

## EVN in Bulgaria “Eastern Fantasy” Meets Eastern Reality

For Stefan Szyszkowitz, managing director for Bulgarian operations of the Austrian energy company EVN, the so-called “Eastern Fantasy” that drove his company to expand into Eastern Europe and participate in the much anticipated market growth had just revealed a grim face. It was a cold Friday afternoon in October 2006, and Szyszkowitz was devastated by the aggressive stance adopted by the local media and civil society organizations towards him during the press conference that the Ministry of Energy had just hosted in Sofia, the capital of Bulgaria. He had thought that the press conference would allow him to raise awareness of all the efforts and improvements made by EVN to deal with the many problems with electricity distribution that it had inherited in 2004 as part of its acquisition of two distribution companies in Southern Bulgaria.

It was quite a turn of sentiment. In the beginning, there had been much enthusiasm on both sides, EVN and Bulgaria, for the smooth and transparent privatization process that resulted in the sale of the majority of stakes in Bulgaria’s electricity distribution companies to three foreign private investors. EVN, in particular, had worked hard to speed up the integration of the local businesses into the “EVN” family. Szyszkowitz felt they had managed that process much more successfully than Germany’s E.ON and the Czech CEZ, these being the other two companies that had acquired stakes in Bulgarian distribution companies in 2004. The first two years had also seemed economically successful, and EVN’s engagement had been rewarded on the Austrian stock market, where EVN was listed. For Bulgaria, this privatization was crucially important in supporting their request for membership of the European Union (EU), which made the unbundling and liberalization of electricity markets a legal requirement for any member country. Bulgaria formally joined the EU in 2007.

At the time, however, Stefan felt he was stuck in a bewildering array of issues that seemed to be controlling him rather than the other way around. How could he reclaim a constructive space for EVN and return to actively shaping his business strategy, rather than being a scapegoat for all kinds of problems that the specific Bulgarian context seemed to create in great abundance?

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This case was prepared by Professor Christian Seelos as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. January 2011.

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## EVN

*“As an energy and environmental services provider, we fulfill the daily needs of our customers. Through our reliable and high-quality services, we make a sustainable contribution to their quality of life.” (EVN, mission statement)<sup>1</sup>*

When asked, in 2010, what EVN as a company was all about, its head of communications produced a recent Austrian newspaper advertisement. “Nothing explains it better than this,” he stated. The advertisement read: “Six business areas. Nineteen countries. Three and a half million customers. My EVN. Deeply rooted in Lower Austria. Successful in Europe.” (Translated from the German - see Figure 1).

### Figure 1

Advertisement for EVN in an Austrian newspaper



The predecessor of EVN, NEWAG (the Lower Austrian Electricity Company) was established in 1922 to construct power plants, create a regional distribution network and provide electricity to areas without access to electrical power. After World War II, NEWAG was fully nationalized, and invested in its power capacity to meet the demand for electricity that doubled every 10 years until the 1980s. A further company, NIOGAS, was founded in order to expand activities into the supply of natural gas. In the 1980s, Austria abandoned its long-standing nationalization paradigm. The merger of NEWAG and NIOGAS resulted in the creation of EVN, which implemented two public offerings to sell 49% of its share capital through the Vienna Stock Exchange. In addition, Austria’s ascension to the EU in 1995 created new strategic challenges for EVN. The EU-wide liberalization of the electricity and gas markets meant that EVN had to look for new growth opportunities outside the mature and competitive home market and its traditional business areas to compensate for losses in market shares. In particular, the neighboring countries in Eastern Europe seemed attractive. The legacy of the former communist regimes had left Eastern European countries with inefficient energy industries characterized by outdated technology, heavy debt and environmental problems. In the words of Peter Layr, member of EVN’s executive board, reflecting back on the 1990s: “When early reformers such as Hungary or the Czech Republic started to privatize their industries in the 1990s, many of the big European energy companies were submitting bids that were beyond

<sup>1</sup> [www.evn.at/Gruppe/Vision-Mission.aspx?lang=en-us](http://www.evn.at/Gruppe/Vision-Mission.aspx?lang=en-us). Accessed October 2010.

EVN's financial capacity and appetite for risk."<sup>2</sup> Furthermore, rumors about "phone calls" from top-level politicians in support of bids from firms from their own countries highlight the competitive political dimension of these tender processes. Only a smaller project in Hungary, in partnership with Germany's Bayernwerke, provided EVN with its first opportunities for expansion and learning.

### *"Eastern Fantasy"*

*"Some of you would have not expected that South East Europe would become not only "A," but "THE" growth region. The growth champion of Europe, and it has undergone this development for the past few years. With real growth of over 23% over these years, and what is most surprising is that this growth of 23% has been made over the last four years, of course on an accumulated basis. ... South East Europe shall remain Europe's most dynamic region over the years to come. Without doubt, inclusion of the whole region into the European integration process has proven a predominant engine of this development."*

Martin Bartenstein, Austrian Federal Minister of Economics and Labor.<sup>3</sup>

In 2005, the "Eastern Fantasy" was in full fledge. The so-called "Red Bull Effect" ("Gives you wings!") had awakened the Vienna Stock Exchange (see Figure 2) and had an irresistible effect on investors and companies. In 2005, Austria became the largest foreign investor in Bulgaria with accumulated investments exceeding €1.3 billion (€700 million invested in 2004 alone), leaving Greece in second place with investments of €950 million.<sup>4</sup>

### *EVN's Growth Strategy*

In 2004, EVN's stock had not yet participated in the wild ride of the "Eastern Fantasy" (see Figure 2) and its dividend yield of less than 2% was small compared to industry peers. EVN articulated its mid-term strategic direction as centering on the following main objectives:<sup>5</sup>

- To focus on selected regional markets with potential for developing integrated electricity, gas, water and waste management solutions.
- To pursue opportunities in the core energy business, through acquisitions or direct investment, in selected markets of Central and Eastern Europe such as Bulgaria, Croatia, Montenegro, Germany, Italy and Romania.
- To exploit the substantial growth potential in the water and waste treatment markets in Central and Eastern Europe.

### **Figure 2**

Performance of the Austrian stock market index ATX (consisting of the 20 most important Austrian companies) and of the Austrian energy competitors Verbund and EVN (January 2002 to December 2004)

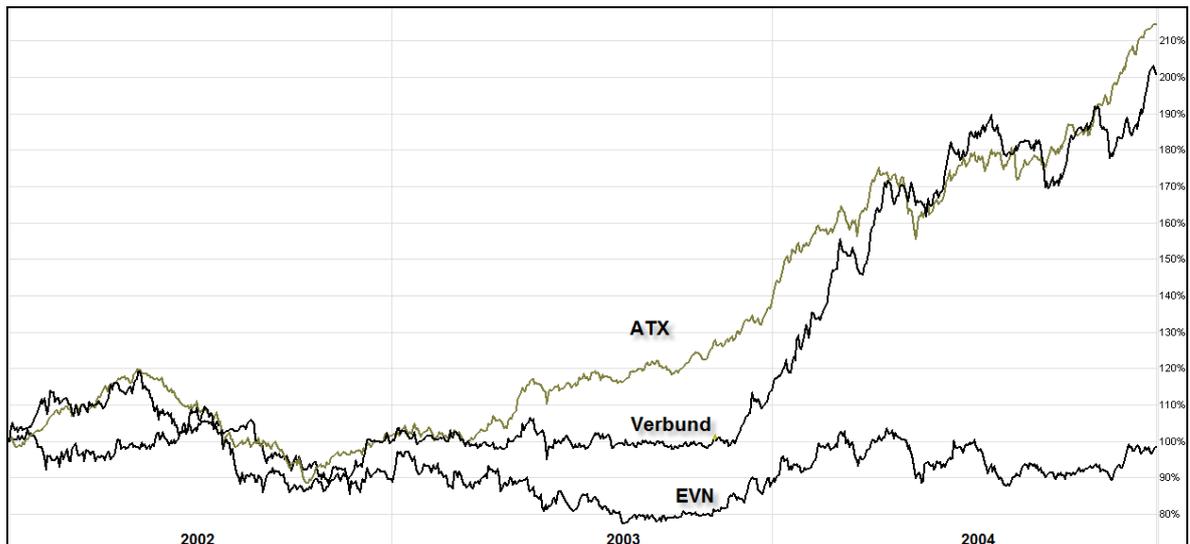
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<sup>2</sup> Telephone interview. September 2010.

<sup>3</sup> Vienna Economic Forum. November 7, 2005.

<sup>4</sup> Österreicher stürmen Bulgarien (2005). Wirtschaftsblatt. March 9, 2005.

<sup>5</sup> EVN press release. July 7, 2004.



Source: Vienna Stock Exchange.

To implement this strategy, EVN decided to issue, in July 2004, new ordinary shares representing up to 8.8% of its existing share capital. This first required clearing a political bottleneck. The Federal Province of Lower Austria was a 51% shareholder in EVN. As it intended to remain a majority shareholder, it had to agree to participate in the capital increase. According to EVN's then CEO, Gruber, "The EVN Group has highly specialized know-how in the infrastructure fields of energy, water and thermal waste treatment. With this capital increase, we are strengthening our position in order to pursue the growth potential in Austria and abroad."<sup>6</sup>

An important element of this strategy was the acquisition of the German firm Wassertechnik GmbH (WTE), which in 2003 was a leading service-provider in the drinking water and water-purification sectors. CEO Gruber stated that this acquisition would provide EVN with "colossal development opportunities" in Central and Eastern Europe, where WTE had been doing business in Poland, Slovenia, Croatia, Lithuania, Russia, Ukraine and Bosnia-Herzegovina.<sup>7</sup> Another important element was the expansion into Bulgaria on the basis of EVN's traditional competencies in the electricity distribution business.

In 2004, Bulgaria invited bids for 67% of its stakes in its seven electric power distributors that were grouped in three regional packages: Western Bulgaria, Southeastern Bulgaria and Northeastern Bulgaria (see Table 1 for details of the three regions). On February 16, 2004, Reuters released the following news:

"Five international companies submitted non-binding bids on Monday for majority stakes in Bulgaria's seven state power distribution utilities, hoping to cash in on strong growth in the EU candidate country. The five were Italian energy firm Enel (ENEI.MI), German utility E.ON (EONG.DE), the Czech Republic's state-run CEZ (CEZPsp.PR), Greece's state-run Public Power Corp (DEHr.AT) and Austrian regional utility EVN (EVNV.VI), Bulgaria's sell-off agency said."

<sup>6</sup> EVN press release. July 7, 2004.

<sup>7</sup> EVN to acquire German firm WTE (2003). Austria Today. July 3, 2003.

**Table 1**

Characteristics of the three regional packages offered by Bulgaria's tender process<sup>8</sup>

**Combined financial and electricity usage data for 2003**

Package	Revenues million euros	Profits million euros	Customers millions	GWh
<b>West</b>	338.18	9.67	1.89	8,596.00
<b>Northeast</b>	210.42	6.66	1.13	4,935.00
<b>Southeast</b>	285.57	5.21	1.49	6,577.00

**Western Bulgaria**

This package comprised the capital Sofia, the Sofia region and the Pleven electricity distribution utilities. According to power analysts, the distribution networks in these regions were short and well utilized with comparatively fewer technological losses. Analysts also saw the potential that the future establishment of a single European energy market held for the newly unified Bulgarian company to participate in the Balkan power distribution network that would join distribution grids in Romania, Bulgaria, Greece, Serbia and Montenegro.

**Northeastern Bulgaria**

This package combined the distribution companies in the Black Sea port of Varna and in the town of Gorna Oryahovitsa. A big advantage for this region was thought to lie in the opportunities for importing cheap electricity from neighboring Moldova, Ukraine and Russia.

**Southeastern Bulgaria**

This package combined the two utilities in Bulgaria's second-largest city Plovdiv and in Stara Zagora. Part of its attractiveness lay in the co-location of a coal-based energy generation plant, generating 30% of Bulgaria's power consumption, which could be potential source for a robust electricity supply at cheap prices. Furthermore, the region had two high-voltage power lines to Turkey and was expected to get a transnational power line from the Maritsa East 3 thermal power plant, which would bring opportunities for power exports to Greece. Ports and tourism centers at the Black Sea were also considered attractive assets.

That same Monday, Austria's President Thomas Klestil honored EVN's CEO Gruber with the "Silver Star Medal" in recognition of his special contributions to the Republic of Austria. Gruber had been EVN's CEO for 36 years, and at the age of 70 was expected to be retiring from this position soon. Gruber did not know yet that this bid would eventually result in the largest foreign investment in the history of EVN.

All five bidders were short-listed and invited for due diligence by the Bulgarian privatization agency. Werner Casagrande, a senior manager in EVN's Mergers and Acquisitions unit, remembers:<sup>9</sup>

"This was a long process. We had a first contact with BNP<sup>10</sup> during the fall of 2003. They were on a road show with the Minister and the management of the Bulgarian companies across Europe, which brought them into EVN's radar. We had to evaluate three packages with two to three companies each. We were interested in two packages, which meant we had to evaluate five companies. EVN is a relatively small company and we just do not have the capacity to do something like that on a routine basis. This was a real stretch to the responsible team in terms of time and effort."

<sup>8</sup> Sources: KEY FACTS – Bulgarian Power Distributors Slated for Privatization (2004). South East Europe Newswire. July 9, 2004; FACTBOX – Bulgaria's privatization of power distributors (2004). Reuters News. July 9, 2004; European Utilities Jockey for Position in Bulgarian Power Distributor Sell-Off (2004). World Markets Research Centre. July 12, 2004.

<sup>9</sup> Interviews at EVN HQ in Maria Enzersdorf, Austria. September 2010.

<sup>10</sup> BNP Paribas was the transaction advisor to Bulgaria for this privatization process.

Casagrande also shattered some illusions about the possible levels of analytical rigor of such a due diligence process.

“The distribution companies were only spun off from their mother company NEC two years before the bid. There was no real data history. We had an eight-hour management meeting and one full day of site visits with each of the five companies. Furthermore, you don’t really get a sufficient level of understanding of the books. Some important facts you only realize after you have bought the companies. And some things emerge after the sale that you did not even think of during the due diligence. For example, we were stunned that we inherited not two accounting departments for the two companies that we acquired but, - I believe – 21, each of which acted independently. We learned something new every day - not always without pain.”

The Bulgarian privatization agency had stated that price would be the key criterion in determining the winner for the individual packages, particularly since it had pre-qualified all five bidders as being financially stable companies (the Russian company UES, for example, had been disqualified by Bulgaria in the course of this process) that would comply with all terms of the privatization process. Bulgaria had stated clearly that each bidder could acquire only one of the three packages. In early July, the five bids were publicly communicated (see Table 2 for details). On July 15, 2004, a spokeswoman for the Bulgarian Energy Ministry stated that it had selected E.ON (Northeast package), CEZ (West package) and EVN (Southeast package) as the winning bids.<sup>11</sup> EVN also negotiated an option to buy the power distribution for the Black Sea resort of Slanchev Bryag for 25 million leva.<sup>12</sup> The Bulgarian regulator approved a plan that the new owners realize a 16% return on equity based on the regulator’s 2003 asset valuation in the first three years, followed by subsequent adjustments based on a CAPM or similar model. Revenue requirements for achieving these returns for the three private operators depended on achieving a number of service-level metrics to ensure an efficient electricity supply to private and industrial customers.<sup>13</sup> The regulator also requested that the new owners reduce their infrastructure investment targets valued against the regulatory asset base in the first three years after the acquisition.<sup>14</sup>

**Table 2**

Bids made by the five competing companies for the three regions (in million euros, highest bid per region in bold)<sup>15</sup>

Package\Bidder	EVN	E.ON	Enel	CEZ	PPC
<b>West</b>	<b>302.00</b>	270.50	241.20	281.00	165.00
<b>Northeast</b>	–	<b>140.70</b>	120.60	121.50	80.00
<b>Southeast</b>	<b>271.00</b>	–	201.00	171.50	180.00

<sup>11</sup> Bulgaria Picks E.ON, CEZ, EVN as Power Distributors Buyers (2004). South East Europe Newswire. July 15, 2004.

<sup>12</sup> Bulgaria May Sell Its Stake in Resort Operator to Unblock Sale of Power Distributor to EVN (2005). South East Europe Newswire. November 2, 2005.

<sup>13</sup> SERC Directions for Electric Distribution Company Tariff Setting Under Revenue Cap Method (internal EVN document).

<sup>14</sup> E.ON Bulgaria Awaits New Law To Mould Investment Plan (2006). SeeNews. June 27, 2006.

<sup>15</sup> Sources: KEY FACTS – Bulgarian Power Distributors Slated for Privatization (2004). South East Europe Newswire. July 9, 2004; FACTBOX – Bulgaria’s privatization of power distributors (2004). Reuters News. July 9, 2004.

## Bulgaria<sup>16</sup>

When President Zhelyu Zhelev of Bulgaria visited President Askar Akaev of Kirghizia in July 1993, he was told:

“Honoured Bulgarian friends, many centuries—perhaps millennia—before you became Christians and we Muslims, we both knelt before the same god, Tangra. And even now, were you to go out into the steppe and ask an ordinary Kazakh shepherd whose is that mountain over there whose peak is always covered in snow and shrouded in mists, he will answer: that is the Bulgarians’ mountain, that’s where their god lives.”<sup>17</sup>

The culturally, ethnically and linguistically rich area around the Balkan mountains form the historical origins of Bulgaria, whose first empire was established in 681. Invasion by the Ottomans in the 14th century brought it under the influence of the multicultural Ottoman Empire and religious and linguistic Turkish elements have survived until today. Nomadic shepherds from other regions and Jewish and Gypsy communities settled in Bulgaria during that time. This racial and religious complexity is also embedded in the word “bulgar,” derived from a Turkish verb meaning “to mix.” For much of World War II, Bulgaria was occupied by Germany, however in September 1944 it was invaded by Soviet troops and was then ruled over, until 1989, by the communist party.

The Bulgarian economy became one of the closest replicas of the Soviet model of a rigidly planned economy. It brought its economy under state control with the objective of building a heavy industrial base with most of the investments allocated for the development of electricity generation and the chemical industry. Between 1948 and 1970, agricultural output declined from 70% to 17% and industrial output increased from 30% to 55%. One of the effects of this radical change was a large increase in the urban population – in the 1970s over three fifths of the Bulgarian population lived in towns. By the 1980s, the problems that this approach to reform had created were becoming apparent. The frustration over economic performance and the appalling gap between them and Western countries could no longer be hidden:

- Management was used to production quotas driven by a central ministry rather than a reflection of the levels and dynamics of market demand and competition. Losses were usually subsidized.
- Products and services were of poor quality and could not be exported for hard currency to Western countries, while the know-how and sophisticated technology needed to be imported from Western countries.
- Public morale was seriously affected by highly unreliable electricity supplies with frequent power failures and off hours. A quarter of all electricity was supplied by a nuclear plant built in 1974, but delays in repair and capacity expansion resulted in frequent high-impact interruptions in supply.
- Protests against the appalling pollution of the Black Sea and other forms of environmental degradation became more frequent. Factory managers often could not be held responsible in court because they pleaded that they were merely fulfilling central plan targets.

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<sup>16</sup> Main Sources: Crampton, R.J. (2007). Bulgaria. Oxford University Press Inc. New York; Otfinoski, S. (2004). Nations in Transition: Bulgaria. Facts on File Inc. New York. 2nd edition.

<sup>17</sup> Crampton, R.J. (2007). Bulgaria; Oxford University Press Inc. New York. p.6.

The constellation of these factors proved highly resistant to a number of reform efforts aimed at introducing Western management practices. In the late 1980s, protests grew sharply and by 1989 the communist power monopoly had collapsed. Bulgaria saw the first free elections in 1990 and engaged in a process of economic reforms to build more modern competitive markets. The resulting collapse of the old uncompetitive industries created high levels of unemployment and rising social inequality. Within the first four years of reform, GDP dropped by a quarter.

### *Power, Politics and Economics*

The collapse of the system created a power vacuum that was readily filled by former system bureaucrats and members of the former secret police who used funds parked in foreign accounts to form a number of conglomerates. Such conglomerates subsequently had substantial political influence and were strongly resistant to reforms. Under the reign of the new Bulgarian Socialist Party, conglomerates dominated Bulgaria's economy and engaged in a number of illegal activities, such as paying inflated prices to suppliers in return for profit shares or selling products below market prices in return for cash-backs to managers. State subsidies covered any losses and inflated salaries to keep the general workforce happy. By 1995, subsidies to loss-making enterprises from state banks amounted to 15% of GDP.

In 1993, the EU had decided it would admit former communist states provided they fulfilled certain criteria, including having democratic political structures and competitive and functioning market systems. In December 1995, President Videnov formally submitted Bulgaria's application to join the EU. In 1996, however, the banking system, financially stretched to its limits, broke down and the economy collapsed. Interest rates climbed to 300% and inflation reached over 500%. After 1997, under pressure from the IMF and to comply with the terms of possible EU membership, a succession of governments pushed a reluctant population into shaping Bulgaria along Western political and economic models. This involved radical reforms. By 2001, more than 70% of Bulgarian enterprises had been privatized and over 40 of the largest loss-making conglomerates had been sold or closed down. Bulgaria also abolished duties on almost 500 agricultural products imported from the EU and closed hundreds of meat-producing plants and dairy farms that did not meet EU food standards. Inflation had fallen to single digit levels and salaries too had decreased. Unemployment had reached a level of more than 18% and particularly affected the Turkish and Roma minorities and young Bulgarians, thus exacerbating emigration dynamics. About 50,000 Bulgarians have emigrated every year since 1995. Bulgaria's net population growth in 2001 was -5.1%<sup>18</sup> and this trend was exacerbated by low fertility rates (see Figures 3a and 3b). One Bulgarian emigrant, Elena, who in 2004 was living as a young health care consultant in the US, truly missed her family in Sofia and often returned on visits. She did not, however, miss the everyday struggle experienced by most people in Bulgaria: "This is the only place on earth that I know, where people make 200 leva on average and have 400 leva expenses per month. Miraculously, they survive somehow."<sup>19</sup>

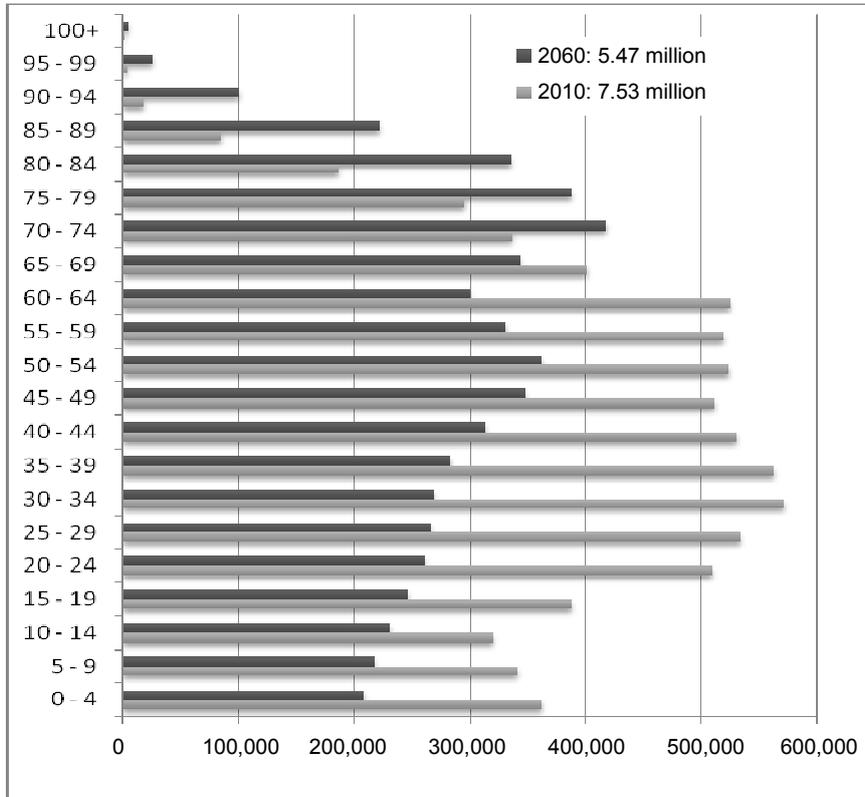
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<sup>18</sup> National Statistics Institute.

<sup>19</sup> Otfinoski, S. (2004). Nations in Transition: Bulgaria. Facts on File Inc. New York. 2nd edition. p.103.

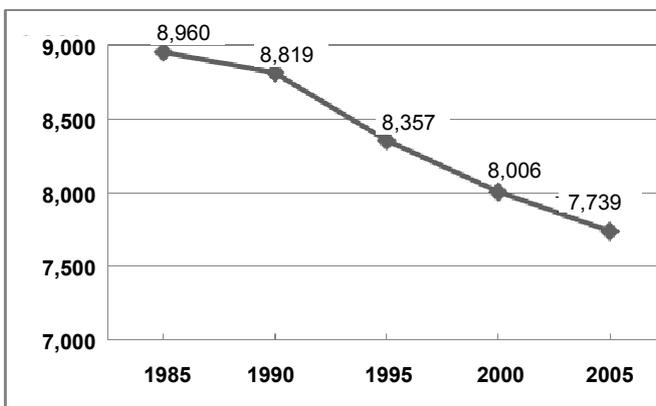
**Figure 3a**

Population projections between 2010 and 2060 (number of people by age group)<sup>20</sup>



**Figure 3b**

Historical population data, 1980 to 2005<sup>21</sup>



<sup>20</sup> National Statistical Institute (2010).

<sup>21</sup> United Nations Population Division (2008 revision).

Nevertheless, the IMF, World Bank and EU provided new loans and praised the tough economic policies implemented by the Bulgarian government. Bulgaria also made dramatic fiscal reforms, slashing corporate and individual taxes to record lows (see Table 3). With economic metrics improving, the EU then concentrated more on reforms that were not related to economic activity and which challenged Bulgaria's readiness for EU membership. This included combating crime and corruption, reforming the judicial system and improving the situation of minorities, particularly the Roma. Bulgaria quickly responded by implementing a framework program for integrating the Roma into Bulgarian society. This program included activities to educate Roma illiterate adults, as well as improvements in how Roma children were taught in primary and secondary schools. In 2003, the government passed an anti-discrimination law banning all forms of discrimination based on gender, ethnicity, race, religion, age, education, property and sexual orientation.

**Table 3**

Tax rates on personal and corporate income<sup>22</sup>

	Personal*		Corporate	
	2000	2010	2000	2010
<b>EU 27</b>	44.7	37.5	31.9	23.2
<b>Bulgaria</b>	40	10	32.5	10
<b>Austria</b>	50	50	34	25

\* Bulgaria: flat rate; Austria: top income rate bracket.

From April 2001, Bulgarian citizens no longer required visas to enter the Schengen area. Accession negotiations with Bulgaria were successfully completed in December 2004 and accession was scheduled for January 1, 2007. This was dependent on a final monitoring report submitted in 2006 to the EU Council and Parliament and the EU Council of Ministers, which would then, under Austrian Presidency, have to take an appropriate decision.<sup>23</sup>

### *Bulgaria's Electricity Industry*

*"Every fourth public procurement contract is concluded in the energy sector, making it one of the biggest taxpayers' money spenders in the country."*<sup>24</sup>

According to the President of the International Gas Union, George Verberg, corruption and bribery were a "major impediment to investment in the energy sector."<sup>25</sup> This was driven by excessive state influence on a global level and appeared to be particularly acute in the Central and Eastern European region, thus challenging necessary private investments. Other factors seemed to be the high levels of cash flows through the power supply chain as a whole and the large numbers of players involved between power generation, distribution and consumption.

<sup>22</sup> Taxation trends in the European Union (2010). Eurostat. June 28, 2010.

<sup>23</sup> Vienna Economic Forum 2005.

<sup>24</sup> The Energy Sector in Bulgaria. Major Governance Issues (2010). Center for the Study of Democracy. p. 9.

<sup>25</sup> Verberg says corruption a big obstacle to energy investment (2006). Platts Commodity News. May 15, 2006.

Total electricity consumption in the EU has been consistently growing (see Table 4), but since 1997, energy intensities of the economies of the EU-27 member states have fallen by 17% with the most significant decreases in the new member states (see Figure 4). However, two countries stood out. Although Bulgaria and Romania have also decreased their energy intensities since 1997 by almost 40%, in 2007 they were still the most energy intensive economies (Bulgaria: 1016 kgoe/€1000 of GDP; Romania: 656 kgoe/€1000 of GDP).<sup>26</sup> The significant electricity transmission losses in the power sector were partly blamed for these high intensities.

**Table 4**

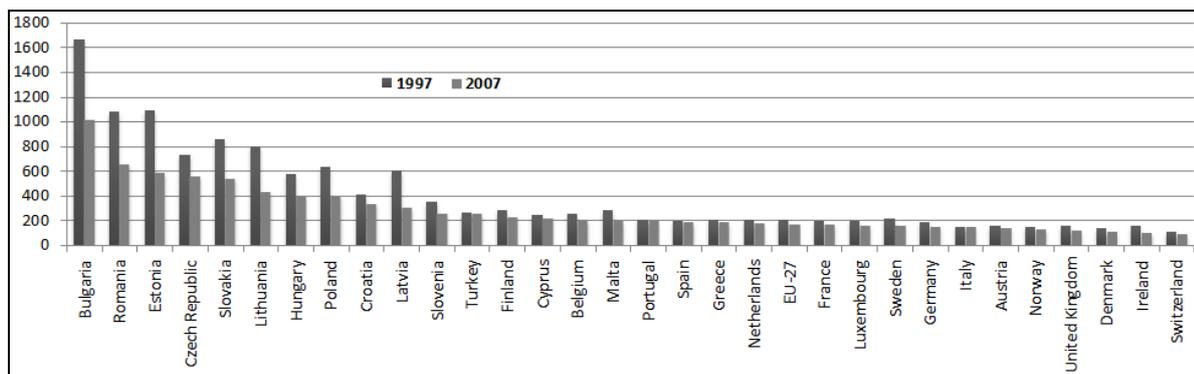
Total final electricity consumption (GWh), 1990 to 2003<sup>27</sup>

	1990	1995	1999	2000	2001	2002	2003
<b>EU-15</b>	1,813,456	1,969,052	2,157,258	2,229,599	2,297,066	2,306,493	2,370,610
<b>Bulgaria</b>	35,272	28,689	23,728	24,132	24,530	24,041	25,043

Bulgaria's main sources of electricity prior to EU accession had been coal and nuclear (see Figure 5). The country was highly dependent on foreign sources for its energy supply, in particular for gas and nuclear fuel from Russia. Dependency rate estimates ranged between 46% (Eurostat) and 70% (CDI).<sup>28</sup> A large part of electricity generation was in the hands of the state-owned National Electricity Company (NEC). NEC was also the main supplier of energy to EVN Bulgaria. However, despite being a state-owned monopoly, NEC suffered from having an old infrastructure and extremely low margins.

**Figure 4**

Energy intensity (kgoe/€1000 of GDP at year 2000 exchange rates)<sup>29</sup>



Energy intensity gives an indication of the effectiveness with which energy is being used to produce added value. It is defined as the ratio of gross inland consumption of energy to gross domestic product.<sup>30</sup>

<sup>26</sup> Eurostat Report (2010). p.37.

<sup>27</sup> Gas and electricity market statistics (2005). Eurostat.

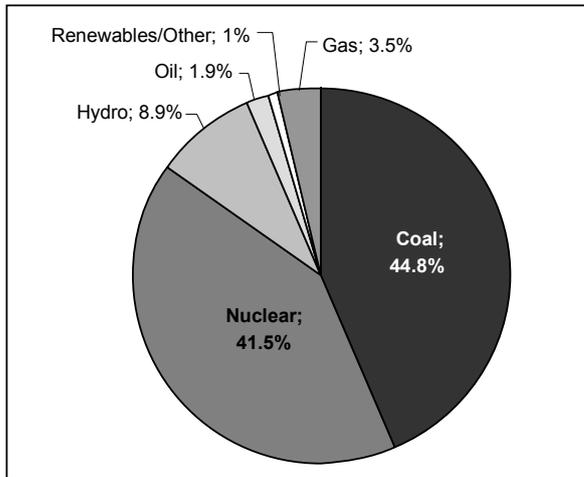
<sup>28</sup> The Energy Sector in Bulgaria. Major Governance Issues (2010). Center for the Study of Democracy.

<sup>29</sup> Energy, transport and environment indicators (2009). Eurostat.

<sup>30</sup> Energy, transport and environment indicators (2009). Eurostat.

**Figure 5**

Primary energy sources for power generation in Bulgaria in 2004 (Total = 37.5 TWh)<sup>31</sup>



Amongst EU countries, Bulgaria had very low electricity prices for both industrial and household customers (see Figures 6a and 6b). These prices were set by the State Energy Regulatory Commission (SERC). However, in relative terms, for households in Bulgaria electricity costs were very high. In most transition countries, average electricity payments do not account for more than 5–6% of total expenditures.<sup>32</sup> In Bulgaria, the total household bills for electricity and fuel exceeded actual rents and imputed rentals. Electricity represented around 30% of housing expenditure in the decade between 1995 and 2005.<sup>33</sup>

In 2003, Bulgaria adopted its landmark energy law, intended to comply with EU energy legislation and resulting in major changes in the energy sector.<sup>34</sup> It proposed the creation of a competitive power market through a series of privatizations. EVN of Austria, E.ON of Germany and CEZ of the Czech Republic were the first foreign investors to participate in this process. The three companies generated almost €700 million for the Bulgarian government for the purchase of 67% stakes in nine electricity distribution companies. A major concern regarding the expected EU accession in 2007 was the threat posed by the old nuclear reactors, which were legacies of the Soviet system. Together, these generated almost half of Bulgaria's electricity.<sup>35</sup> Bowing to EU pressure, the Bulgarian government closed the two oldest reactors in 2004, and two others in December 2006. The EU provided €550 million in compensation to cover the costs of these closures.

<sup>31</sup> The Eastern European Electricity Market Outlook 2007 (2007). Business Insights Ltd.

<sup>32</sup> Fankhauser, S. and Tepic, S. (2007). Can poor consumers pay for energy and water? An affordability analysis for transition countries. *Energy Policy* 35, 1038–1049.

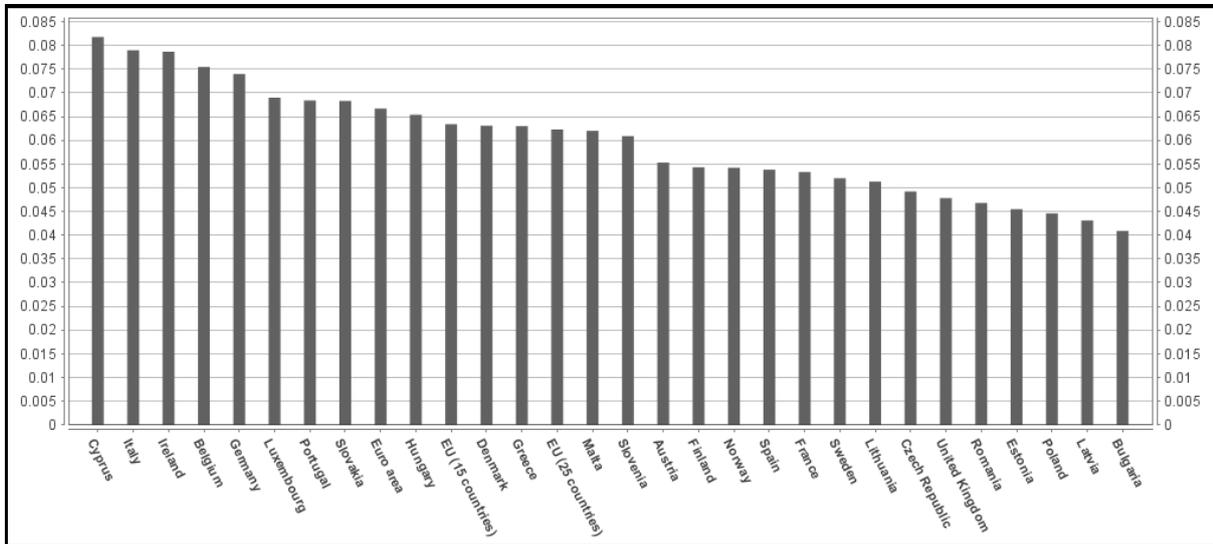
<sup>33</sup> Euromonitor (2007). *Consumer Lifestyles – Bulgaria*.

<sup>34</sup> Taking great strides in reforms and privatization (2005). *Platts Energy in East Europe*. January 21, 2005.

<sup>35</sup> The World Nuclear Industry Status Report 2007 (2008). The Greens-European Free Alliance Group, European Parliament.

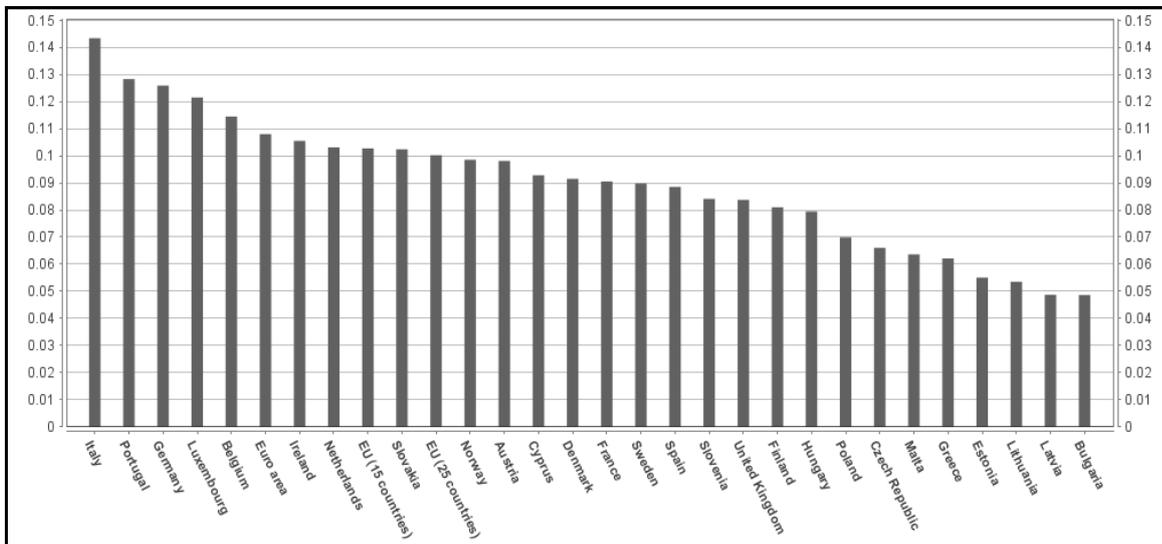
**Figure 6a**

Country comparison of 2004 electricity prices for industrial consumers (€/kWh)<sup>36</sup>



**Figure 6b**

Country comparison of 2004 electricity prices for household consumers (€/kWh)



## EVN: Doing Business in Bulgaria

In 2005, EVN's world looked very different. Burkhard Hofer, an EVN veteran who had been with the company since 1980, and who had succeeded Gruber as CEO of EVN in 2005, needed to deal with a new reality. On the one hand, EVN's project businesses in the water and waste-water segments were already providing around 20% of revenues,

<sup>36</sup> European Commission. Eurostat. [http://epp.eurostat.ec.europa.eu/portal/page/portal/energy/data/main\\_tables](http://epp.eurostat.ec.europa.eu/portal/page/portal/energy/data/main_tables). Accessed October 2010.

with large ongoing projects in Moscow (Russia), Zagreb (Croatia) and Stettin (Poland). On the other hand, the acquisition in Bulgaria had dramatically changed EVN as an organization: the number of electricity customers had increased from 775,000 to around 2,300,000 and one third of all Bulgarians were now EVN customers. EVN's workforce had grown from 2,600 to roughly 6,650, with two thirds of its employees now in Bulgaria. However, in contrast to the 155% growth in employees, personnel costs grew only by 15.9%, reflecting the lower wage levels in Bulgaria.<sup>37</sup>

EVN's head of corporate communications, Stefan Szyszkowitz, was promoted to managing director of EVN Bulgaria and relocated with his family to Sofia. The first strategic priority was a rapid and complete integration of the Bulgarian companies into the EVN Group structure. Stefan remembers: "We did not know what the attitude of the Bulgarian employees would be towards us. So we met with them even before the closing. They seemed rather distant. In retrospect, we did not have a sophisticated understanding of Bulgarian culture or of the particular organizational legacy of the communist era." The organizational culture of the Bulgarian companies that EVN inherited was based on central command and control and individual ambition was neither expected nor rewarded. EVN's focus on implementing optimized processes from their Austrian business was thus met with little resistance. EVN's insistence on fully implementing its well-documented processes locally thus enabled rapid standardization and a move towards transparency and accountability. EVN implemented a three-party management board as required under Bulgarian law. For each of the two companies it appointed two board members from EVN Austria and the former managing director of the respective Bulgarian company. As Peter Layr commented: "While the other foreign companies continued to manage the existing local structures in the first years, our strict focus on change achieved full integration and adaptation to the EVN group within a very short time. Now our competitors are dealing with personnel issues and conflicts with the unions, while we are already focusing on efficiency and optimization – a huge advantage."<sup>38</sup>

## Challenges for EVN Bulgaria

In July 2005, after the successful integration of the Bulgarian companies, Stefan Szyszkowitz was very optimistic about growth in Bulgaria's electricity consumption. Revenues and EBIT had improved (see Table 5) and he expected further revenue growth from gradually bringing the historically low electricity prices in line with EU levels. Further potential for growth was seen through investing in electricity generation and expanding EVN's project-business in water and waste services.<sup>39</sup> But the reality in Bulgaria turned out to present a number of obstacles to achieving EVN's growth objectives.

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<sup>37</sup> DGAP-News: EVN AG (2005). Reuters News. December 15, 2005.

<sup>38</sup> Telephone interview. October 2010.

<sup>39</sup> EVN Forsees Higher Bulgarian Electricity Consumption (2005). APAEC. July 8, 2005; EVN will in Bulgarien bei Stromproduktion einsteigen (2005). Down Jones – VEW. April 21, 2005.

**Table 5**Consolidated financial data of EVN Bulgaria (2003 - 2006)<sup>40</sup>

In million euros	2003	2004	2005	2006
Revenues	448.8	466.8	519.2	557.2
EBITDA	39.9	50.9	60.1	65.3
EBIT	14.0	22.2	26.0	28.5
EAT	8.1	14.9	22.1	21.1
Investments	32.6	38.0	35.0	55.6
Total Assets	301.2	368.7	406.4	454.7

### *Contractual Problems*

Early in 2005, an unexpected problem emerged that threatened relationships between EVN and Bulgaria. One of Bulgaria's contractual obligations as part of the privatization deal was to sell EVN the distribution company in the Black Sea resort of Slanchev Bryag, also known as *Sunny Beach*, for a price of 25 million leva (\$16.6 million/€12.78 million). Bulgaria held a 75% stake in the company, but the minority shareholders felt that the price was too low and refused to sell.<sup>41</sup> In a private shareholder meeting they decided to ask for 79 million leva instead. This was a sensitive issue for Bulgaria. If the deal fell through, it was liable to EVN for €27 million in penalties. A series of negotiations was unsuccessful and, in 2006, EVN filed a claim against Bulgaria with the International Arbitration court in Paris to enforce receipt of the penalty payments.<sup>42</sup> This move had unforeseen consequences: in April 2007, Bulgaria's privatization agency delayed for over five months the sale of the Plovdiv district heating utility for which EVN had won a competitive bid in October 2006. Eventually, EVN paid 43 million leva instead of the originally agreed 25 million to acquire the *Sunny Beach* distribution company.<sup>43</sup>

### *Technical Losses, Electricity Theft and Customer Relations*

EVN faced a number of obstacles in its attempts to deliver on the expected improvements in the technical quality of its distribution supply chain, its legitimacy as a foreign provider and its ability to generate financial returns. The distribution network that EVN inherited was not up to the standards at which it operated in Austria. Technical losses were high, and investments and coordination were required along the supply chain. The idea of "unbundling" that was required by the EU meant that power generation and transmission were uncoupled from power distribution to break up monopolies and generate competition. However, for EVN Bulgaria it was not easy to establish exactly which assets it owned and it was thus responsible for, and which were the responsibility of generation and transmission companies. EVN Bulgaria got its electricity supply by connecting to transmission substations owned by NEC, where high voltage electricity was converted to lower voltage and then distributed to industrial and household consumers. The substations

<sup>40</sup> Source: Annual Reports. EVN Bulgaria. 2005 and 2006/7.

<sup>41</sup> Spat Threatens Bulgarian Black Sea Power Distributor Sale to EVN (2005). SeeNews. April 26, 2005.

<sup>42</sup> EVN sues Bulgaria over power utility privatization (2006). Reuters News. January 24, 2006.

<sup>43</sup> Bulgarian Sell-off Agency, EVN Legal Dispute Blocks Plovdiv Heating Utility Sale.

were the demarcation lines between long-distance transmission from the site of power generation and local distribution to the site of power consumption.

In the summer of 2006, after complaints from customers in the Plovdiv region that EVN serviced, municipal officials filed a complaint against EVN for providing electricity at levels of voltage that damaged household appliances. In a different region, 139 villages filed complaints against German company E.ON on the same grounds, as well as for the too frequent power outages. The power regulator launched checks on the companies and threatened to fine them if the complaints were found to be justified. This put pressure on EVN to invest even more in modernizing the technical infrastructure.<sup>44</sup>

Technical losses, however, were only one of the obstacles to growth. Bulgarian households on average consumed about 30–40% less electricity than average consumers in Austria. This was despite the fact that Bulgarian households did not have modern low-energy consuming appliances. Another major challenge for EVN was large-scale electricity theft. “Energy theft is almost a form of popular sport here,” said Stefan Szyszkowitz.<sup>45</sup> This form of theft was facilitated by the old energy meters that customers found easy to manipulate. Energy theft was a particular problem in the Roma communities. To combat this, the previous management of the Bulgarian electricity distributors had put the meters 20m above ground level in Roma communities, making it difficult to manipulate them but equally difficult to read them. As a result, EVN inherited a stubborn problem that seemed to resist all attempts to solve it. The Plovdiv-based power firm that EVN acquired had stated, in September 2004, that it would make a last attempt to collect the huge amount of accumulated debts from non-paying customers.<sup>46</sup> The Roma community alone owed more than €2 million in outstanding bills to the utility<sup>47</sup> and were, therefore, only supplied with electricity during the night to limit losses to the distribution companies. EVN engineers required police escorts when checking meters and power lines in those communities. Szyszkowitz said that EVN would stop the tradition of accumulating debt that was considered a sunk cost and, thus, constituted the provision of free electricity to non-paying customers. He was adamant that “each subscriber should be treated equally, which was a principle for EVN and all its subsidiaries.”<sup>48</sup>

In 2004, electricity price hikes had raised the average monthly electricity costs of Plovdiv households to 42 leva (\$29/€22) in November 2004, as compared to 27.4 leva (\$18.8/€14) in October 2004.<sup>49</sup> It was expected that EVN, after assuming management, would systematically cut electricity supply to customers who failed to pay their bills and any outstanding debt after a brief “grace period.” EVN felt that solving the problem would also require significant investment to replace about 400,000 electricity meters with modern meters resistant to manipulation and which could also be monitored remotely. In 2006 alone, it replaced about 250,000 meters. This was expected to lower electricity losses to below

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<sup>44</sup> Bulgaria Power Regulator Urges Power Distributors To Improve Quality of Service (2006). Bulgarian News Digest. July 4, 2006.

<sup>45</sup> Stromstehlen ist Breitensport (2005). Der Standard. July 9, 2005.

<sup>46</sup> Bulgaria Plovdiv Power Distributor Takes Tougher Measures against Tardy Payers (2004). Bulgaria News Digest. December 8, 2004.

<sup>47</sup> Kein Strom untertags (2006). Die Presse. December 20, 2006.

<sup>48</sup> Plovdiv, Stara Zagora Electricity Distribution Companies to Shed some 1,000 Jobs by End-2007 (2005). Bulgarian News Agency. December 13, 2005.

<sup>49</sup> Bulgaria Roma Owe 11 million Leva in Bills Arrears to Plovdiv Power Firm (2004). Bulgarian News Digest. September 3, 2004.

10%, from levels of 14% in Stara Zagora and 20% in Plovdiv, of which only half were due to technical infrastructure losses.<sup>50</sup>

### *Mass Protests*

The new meters would also facilitate a solution to another challenge in customer relations. Bulgaria had a tradition of monthly meter readings. Stretched household budgets and a lack of trust towards distributors meant that an army of meter readers was required to provide monthly bills based on actual consumption levels. In the EU, the standard was to read meters once or twice a year and update bills accordingly. In late summer 2006, a tense situation arose that triggered mass protests against EVN. EVN had introduced organizational changes and a new IT system to facilitate an efficient billing mechanism based on a rolling meter reading. A software glitch resulted in the accidental overbilling by a few levas of some customers in 11 small villages in one month. Immediately, jokes about rip-off electricity bills in Bulgaria became popular on radio stations. The International Macedonian Revolutionary Organization (IMRO) organized citizens of Plovdiv and Stara Zagora to stage protests against EVN.<sup>51</sup> One of the protesters asked: "If EVN acted like that in Austria, what would the Austrians say?" Her bill for August 2006 went up to €25 from the approximate €9 that she had usually paid. Protesters displayed signs that read "EVN go home" or "EVN = Energy Occupiers."<sup>52</sup>

Six months later, the populist IMRO staged another round of protests against EVN. The Association for European Integration and Human Rights had reported to the European Commission the practice of limiting electricity supply to Roma communities that did not pay the bill to a short period during the night. The impact of such a limited electricity supply could be interpreted from two perspectives. One set of voices criticized it as being inhuman treatment of minorities. Another set of voices claimed that it was unfair that Roma should receive electricity free of charge while "Bulgarians" had to pay. One complication was the practice of indiscriminately cutting the supply of electricity during the day for Roma communities. Some residents had power lines that were illegally manipulated to serve other households as well and were thus cut off from electricity despite paying their bills. "I want to live like a normal human being, not like in the middle ages," said one Roma, who had been affected by the cutoffs despite paying his bills, after winning two legal disputes against EVN Bulgaria.<sup>53</sup> Bulgaria fined Szyszkowitz and two other board members personally €1000 each on charges of discrimination.

### *Electricity Prices*

Bulgaria had increased electricity prices in 2003 and 2004 and requests for further price increases by the distributors were subsequently met with strong resistance from the regulator. In October 2005, the regulator decided that household prices remain flat while prices for industrial customers would rise by 13% to 17%, depending on the region. This would affect end-product costs in the metallurgical and chemical sectors, as well as in the foodstuffs, textile, wood processing, machine-building, paper and cellulose sectors.<sup>54</sup>

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<sup>50</sup> Neue Kunden, alte Zähler (2005). Salzburger Nachrichten. July 9, 2005.

<sup>51</sup> At Loggerheads with EVN, E.ON (2006). Capital Weekly. November 20, 2006.

<sup>52</sup> Nationalisten organisieren Proteste gegen EVN (2006). Die Presse. November 15, 2006.

<sup>53</sup> Kein Strom untertags (2006). Die Presse. December 20, 2006.

<sup>54</sup> New Electricity, Natural Gas Prices (2005). Capital Weekly. October 3, 2005.

The distributors filed complaints about these modest price increases. Paired with the decision by the regulator to limit expenditure on necessary investments, these low prices challenged the distributors' ability to improve the quality of service and to realize the expected annual returns.<sup>55</sup>

In 2006, the companies filed new proposals for price increases with the regulator. All three foreign-owned distributors also requested price hikes for households in excess of inflation rates, which were 6.5% in 2005.<sup>56</sup> This time they were joined by the state-owned NEC, which also requested a 15% price increase. NEC was troubled by extremely low profit margins of less than 2%. NEC also implemented two other strategies to cover its costs. One was to export electricity and sell it at higher market prices outside of Bulgaria and the other was to start competing with the distributors by selling directly to large industrial customers below retail prices. Protests by the distributors had little impact, and the energy minister declared that unlike NEC, these distributors "are not investing anything. They are just metering."<sup>57</sup> Furthermore, the regulator stated that average prices for end customers would remain unchanged from October 1, 2006. However, it allowed NEC to raise its prices.<sup>58</sup>

### *How and What to Prioritize?*

As Stefan Szyszkowitz stepped out of the Ministry building that day in October 2006 after the unfortunate press conference, he almost appreciated the cold autumn wind blowing in his face. It allayed his tiredness and frustration and he tried to think more clearly through the bewildering set of complicated problems that seemed to have taken on an uncontrollable dynamic. He wondered: "Should I prioritize large investments to fix the technical problems of the electricity distribution network that EVN had acquired in Bulgaria? The quality of the service was still under dispute and was triggering protests and hostility against the foreign investors. In fact, the regulator had even threatened to rescind E.ON's license if they did not improve their record of power failures.

"Or should I deal first with the challenges of human misery and the perceived injustice of underserving customers with huge debt burdens from years of unpaid services?" This was a particular problem in the large Roma communities that EVN Bulgaria inherited as the main local electricity distributor.

"Or should I align more closely with the two other foreign investors that had acquired distribution companies in Northern and Western Bulgaria?" Together they could increase the pressure on the government to raise prices, which all three companies deemed necessary to generate the expected and contractually guaranteed returns on their investments. One option was not on his mind, though – to sell the Bulgarian operations and use the capital for potentially more fruitful investments. He was confident that success was only a matter of time and, as he said, "time has a different dimension in this business."

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<sup>55</sup> Nine contest new prices (2005). Platts Energy in East Europe. October 14, 2005.

<sup>56</sup> EVN requests higher electricity prices (2006). PARI Daily. April 25, 2006; Price Fog in the Energy Sector (2006). Capital Weekly. 3 May 3, 2006.

<sup>57</sup> Discontent (2006). Platts Energy in East Europe. June 23, 2006.

<sup>58</sup> Press Review (2006). Bulgarian News Agency. September 12, 2006.