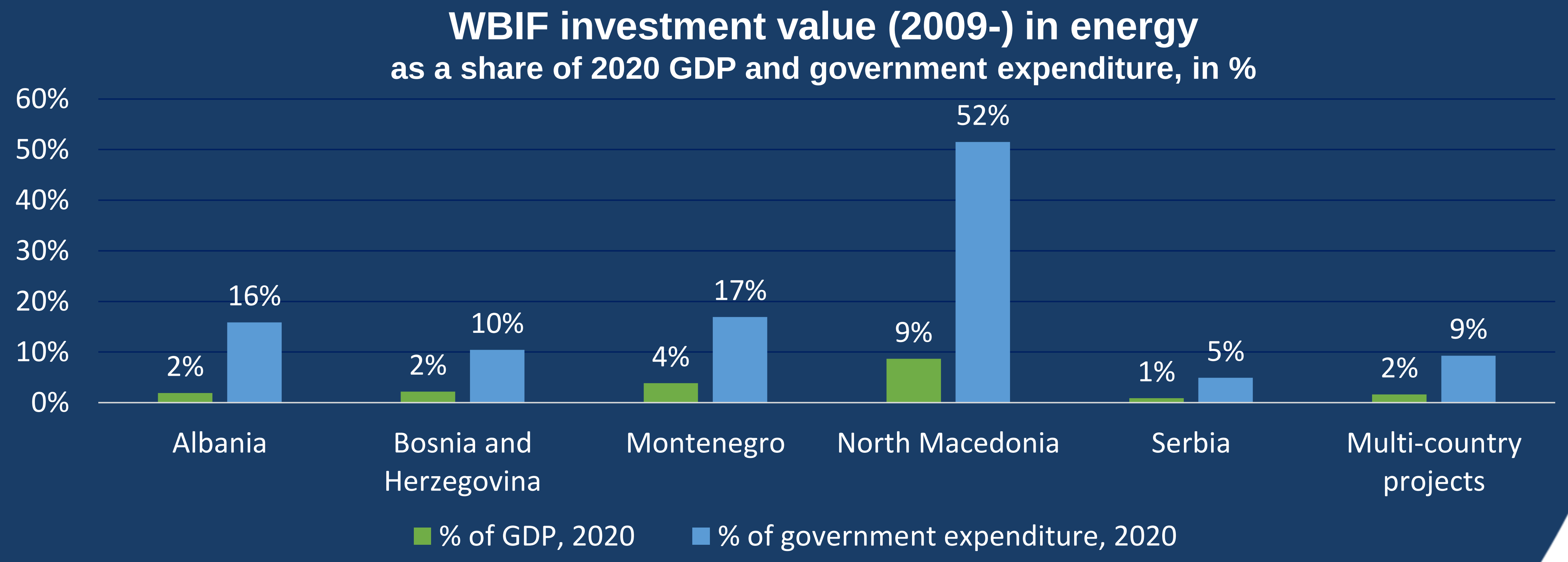
EU programme funding related to energy/green transition as a share of 2020 GDP, in %



Notes: *For the Recovery and Resilience Facility 2021-2027 data includes Pillars 1 and 3 (Green transition and Smart, sustainable and inclusive growth).*
For LIFE, the amount displayed is the sum of EU contribution to each countries' projects.
For Horizon Europe (2021-2027) data is not available, data refers to predecessor programme Horizon 2020.
Sources: *EU funding: Bruegel, 2021; nextgeneration.bg; European Commission: Just Transition Fund, Horizon Europe 2020; REACT-EU; LIFE; Data on GDP: World Bank; Data on EU spending: European Commission.*

EU fundings for the Western Balkans

- **Economic and Investment Plan for the Western Balkans** (EUR 9 billion in grants / expected to mobilize EUR 20 billion investments).
- **Instrument for Pre-Accession Assistance III** (EUR 13.8 billion, incl. EUR 5.9 billion for Green Agenda and Sustainable Connectivity).
- **Western Balkans Investment Framework (WBIF).**



__Sources__: WBIF website; World Bank (GDP and government expenditure).

Key uncovered governance risks for the management of energy sector SOEs

Key governance risks

- **Legal set-up not compliant with OECD guidelines**
- **Limited financial transparency**
- **Financial vulnerability and lack of strategic investment vision**
- **Political appointments**
- **Public procurement integrity deficits**

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Management risks in energy SOEs

Legal setup

- No special law on SOE management
- Non-compliance with OECD guidelines of corporate governance
- Implementation gap and inconsistency with EU law
- Non-application of environmental impact assessments

Financial transparency

- Publishing of partial or fragmented financial information
- Irregular updates of the financial reports, data on management processes and board structures
- Financial reports not based on international accounting standards
- Long delays in disclosing information on corporate deals
- Limited public scrutiniy of company performance

Financial vulnerability

- High debts and low liquidity
- Government efforts to keep energy prices artificially low
- Subsidies foster an unhealthy corporate culture
- Increased political dependence of SOEs and partiality (bias) of the regulatory bodies
- Financial vulnerability leads to a lack of strategic investment vision

Appointment procedures

- Non-competitive politically-driven appointment procedures
- Non-public, non-competitive procedures for Board member selection
- Conflicts of interests among board members
- Former members of energy regulators appointed to the Board of SOEs
- A channel for political influence on commercial activities

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Financial transparency and political appointment risks in SOEs management

	Financial transparency			Management appointments		
	Regular reporting	Detailed information	Accessibility	Transparency of the selection procedure	Political independence	Integrity
Albania	■■■	■■	■■■	■■	■	■
Bosnia and Herzegovina	■■	■	■■	■■	■	N/A
Bulgaria	■■■	■■	■■■	■■	■■	■
Croatia	■■■	■■	■■■	■■	■	■
Hungary	■■■■	■■■■	■■■	■■■	■■	N/A
Montenegro	■■■	■	■		■	
North Macedonia	■■	■■	■■	■■	■	■
Romania	■■■	■■	■■■	■■■	■■	■■
Serbia	■■■	■	■	■	N/A	N/A

■■■■ Front-runner ■■■ Satisfactory ■■ Unsatisfactory ■ Major concerns.5 N/A Not enough available information

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Public accountability and transparency of energy SOEs

EU membership does not ensure lower governance risks for SOEs in the energy sector.

- **Financial Transparency**
  Going public could help energy sector SOEs in improving transparency – e.g. Romgaz and Hidroelectrica in Romania, MVM Group in Hungary.

- **Political Appointments** of managers and board members
  E.g. in Croatia political party board members are (unofficially) obliged to devote part of their salary to the party funds.

- **Legal Setup and OECD Guidelines on SOEs Corporate Governance**
  The framework is still under development and its implementation is progressing slowly. EU Member States are performing better than those in the Western Balkans.

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Regulation, financial state and investment decisions

- Fossil-fuel dependency, which slows the decarbonization process, path dependencies leading to vulnerable financial state, price regulation and financial mismanagement

- Most energy SOEs display high losses and debt exposure, leading to the inability to complete key investments

- The weak performance of SEE-9 coal power plants led to financial difficulties. They are, however, subsidized by more profitable companies under the umbrella of a national major holding structure.

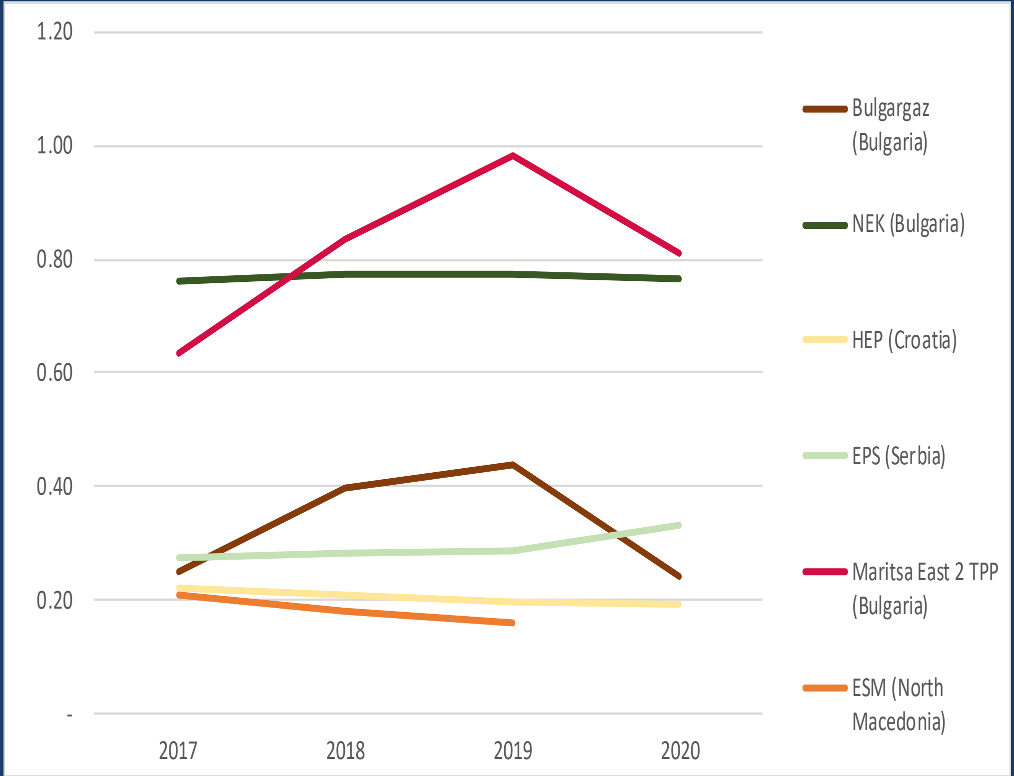
- Short-term profits from rising gas and electricity prices hinder the implementation of financial management reforms in the medium-term

- Strong politicization of the energy sector, jeopardizes the financial health and political independence of SOEs, resulting in low liquidity and falling current ratios – e.g. OSHEE in Albania, NEK and Bulgargaz in Bulgaria

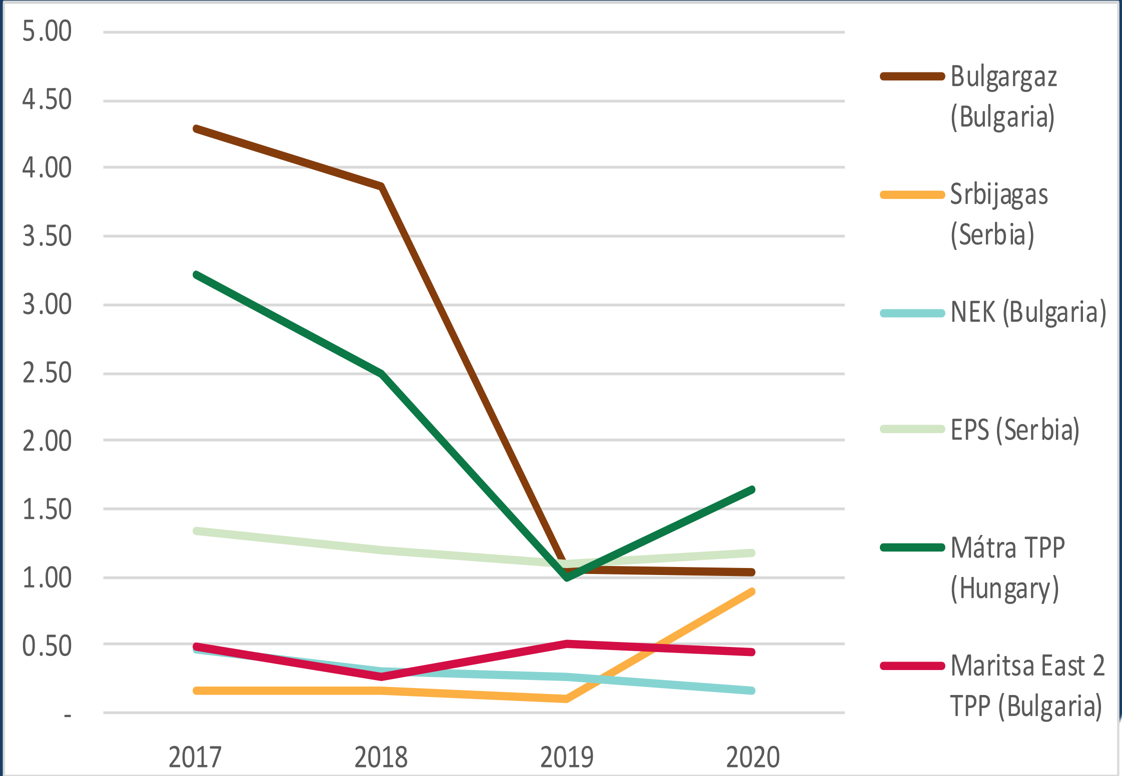
Public accountability and transparency of energy SOEs' management

Some of the SOEs are making considerable annual losses and have short-term liquidity issues.
Some governments try to "solve" the problem (e.g. writing off the debt of Srbjagas amounting to EUR 1.2 billion in 2020)

- Debt ratios for selected SOEs



- Current ratios for selected SOEs



***Source**: CSD based on data from KESH and OSHEE annual financial reports.*

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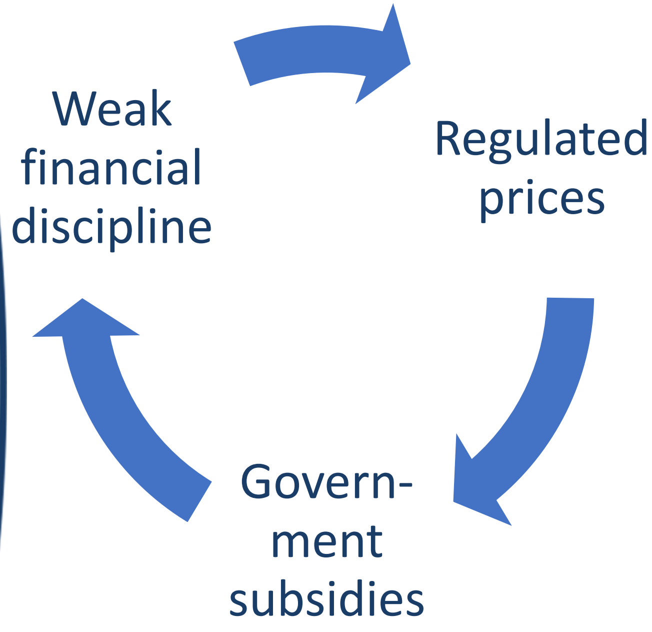
SOEs common path dependencies

- **Misguided Regulatory Policy**
  political influence on regulatory authorities to control energy prices. This erodes SOEs profitability, therefore governments subsidize state companies with direct aid or redistributing profits of more successful SOEs (e.g. Srbijagas).

- **Financial Mismanagement**
  Excessive staff size and overly generous remuneration. This does not help SOEs to restructure into more sustainable companies.

- **Political Influence**
  The direct political involvement in the energy sector compromises efficiency of decision-making and innovation, favoring SOEs' monopolistic position on the national market.



SOE state capture vulnerabilities

- Financial mismanagement undermined SOEs ability to invest in efficient projects, maintenance and modernization
- Regional energy SOEs require consistent long-term investments, strategic vision and operational strategies – e.g. Hrvatska Elektroprivreda in Croatia (has detailed 2030 investment strategy)
- Large investment projects in SEE-9 are often supported by Russia and China associated with domestic political and economic elites, leading to corruption risks and misalignment with national and EU energy and climate objectives – e.g. TurkStream project in Bulgaria, Serbia, Hungary
- In many cases, Chinese investments reinforced national coal industries, such as the lignite-fired Stanari plant in Bosnia and Herzegovina
- Lack of transparency in energy SOEs funding represents a serious corruption risk (Bulgarian ESO and Srbijagas in Serbia)

Governance deficits in the energy sector public procurement

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Before the selection procedure

- Ad-hoc creation of winning company is created only to win tenders (no past experience)
- contractors prepare documentation

  specifications "tailored" for the designated winning company
- provision of inside information about the tender
- unrealistically short deadlines
- creating artificial competition
- the tenders allocate funding for unnecessary investments
- overestimating the size of the investment
- overpricing the contract

During the selection procedure

- conflict of interest, political influence or bribing the evaluation committee
- avoiding the use of procurement procedures (direct negotiation, lowering the price, use of emergency procedures)
- listing specific projects as pre-determined for funding
- using centralised public procurement and framework agreements favouring big market players
- omitting social and/or environmental risks, thus artificially lowering project costs

After the selection procedure

- annulling tenders where "preferred" companies do not win
- disqualification of competitors on formalistic charges
- changes of the contract through annexes after the award
- conclusion of a second contract with the same provider, before the first job is completed
- paying for services/equipment which do not meet minimum requirements
- no investigation of high-level officials and businesspersons linked to a certain contract

The way forward

Safeguarding public procurement integrity

- Strengthen procurement monitoring
- Increase institutional efficiency
- Decrease share of non-open procedures
- Improve contract awarding mechanisms

Discontinuing Covid-19 emergency procurement rules

- Reverse temporary changes to emergency procurement rules
- Increase transparency of public procurement system
- Decrease buyers’ dependence by increase the fair competition

Improving the management of energy sector SOEs

- Apply the best international standards on corporate governance of state-owned enterprises (OECD Guidelines)
- Establish integrity checks and stronger due diligence specifically for the procurement procedures in energy sector SOEs

Thank You for Your Attention!