# MAGISTERARBEIT

Titel der Magisterarbeit

## The Rationale behind M&A and the Privatization of State-Owned Companies from the Energy Sector in SCEE

## Empirical Case Study E.ON AG

Verfasserin

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## Abstract: English

One purpose of this Master Thesis is to give us an insight on the reasons why a manager would choose to engage in a merger, by analyzing its decision from a financial and a strategical perspective. The other research direction looks at governments decisions to privatize state-owned companies with the purpose of offering possible explanations to why the state would willingly transfer its ownership to the private sector. Building up on the theoretical concepts, a case study is presented: the merger of E.ON, the acquirer, with Electrica Moldova, the target and a formerly state-owned utility from Romania.

The geographical area of interest for this paper is the South Central and Eastern Europe. The region per se is highly challenging but has an increased business potential at the same time, largely attracting foreign direct investments over the last years. The challenge comes from the environment's specificity and from the particularities of the decision-making process, possibly all due to a common post-communist heritage. Moreover, the focus casts on the energy sector firstly, because the privatization of state-owned utilities usually brings along other additional benefits, and then because of the sector's crucial importance for the local and regional sustainable development.

After analyzing the theoretical concepts and applying them in practice using the case in point privatization and merger, the paper ends with drawing the relevant conclusions. Some recommendations for future research are made at the end.

## Abstract: Deutsch

Diese Magisterarbeit behandelt zwei Fragestellungen: Zum einem sollen die finanziellen und strategischen Beweggründe, die zu einer Fusion oder Übernahme führen, aus Sicht der Firmenleitung beleuchtet werden. Ferner sollen die zur Privatisierungsentscheidungen im öffentlichen Sektor führenden Motive aufgezeigt und analysiert werden. Aufbauend auf den hierbei erarbeiteten theoretischen Konzepten wird eine Case Study vorgestellt: Die Übernahme des ehemaligen rumänischen Staatsunternehmens Electrica Moldova (Zielunternehmen) durch E.ON (Käufer).

Geographisches Hauptaugenmerk dieser Arbeit liegt auf Mittel-/Osteuropa. Zwar handelt es sich hier durchaus um eine hoch prekäre Region, dennoch führen zunehmende Geschäftsmöglichkeiten zu einem großen Anstieg der ausländischen Direktinvestitionen. Die Spezifität des Umfeldes und Eigenheiten der vorherrschenden Entscheidungsprozesse, vermutlich beides auf die kommunistische Vergangenheit der Region zurückzuführen, stellen jedoch Schwierigkeiten dar. Die Energiebranche wurde gewählt, da die Privatisierung von staatlichen Versorgern für gewöhnlich zusätzlichen Nutzen bringt und der Industriezweig von grundlegender Bedeutung für eine nachhaltige Entwicklung auf lokaler und regionaler Ebene ist.

Nach Analyse der theoretischen Konzepte und deren praktischen Anwendung im Rahmen der Case Study, werden abschließend die relevanten Schlussfolgerungen gezogen und Empfehlungen für zukünftige Forschungsarbeiten gegeben.

## Explaining my Interest in the Topic

My interest in the energy industry and possible mechanisms to improve the efficiency in this particular strategic domain dates back to last year when I accidentally came across an article in a Romanian newspaper relating to the energy crisis that began shortly after 1937. In particular, the article highlighted future oil shortage, followed by a natural gas shortage, which can explain present and future energy production and consumption patterns. In this sense, high energy bills (electricity or gas) for home heating can be seen as a tool of creating public awareness of energy prices.

At the University of Vienna I was fortunate to have courses such as International Strategy and Organization with topics regarding privatization in SEE that have further stimulated my interest in the SEE emerging markets as an opportunity to do business. These courses have enabled me to achieve a theoretical framework to work with in the future and have provided me a fundamental understanding of how analytical thinking works.

In the summer of 2009, I was lucky enough to get an internship at E.ON Romania, in the Planning and Controlling Department where I was responsible for doing market research about competitors such as CEZ SA, cost analysis and cost of capital calculations as well. It was there that I came to learn more about the Romanian Energy Market. Again I was very fortunate to spend some very fruitful time with very knowledgeable people in the industry including executives from whom I learnt about E.ONs acquisitive vision, or engineers that filled me in with many of the technical issues. These individuals made a special contribution to my understanding of both the company and the industry.

Additionally, the energy industry sector has essential importance on the local, regional, and global level because of its huge impact on sustainable development. At the end of the day, it all reduces to combining the benefits of adding economic value by doing business in the sector with the costs implied. Consequently, we, as consumers, have to take into account the resource based view and the environmental concerns. Resources are scarce and have to be allocated optimally and by reducing the damage on the environment to its minimum.

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# Introduction

### 1. Focus of the Research

In the last 20 years, international corporate governance has known significant development due to the intense activity of privatization of state-owned enterprises. There is clear evidence from all over the world that privatization has influenced positively the firm performance, however it is difficult to isolate the source for this improvement. The facts and figures across countries and industries indicate that mergers result in net wealth creation for privatized enterprises and thus indicate that one effect of privatization is wealth-creating mergers.

The aim of this paper is to identify the reasons that stand behind M&As when looking from a firm's perspective, on the one hand, and to highlight the main reasons standing behind privatizing state-owned enterprises when looking from the government's point of view, on the other. What the two theoretical concepts presented (M&A and Privatization) have in common is the transfer of ownership. However, the crucial distinction between them is that in the case of a merger the transfer occurs from one firm to another, whereas in a privatization process the transfer is made from the government to a company. Additional issues for debate raise from having the government playing the seller's role. These issues are largely discussed in Chapter III.

We ask ourselves the question which of the possible motives is / are significant enough to become drivers behind the transfer of ownership and convince managers engage in a merger, namely, determine governments to prefer efficiency and profitability instead of political benefits, that usually stand behind their reluctance to privatize, and sell the voting / control rights to private investors.

### 2. Methodology and Structure

The present paper is structured in two central parts. The first part is theoretical and tackles the subject of mergers and acquisitions, largely discussed in the management literature beginning with the 1950's. Additionally, the theoretical framework is completed by the privatization issue. The second part is empirical and comes to combine the two theoretical frameworks with the practice. The empirical case study is meant to helps us better define the driving motives behind mergers and privatizations in the SCEE and the energy sector in the area. The case study presented refers to the privatization of a formerly state-owned utility from Romania, Electrica Moldova SA. Based on the theoretical background, the expert interviews and internal company data that is allowed to be disclosed, conclusions are drawn at the end.

| Chapter | Purpose |
|---|---|
| I. Introduction | Presenting the research topic, the methodology and the structure of the thesis |
| II. The Rationale behind M&As | Classification of the motives behind M&As from a financial and strategic perspective |
| III. - V. The Rationale behind Privatization | Presenting the Privatization taking into account the ways to privatize and the governments reluctance to proceed with the process; Observing the activity in the domain from SCEE and the energy sector |
| VI. - VII. Case Study: Merger / Privatization | Introducing the two companies undergoing the merger by taking into account the economic, industry and legal conditions |
| VIII. Case Study: The Rationale behind the Merger / Privatization of Electrica Moldova | Describing the privatization steps, privatization strategy and the strategic fit of the two merging companies |

Theoretical part

Empirical part

# I. The Rationale behind M&As

Mergers have drawn the attention of academicians since the mid 1950's until present times. DePamphilis claims that the first decade of the new millennium heralded an era of global megamergers. Patterns of takeover activity and their profitability vary significantly across M&A waves. The combination of record high oil prices and a reduced availability of credit caused most of the world's economies to slip into recession in 2008. Consequently, global merger activity dropped precipitously in the same year. That is why, governments worldwide have intervened aggressively in global credit markets in an effort to restore business and consumer confidence and offset deflationary pressures.

Mergers have become to be a feature of corporate management all over the world and of the South Central Europe as well, especially after the Post-communist period. Researchers made numerous attempts to explain why corporate managers should consider M&As as strategies to create real economic value.

## 1. M&As Creating Value - the Financial Perspective

Most recent work related to acquisitions have been done in the finance area with a special care given to the wealth gain accruing to shareholders of the merging firms. One way to measure the wealth gain is to look at the positive abnormal returns during the merger announcement period. On the other hand, the finance literature makes a clear distinction between three possible synergies through which the economic actors achieve value creation.

M&As represent an important means of transferring resources to where they are most needed and removing underperforming managers, thus a transfer of a company's control. Samuelson states the following:

*"Takeovers, like bankruptcy, represent one of nature's methods of eliminating deadwood in the struggle for survival. A more open and more efficiently responsive corporate society can result." (Samuelson, 1970, p.505)*

Looking from a financial perspective we can differentiate between the following main sources of value creation through M&A:

- ✓ operating synergies;
- ✓ financial synergies;
- ✓ and tax synergies.

### 1.1. Operating Synergies

Operating synergies can arise from two essential sources, from increase in revenues and from cost reductions. Moreover, the increase in revenues can be realized through: improvements in distribution, improvements in marketing, improvements in the product-mix, strategic competitive advantages, realization of monopolistic profits, and increase in management efficiency. Whereas cost reductions are achieved through: economies of scale, advantages of vertical integration, better utilization of input factors, and again through increase of management's efficiency. Related firms are more likely to be able to realize cost savings due to overlapping functions and product lines than unrelated firms.

### 1.2. Financial Synergies

Through a merger a firm generally appears to be less risky than the two stand-alone firms before the merger because it reduces the cost of debt. What happens is that the two formerly independent firms end up guaranteeing for each other. An internal capital market is created, which would allow the funding of positive net present value projects otherwise difficult to finance through external funds. The creation of the internal capital market represents the financial synergy per se.

### 1.3. Tax Synergies

The increased debt capacity of the merged firm results in higher levels of debt, which generates higher tax savings. The higher tax savings represent the tax synergy per se. Additionally, there are also other sources to achieve tax synergies such as loss carry forwards and investment tax credits, that can be used to offset the combined firms' taxable income. The taxable nature of the transaction plays an important role in determining if the merger takes place or not and than to what extent any tax benefits that accrue to the acquiring company. In this sense, efficiency implies that a target's share price reflects accurately its true economic value.

### 1.4. Financing M&As and its Value Creating Implications

The acquirer firm can pay for the target firm in two possible ways. It is either cash or stock. Depending on the financing method chosen, there are tax implications, accounting implications, capital structure implications, information effects or cost effects.

The success of a merger or acquisition often depends on tax implications associated with the transaction. Transaction taxes are lower for share purchases than for cash purchases. Capital gains are the most common and prevailing taxes associated with mergers. In planning an acquisition, the tax structure following a transaction can result in significant tax efficiencies. However, obtaining capital gains tax relief is difficult when a foreign company is the acquiring firm. Many countries allow corporations to file consolidated tax returns wherein the profits and losses of the various subsidiaries are pooled. Thin capitalization rules exist to discourage foreign companies from structuring local subsidiaries with high levels of debt. Violation of an established debt-to-equity ratio often results in the interest payments treated as a de facto dividend payment. Ferris and Drake state that listing on domestic stock exchanges and indexes requires that a company be a domestic corporation. That is why many companies use the dual-headed structure as an initial merger structure.

The preparation of consolidated financial results has been standardized in many countries to help avoid the problem of information overload by investors. The preparation of consolidated financial accounting statements provides certain cost savings to a parent company. Consolidated data is so highly aggregated that it is often difficult to assess how individual business segments are actually performing. When an acquisition is executed by an exchange of stock, it may be permissible to account for the transaction as a merger using the pooling-of-interests method. This means that the accounts of the target and of the acquirer are simply added together. The difference between the purchase price and the book value of the target is called goodwill on the merged firm's balance sheet. The goodwill needs to be amortized and this will reduce the reported earnings of the merged firm. (Ferris, Drake, 2008, p. 160-182)

The capital structure implications for a firm that plans to finance the project with cash, and it does not have the necessary internal funds for it, would be that the firm would, increase the tax savings associated with debt, on one hand and on the other, it will also increase the danger of bankruptcy. When a firm is cash constraint it might be better to consider the stock financing possibility. Only acquirers with abundant free cash flows should use cash financing.

Regarding the information effects, if the acquirer's manager uses stock financing, the company's stock will usually drop on the announcement day. If the manager believes that the stock is undervalued he will not choose this type of financing but rather go for a cash offer. With cash-financed mergers, the stock usually knows a small increase on the announcement day.

The cost effects, depending on the financing type, relate to the uncertainty surrounding the target's value. If the acquirer knows that the merger is a good deal he will finance the project with cash because he would not want to share the synergy's benefits. In this case the cost of the acquisition is given. Whereas, with stock financing the cost depends on the target's value and remains uncertain at the announcement date and shortly after. Integration frequently turns out to be more challenging than anticipated.

### 1.5. Positive Abnormal Returns following a Merger

The large positive M&A announcement date returns could reflect anticipated future synergies resulting from the combination of the target and acquiring firms. Positive abnormal returns are abnormal in the sense that they exceed what an investor would normally expect to earn for accepting a certain level of risk. Abnormal or excess returns reflect the difference between the premium shareholders receive for their stock and what is considered a normal return for the risk they are assuming. The bidding firms see the highest potential for gain among those target firms whose management is viewed as incompetent.

DePamphilis argues that abnormal returns to acquirer shareholders may vary according to type of acquirer (i.e., publicly traded or private), form of payment (i.e., cash or stock), and size of acquirer and target. Private firms or subsidiaries of public firms are more likely to be acquired at a discount from their actual economic value than public firms. Bidding firms using cash to purchase the target firm exhibit better long-term performance than do those using stock. Larger deals may offer significant positive abnormal rates of returns.

## 2. M&As Creating Value - the Strategic Perspective

The managerial strategic perspective to M&As completes the financial one. It adds other possible synergy effects that stand behind the rationale for merging. Moreover, the strategic management literature goes into more detail in the case of operating synergies by analyzing them from resource-base and transaction cost-based points of view as well.

The synergy concept was initially discussed by Penrose, in 1959, who distinguished between the possibility of sharing managerial resources, and the transfer of excess capacity. Porter agrees with her, in 1987, and moreover, he states that these two types of synergies are the only ones a firm knows, though this statement has been later proven to be too narrow in scope. Then, the concept was further developed by Ansoff, in 1965, when he talks about four different types of synergies: sales synergies, operating synergies, investment synergies, and managerial synergies.

Today, numerous theories about M&As' value creation potential have appeared in the field of management and economics. By studying mergers from a strategical point of view and through different theoretical lenses we conclude that value creation derives from:

- ✓ operating synergies in production, R&D, and administration;
- ✓ collusive synergies from market and purchasing power;
- ✓ managerial synergies.
- ✓ and financial synergies. (Larsson, Finkelstein, 1999)

### 2.1. Operating Synergies in Production, R&D, and Administration

Considering the resource-based view, firms often take the decision to diversify and expand to be able to exploit the "pool of unused productive services, resources, and special knowledge" that comes from the routinization of activities. It is an expression of using excess capacity. On another market the same resource might be needed more or even worth more. It is usually the case of intangible resources, such as R&D skills or administrative know-how, that are not specific to a certain industry. Typically no significant costs are associated with their incremental use. The opportunity that arises from exploiting the excess capacity of this resources is one important explanation to why firms decide to merge. In this scenario, another possible alternative to mergers would be firm-specific investment or investments in sunk assets, but this would only generate additional unwanted transaction costs.

### 2.2. Collusive Synergies from Market and Purchasing Power

Mergers that happen in the same industry when a firm spots the productivity opportunity in acquiring another, usually has as a follow-up an increase in the market share. Having a higher market share enables the acquirer to achieve higher market power and a competitive advantage in comparison with other similar companies. Such a position might allow the firm to charge higher prices to consumers or negotiate too low input prices with suppliers. To avoid this certain anti-trust competition laws forbid firms to achieve such a monopolistic position which could turn into an antisocial activity.

### 2.3. Managerial Synergies

When a firm with superior management takes over a firm with many management inefficiencies, the shareholders of the target firm enjoy synergistic gains from either achieving a better coordination of the assets following the merger, or from the control shift of the firm's assets to a management that is more effective. The effectiveness of one management structure can be a function of higher know-how or stronger incentives in the process of creating value and maximizing profitability. (Slutsky, Caves, 1999)

## II. The Rationale behind Privatization

Half a century ago the economists were quick to be in favor of government ownership whenever a market imperfection like monopoly power arose or was even suspected. Even the laissez-faire economists overwhelmingly accepted this approach because the supreme goal of achieving competitive prices was at stake. Thus, in 1934, Henry Simons said:

*"The state should face the necessity of actually taking over, owing and managing directly, both the railroads and the utilities, and all other industries in which it is possible to maintain effectively competitive conditions". (Simons, 1934, p. 50-51)*

Only a few years later, Samuelson appeared less confident in the benefits of a socialist system:

"*It is too easy to gloss over the tremendous dynamic vitality of our mixed free enterprise system, which, with all his faults, has given the world a century of progress such as an actual socialized order might find it impossible to equal*". *(Samuelson, 1948, p.604)*

A lot has changed since then! Nowadays, governments throughout the world adopt reforms that have privatization as a central focus for their sustainable development. According to the World Bank, evidence of the failures of state ownership on a global level continue to accumulate, so that the theories regarding ownership and the question of state versus private provision are of pivotal research interest again. In this view, it all dates back to Coase (1937) and his "make or buy decision", except this time the private firm is no longer in the middle point of the discussion, but rather the government.

Gerald Roland calls privatization "the greatest transfer of ownership in the history of the corporation" in his book entitled "Privatization, Successes and Failures". The first wave of privatizations began in the '80s, continued during the '90s, and as it is a major component of market liberalization reforms still continues today, despite the current bad outlook in equity markets. Bortolloti defined privatization as the process through which governments all over the world sell "large chunks of their ownership in corporations to the private sector". This change in ownership has greatly reduced the role of the state in many national economies.

Consequently, an event as profound as privatization has raised important questions and thus, has been the central topic for debate of many research papers in the last years.

The privatization process, which has become a common global trend, varies considerably across industries and countries. Some countries pursue a sustained and consistent privatization policy as an important point in the reform program, while others block the free access of foreign investors only to small interest groups, thus registering weak and sporadic activity in this domain. The first example is the case of the United Kingdom where the process was first sustained by Mrs. Thatcher and then the divesture of SOEs became a priority of the political manifesto, allowing the Conservatives to be re-elected in 1987. The second example refers to the case of Belgium where Prime Minister Martens was severely contested by the trade unions at his attempts to restructure and denationalize the public sector.

## 1. Ways to Privatize

There are three different ways through which the governments can choose to privatize state-owned companies:

- asset sales;
- share-issue privatizations;
- and Voucher privatizations.

In general, through an asset sale the government sells the ownership of state owned enterprises to private investors and small groups of people. An auction is organized in most of the cases, although sometimes the government decides to sell directly to private investors.

Alternatively, the government can decide to sell SOEs in share-issue privatizations (SIPs). In this case what the government does is to offer equity shares to the public, to both retail and institutional investors. This is the most common form of privatization known because it is the largest and most significantly relevant.

Voucher privatizations are usually typical for former Communist Eastern European countries and it is a way of making the citizens become owners of state's assets. These rights are given for free or sold at very low prices. Privatization took this form in the Communist countries (and formerly Communist) because SIPs were politically unacceptable. Low income levels and unequal distribution of it are two important characteristics that should be taken into account here. In this view, only individuals with wealth were able to acquire them and these were often "Communists, criminals, and foreigners". (Parker, Saal, 2003, p.34)

## 2. Factors that affect the Government's Decision when Choosing the Way to Privatize

The most common factors that determine the choice of the privatization method are: market and potential investors considerations; political and legal environment; and firm and industry characteristics. Several of these factors might be influential in ways impossible to predict ex-ante.

When considering the market characteristics, two subsequent factors influence governments in their decisions, namely: the current level of market valuation and the development level of the country's capital market. There are periods more favorable to privatize than others, such as the high valuation periods or "hot markets" (Megginson, Nash, Netter, Poulsen, 2000). Then, governments would in this case prefer to privatize using SIP[1]. Consequently, in countries with less developed capital markets, governments may favor privatizing by asset sales due to higher underpricing and uncertainty about the SOE's intrinsic value. Additionally, it has been argued that the privatization programs using SIPs can be used as a tool to jumpstart stock-market development by encouraging more firms to go public. [2]

If the political and legal environment is to such a degree that it greatly protects the private property rights, then the state's officials would consider an asset sale type of privatization. On the other hand, this is a risky decision for the buyers of SOEs, because it holds no guarantee to them that the next government will not renationalize the enterprise in the

[1] Share-issue Privatizations

[2] It creates a so-called "snow-ball" effect on the capital market. (Megginson, Nash, Netter, Poulsen, 2000)

future or change its privatization policy. They would unquestionably prefer a SIP type of privatization because it creates thousands of citizen investors, and induces the risk that the government will incur substantial political costs should it tried to renationalize.

The firm-specific characteristics can greatly affect the government's decision to privatize and the method. Information asymmetry surrounding the uncertainty regarding SOEs value, the firm's size and the post-divestment performance are the three most important indices that the government and investors take into account when engaging in the privatization process. On the other hand, the industry-specific characteristics also play an important role. Therefore, governments may be more likely to privatize SOEs belonging to strategically important industries through an asset sale.

### 3. Reluctance to Privatize

When faced with the privatizing decision, governments are reluctant to lose the power control and voting rights to the private sector. Usually, there is no such thing as privatizing with enthusiasm. This is especially true in the case of Italy. Even though Italy occupies the third place in the world for the intense privatization activity, the Italian government is still the largest shareholder in several privatized firms.

The government's reluctance to privatize manifests itself the most in the case of basic, strategic industries such as the energy sector. Studies carried from OECD[3] countries show that, after a privatization, 77.1% of the privatized utilities have the government as the largest shareholder. (Bortolotti, Faccio, 2004)

Trade unions around the world are typically one of the strongest opponents when a privatization opportunity comes along. Their members enjoy various benefits from SOEs for offering their support in elections and even have the power to bring down a government. Subsequently, the unions' job is to protect employment. Most often, the privatization of state enterprises comes along with strict restructuring plans to pursue improvements in productivity and profitability which may imply the reduction of employment rates.

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[3] Organization for Economic Co-Operation and Development

## 4. The Government - A Bad Owner of Companies

The first order reasons to privatize are generally budgetary constraint or external pressure. The external pressure can either be exercised by lending agencies or international institutions. Other possible reasons, would be the inefficiency of SOE or management failure, also exist. It is often the case that these state owned companies are run to achieve political objectives, notably by increasing employment rates and maximize social welfare rather than pursuing the maximization of profitability. In this view, the privatization solution comes as the next best natural solution and makes an ownership and control transfer to outside investors whose only interest is to get the highest rents for their investment, and thus achieve efficiency. (Shleifer, Vishny, 1994) Other reasons to why the government should switch from public to private provision are the high innovative potential of entrepreneurial firms and their capability to deliver higher quality products at competitive costs.

There is only a limited set of circumstances when the government ownership is superior to private ownership, namely when:

1. “the opportunities for cost reduction that lead to non-contractible deterioration of quality are significant;
2. innovation is relatively unimportant;
3. competition is weak and consumer choice is ineffective;
4. and reputational mechanisms are also weak.” (Shleifer, 1998)

As the researcher himself argued, the above circumstances would only prove again just how “tenuous” the government production is. Just to point out the rareness of such a situation consider the case of operating Air Force One, the airplane responsible to service the President of the United States.

## 5. The Political Pressure - A reason for Inefficiency

Bortolotti, Siniscalo and Fantini (2003) discuss the effects the political influence has on firms and their efficiency. It is mostly argued that privatization is more likely to be implemented when there is a low level of corruption. By itself, it is a tool in the reformers’ hands to restrict governments from spending and helps eliminate politically motivated resource allocation.

Thus, the corruption consideration becomes vital when addressing the issue of state versus private ownership and further reduces the optimal range of government ownership.

There is also often the case when politicians and managers bargain endlessly over power benefits instead of efficiently allocating the resources. Their relationship is governed by contract incompleteness instead of incentive contracts, and thus they spend precious time on bargaining over the residual rights of control. In this context, the question that arises is: how would private ownership make a difference? The right answer to this question is that with full corruption privatization does not matter. The allocation of control rights and cash flow rights does not influence resource allocation with full corruption. The corruption issue related to successful privatization is a severe problem especially in the case of Eastern European Countries.

Even though politicians follow their own incentives and are highly reluctant to privatize we see intense activity in this sense, even in geographical areas like SCEE. Following this, we would logically ask ourselves why rational politicians ever agree to privatize? This is due to competition between two types of politicians stemming from different motives: there exist those who receive benefits from government spending and bribes, and then others that benefit from low taxes. Thus, privatization happens when democratic governments replace left wing, communist governments. The democratic governments represent the interest of the tax payers and the communist ones are favored by public employees. Additionally, it has been proven that majoritarian political systems, as opposed to proportional systems, are more likely to privatize.

### 6. Private Ownership has its Costs

Minority shareholders's interests are at stake since they are exposed to expropriation of management and controlling creditors. Additionally, concentration of ownership creates opportunity for large shareholders to extract private benefits at the expense of outside investors. (Jensen, Meckling, 1976; Shleifer, Vishny, 1986) In this respect, a residual government stake in a privatized company can be beneficial because the government can afford favorable treatment to companies by subsidizing loans or guaranteeing contracts. By using this measure governments shield privatized companies from competition. This is often the case of former state monopolies operating in the energy sector (e.g. utilities), who are thought to be strategically significant for the national welfare and are consequently granted these monopolistic rents.

## III. Privatization in SCEE

Privatization, by itself, represents an ideological and symbolic "break" with a history of state control over a country's products and assets. In this view, this symbolism and its effects are the most apparent in the economies of Eastern European the former Soviet Union, where privatization of state owned enterprises (SOEs) "has come to signal a nation's transition from communism to democratic capitalism". (Megginson, 2000)

Privatization was an uncommon practice during the Communist period due to political reasons and the nationalization policy following various ideologies. The Communist governments came to own entire economies for the purpose of keeping the ruling dictators in office. They were also engaged in planning nearly all resources, and controlling the people through monopsony over employment.

One significant particularity that makes the difference between Western European countries and the SCEE is the fact that in the West, SOEs usually operate in only a few sectors and differ systematically from other firms. By contrast, in the SCEE countries operate in nearly all sectors. Additionally, we notice the distinction of careful selection along the privatization process in the West, as opposed to the rapid transfer of ownership and in a short period of time for the SOEs privatized in SCEE. Moreover, Uhlenbruck and De Castro (2000) found substantial differences in organizational structure, management culture, and human resource policies between Western acquirers and SOEs in formerly Communist countries in SCEE.

In this sense, the transition economies of South Central and Eastern Europe offer good grounds on which to test and refine the existing management theories and the traditional views on mergers and acquisitions. A couple of other additional factors related to the specificity of the region have to be considered, not just the mere transfer of ownership from public to private sector. In privatization the government is the seller and its interests go beyond economic concerns (e.g maximization of profitability). The economic concerns do not surpass the political and social ones (e.g employment rate, labor union's political support). Moreover, unlike in a traditional M&A process, the government can enforce conditions after the acquisition due to its power to control many of the country's resources and distribution channels or because it might be the SOEs most important customer.

In Central and Eastern Europe, the rationale behind privatization is:

- the scope of reducing the government's influence in the economies[4];
- achieving efficient capital markets / developing them;
- need for entrepreneurial and managerial skills;
- need for technology skills;
- need for marketing skills;
- achieving productivity and corporate performance;
- cost reduction considerations.

## 1. Privatization and Merger Frameworks: Evidence on Performance from SCEE

In combining the two frameworks: privatization and mergers, strategic and organizational fit together with firm transformation have to be taken into account. Also significant is that M&As in formerly Communist countries involve much higher risks than those of typical mergers. The problems appear due to uncertainty in the valuation of the target companies, as well as political and economic risks.

The management literature defines a strategic fit of the situation where the anticipated merger benefits of the acquirer are based on the asset and complementing operational effect of the merging companies. In this view, the main motive for merging with Eastern European SOEs is the acquisition of operational synergies by building upon trade relations or lower costs associated with the privatized firms. (Chatterjee, 1986) Outsourcing comes as an additional motive for foreign investment in the area and this motive is strictly tied to industry-specific firm capabilities and the acquirer's industry know-how. This is why industry

[4] During the 1980s, the state's share of production was approximately 80% in the CEE. (Uhlenbruck, De Castro, 2000)

and vertical relatedness between the merging firms is positively correlated with the SOEs' post-privatization performance.

Organizational fit means primarily the similarity in organizational culture, management style, control and reward mechanisms, and the size of the emerging firms. The most critical aspect of all, which makes the unification more difficult and the transition more painful, is the difference in the reward and control policies between the acquirer and the target. However, Uhlenbruck and De Castro (2000) argue that the similarities in control and compensation schemes of merging companies are, surprisingly, negatively correlated with the SOEs' post-privatization performance. This highlights the unique characteristics of privatization acquisitions. A logical explanation to this finding would be that managers of SOEs from SCEE countries followed goals other than financial performance (e.g minimizing inputs for a given volume of output). Cross-cultural studies show that motivations and goals of managers differ from one culture to another. (Hofstede, 1980)

The integration, and thus transformation process of the recent acquired SOE would imply considerable efforts and immense costs on the acquirer's side to improve the target's processes and technology. Consequently, this requires large investments. Investment level becomes a way to measure and reflect the intensity of the firms' actions in the integration process. In terms of performance, it has been proven that investments in the transformation process of SOEs are positively correlated with post-privatization performance. (Uhlenbruck, De Castro, 2000)

The government involvement is another key determinant of foreign direct investment with the purpose of acquiring SOEs from the South Central and Eastern European countries. SOEs are often not sold to the highest bidder, thus implying that there are incentives for the acquirer to behave opportunistically. Because the government anticipates this it has its ways to avoid it: it stipulates that acquirers must not liquidate the business, limits layoffs, stipulates a maximum level of post-privatization specific investments, etc. (Brouthers, Bamossy, 1997) However, it can also offer the investors better conditions, such as: securing financing, guaranteeing procurement, allowing tax breaks, restricting import competition, or limiting new entry. All in all, government involvement and post-privatization conditions, such as afore mentioned limiting of layoffs, is negatively correlated with performance.

High country risk hinders foreign direct investment in the region. The country risk includes the following elements: limitation on currency convertibility, high inflation rates, GDP decline[5], political risk (e.g. government instability). When investing in a country with a higher risk the returns are calculated with a higher return because the return also accounts for the country risk premium. Consequently, the post-privatization performance is positively associated with the degree of country risk. However this result does not apply to a long term period.[6]

## 2. Privatization's Effects on Productivity in Hungary, Romania and Ukraine

The empirical work on the topic found evidence of a substantial positive effect of privatization on productivity. Romania showed the best results with a range of estimates from 15 to 50%; Hungary had a range of 8 to 28%; and for Ukraine the range varied from 2 to 16%, on annual basis.[7] (Brown, Earle, Telegdy, 2005)

The differences in the firms' productivity across the countries appear primarily because the methods and pace of privatizing differ from one country to another. Hungary has a maintained a constant and continuous process and chose the case-by-case privatization method throughout the transition period. Romania, in turn, knew a slower pace in the beginning when it tried the voucher programs. After 1993, it proceeded towards mass-privatization and then engaged in programs with large-scale employee ownership and dispersed shareholdings, focusing on foreign direct investment at the same time. Ukraine witnessed a moderate speed and there is proof of large manager and worker large-scale ownership.

There is another important aspect to be considered, namely foreign investment privatization as opposed to privatization involving domestic ownership. It is usually the case that the positive effects on productivity are higher, when transferring ownership to foreigners rather than to domestic investors, especially if the owners believe that they can tap more benefits

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[5] The Gross Domestic Product in the SCEE countries often decreased by 20% p.a in the beginning of the transition period. (Uhlenbruck, De Castro, 2000)

[6] Internet: www.emergingmarketsmonitor.com - Homepage Emerging Markets Monitor, accessed: 20.06.2010

[7] The range of estimates is explained by the varying approaches taken when dealing with selection bias.

from better management skills or have access to finance and new technologies. On the other hand, foreigners do not find the incentives to invest when layoff decisions are highly politicized and when local networks and knowledge of local conditions are nontransparent. (Brown, Earle, Telegdy, 2005)

In this view, at studying the positive productivity effects of these countries when the origin of investment is involved, we come across no statistically relevant differences, not even when scrutinized. Foreign investment assures better productivity for everyone. The positive effect of foreign ownership are significant in Romania, especially after 1997, when greater efforts were made to attract foreign direct investment (FDI).

Regarding the dynamics of the effects, related to the privatization's impact, Brown et al observe an immediate effect for Hungary and Romania. For Ukraine, the effects seem to appear only after one year. Moreover, they continue to be positive and to have a sustained increase after three years, in the case of Romania and Ukraine. The thin differences in the dynamics of the effects between the three countries are explained by two essential drivers: the management's attitude after anticipation of the events, and the supposition that investors have private information on the company's growth potential.

Consequently, the managers in Hungary are more career-concerned and have the necessary incentives to show their skills and perform well, while those from Ukraine engage in asset-stripping[8] because they would expect to be fired after the privatization. On the other hand, it is implied that the investors own private information which drives them to buy and they believe that the acquired firm would experience a positive productivity shock comparable to other firms in the same industry. (Brown, Earle, Telegdy, 2005)

[8] The individual sale of the company's assets, such as its equipment and property, due poor management conditions, because they are seen to be more valuable than the company as a whole. (www.investopedia.com - Financial Dictionary, accessed: 14.04.2010)

### 3. Privatization's Effects on the Firm's Revenue and Cost Performance

Effective privatization affects the firm's revenue and cost performance in a positive way. In the transition economies like Czech Republic, Hungary and Poland, the performance effects differ depending on the type of owner to whom control is given. (Frydman, Gray, Hessel, Rapaczynski, 1999)

In the case where privatization is effective, the outsider versus insider ownership after restructuring receives significant importance in observing the different effects it has on revenue performance and cost reduction. This distinction is primarily given by the owners' different attitude towards risk and uncertainty. Therefore, with insider ownership, the manager or the employees are in charge, and with outsider ownership foreign investors have the control power. The results of the study carried forward by Frydman et al (1999), using data from these Central European countries, reports that privatization is effective in enhancing revenue and productivity performance when the firms are outsider-controlled, but produces no significant effect for firms controlled by insiders.

Regarding the generalization potential of the results on corporate performance, it has been argued that they might be specific to the Central European environment due to the political, macroeconomic and sectoral specificity of these post-communist countries.

## IV. Privatization in the Energy Sector in SCEE

High energy consumption bills for gas or electricity has created public awareness and awoke the interest of the end consumer concerning energy efficiency. Many utilities face financial difficulties because they have weak corporate governance and internal inefficiencies. Most of these utilities are usually still state owned enterprises (SOEs), especially in the South Eastern Europe. Shleifer and Vishny (1997) call these companies a "manifestation of radical failure of corporate governance".

How has the world changed in the last decades respective to the economists' beliefs upon state ownership of certain industries? It was 80 years ago when Henry Simons said:

*"The state should face the necessity of actually taking over, owing and managing directly, both the railroads and the utilities, and all other industries in which it is possible to maintain effectively competitive conditions". (Simons, 1934, p. 50-51)*

The South Eastern European countries have a Communist heritage in common, which can explain why these countries have the same issues regarding the profitability of their actual former state owned utilities. The inefficiency of the former state enterprises is the most important social cost. Foreign investors, especially Western European, have already spotted the great potential of the sector and area, and naturally this is why there is currently an intense investment activity in the energy sector of these emerging markets.

Most often, Foreign Direct Investment addresses the form of privatization in the case of state owned utilities. As privatization has now become a governmental encouraged measure to achieve sustainable development in the long run, the investors buy these companies at more than advantageous prices. The goal would be to transform the inefficient former state owned utilities into modernized and highly efficient companies with a better infrastructure at almost any costs. The gains come from the achieved efficiency along the resource-production-transport-distribution-consumption chain that brings along a better use of the resources, the infrastructure's development, more affordable bills for consumers, and sustainable development within the environmental norms. (Czamanski, 1999, p. 1-25) In this sense, Romania would be an eloquent example of the governmental friendliness towards privatization with foreign ownership.

Moreover, once an activity is privatized, the role of government in control and regulation generally falls to some extent, and consequently so do the opportunities for corruption, which previously was the source of so many inefficiencies in the SCEE area. However, there is evidence that the East European countries and even Russia succeeded in designing relatively corruption-free privatization programs despite widespread corruption in their bureaucracies. (Bycko, Shleifer, Vishny, 1995)

The regulation responsibility is partly delegated to a higher level, e.g. the EU level, and lately, has become a central global interest. Public Utility Regulatory Policies began to play an increasingly important role having the mission to promote sustainable development at both a global and regional level. For instance, the European Union has launched in 2007 the new energy policy, and energy occupies an essential role in the Union's development. The explanation for this central role lies in the sector's impact on climate change, among other factors.

Usually the government is reluctant to privatize, especially when it comes to strategically important sectors like the energy industry. Studies carried from OECD[9] countries show that, after a privatization, 77.1% of the privatized utilities have the government as the largest shareholder. Moreover, this reluctance can manifest itself irrespective of the origin of the investors. Take for instance the example of Mexico and Venezuela where the constitution explicitly prohibits the privatization of their national monopolies even to domestic capitalists. However, this reluctance towards privatization does not apply to the Communist and formerly Communist countries in SCEE, thus again proving the specificity of the area. (Bortolotti, Faccio, 2004)

In the transition countries of Eastern and Central Europe, the decentralization process has begun with cities establishing semi-private ventures on a concessionary basis as a part of political reforms, so that the tasks of former regional state agencies are being given to municipalities. This is the case of some big cities in the Czech Republic and Hungary. However, this did not provide the long sought efficiency. The reason why the strategy failed was because of the lack of financial and infrastructural capacity at the municipal level. This fact might well prove an incentive to privatize. Of all the transitional economies Hungary, the Czech Republic, and Poland were the most successful with these decentralization attempts. Hungary followed the privatization path with a fast pace, in the Czech Republic independent power producers are very active in the domestic market and in Poland a new energy law was enacted in 1997. (International Labor Office, 1999)

The trend in the gas sector is the continuous seeking of ways to extend the network across the continent via joint ventures. The sector is partially privatized by the Russian gas company Gazprom, which produces almost one-third of the world's natural gas. Ruhrgas, which is Germany's largest gas distribution company, announced that it will establish a long-term "strategic alliance" with Gazprom, and signed contracts for the supply of up to 13 billion

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[9] Organization for Economic Co-Operation and Development

cubic meters of Russian natural gas. (International Gas Report, 1998) This would possibly lead to the construction of new pipelines. Gazprom is also expected to establish other strategic alliances with Royal Dutch Shell and ENI of Italy. However, the former Soviet Union countries have shown some political resistance regarding the Russian gas company, and they are still making considerable efforts to seek alternative supplies. (International Labor Office, 1999)

## Empirical Case Study

## V. Background Information: Merger at Horizon

The energy sector dominates M&A worldwide with over two thirds of the transactions located in Russia. In Romania as in all emerging markets, M&A is largely a privatization driven sector. The transition from centrally planned to market economies in Eastern Europe has become a field of debate in economic literature since the late 1980s. Intensive mergers & acquisitions (M&A) activity and privatization of state owned companies, have been characteristic of the energy industry for more than 20 years.

It is assumed that over the next three decades, Eastern Europe will approach current Western living standards thus leading to an increase in the energy consumption. Such optimistic prediction, however, should not be taken at face value. Financial and technical constraints will impede some of the potential gains in energy efficiency in Eastern Europe. Overcoming them will require national leadership and decisive international cooperation. For capturing the energy-efficiency potential in Romania a certain reform in the energy market was implied. (Chandler, W., Kolar, S., Gheorghe, A.,and Sitnicki, S.)

Since 2000, the Romanian government has accelerated efforts to restructure and privatize the inefficient systems of energy production and distribution inherited from the Ceauşescu regime. 2004 was the year when the Romanian energy sector, seen by many as the backbone of Romania's economy, took a decisive step towards integration in the European single market. Four European investors took over the reins of key companies forming the backbone of the Romanian energy sector, in transactions totaling a rough €2.25 billion. Among these companies there was E.ON AG, who won the auction to merge with Electrica Moldova SA, a state owned company. The time line to this merger expands over a period of 6 years, from 2004 - 2009.

The reform started following a Government Decision in January 2002 with the market liberalization. Then, the market openness was increased to 33%, with licensed suppliers and eligible customers defined by the regulatory authority. In practice, the contracts signed between licensed suppliers and eligible customers amount to around 8% of the market.

Moreover, from January 1, 2007, as Romania became part of the EU, the domestic natural gas market was liberalized for all non-household consumers, and from July 1, 2007, for all consumers. [10]

## VI. Merger and Privatization Environment

### 1. Companies' Profiles

### 1.1. The Acquirer: E.ON Group

*Figure 1: E.ON Group Logo*

E.ON AG is an industrial group in Germany active in the energy business. Moreover, it is the second largest listed power generation company in Europe according to Business Insights report of June 2009. It has a market share of 6.7%, based on the sales in 2007 according to the same energy market valuation report.

The company is very internationalized with company's operations vertically integrated and split into separate market units all over the world. It possesses long term gas supply contracts and it began with expanding on the electricity as well. The units of business operation are: Central Europe, providing energy for the Netherlands, Slovakia, Hungary, the Czech Republic, and Switzerland; Pan-European Gas; UK; Nordic, distributes energy for the northern Europe; U.S. Midwest; Energy Trading; Climate and Renewables; Russia; and Italy. The company is based in Dusseldorf.

In the future, E.ON plans to invest €30 billion to strengthen its infrastructure and customer base. The investments should take place during 2009 - 2011. However, in 2008 and 2009, the company's investment appetite was cut to certain extent, when the group had to pay a fine of €38 million, and €553 million respectively. In 2008 it was for the breach of a European

[10] Internet: http://www.enercee.net/romania/energy-market-actors.html - Austrian Energy Agency, accessed: 5.03.2010

Commission seal in E.ON's premises during an inspection[11] and in 2009 for market sharing behavior together with GDF Suez SA (of France) in breach of EC Treaty rules on cartels and restrictive business practices (Article 81).

The company that acquired the state-owned utility Electrica Moldova S.A is E.ON ENERGIE AG, a subsidiary of the German company E.ON AG (100%), the mother company of E.ON Holding. The company E.ON ENERGIE AG represents the E.ON Holding for Central Europe for businesses in energy field.

### 1.1.1.Major Acquisitions

According to the energy market research report, issued June 2009, and available on the Business Insights database, between 2007 - 2009, E.ON closed the following major deals[12]:

| Year | Target Company | Rationale |
| --- | --- | --- |
| Jul-08 | Wind farm (Shell), the UK | Strengthened renewable energy portfolio |
| Jun-08 | Endesa Europa, Spain | Expanding generation capacity in France, Poland, Spain and Italy |
| Jun-08 | EnelViesgo, Spain | Expanding power generation in Spain |
| Oct-07 | OGK-4, Russia | Market entry decision into Russian electricity market |
| Aug-07 | Energi E2 Renovables, Ibericas, Spain | Strengthened renewable energy portfolio in Spain and Portugal |

*Table 1: E.ON major M&A Activity (2007 - 2009)*

Source: E.ON Archive, Internal Data

[11] Council Regulation 1/2003 (Article 23(1) (e)) provides that the Commission can impose a fine of up to 1% of the company's total turnover for a seal broken intentionally or negligently.

[12] Internet: www.bi-interactive.com - Business Insights Database / Energy, accessed: 23.03.2010

### 1.1.2.Historical Financial Information

E.ON generated €86,753m consolidated revenues in the fiscal year 2008[13], registering 35.5% growth over 2007. Revenues, though, decreased by 32.7% and reached €30,813m in 2008. The figures relate to its utilities business in Europe. The decrease in revenues is strongly connected with the formation of a separate reporting division designed for energy trading. This lead to the exclusion of trading revenues from segmental revenues which was not possible during 2004–07. E.ON recorded operating profit of €8,838m in 2008, 7.6% growth over 2007. During 2004–08, E.ON's operating profits from its utilities business in Europe increased at a CAGR[14] of 13.4% during 2004–08[15].

| € m | 2004 | 2005 | 2006 | 2007 | 2008 | CAGR 2004-2008 |
|---|---|---|---|---|---|---|
| Turnover | 45,024 | 54,096 | 43,272 | 49,174 | 30,813 | (9.0%) |
| Operating Profit | 6,326 | 6,796 | 7,930 | 8,820 | 8,838 | 8.7% |
| Recent fiscal year end is December 2008. | | | | | | |
| Segmental revenues for 2004 and 2005 include up/midstream gas revenues whereas for 2006-2008, up/midstream were reported separately and are excluded. | | | | | | |
| Segmental revenues during 2004-2007 include trading revenues, as their backup is not available in the company annual report. | | | | | | |
| Operating profit also includes profit from up/midstream gas sales. | | | | | | |

*Table 2: E.ON European utilities' financial performance (2004-2008)*

Source: E.ON Archive, Internal Data

[13] Company insider information made public without any breach of confidentiality contract

[14] CAGR stands for Compound Annual Growth Rate which is calculated as:
Internet: www.investopedia.com - Financial Dictionary, accessed: 6.05.2010

$$CAGR = \left(\frac{\text{Ending Value}}{\text{Beginning Value}}\right)^{\left(\frac{1}{\#\text{ of years}}\right)} - 1$$

[15] Business Insights Report: Top 10 European Utility Companies (Internet: www.bi-interactive.com - Business Insights Database / Energy, accessed: 23.03.2010)

### 1.1.3.History and Nature of Business of the Acquirer

The National Company named Societatea Nationala de Gaze Naturale Romgaz, was reorganized according to the services provided. After the reorganization resulted DistriGaz Nord, a state-owned company that would become privatized in June 2005 by E.ON Ruhrgas. Until April 2006 the company continued to run under the same name when it became E.ON Gaz Romaina. Another important point in the company's history had been July 1, 2007, when the management had to split the activity into supply and distribution and thus to organize two legally independent entities: E.ON Gaz Romania (supply activity) and E.ON Gaz Distributie (distribution activity). The decision came as a consequence of the alignment of the Romanian legal requirements to EU and had the main purpose of ensuring a full liberalization and fair competition on the market. Both companies are held by E.ON Gaz Romania Holding S.R.L since January 14, 2008.

At foundation the share capital of the company, E.ON Gaz Romania Holding S.R.L was RON 10,000 and the only shareholder was E.ON Ruhrgas International AG. The capital structure of the company changes on March 17, 2008, with E.ON Ruhrgas holding 90.2% of the shares and European Bank for Reconstruction and Development (EBRD) owning 9.8%. There is also a capital increase to RON 1,116,800,660.

### 1.1.4. SWOT Analysis

According to the same energy market research report, issued June 2009, and available on the Business Insights database E.ON's growth strategies are: to develop generation portfolio and modernize distribution network in core markets, to expand into new markets, to focus on renewable energy, and to further develop its acquisitions strategy.

The following figure highlights the best the company's strengths, weaknesses (internal factors) and opportunities and threats (external factors):

**strengths**

- Vertically integrated business with operations in all activities rainging from production to distribution of power and gas.
- Strong balance sheet with limited debt maturities by 2011.
- Long term gas supply contracts complements its power generation business in Russia.

**weaknesses**

- EU investigations in 2008 found E.ON guilty of market manipulation and charged a fine of $56 m.
- Several customers in Germany, Sweden, and the UK were affected by power outages.

**opportunities**

- 11 GW of conventional power generation capacity under construction will ensure earning growth beyond 2011.
- Joint venture with RWE and partnership with Areva will help it implement modern technologies in nuclear power.
- Planned EUR 6 bn investments in renewable energy will help it to achieve its target of decreasing its CO2 emissions by 50% until 2030.

**threats**

- Gas suppliers interruptions such as Russia-Ukraine dispute in 2009 may impact both gas and power businesses.
- Rapidly dropping prices for fossil fuels may have an impact on renewable energy's cost competitiveness.

*Figure 2: E.ON's SWOT Analysis*

Source: Energy Report, June 2009

### 1.2. The Target: Electrica Moldova SA

*Figure 3: ELECTRICA MOLDOVA' s Company Logo*

### 1.3. History and Nature of Business of the Target

Electrica Moldova is one of the eight electricity transport and transmission subsidiaries owned by ELECTRICA SA. It operates in the Northern and Eastern part of Romania and has the headquarters in Bacau. Electriva Moldova provides electricity for 6 counties[16] - Bacau, Botosani, Iasi, Neamt, Suceava and Vaslui. In 2004 the company registered 1,335,305 consumers to whom it distributed 4,186,878 MWh of electricity. This represents 12% of ELECTRICA SA's sales and out of the total consumer's number 25% are households. Additionally, the company has a total distribution network of 36,850 $km^2$ and it is interconnected with the national network of high voltage transport and with other transmission networks belonging to ELECTRICA SA.

| | Electrical Wires 110 kV | Electrical Wires (medium voltage) | Electrical Wires (low voltage) | Transformation Stations | | Transformation stations and Power Supply Stations | |
|---|---|---|---|---|---|---|---|
| | km | km | km | nr | MVA | nr | MVA |
| ELECTRICA MOLDOVA | 2.688 | 16.992 | 30.745 | 134 | 4.181 | 10.080 | 2.888 |

*Table 3: Electrica Moldova's Distribution Network*

Source: E.ON Archive, Internal Data

The activities are coming off based on Supplying Licence No. 452/29.04.2002 and Distribution Licence No. 451/29.04.2002 that were conferred by the National Authority for Energy Regulation (ANRE).

## 2. Economic Conditions

Romania is an upper-middle-income EU member economy which is located in the Central Eastern Europe (CEE). It is the 11th largest economy in the EU by total nominal GDP and it

[16] From an official administrative point of view, Romania is organized in 41 counties and the municipality of Bucharest. Each county serves as the local level of government within its borders and they also represent the NUTS-3 statistical subdivisions of the European Union. (Internet: www.wikipedia.com - Romania's Counties, accessed: 1.07.2010)

occupies the 8th place based on purchasing power parity. As surface, it is the 7th largest country in the European Union with the largest financial center being the capital, Bucharest. Since 1989, there has been a steady growth rate in foreign direct investment, totaling more than €45 billion.

A complete valuation of a business and of business activities implies the considering of current and prospective economic conditions, both in the national economy and of the industry or industries of interest. The most important variables taken into account in this respect are: GDP (real gross domestic product), the unemployment rate, interest rates, and inflation rates. The period of our interest is the year of the merger and the years following it to finally be able to estimate the success of the merger.

| Romanian Key Economic Indicators and Forecast 2008 - 2011(F) | | | | |
|---|---|---|---|---|
| | **2008** | **2009** | **2010(F)** | **2011(F)** |
| GDP, real (%) | 7.1% | (7.1%) | 0.4% | 3.5% |
| Unemployment Rate (% of Laborforce) | 4% | 6.3% | 8.5% | 7% |
| Private Consumption | 8.4% | (9.2%) | 0.7% | 4.6% |
| Consumer Prices | 7.9% | 5.6% | 4% | 3.9% |
| Export Volume Growth (% p.a.) | 19.4% | (5.5%) | 4.8% | 7% |
| Policy Interest Rate (% p.a.) | 10.25% | 8% | 6.25% | 5.75% |
| Gross Foreign Debt (% GDP) | 37.6% | 55.4% | 57.2% | 56% |

*Table 4: Romanian Key Economic Indicators and Forecast*

Source: Central Bank, Central Statistical Office, UniCredit Tiriac Bank Macroeconomic Research, Uni Credit Group, CEE Research - CEE Biweekly and DB Research

The actual financial crisis (2007 - present), considered by many economists to be the worst since the Great Depression of the 1930s, left Romania significantly exposed to the global downturn. Its weakness was increased by the continuous foreign borrowing needed to sustain its modernization needs. The year 2009 was the year when the vulnerable Romanian economy felt the shock of the financial crisis.

The event studied, the merger between E.ON Gaz Romania and Electrica Moldova, happened over a period of 4 years before it was finally completed by 2008. At the time, the external environment was characterized by a private consumption level dropping from 14.6%, in the last quarter of 2008, to 3.7%; an investment level steeply declining from 27.7% to 2.8%; and a National Bank struggling with any array of instruments to stop the inflationary pressures. The gas and electricity prices were on an ascendent slope with the gas prices going up by 12.5% and the electricity prices increasing by 5.3%. Moreover, gas distribution companies have already announced their intentions to apply to the energy regulator "Autoritatea Nationala de Reglementare in domeniul Energiei" (ANRE) for additional increases in natural gas prices later on that year.

The year 2009 was the year when crisis hit the Romanian economy. A negative GDP of -7.1% was registered together with a fall of the private consumption by -9.2% and a huge loss in investment of -25.3%. Only a very slow recovery of 0.4% was registered during 2010 and consumption level is affected in both private and public sectors. Analysts foresaw from the beginning that the only solution Romania had to recover from financial distress was to take Poland's example and start implementing government infrastructure projects and other EU funds projects. Additionally, major steps towards adopting structural reforms for reshaping the public sector need to be made.

Some of the pressure induced by the significant budget deficit risk was offset by the International Monetary Fund (IMF) assistance [17] for current spending reduction and public sector restructuring. The IMF-EU agreement has assured both the stability to Romania, as the credit rating went from negative to stable,[18] and the needed external financing. After the Executive Board discussion regarding the stand-by-agreement on Romania, Mr. John Lipsky, First Deputy Managing Director and Acting Chairman, said that the joint funding will "(...) help (Romania a.n.) cushion the economic downturn and will provide reassurance to markets that Romania's external obligations will be met. It sends a strong signal of the international community's confidence that, with the consistent implementation of the

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[17] May 4, 2009, IMF Executive Board approves €12.9 Billion Stand-by-arrangement for Romania
February 19, 2010, IMF completes Second and Third Review under Stand-by-arrangement with Romania and approves $3.32 Billion disbursement

[18] Fitch and S&P's long term foreign currency credit rating from February and March 2010

program, Romania will weather the current difficulties and emerge with a better-balanced and more flexible economy," Mr. Lipsky said.[19]

The National Bank of Romania announced a series of increases in the interest rates. The rate started increasing gradually from 7.5% in January 2008 until peaking the 10.25% value, in January 2009, and then began decreasing slowly until hitting the actual value of 7% as of April 2010. The raising of the key policy until 10.25% signals the fact that the Romanian Central Bank is ready to use the entire array of instruments[20] to counter the inflationary pressures that appeared as a follow-up of the strong growth in consumption.

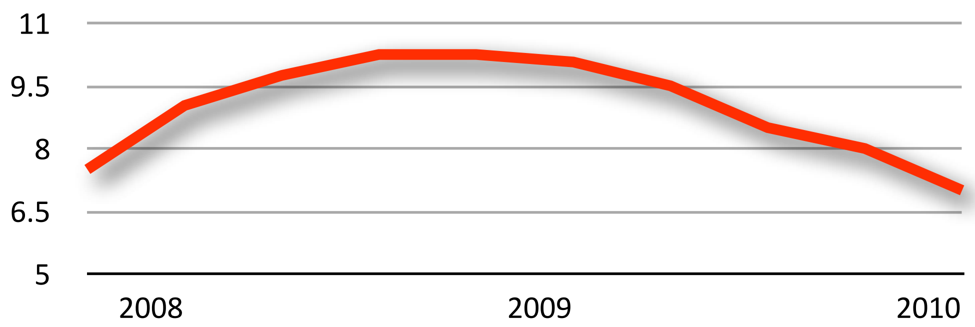


Figure 4: The NBR Reference Rate Evolution (%)

Source: The National Bank of Romania (Internet: www.bnro.ro, accessed: 7.05.2010)

## 3. Industry Conditions

Romania is modest in its own oil and gas reserves and there is continuous exploration in the Black Sea despite disputes with Ukraine. The country has also valuable coal reserves, a network of hydro power plants, and two nuclear power plants at Cernavoda. According to the U.S Law Library of Congress' country report, issued December 2006, Romania is the only Central European country with enough reserves of primary energy to have the potential to be energy self-sufficient for several decades. Moreover, the sector is the third largest employer of the country with 6% of the labour force active in the field.[21]

[19] Internet: www.imf.org - International Monetary Fund, accessed: 4.05.2010

[20] It is expected that inflation rates will fall within the aimed limits in 2012 to 2013.

[21] Internet: www.memory.loc.gov - American Library of Congress, accessed: 15.06.2010

### 3.1. Romanian Gas Market

Most of the natural gas consumed in Romania is imported from Russia through the *Progress* pipeline. At the moment, it has been able to reduce the imports by 30% because of the start-up of a second nuclear plant. Moreover, a third unit of the Cernavoda station is scheduled to begin in 2006 and reach completion by 2011.

At the time of the merger, namely 2008, the gas reserves were valued at 162 billion cubic meters. The figures are expected to drop until 141 billion cubic meters by 2010 and to 77 billion by 2020, according to the Energy Strategy report for Romania for the period 2007 - 2020.

### 3.2. Romanian Electricity Market

Regarding electricity generation, Romania has a capacity of 22.2 gigawatts, according to the same country report. With this capacity, it is southeastern Europe's largest power producer and a net electricity exporter. However, current exploitation of hydropower resources is thought to be far below capacity. The U.S. Department of Energy estimates that Romania may have more than 5,000 locations favorable to hydroelectric power plants. (Internet: www.memory.loc.gov - Library of Congress, accessed: 15.06.2010)

A certain decrease in imports is noticeable from 2008 to 2009, according to the information issued by The National Electricity and Heat Regulatory (ANRE). The decrease is due to the start-up of the second nuclear plant. In the same time, the quantity generated electricity decreased from one year to another as opposed to the previous periods.

| No. | Indicator | UM | 2008 | 2009 |
|---|---|---|---|---|
| | 1 | 2 | 3 | 4 |
| 1 | Generated Electricity | TWh | 64.01 | 56.69 |
| 2 | Delivered Electricity | TWh | 59.07 | 52.40 |
| 3 | Import | TWh | 0.92 | 0.68 |
| 4 | Export | TWh | 5.37 | 3.15 |

| No. | Indicator | UM | 2008 | 2009 |
|---|---|---|---|---|
| 5 | Internal Consumption | TWh | 54.63 | 49.92 |
| 6 | Electricity supplied on the regulated market | TWh | 10.38 | 10.99 |

*Table 5: Romanian Electricity Market*

Source: ANRE December 2009 (Internet: www.anre.ro, accessed: 7.06.2010)

## 4. Legal Conditions and ANRE

The following major pieces of legislation, are enforceable when regulating foreign investment in Romania:

1) Commercial Code
2) Company Law
3) Competition Law
4) Law on Direct Investment
5) Law regarding the promotion of direct investments
6) Law on Banking Activities
7) Securities Law
8) Commercial Companies Privatization Law
9) Trade Register Law
10) Taxation Law.

The agency responsible with the legal issues regarding electricity and gas supply, generation, transmission and distribution is called ANRE (The National Electricity and Heat Regulatory). It is a public independent body working together with other central or local public administrative bodies, and international organizations to safeguard the interests of all sector players to ensure efficiency, transparency, and consumer protection. The agency has also an important saying in the energy market liberalization in Romania as it is responsible for issuing licenses. The process and requirements are outlined in the *"Regulatory White paper for Sustaining the Liberalization & Privatization Processes in the Electricity and Heat Sector".*[22]

[22] Internet: www.anre.ro - ANRE, accessed: 7.06.2010

The merger between E.ON and Electrica Moldova falls under the provisions of Competition Law no. 21/1996, with subsequent amendments and completions, complying with the provisions of Art.11 align (2) lit. b) regarding the economic concentrations and provisions of Art. 15 regarding the turnover threshold.

## 5. The Energy Strategy Plan for Romania

The new energy policy has significant influence at the European level as well. The new energy strategy plan was launched in 2007 and describes energy as an essential ingredient for the development of the Union. The explanation for this central role lies in the sector's impact on climate change, in the Union's dependence on energy imports, and in the upward trend in energy prices which considerably affects the households and the industrial consumers. As an additional fact, the EU is currently highly vulnerable to the instability of international energy markets and to the concentration of ownership over hydrocarbon resources. The target of the future is to develop the internal European Union's energy market by encouraging energy savings and bringing more investment to the sector. At the same time, it pays significant attention to the competitive and fair pricing regulations.

The thoughts for the future regarding Romanian energy strategy include a 2013 horizon. The national objective is to meet the short and medium-term energy demand and to create the prerequisites for national energy security in the long run that would respond to the requirements imposed by a modern market economy for safety and competitiveness. Furthermore it has to fulfill the obligations under the Kyoto Protocol which points out the necessity of reducing the greenhouse gases emissions by 8%. Additionally, it needs to promote and implement measures in order to adjust for the effects of climate change and to observe the principles of sustainable development.

With regard to Romania, a member state of the European Union, it is particularly important to make sure it implements the four major medium to long-term objectives of the Union's Energy Strategy Plan: to enhance the security of energy supply and of critical infrastructure, to increase competitiveness in the sector, to reduce the environmental impact, and to achieve the integration to the regional energy market.[23]

[23] Internet: www.sdnp.ro - The New Energy Strategy Plan (2007), accessed: 8.06.2010

### 5.1. Energy security

As a first step, Romania has to maintain national sovereignty over primary energy resources and independence in national choices in the energy sector. Then, it has to ensure the reliability of energy supply and to keep the degree of dependence on imports at a low level. It is possible to achieve that through the diversification of external sources, national energy resources, national and regional energy transport routes and networks. Additionally, it has to promote cooperation, on a regional level, for the protection of critical energy infrastructure.

### 5.2. Sustainable development

To achieve the objective of sustainable development Romania will need to improve energy efficiency along the chain of resource-production-transport-distribution-consumption. This would be feasible through the optimization of production and distribution processes and the reduction of total consumption of primary energy relative to the value of products and services. Additional to this, renewable resources have to play an increasingly more significant role in the energy production in the future. In this sense, a particular attention must be paid to support research development and innovation. However, whilst attempting to find new alternative sources a special emphasis must be given to living up to commitments to reduce the emissions of greenhouse gases and atmospheric pollution.

### 5.3. Competitiveness

Looking from an economic perspective, maybe the most important objective regarding sustainable development of Romania in the long run would be to further develop and improve competitive markets for electricity, gas, oil, uranium, coal and energy sector services. In this view, the main objectives are: the increase of profitability and access to capital markets, the continuing of restructuring and privatization process, the sector's liberalization for transport and distribution, support for investments for new power generation and better technology, the improvement of the infrastructure, etc.

Regarding liberalization of the market, the national policies have to promote the modernization of the systems through high performance technologies and thus the need for support of uninterrupted and non-discriminatory access of international market actors and Foreign Direct Investment (FDI). The national policies have to be seconded by a frictionless cooperation with the relevant authorities, namely the government and the Romanian national energy regulator ANRE.

The following two recommendations are made for Romania in order to stick to the national strategy plan for sustainable development:

1. To establish an institution, as a part of the Romanian Government, specialized in creating and implementing economic and social development strategies that is coherent with the government's plans and the EU financing opportunities.
2. To create a Ministry of Energy and Resources and to assure the efficient and transparent functioning of the regulatory mechanism (ANRE) and its specialized agencies according to the EU policies and practices, while taking into account the environmental issues.

## VII. The Rationale behind the Merger / Privatization

On April 4, 2005, E.ON ENERGIE AG (as the acquirer) and SC Electrica SA (as the target) merged and concluded a Privatization Contract through which E.ON ENERGIE AG gained a participation of 51% of the formerly state-owned subsidiary SC Electrica Moldova SA, under the condition of fulfilling some intermit requirements.[24]

The Romanian government's decision to privatize comes from the need to ensure Electrica Moldova's necessary financial resources. By encouraging the participation of strategic investors that possess the managerial and operations' specific know-how, the Romanian government assures itself of the sector's development in the context of energy market liberalization. Furthermore, according to the European patterns, the market liberalization would encourage competition which would consequently assure better services at

[24] Laws: Decree No. 57/17.02.2004

affordable prices to the consumers. Additionally, the privatization strategy pursued the maximization of the privatization's transaction value, though through a transparent and competitive auction process and an increase in the professional qualification of the employees.

### 1. The privatization steps

Having a quick overlook over the event's sequences facilitates a better understanding of the rationale behind the merger, from E.ON's perspective; the rationale behind the privatization, from the Romanian Government's perspective. The following timeline describes the basic steps in the privatization process of a formerly state-owned utility in the Romanian transitional environment.

- In 2003, the Romanian Ministry of Public Finance, with the help of the PHARE Office for Payments and Contracting ("Oficiul de Plati si Contractare PHARE"), selected the main privatization consultant through a public auction. The consulting consortium was lead by the Banc of America Securities LLC (BAS)[25]. Responsible for the juridical issues were Allen & Overy, an international law consulting firm, and Nestor Nestor Diculescu Kingston Petersen , a local law consulting firm. The local financial consultant, BDO Conti and WS Atkins plc., an international consultant on environmental issues, also took part in the process. The fix commission was covered through PHARE funds by the European Commission.

- The consultants filed a report which included several analyses and recommendations which were made taking into account several market research reports and the regulation implied. Based on this report, on April 7, 2004, the privatization strategy for Electrica Moldova was voted by the Romanian Government.

- The Government's intent to sell was publicly stated via an announcement published April 28, 2004, both in the internal press and in the Financial Times newspaper, the international edition. The announcement addressed an invitation to all strategic

[25] The consortium also included Central Europe Trust Company Ltd, an independent strategic consultancy firm specialized in Central and Eastern Europe.

investors for submiting their letters of intent. It was also specified that the investors should meet some criteria related to:

- technical and operational experience;
- capacity and resources;
- and experience with operating a similar company, on liberalized markets.

- After the announcement, by May 31, 2004, five letters of intent were received from:

  1. AES – USA
  2. CEZ a.s. – Czech Republic
  3. E.ON Energie A.G. – Germany
  4. PUBLIC POWER CORPORATION – Greece
  5. The Consortium formed by UNION FENOSA INTERNATIONAL – Spain and POWER DEVELOPMENT LIMITED – Malta.

- After analyzing in detail all the documents submitted, the team of consultants decided in June, 17, 2004, that all five candidates would be able to proceed forward with the privatization process. The process included: access to the company's database, meetings with the SOE's management and the team of specialists, visits at the company's sites, and meetings and discussions with ANRE[26].

- The privatization procedures knew a transparent process of selection and on August 27, 2004, three out of the five initial candidates made it to the short list: E.ON, CEZ, and Union Fenosa. Further on, preliminary negotiations took place, and their main target had been to clarify of the following:

  a) the business strategy, the organization, and management of the SOE;
  b) the legal requirements to be followed when setting further necessary adjustments;
  c) the content of the privatization contract, and of the additional documents needed for the transaction.

[26] ANRE stands for "Autoritatea de Reglementare în Domeniul Energiei Electrice".

- October 18, 2004, was the day the Romanian Government received the final offers, including the additional requirements, from two out of the three investors shortlisted: E.ON and CEZ. Only these two could keep up with the requirements imposed.

- On November 8, 2004, the two investors: E.ON and CEZ, submitted their final offers again, this time with several adjustments made to meet the Government's condition of maximizing the privatization's transaction value.

- According to the last offers submitted, E.ON was declared the winner of the auction (April 5, 2005).

### 2. The privatization strategy

Electrica Moldova's privatization was made through Romanian state's ownership transfer to a strategic investor that had significant experience in the utility sector, which also was be able to ensure the company's continuity on the long run. The elected candidate had been E.ON.

The Romanian Government knew the SOE's real need for liquidity and therefore the following payment method was adopted:

(i) 24.62% of Electrica Moldova's social capital was sold to E.ON. Consequently, E.ON acquired a number of 10,174,004 nominative ordinary shares, each one having a nominal value of ROL 100,000[27] (April 4, 2005). E.ON paid EUR 31,4 Million for the 24.62% share of Electrica Moldova's social capital;

(ii) at the same time a cash infusion was made. The amount of cash absorbed by the company needed to be sufficiently large so that E.ON could own 51% of shares, which is the majority of the voting / cash flow rights;

(iii) in the end, the total transaction price amounted EUR 100 Million.

[27] The Appendix enhances the exchange rate for the end of April 2005, given by the Romanian National Bank. Additionally, after the Romanian Leu conversion at July 1, 2005, ROL 100,000 is equal to RON 10. The historical data of the Romanian National Bank is published in RON.

The privatization strategy also pre-allowed E.ON to cede up to 5% out of the 51% majority shares to one or both of the following financial investors: the European Bank for Development and Reconstruction (EBRD) and the International Finance Corporation (IFC). This eventually happened, on September 28, 2006, when EBRD acquired the 5% package and engaged to support and facilitate the efforts made by the E.ON Group to realize the necessary technical and operational improvements in the operating company.[28]

## 3. The Strategic Fit

First, the strategic fit between the acquirer and the target comes from the fit in business strategy. This was confirmed to be the most important factor for E.ON's management, based in Targu Mures, Romania, when deciding to take over Electrica Moldova. When asked during the interview, the CFO replied with:

*"Above everything, the merger project was important because it contributes to the realization of the company's strategic goals."*

Apparently, financing was not a problem as long as the project was thought to be strategic.

*"One can always find money to finance a good project." (E.ON's CFO)*

Surprisingly, profitability of the investment was not a strong enough driver to entail a positive decision, but the financial evaluation techniques had an important saying in the final decision. Then, the CFO and a technical manager were asked to rank, using a scale from 1 to 5, the following possible drivers for strategic investment decision making: risks, costs, value, market entry, resource seeking, competition, staff motivation and professionalism, social responsibility, and image. The results gave different results to what is perceived to be the highest strategic fit of the investment. The CFO saw market entry, resource seeking, competition, social responsibility, and E.ON's image to be the most important factors. Whereas in contrast, the technical manager saw resource seeking with the purpose if diversifying the company's activity in the energy sector as the most important.

[28] Internet: www.ebrd.com, European Bank for Reconstruction and Development, accessed: 3.07.2010

Taking into account the type of services provided by the target SOE, Electrica Moldova, and the categories of consumers to whom it addresses, it is highly important to define the following relevant markets:

- the market of electric energy distribution for captive consumers;
- the market of electric energy distribution for eligible consumers;
- the market of electric energy supply for captive consumers;
- the market of electric energy supply for eligible consumers.

Moreover, when considering the Competition Law No. 21/1996 and the licenses conferred by the energy regulator ANRE, the geographic market is represented by:

- Moldova area, for electric energy distribution for both captive and eligible consumers;
- Moldova area, for electric energy supply for captive consumers;
- Romanian territory, for electric energy supply for eligible consumers.

(Governmental Decision No. 99/27.05.2005)

The market of electric energy distribution was at the time of the merger a closed market. The distribution licenses allowed the distribution companies holding them to attain an exclusive character. Considering this scenario, the market was free of competition, which is by itself a huge incentive to encourage the acquisition of an enterprise such as Electrica Moldova that owns such a license.

The market of electric energy supply was at time of the merger partially open. Its dimensions are influenced by the consumers that become eligible but yet chose to stay captive. The difference between the two is that electric energy is supplied to the captive consumers at regulated tariffs. The market becomes more open as the minimum consumption limit, which a consumer has to reach to become eligible, decreases. Thus, "the market opening is being realized through a progressive increment of the competitive market share, according to the provisions of the energetic strategy and policy, and is approved through a Government decision". (Governmental Decision No. 99/27.05.2005)

Analyzing from the Romanian Government's perspective and considering the presented arguments, the economic concentration realized through taking over the control of Electrica

Moldova by E.ON does not imply a significant restrain, suppression or distortion of competition in Romania on the relevant markets, as these were defined before.

The market conditions in Romania are of a such nature that, in a short time, there won't be any significant price increases on the above defined relevant market, neither for captive nor eligible consumers. Consequently, from the acquirer's perspective (E.ON), the fundamental purpose of this merger is the diversification of the company's activity through entering the electricity market and the improvement of the economical performance by acquiring a company (Electrica Moldova) that fits E.ON's business strategy.

### 4. Transformation of the SOE

According to the Privatization Contract and the Governmental Decision No. 99/27.05.2005 regarding the economic concentration realized by E.ON ENERGIE AG by taking over the control of the state owned enterprise Electrica Moldova SA, the main effects that are aimed via this economic transaction are considered to be the following:

- ✓ the unbundling of transmission and distribution (Electrica Moldova has split after the merger in two: E.ON Moldova Furnizare SA and E.ON Moldova Distributie SA), according to the electricity directive 2003/54/EC;
- ✓ the increment of distribution networks general efficiency;
- ✓ the modernization of distribution assets;
- ✓ the optimization of personnel structure;
- ✓ lining up Electrica Moldova SA to the occidental standards in the field;
- ✓ and the increment of quality and reliability of services.

### 5. Government and ANRE Involvement

It is important to point out that in Romania, foreign and domestic investments enjoy equal treatment. Moreover, fiscal facilities have been promised by the Romanian Government for strategic projects with the purpose of promoting green energy. According to Law 220/2008, Electrica Moldova, as well as other strategic investors can always benefit from the following:

- ❖ loans awarded by the Romanian Government guaranteeing up to 50% of the loan on medium and long term;

- the ensuring of transport infrastructure for commencing and developing the strategic investment;
- the ensuring of ways of access in the existing infrastructure;
- tax exemptions of reductions for the reinvested profit;
- financial compensation for creating new jobs and raising employment.

On the other hand, in case the acquirer E.ON does not align with the clauses specified in the Privatization Contract, the Romanian Government is entitled to apply penalties. These are can amount up to the maximum of the adjusted acquiring price, which means up to a maximum of EUR 32, 2 Million.[29]

The Romanian Energy Regulatory Authority ANRE is another important factor that E.ON needs to permanently take into account especially when establishing the energy prices. The regulation tariffs are applied for captive consumers, including consumers that have decided not to use their eligible statute. E.ON is bound to apply these regulated tariffs until a total liberalization of electric energy market. Afterwards the prices will be established in a competitive manner, based on the demand and supply relation.

The estimates at the time of the merger were that the electric energy supply market will be completely liberalized by the year 2007[30]. From that time on, ANRE will not grant supply licenses with exclusive character anymore, thus completely opening the market for potential competitors. Of course, every potential competitor has to comply with both the norms and regulations of the Romanian legislation and those issued by ANRE to acquire the supply license and the necessary functioning authorizations.

## 6. Foreign Investment Risk

Even though, the macroeconomic picture is recently improving from quarter to quarter, the environment specificity of the emerging markets still has a strong impact on the foreign

[29] Internet: www.zf.ro - "Ziarul Financiar" Newspaper, accessed: 4.05.2010

[30] The estimates were accurate because from July 1, 2005 all industrial consumers were able to choose their energy supplier and the energy market was completely liberalized. Additionally, the opening of the competition grew from 10% in 2000 to 83.5% in 2005.

direct investment activity in the area. The Central and Eastern Europe is particularly known for having high country risks, which is an obstacle to investment.

According to Business Monitor International (BMI)[31], a leading, independent provider of ratings, rankings for different regions and industry sectors, Romania is rated C, in terms of riskiness. The sovereign ratings range from A to E, where A signifies very little to no risk. Additionally, Romania's market outlook scores 3 on a scale of 1 to 5, where 1 would be very bullish and 5 very bearish. A score of 3 is being neutral. Regarding the ability to pay, a midterm perspective for the years 2007-2010 is given in the table bellow and shows a regress in 2009, which however is not dramatical (from 39 to 31). Each number is a mark out of 45.

| Country | Total | Sovereign Rating | Market Outlook | Ability To Pay | | | |
|---|---|---|---|---|---|---|---|
| | 2010 | 2010 | 2010 | 2007 | 2008 | 2009 | 2010 |
| Slovakia | 76 | B | 4 | 43 | 41 | 36 | 38 |
| Estonia | 72 | B- | 4 | 38 | 31 | 32 | 36 |
| Russia | 71 | B- | 3 | 48 | 44 | 33 | 37 |
| Macedonia | 69 | C+ | - | 35 | 31 | 23 | 34 |
| Czech Republic | 69 | C+ | 4 | 36 | 37 | 31 | 36 |
| Bulgaria | 69 | C+ | 3 | 37 | 38 | 30 | 32 |
| Romania | 67 | C | 3 | 39 | 39 | 31 | 37 |
| Poland | 66 | C | 4 | 30 | 28 | 26 | 30 |
| Kazakhstan | 62 | C- | 3 | 32 | 36 | 30 | 35 |
| Croatia | 60 | C- | 3 | 31 | 28 | 23 | 26 |
| Hungary | 60 | C- | 3 | 19 | 21 | 26 | 28 |
| Serbia | 59 | D+ | 3 | 34 | 32 | 23 | 29 |
| Turkey | 58 | D+ | 3 | 31 | 23 | 19 | 27 |
| Lithuania | 56 | D | 3 | 37 | 31 | 25 | 27 |
| Latvia | 52 | D- | 3 | 36 | 28 | 27 | 28 |
| Bosnia & Herzegovina | 44 | E | - | 27 | 23 | 21 | 23 |
| Ukraine | 30 | E- | 3 | 28 | 26 | 20 | 20 |

*Table 6: Sovereign Risk Ratings for CEE (2007 - 2010)*

Source: BMI

[31] BMI's purpose: "Our mission is to integrate Country Risk and Financial Markets analysis with Industry Research, to best inform decision-making at the highest level in multinational companies, financial institutions, multilaterals and government." (Internet: www.businessmonitor.com - International Business Monitor, accessed: 21.06.2010)

## 7. Case Study Conclusion

All in all, now, after the five years from the privatization decision, the benefits for the Romanian state come primarily in the form of having a formerly state-owned company, with many managerial and supply chain inefficiencies, transformed into a modernized company. Additionally, the privatization in case solidifies the premises for creating a competitive energy market in Romania. The positive effects of a competitive market are to be felt by the end consumer that will enjoy having lower bills. On the other hand, the Romanian Officials declared that the ownership concentration had barely no positive effect on the Ministry of Economy and Commerce's budget. [32]

The best outcome of the merger for E.ON stands in the access to a new market (Moldova area), that at the time of the merger and for two more years following it, was a competition-free market. Consequently, through merging, it achieved synergistic gains from diversifying in a new industry (electricity) and being able to utilize its surplus capacity of management and technological know-how. However, even if promises were made by the Romanian Government that financial support will be given for innovative projects that help building / modernizing the infrastructure, not much has been done in this respect. (Source: Interview)

[32] Internet: www.zf.ro - "Ziarul Financiar" Newspaper, accessed: 4.05.2010

## Conclusions

The present paper covers the theoretical aspects regarding mergers and privatization by looking at the positive effects obtained through the transfer of ownership from one company to another. The main focus of the research is the South Central and Eastern Europe region, and particularly the energy industry because of its strategic importance for the area of interest. The empirical analysis should provide support that both the management of the acquirer and the government engaged in a privatization primarily look for a strategic fit between the companies and follow the goal of transforming an unproductive and inefficient SOE into an efficient and better managed one, at the same time.

First, the reasons behind merging were identified. At this point the entrepreneurial dimension was taken into account. Mergers and acquisitions have proven to be strategies to create value. There is the possibility to look at a merger from a financial or a strategic perspective when valuing its outcome. The two perspectives complete each other perfectly. Value creation comes from synergistic gains and it also is an expression of the similarity or complementarity of the acquirer with the target firm, what we would call the strategic fit. Another relevant finding is the fact that the manager's decision when considering a cross-border merger with a state-owned company is highly influenced by the future government's / regulating authorities' involvement and the investment risk of the host-country.

The second research dimension relates to the government's point of view on the transaction. The first order reasons to privatize are budgetary constraint or external pressure. Then, there are some additional reasons, like operational and managerial inefficiencies of state-owned companies, that urge state officials to accept loosing their controlling power, even beyond their political driven reluctance. Governments all over the world start realizing that efficiency and performance are, in fact, the factors that ensure re-elections. When focusing on the energy industry, the explanation lies in the fact that high energy consumption bills have created general awareness and continues to awaken the interest of the end consumer. Privatizations of utilities have proved to be success stories because of their potential to eliminate many inefficiencies that result from state being a bad owner of companies.

Additionally, a relevant conclusion can be drawn by looking at the privatization patterns in the SCEE area. The recent intense privatization activity in South Central and Eastern Europe stands as a clear signal that transitional economies of the region are ready to turn from communism to democratic capitalism. The facts and figures show positive effects of privatizing on revenues, cost reduction and profitability of the formerly state-owned enterprises. Moreover, intense privatization activity is registered in the energy sector of the area. This has a lot to do with the fact that the transitional economies of SCEE region were highly encouraged to liberalize their energy markets and to facilitate privatization programs by the European Union.

To summarize, it seems that foreign investors have begun to spot the opportunities of doing business in the South Central Eastern European countries and with the governments of these countries. Hence, privatization turned out to be a good way of tapping synergistic gains and gains coming from successfully diversifying on a new market by acquiring state-owned companies. However, necessary prerequisites like being in the same business, having the same business strategy, or disposing over similar or complementary resources, have to be met.

## Recommendation for future research

It is a fact that the Communist and formerly Communist countries are undergoing dramatic changes in their political and economic processes making the reliability of the macroeconomic data from the region doubtful. Moreover, it is hard to quantify such processes in empirical tests. This brings us to the problem of data availability, especially in English. There is barely no industry-level data and most of the studies on the topic rely on data coming from a single source. For example, there is barely no information about voucher privatizations in the former Communist countries. Further research should overcome this limitations because the SCEE is an area of great business potential.

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## Laws

1. The Decree No. 57/17.02.2004 pertaining to the appointment of the Competition Council Plenum members;

2. The Competition Law No. 21/1996 with subsequent amendments and completions;

3. The Regulation on organization, functioning and procedure of the Competition Council, with subsequent amendments and completions;

4. The Regulation for authorising the economic concentrations;

5. The Instructions regarding the relevant market definition for establishing a substantial market share;

6. The Privatization Contract of Electrica Moldova.

## Interviews

1. Personal Interviews with Gabriela Budian, Head of the Controlling Department of E.ON Romania Headquarters, 3.08.2009 and 25.06.2010

2. Personal Interview with Dragos Barbulescu, General Director E.ON Romania, 8.08.2009

3. Interview with a Technical Director, through Gabriela Budian, 26.06.2010.

# Appendix

**Ownership of electricity and gas industry in the EU, 1997**

(M= municipal; P=private; S=state)

| Country | Electricity generation | Electricity transmission | Electricity distribution | Gas transmission | Gas distribution |
|---|---|---|---|---|---|
| Austria | S/M | S | M | S | M |
| Belgium | P | P | P/M | S/P | P/M |
| Denmark | M | S/M | M/P | S | |
| Finland | S/P | S/P | M/P | | |
| France | S | S | S | S | S |
| Germany | P | P | M | P | M |
| Greece | S | S | S | | |
| Ireland | S | S | S | S | S |
| Italy | S | S | S | S | M |
| Netherlands | S | S | M | S/P | M |
| Norway | S/P | S | M | | |
| Portugal | S/P | S | S | S | S |
| Spain | S/P | S | S/P | S/P | |
| Sweden | S/P | S | M/P | S | P/M |
| United Kingdom | P | P | P | P | P |

Table 7: Ownership of electricity and gas industry in the EU

Source: International Labour Office Report, 1999

## Activities of international companies in energy industry in Europe

| Company | Home country | State owns(%) | Western Europe | CEE | Other regions | Other sectors |
|---|---|---|---|---|---|---|
| AEP | United States | | United Kingdom | | | |
| AES | United States | | United Kingdom | Hungary | Latin America, Asia | |
| British Gas | United Kingdom | | Italy | Czech Republic, Poland | Latin America | |
| Calenergy | United States | | United Kingdom | | | |
| CEZ | Czech Republic | 67 | | Slovakia | Asia | Telecom-munications |
| Cinergy | United States | | United Kingdom | | | |
| CSW | United States | | United Kingdom | | | |
| Dominion | United States | | United Kingdom | | | |
| Edison | United States | | United Kingdom | | Latin America | Housing |
| Electricité de France (EDF) | France | 100 | Austria, Italy, Portugal, Spain, Sweden, Switzerland | Bulgaria, Czech Republic, Hungary, Poland, Russian | Africa, Asia, Latin America | Water, waste management |
| NRG | United States | | | Poland Czech Republic, Estonia | | |
| Pacificorp | United States | | | | | |
| Powergen | United Kingdom | | Germany, Portugal | Hungary | Asia | |
| PS Colorado | United States | | United Kingdom | | | |
| Ruhrgas | Germany | | | Estonia, Czech Republic, Hungary, Latvia | | |
| RWE | Germany | | Spain, Switzerland | Czech Republic, Hungary, Poland | | Telecom-munications, water, waste management |
| Southern Company | United States | | United Kingdom | | Latin America | |
| Tractebel (now 50% owned by Lyonnaise des Eaux) | Belgium | | Germany, Italy, Portugal, Spain, United Kingdom | Hungary | North America, Latin America, Asia | Telecom-unications, waste management |
| United Utilities | United Kingdom | | United Kingdom | | North America | Water |
| Vattenfall | Sweden | 100 | Finland, | Estonia, | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | Federation, Slovakia, Ukraine | | |
| Endesa | Spain | 75 | France, Portugal | | Africa, Latin America | Water, waste, telecom-munications |
| ENI-SNAM-Italgas | Italy | 100 | | Hungary, Slovenia | | |
| Enron | United States | | | Poland | | |
| Entergy | United States | | United Kingdom | Czech Republic | Latin America | |
| Gaz de France (GDF) | France | 100 | Spain | Hungary, Romania, Slovakia | | |
| Gazprom | Russian Federation | 40 | Austria, Belgium, Finland, Germany, Greece, Italy, United Kingdom | Belarus, Bulgaria, Estonia, Hungary, Moldova, Poland, Slovakia, Ukraine | | |
| GPU | United States | | United Kingdom | | | |
| Hyder | United Kingdom | | United Kingdom | | | Water, construction |
| Imatran Voima Oy (IVO) | Finland | 97 | Sweden, United Kingdom | Estonia, Hungary, Latvia, Lithuania, | Asia | |
| Veba-Preussenele-ktra | Germany | | Sweden | | | Telecom-munications |
| Viag-Bayernwerk | Germany | | Austria | Czech Republic, Hungary, Slovakia | | Telecom-munications |

Table 8: Activities of international companies in the energy industry (Europe)

Source: De Luca, L., ILO, 1998, p.151

**Exchange Rate RON - EUR for April 2005**

| Symbol | Currency | 29 Apr. 2005 |
|---|---|---|
| EUR | Euro | 3.6211 |

Table 9: Exchange rate RON - EUR (Apr. 2005)

Source: The Romanian National Bank Archive

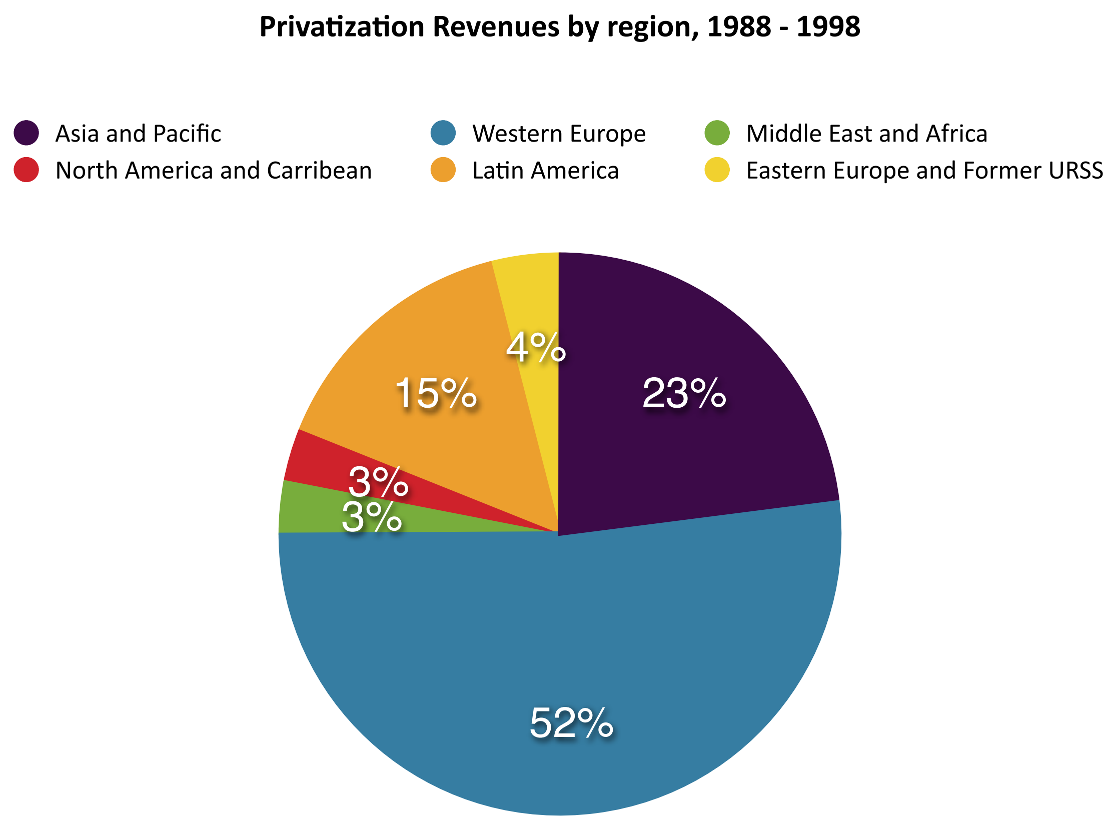


Figure 5: Privatization revenues by region
Source: Gibbon, H., (1998), “Worldwide Economic Orthodoxy”

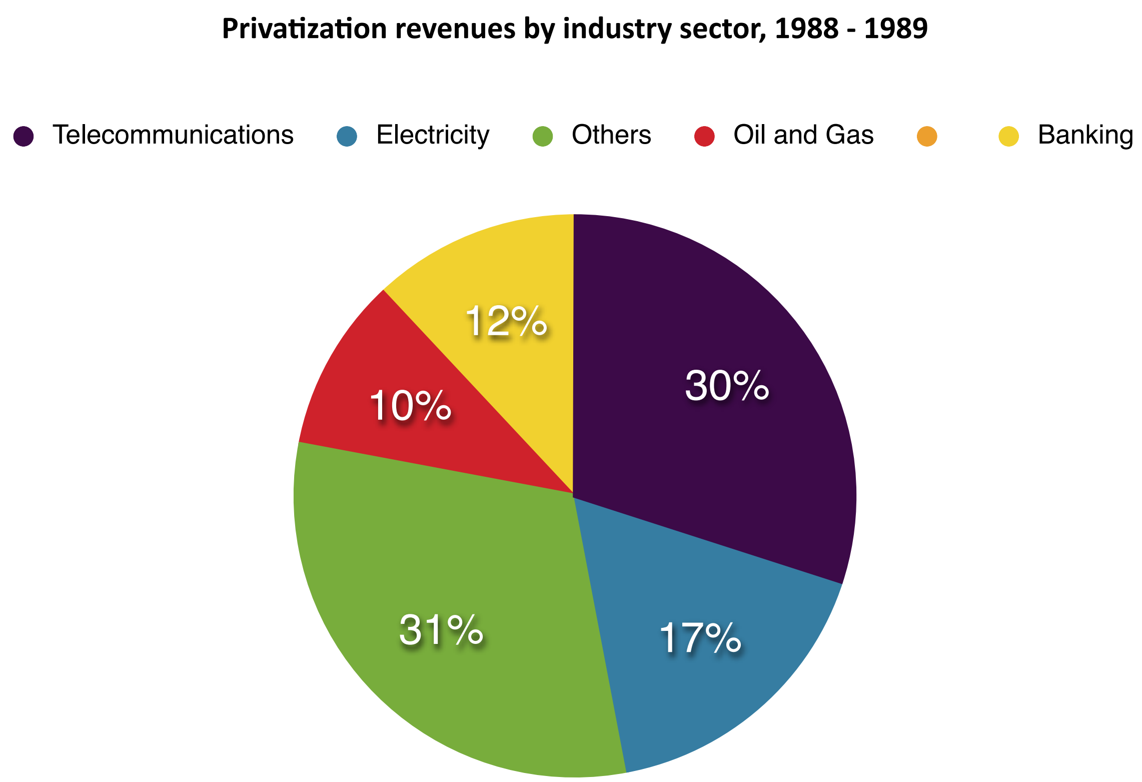


Figure 6: Privatization revenues by sector
Source: Gibbon, H., (1998), "Worldwide Economic Orthodoxy"

# CURRICULUM VITAE


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## Persönliche Daten

| | |
|---|---|
| **Staatsbürgerschaft** | Rumänien |
| **Geburtsdatum** | 8. Juli 1986 |
| **Familienstand** | ledig |
| **Führerschein** | B |

## Akademische Ausbildung

| | |
|---|---|
| **10/08-06/10** | **Universität Wien** – Materstudium Internationale Betriebswirtschaft<br>Spezialisierung in Finanzwirtschaft sowie Internationales Management |
| **10/08-06/09** | **Modul zur Erlangung der Lehrerlaubnis ab Gymnasialstufe (Pädagogikmodul)** |
| **10/05-06/08** | **Universität „Babes-Bolyai" Cluj-Napoca** (Rumänien)<br>Bachelor Studium Internationale Wirtschaftsbeziehungen |
| **09/01-07/05** | **Gymnasium „Unirea" Targu Mures** (Rumänien) – Schwerpunkt auf Mathematik, Informatik und Sprachen (English, Deutsch) |

## Berufserfahrung

| | |
|---|---|
| **07/09-08/09** | **E.ON Ruhrgas AG (Gas- uns Energie-Industrie) / Targu Mures, Rumänien**<br>Praktikum in der Abteilung Planung und Controlling<br>Aufgaben: Mitarbeit bei m M&A Project der Fusion zwischen E.ON Energie S.A und E.ON Gaz Romania Holding S.R.L ; Leistungsbezogene Beobachtung der Bewertungen und Unterstützung des Managements bei der Bewertung des Marktwertes der beiden Unternehmen; Recherche |
| **07/08-08/08** | **T&Anders GmbH (Audit und Beratung) / Targu Mures, Rumänien,** Praktikum<br>Aufgaben: Beobachtung der Wirtschaftsberatungsprozesse und Wirtschaftsprüfung der Unternehmen (nach der rumänischen Standards) und Recherche Tätigkeit |
| **07/07-08/07** | **COMODEX AG (Holz-Industrie) / Targu Mures, Rumänien,** Praktikum<br>Aufgaben: Officemanagement |

## Forschungsarbeit (Co-author) - Papers

***„The Exigencies of the Documents required by the Financial Audit“*** – International Scientific Conference (Miskolc, Ungarn), 2008: ISBN 978-963-661-812-4

***„The Internal Control over Financial Reporting – Identity Crisis of Financial Information Published by Companies in Romania“*** (Tunesien), in Arbeit – wird voraussichtlich in Mai 2010 finalisiert

***„The Great Change in Romanian Audit Field Sustained by IT Procedures“*** (Tunesien), in Arbeit – wird voraussichtlich in Mai 2010 finalisiert

## Zusatzqualifikationen

| | |
|---|---|
| **Sprachen** | **Rumänisch**, Muttersprache<br>**Englisch**, verhandlungssicher<br>**Deutsch**, verhandlungssicher<br>**Italienisch**, verhandlungssicher<br>**Französisch**, Grundkenntnisse |
| **EDV** | **MS Office** (Word, Power Point, Excel, Access)<br>**iWork** (Pages, Numbers, Keynote)<br>**Internetkenntnisse** aus der Sicht eines Anwenders<br>**SAP** Grundkenntnisse |

## Zertifikate & Kompetenznachweise

| | |
|---|---|
| **2008** | IELTS Academic |
| **2006** | ECDL - Europäischer Computer Führerschein |
| **2005** | ZMP - Zentrale Mittelstufenprüfung (Goethe Institut) |
| **2004** | CAE - Cambridge Advanced English |

## Andere Interessen

Lesen, Reisen, Schifahren, Tennis, Salsa, Paragliding