



# Privatisation & Public Private Partnership

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# Privatisation of the power generation sector in Bulgaria

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**Over time, direct privatisation (as opposed to PPP projects) has gained importance for the development and restructuring of the Bulgarian energy sector. Recent practical experience shows that a successful direct privatisation of a power generation asset depends largely on the following milestones: (i) appropriate privatisation strategy; (ii) availability of purchase price enhancement mechanisms; and (iii) efficient bidding process and reasonable negotiations. Although not all of these factors are properly addressed during the different stages of the process, the practice shows that the more efforts are devoted to each of them, the less “broken deals” remain in the statistics.**

## Introduction

In recent years the need for modernisation and attraction of significant private investments in the energy sector, as well as the requirements imposed in view of Bulgaria's intended accession to the EU, have resulted in continuing unbundling of the existing energy monopoly structures and the undergoing liberalisation of the electricity and gas market.

A couple of big energy projects were launched, including: (i) the €600m Maritsa East III PPP project (structured as a joint venture between the state owned National Electricity Company, the US energy company Entergy and the Italian utility company Enel for the rehabilitation, reconstruction and operation of Maritsa East III Thermal Power Plant); and (ii) the US\$1.4bn Maritsa East I BOOT project (involving the construction, development and operation of a replacement 670 MWs power generation capacity at the Maritsa East I Thermal Power Plant by the US energy company AES).

Due to the pioneering nature of these projects, their structuring and implementation took a while. Mainly for this reason, in the following years the Government decided to pursue subsequent restructuring activities in the energy sector as direct privatisation sales of assets or shares of energy companies to interested investors.

Currently, about 20% of the state-owned assets in the energy sector are privatised, including district heating companies, seven electricity distribution companies and some thermal power stations. The reorganisation of the state owned electricity supply and transmission company and the privatisation of certain other power generation companies are still to come. Thus, over time direct privatisation (as opposed to PPP projects) gained significant importance for the energy sector development and

proved to be a viable tool for the sector restructuring.

Recent practical experience shows that a successful direct privatisation of a power generation asset depends largely on the following basic milestones: (i) appropriate privatisation strategy; (ii) availability of purchase price enhancement mechanisms; and (iii) efficient bidding process and reasonable negotiations.

## Privatisation strategy

A key factor for a successful privatisation of a power generation company is the preparation of a privatisation strategy corresponding to the specifics of the privatisation object and meeting the sector/country objectives. The principle targets for the Bulgarian energy market, as outlined in the Energy Strategy of Bulgaria, could be summarised as: (i) attracting investments to ensure efficient, secure and environmentally-friendly energy supply; (ii) introduction of up-to-date management practices; and (iii) making the Bulgarian energy sector competitive. Those targets should form the core of the privatisation strategy.

An appropriate privatisation strategy would also take into account the interests of key potential investors, as well as the prevailing market conditions, in order to ensure consistency between the Government objectives and the investors' expectations.

For the purposes of an appropriate privatisation strategy it is extremely important that the seller, in a thorough and comprehensive manner, analyse the actual situation of the privatisation object, identify key issues and suggest remedial actions.

Areas requiring remedial actions would often include environmental non-compliance, uncertainties related to title to assets and asset valuation,

expiration of the term of sector specific licences and possibilities of extension, supply of local raw materials and alternatives if such raw materials are exhausted, renegotiation of previous indebtedness, pre-privatisation tax liabilities and liability of the state for historical pollution. Generally, remedy of irregularities and uncertainties established in the process of the seller's due diligence and disclosure of information to the fullest extent possible would be in the interest of all participants in the privatisation and would facilitate the process as a whole.

A good privatisation strategy should also be based on a profound market analysis. The ability of various possible privatisation structures to meet the privatisation objectives should be evaluated within the context of the market environment. Analyses would have to be made of the local and regional market, and of the position of the power generation company, subject to privatisation within those markets. The privatisation strategy should study potential developments on region-wide and EU-wide basis and implement the established projections in the requirements of the particular deal.

## Purchase price enhancement mechanisms

In view of the regulatory uncertainties inherent in transition to a liberalised market, it is advisable to consider options for providing certainty of cash flow. Such options could increase the value of the power generation company that is subject to privatisation and contribute to the bankability of the project in general. One way of providing an investor with such a certainty in cash flow and of enhancing the bankability of the privatisation is a long-term power purchase agreement (PPA) since the offtaker of the power would provide for a guaranteed market of a part (or whole) of the generator's output. An alternative mechanism for enhancement of the purchase price is a long-term capacity payment contract (CPC). The CPC is a tool to reward the investor of a power generation company (usually a peaking plant) for having capacity (as opposed to electricity) available for dispatch. Within the privatisation structure, a PPA or a CPC would typically be entered into between the power generator and the state owned electricity supply and transmission company.

The introduction of a PPA or a CPC within the structure of the privatisation deal, however, requires good coordination and cooperation within the government itself since it intertwines the interests of different constituencies. In the first place, such a purchase price enhancement mechanism engages the governmental body that is entitled by law to carry out the privatisation; secondly, the introduction of a

PPA or a CPC requires the involvement of the sector regulator and other relevant public authorities; finally, it brings forward in the picture the power generator and the state owned electricity supply and transmission company themselves. Clearly, all these participants have their own interests and aims, which sometimes may be even controversial. That is why the professional management of the process, the sound coordination and the constructive communication between such participants is crucial for the successful implementation of similar options in privatisation within the power generation sector.

## Bidding process and negotiations

From the perspective of the potential investors, a critical moment for the successful completion of the privatisation would be the efficient organisation and management of the bidding process and most notably the professional and careful accomplishment of the buyers' due diligence. Its primary aim would be to identify areas of problems or benefits in the power generation asset that is subject to privatisation but also to identify country and or sector specific risks and potentials. The identified pros/cons, respectively risks/potentials, should be taken into account during the formation of the financial models by the investors and 'priced' in the purchase price to be offered and the investment commitments to be undertaken. Further, the proper completion of the due diligence exercise by the buyer would help him identify these areas in the proposed privatisation that would entail harder negotiations and put aside those issues where compromise would be feasible.

The negotiations between the government and the selected investor are the closing stage of the privatisation. Very often, however, the negotiations in privatisation transactions turn to be the deal breaker. Therefore, a central factor in conducting negotiations on behalf of the government is clear strategy and objectives, on the one hand, and on the other - the composition of the negotiation team with professionals having sufficient capabilities and knowledge for deal managing, deal mending and deal making. However, one of the most important lessons that investors should learn before entering into negotiations with the government is to be reasonable. Potential buyers should understand that privatisation impacts the interests of different constituencies. This requires a great deal of flexibility and creativity on behalf of the investor and its team. The ability of the negotiating parties to understand each other's interests and positions and the capacity to accommodate such interests and positions in the

sales and purchase agreement might prove to be a crucial factor for a successful transaction.

## Conclusion

As illustrated in this article, a successful privatisation of a power generation asset in Bulgaria requires careful structuring, creation of appropriate incentives and a great deal of compromise. Although all of these factors are not always properly assessed and taken into account during the different stages of the process, the practice shows that the more efforts are devoted to them, the less “broken deals” remain in the statistics.

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