

Privatisation of Network Industries: the Case of the Czech Energy Sector

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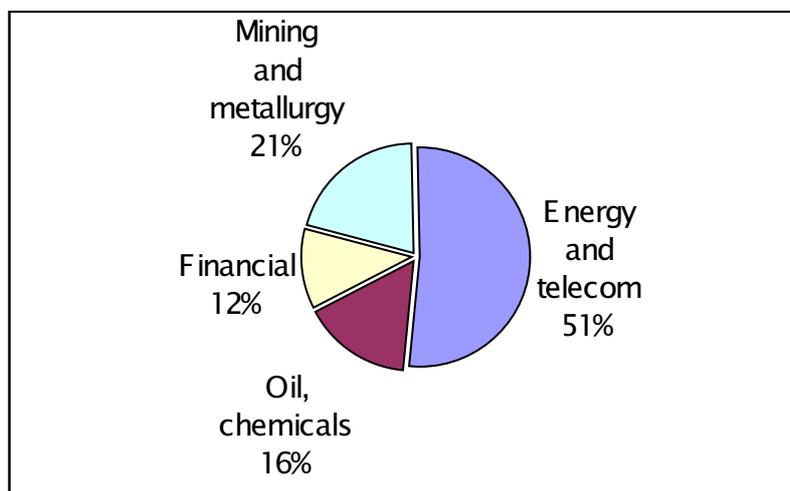
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Introduction

According to the recent analysis the state sustained its influence over the significant part of the Czech economy.¹ However great part of the property recently controlled by state should be privatised during next few years.

The most important companies, which are waiting for privatisation, are so called “strategic companies”, i.e. companies which have monopoly position or play a key role in the economy, namely companies operating in banking, petrochemistry, metallurgy, mining, telecommunications and energy (see Table 1). As by mid 2000 the total value of these companies was 159.9 bn CZK (3.89 bn USD). In half of the strategic companies National Property Fund holds 50% and more shares, in the rest blocing share, ie 34-50%.²

Graph 1 Assets hold by NPF by sectors, June 2000



Source: NPF, note – the share of energy sector is 40%, of which about one third is gas, the rest electricity

¹ See for instance Kocenda E., 1999 or Turnovec, 1999, who showed that the degree of the state holdings is even bigger thanks to the indirect or cross-ownership.

⁹ As by mid 2000 NPF hold minority stakes in total value 18,9 bn CZK (0,46 bn USD). In 64 companies share of NPF was 10% and more. In 180, the share is less than 10%. Out of the minority stakes, 65 are shares with special rights or so called „golden share“, in total nominal value 0,52 bn. USD (19 billion of crowns). Out of these 65 companies, 29 are water production, distribution and sewerage companies, 15 spa-medical treatment companies, 6 research institutes, 6 basically cultural (cinematography and audio production, publishing) companies, in 2 pharmaceutical production companies, and 7 others. NPF holds the golden shares in companies, in case of which the Government decided to limit the firms in their disposal with trade mark, increase or reduce basic capital, change of subject of activities etc. in order to ensure public interest for certain period. With golden share the state retains preferential voting rights and veto right. In some of the companies golden share is foreseen to stay in state hands only temporarily and the state plans to divest.

Reasons for keeping of assets by state seven years after the formal end of privatisation programme are different according to the sector. First group is created by financial institutions. For a long time, bank privatisation had been postponed due to several reasons including interests of political parties in power and large scale of bad debts in the portfolio of state banks. Also bank management opposed successfully privatisation.³

In the second group there are industries, which were developed under the centrally planned economy, having overcapacities and obsolete technology and it is difficult or impossible to find a strategic investor. These are large enterprises that have social leverage and cannot be shut down. This is the case of steel industry, metallurgy or mining companies that should be fundamentally restructured or revitalised before privatisation or eliminated. Due to a big concentration of labour, the restructuring and subsequent privatisation is not only economic but also political issue in which labour unions are involved.⁴

The third and last group is network industries, which used to be natural monopolies such as telecommunication, energy sector or oil industry. State ownership in these industries is a way to regulate these industries in which competition does not exist. For many years these industries were and in some countries still are in state hands even in developed market economies and privatisation started only recently. The privatisation of these industries is more difficult as it requires creation of regulatory and legislation framework allowing for full liberalisation of these industries. Most of the companies in this group are supposed to be privatised during next two years. Dates of privatisation are however tentative as there are still decisions to be done and past decisions might change. Oil and chemical industry is somewhat mixture of third group with the previous group needing restructuring.

³ Large banks have been included into the voucher privatisation. Government retained the strategic stakes in partially privatised banks. Investment funds contributed to greater concentration of the dispersed ownership otherwise generated by voucher privatisation. At the same time the government retained its impact on the lending decisions. Bank privatisation started under the Temporal government (Jan. 1998-June 1998). First IPB became part of the Nomura Group in beginning of 1998, when NOMURA acquired 36% of IPB for USD 0.038 bn. Country third largest bank CSOB has been sold to KBC Bank of Belgium for 1.2 bn USD in June 1999. As by February 2000 share of 52% of Ceska sporitelna has been acquired by Erste Bank der Osterreichischen Sparkassen for 0.5 bn USD. Recently CSOB overtook the failing IPB. There exist a special group for bank privatisation in the Ministry of Finance. Last large bank to be privatised is Komerčni Banka

⁴ Prior to and during the large-scale privatisation, the state did not restructure enterprises in any sense other than divide enterprises into several parts. (Charap J., Zemplerova A., Restructuring in the Czech economy, EBRD, WP No2/March 1993) Restructuring was left to future private owners. Recently numerous companies, often companies which have not been divided and which were partially privatised as a whole, are indebted and facing bankruptcy and have to be restructured. To address the issue of failing companies, the government implemented a revitalisation program for large industrial enterprises. In the framework of the revitalisation programme KOB established in February 1999, based on the decision of the government, a 100% subsidiary of KOB Revitalisation Agency, which is to handle selected specific cases and specialises itself in restructuring transactions with large corporate clients. Based on international public tender, the agency is managed by international consortium. The consortium recently works on restructuring of 8 problematic Czech industrial companies, selected by special governmental commission out of relatively long list of companies.

The agency has got mandate to purchase the classified loans of these enterprises from Czech commercial banks, to manage, restructure or capitalise their outstanding debts and to own and control the company. The ultimate aim is financial restructuring and subsequently privatisation.

Table 1 Stakes in Strategic Companies hold by National Property Fund

Company	%	Industry
CEZ	68	Electricity
Transgas	100*	Gas
16 distribution companies	46-59	Electricity/gas
Cestky Telecom	51	Telecommunication
Ceské Radiokomunikace	51	Telecommunication
Ceské aerolinie	57	Airlines
Ceska pojistovna	30	Insurance
Komerční banka	49	Banking
CEPRO	100	oil industry
MERO	100	oil industry
PARAMO	79	oil industry
Unipetrol	63	oil industry
Nova Hut	49	metallurgy
Vitkovice	67	metallurgy
OKD	46	mining
Sokolovská uhelna	49	mining
Severoceske doly	54	mining

Source:NPF

In addition to companies with shares hold by NPF there are few state enterprises administered directly by the responsible Ministry because of their strategic and political importance. The companies are in the sector of railways⁵, postal services, gas import and transit, airport administration and air traffic control, finances, mass media, healthcare⁶ etc. Their transformation or privatisation is subject to further governmental decisions.

Social Democrats who came into power mid of 1998⁷ are in general in favour of privatisation, as they need means for financing of their social programmes. The pace and extension of privatisation of residual state property is however relatively slow and privatisation of the majority of strategic companies is still in the stage of preparation.⁸

⁵ According to last announcement of government, railway will stay under the state control for the time being. Later a strategic partner can be found, however most probably only for the freight transport. According to the Law on Railway which is in preparation, Ceske drahy should be transformed into a joint stock company but not before the year 2002

Contrary to railways where only a few regional rails have been privatised, in the Czech Republic, bus transport has been fully privatised. (in regional public transport there exist competition, municipalities hire bus companies at regulated prices. Service providers are subsidised through local budget or government budget. In big cities, public transport is provided by a company owned and established by municipality. In Prague the fares cover about 25% of the total costs). Recently bus transport creates competition to railways and curbs the rise of railway fares.

⁶ large hospitals and sanatoriums, other facilities have been privatised

⁷ formed a majority government and signed so called „opposition agreement“ with Civic Democratic Party

⁸ During 1999 only Chemické závody Sokolov (74% stake) and Mostecká uhelna (46%) have been privatised out of the strategic companies and sold to the foreign investors.

Privatisation of energy companies

During the end of last century utility industries including energy sector cease to be considered natural monopoly. Governments are privatising these industries or abolishing the granted exclusive rights to the private enterprises within a certain territory. Privatisation of network industries is necessarily accompanied by changes in the organisation of the energy sector along to horizontal as well as vertical lines. Liberalisation and globalisation are causing deep changes in utility industries such as power utilities.

In the Czech Republic energy sector liberalisation and privatisation is a key issue as the share of energy-intensive sectors in the economy is relatively high. In 1995, the share of energy sector on GDP was 5.7% , is however expected to decrease to 4.8% in 2000 is and to mer 3.6% in 2003.

Privatisation of energy companies is especially complicated as it is accompanied not only by reform of legislation, creation of regulatory agency but also by restructuring of companies. This is a difficult task in developed market economies and even more difficult in the transition economy.

Assets to be privatised in electricity sector

There are eight regional electricitiy distribution companies (up to 46-58%depending on the company) and one monopoly energy production company CEZ (up to 68%)

CEPS, the transmission company owned fro 100% by CEZ should became independent and stay in the state hands.

Network industries are together with rents the sectors, which is regulated in the Czech Republic. As mentioned above, the privatisation of energy sector is accompanied by liberalisation, therefore changes in legislation should go hand in hand or better ahead the privatisation. There are several governmental bodies and other players involved into the privatisation and regulation of energy companies that have different motivation and opinion as for the way and method of privatisation.

The property rights over the energy companies are executed by National Property Fund. Shareholders rights in strategic companies are exercised by National Property Fund in co-operation with the founding/line ministries, in case of energy companies with the Ministry of Industry and Trade. Originally, in energy distribution companies, co-operation involved also municipalities, which were shareholders of the distribution companies, but the municipalities sold their shares during last years to foreign investors who became important players in the privatisation.

The state acts not only as an owner but also as a regulator. In case of energy companies two ministries are in charge of regulation – Ministry of Finance (MF) and Ministry of Industry and Trade (MIT), which are sharing the responsibilities. MIT proposes prices to MF, which is the only authority entitled to issue price edicts (both wholesale price from CEZ to distribution companies as well as end-user prices.)

Privatisation decisions are prepared by the Ministry of Finance in co-operation with responsible the Ministry of Industry and Trade. An inter-ministerial committee (Ministry of Finance, Ministry of Industry and Trade, FNM) decides about the results of the public tender relating to the selection of consulting firm which should prepare and co-ordinate sales of state holdings. The Committee negotiates the conditions of the contract in co-operation with the consulting firm. Finally the privatisation proposal has to be approved by the Government. National Property Fund executes this decision.

In the past utility industries have been characterised by vertical integration. As a consequence of deregulation, and during the transition to a competition energy companies vertically desintegrate and adopt more horizontal focus while specialising in particular parts of the supply chain, i.e. in power generation, distribution, services and trade. Besides specialisation unbundling allows for transparency and identification where the subsidies go.⁹

In the Czech Republic the world trends in the energy sector has been recognised and reflected in the organisation of the energy sector. The company has been both vertically as well horizontally disintegrated. In 1992 the government split the state energy monopoly into production and transfer company CEZ and 8 regional distribution companies. In 1999 CEPS (energy transmission company) hold from 100% by CEZ has been established.

In 1993, during the privatisation programme together with 15% devoted to voucher privatisation, 3% to Restitution Investment Fund substantial stakes of energy distribution companies have been free of charge transferred to municipalities - in each 34%. However during 1996-2000 these municipality shares of the distribution companies have been spontaneously privatised. Municipalities sold their stakes (or voting rights) to foreign investor and state lost majority in distribution companies. Foreign investors invaded energy distribution companies as it shown by Table 3.

Recently state was trying to acquire the majority stake in the distribution companies (CEZ bought shares in some companies), and it succeeded in 5 of them (see Table 3). Boards of all distribution companies were reconstructed by NPF and the status changed in order to re-gain the decisive role. In case of CEZ 68% still owns the state (NPF). Shares of CEZ are traded on the Czech Stock Exchange and are rather liquid.

⁹ EU directive 91/440/EC, Thompson (1997)

Competition versus Monopoly

In general the government can decide whether to privatise the sector as a whole to one investor or to privatise individually each company to different investors. There are two proposals or concepts, completely opposite in the privatisation of the energy sector. One leads to creation and maintenance of monopoly, the other allows for competition. Governmental decision is difficult to predict. Both concepts have pros and cons.

First concepts, preferred by Ministry of Industry and Trade (MIT) proposes to create monopoly and privatise energy sector as a whole. Its major arguments are economies of scale and scope and the sale's price, which is supposed to be higher in case of selling a monopoly. As a counter argument is the fact that there would be hardly more than one potential investor for such a big deal, hence it would not be possible to bargain.

The second solution proposed by Ministry of Finance (MF) is to sell regional distribution companies individually and create competition. The sale's price would allow for bidding as there might be more potential investors beside the incumbent. The bidding could generate higher sale's price. In this case the companies would then later merge anyway but it is probable that there would be at least two or three large companies remain which could then compete.

More specific, these two basic scenarios or concepts of privatisation of energy companies are as follows:

- 1) integrated approach, when prior to privatisation the energy sector is consolidated. Energy production company (CEZ) would be merged with transmission and distribution companies. Thus a huge monopoly would be created and the whole energy sector controlled including production, transmission and distribution. Later this huge monopolistic company should be privatised. This approach would guarantee higher sales price. In case of the sale of monopoly the price is higher than sales of companies in competitive environment. At the same time, consumer would have most probably pay higher – monopoly price. However the company would have to compete with other companies in the world market.
- 2) fragmented approach: energy production, transmission and distribution would be privatised separately and step by step. Advantage of this approach would be creation of competitive pressures, which would lead to lower energy prices for consumers.

On one hand the second approach which would be more in accordance with the trends in energy sector. In Europe utility companies are being privatised and exposed to competition. Liberalisation means to allow customers of electricity to choose supplier from any region or country. In the European Union around 65% of electricity market is open to competition, of which in Germany, UK, Norway, Sweden and Finland 100%. Consumers of the energy have the choice of energy supplier. As a consequence, for instance German electricity industry, last year decreased prices of about 40%. In some countries prices overall have fallen by about 20% during last years. (Price Waterhouse Coopers, Power Revolution). In addition, open competition is expected to enhance innovation and service improvements.

On the other hand utility companies which were monopoly on the regional or national markets, are becoming competitors in the global world. At the same time global markets require global scale and many utility companies merging, The number of companies will shrink dramatically while optimising of performance. Ownership is becoming international with the extensive participation of US companies in the European markets. In combination with growth of e-commerce, retailing markets create possibilities for new energy trading. The emerging trading market will most probably grow with multiple new entries.

In the same way as everywhere, in the Czech Republic liberalisation of the energy sector must be done parallel with the creation of new and efficient legislation and deregulation. Prior to privatisation, institutional framework of energy sector should be established. However the regulation and legislation related to this sector there is still lacking. The only decision made is about prices of energy, which should be subsidised no longer than till 2002. Current prices of electricity do not reflect real production costs. Household prices are below cost and price for industry is too high subsidising the households (this cross subsidising should be abolished till the end of 2002). Household energy should have the same price as in case of enterprises.

The consulting firm should submit models of privatisation of energy industry including independence of CEPS which is held by CEZ and which should stay in the hands of state. Ministry of Finance should carry out in co-operation with NPF analysis of the legislation relating to the independence of CEPS. Transmission company CEPS should become independent, but the state would have guaranteed control over the exploitation, management and regulation.

Ministry of Industry and Trade should create an independent regulatory agency, The Central Energy Board in accordance with legislation and step by step opening of the energy market.

It is assumed that this regulatory agency will

- not directly regulate end-user prices but rather use price cap formula
- not to govern over the investment decisions but free the entry
- abolish the obligation of supply hand in hand with privatisation

As mentioned above, the government selects a consulting firm based on the public tender to propose privatisation of energy sector and organise the process of selection of strategic partners. Contrary to the past period of realisation of a large scale privatisation programme in which foreign investors did not play major role and in some aspects have been discriminated, in the privatisation of strategic companies foreign direct investors are the only choice.

Foreign investors in the energy sector privatisation

As mentioned above, the government is targeting foreign investors in the residual privatisation. The objective of the privatisation of strategic companies is to strengthen their capital, management skills, quality of portfolio, the range and quality of services and their competitiveness. To achieve this objective requires, the government is *de facto* targeting private foreign investors, preferably strong large companies.

In the past and during the Czech privatisation process the role of FDI has been underestimated. A method of direct sales to strategic foreign investors has not been fully exploited and rather the “Czech way” of privatisation has been pursued despite the fact that it has not possessed the beneficial features of FDI. The voucher method led to a very dispersed ownership structure without establishing a long-term commitment between owners and privatised companies. It did not become a source of necessary capital investments, which was also the case of direct sales of state-owned companies to domestic owners. As a result, a great differentiation in the performance of the individual companies is observable. The analysis of performance of foreign versus domestic firms showed that while the firms with foreign participation are permanently enhancing productivity, only a very small proportion of the Czech-owned firms are able to keep up with them. (Zemplerova A., Benacek V., 1999).

Undoubtedly, the negative consequences of the “Czech way” of transformation are reflected in the contemporary problems of the Czech economy. For many Czech companies, the entry of foreign investors is the only way to avoid bankruptcy, keep afloat or secure the necessary capital investment. In addition, the government is in general putting more emphasis on establishing a favourable investment climate.

In addition to improvement of the productivity, foreign investors are an important source for creating revenues from privatisation. The following table contains data on sales/revenue from privatisation registered by the NPF over the period 1992-99. Sales to foreign investor indicate FDI.¹⁰

Table 2 Privatisation revenues 1992-1999

Year	total sales in bn CZK	share of foreign investors
1992	26, 5	52%
1993	24, 4	35%
1994	30, 6	14%
1995	25, 9	16%
1996	24, 5	3%
1997	12, 5	4%
1998	14, 1	29%
1999*	25, 5	96%
Total*	184, 0	33%

* most of the revenue from foreign investors comes from the sale of CSOB bank where 65% of the sale price (CZK 26 billion) was cashed in directly by the Czech National Bank. This is why more representative figures for 1999 would be: foreign investor CZK 50, 6 and total CZK 51, 5 bn.

¹⁰ In the future privatisation of big companies in strategic sectors of the national economy will increase the foreign penetration via FDI in the Czech economy. The radical increase of FDI stock was recorded in 1999, while reaching 15 bn USD and next year it is expected to rise to about 20 bn USD. In terms of privatisation revenues, the privatisation of the state shareholdings in *Cesky Telecom, a.s.* expected for the beginning of 2001 should become the largest privatisation acquisition in the history of the country.

Not only have foreign investors better access to capital, managerial expertise, technology and foreign markets but also increasing the number of potential investors via involvement of foreign investors is increasing sales price at which state-owned-assets can be sold.. As increasing of budgetary revenues is the major motivation for privatisation (in order to be able to cover the social programmes), the final price is important.

Table 3 State and Foreign Ownership of Regional Distribution Companies (incl.voting rights)

Regional distribution company of electricity	Share of state (NPF+CEZ)	Share of Foreign Investors
Southmoravian	48.5	44.9 Bayernwerk
Northmmoravian	54.7	28.0 Bayernwerk
Northbohemia	51.0	5.9 Bayernwerk, 29.0 MEAG (Germany)
Centralbohemia	58.3	35.0 RWE
Westbohemian	48.7	36.2 Bayernwerk ,11.2 Energie AG (Aust)
Eastbohemian	50.1	41.2 Vattenfall (Sweden)
Southbohemian	48.1	35.4 Reiffeisen (Aust.), 13.3 Bayernwerk
Prague	48.2	24.9 Geso AG+RWE, 25.9 municipality

Although the state considers beside foreign investor also institutional investors such as pension funds, foreign investors who already invested large amounts into the energy distributon companies are potential buyers of the state stakes. Foreign investors have the ir representatives in the supervisory boards of distribution companies depending on the number of shares and thus influencing the management as well as privatisation of the companies.

Managing energy distribution companies

State executes its control over its property mainly through the appointment of its representatives in the statutory bodies of the enterprises. The management of the state holdings is exercised depending on the number and kind of shares, which the state holds. The representatives are either top officials from the ministries, NPF or experts approved by the ministries and the NPF. After the Social Democratic Party had formed the government, it replaced a big number of members of the boards of companies in which the state has stakes including Czech Energy Plants (CEZ), Unipetrol, Komerčni banks (KB), Ceska pojistovna, OKD and Mostecka uhelna which shows that politics plays a big role in the selection of board members. ¹¹

The Czech model of corporate governance of joint stock companies is a combination of German and Anglo-American. According to the Czech commercial law Board of Directors (BoD) and Supervisory Board are divided. Board of Directors is selected and dismissed not by Supervisory

¹¹ Other mean is the above described „golden“ share. The rights attached to golden share are further specified in the statutes of the companies. Other companies have been defined as strategic and have a special status that is incorporated in the respective legal provisions.

board as is the case of German model but by the General Assembly. Statute can transfer the right to elect and dismiss the BoD on the Supervisory Board, however the BoD has obligatory obey the recommendation of the General Assembly. According to the law, each joint stock company must have a BoD as well as a Supervisory Board.

Board of Directors is either executive or non-executive or a mixed one. Executive BoD means that the member of the board is a manager at the same time. State delegates its representatives mostly to the non-executive Boards of Directors and positions of executive officers are occupied by professional managers. In cases where BoD is an executive one, the state delegates as many of its deputies to the Supervisory board as possible, which is the case of the energy distribution companies.

Board of Directors in the distribution companies has usually 5 members. These are professional managers. The Supervisory board of distribution companies have 12 members, of which 6 are representatives of NPF in case of majority, and 3 in case of minority, the rest are representatives of foreign investors and employees. The Supervisory board meets approximately once a month.

It is truth that the management has to ask Supervisory Board for approval in all-important issues related to operation, strategy and expansion of the company, however as the Supervisory Board meets only time to time and they are not involved into the operation of the company, they might be manipulated by management as the management possesses monopoly information.

The representatives of the NPF and line ministries who are members of the boards of directors and supervisory boards of the strategic companies are expected to enforce the government policies relating to the respective sectors. However the representatives of state not always play a key role in the Boards, especially if they are not experts and do not have necessary skills and experience. Representatives of state are delegated as a physical persons and so is their accountability. Hence there is no guarantee and vehicle, which would force them to represent the government, interests rather than their personal. Only representatives who are staff of NPF are allowed to be paid for the work on the Supervisory Board. Representatives from ministries are not allowed even to accept the mobil telephone, car or other allowances from the company where they serve on the Boards.¹²

Representative of the NPF who receives compensations for the time devoted to the as a member of Board might be reluctant to promote the privatisation, which by the end would mean change of the Board and loss of his/her compensation. In the last case it can be expected that the member of Board will represent own interest i.e. to receive the compensation as long as possible, hence delay the privatisation.

Corporate governance is not very efficient however the authorities expect an improvement in the field of corporate governance in 2000 thank to recently prepared amendments of the Commercial Code and Securities Act.

¹² In 1999, Code concerning the representatives of NPF in the boards of strategic companies has been amended., Mandatory contracts on exercising of shareholders' rights with the founding ministries were renewed and the rules established for representatives in the Boards.

As the privatisation process is being delayed the management acts as do the existing foreign investors. They are trying to find ways how to control the company and be independent on the state decisions.

Conclusions

Network industries are capital intensive and the return of capital can be assured only if the operation lasts long enough. In addition investment into the energy sector is very specific and cannot be re-allocated, hence have a character of sunk costs ex post investment, therefore the investor requires guarantees for investment return ex ante. Investors make their decisions based on the announced regulatory policy and their credibility.

There exist often changes in the government decisions relating privatisation. Insecurity, low transparency, low predictability of government decisions is a special problem in case of utilities which are capital intensive and strategic decisions are made in accordance with the regulatory policy.¹³

The energy industry is a key industry for economic growth. If government decisions relating privatisation of this sector are intransparent and lacking a clear line, it increases insecurity of strategic decisions and increases risk of capital investment. Low predictability of government decisions is a special problem in case of energy sector as strategic decisions are made in accordance with the regulatory policy. Observed steps in privatisation are not clear and most political forces seem to undertake measures not in favour of the economic growth but in favour of next elections or income to the state budget. In-between other parties involved in the privatisation such as foreign investors, management, municipalities are undertaken activities in order to follow own aims.

Companies wholly or partially under the state control remain often without proper management. Lack of strategic owners and of effective corporate governance may be the reason why these companies do not as efficiently as is their potential. Also the importance of legal and institutional framework of the economic transformation was underestimated in past and legal regulation of many fields is not adequate. Legislation as well as robust regulatory agencies are under preparation. There are still obstacles complicating the restructuring measures and causing delays of privatisation.

¹³ The Czech authorities are aware of the importance of transparency of the privatisation methods, on the other hand the need of transparency and the public discussion may cause delays of the whole process. Privatisation is realised mostly through public tenders on the basis of clearly established rules. The Supreme Audit Office established as an independent body from the government and from the Parliament can exercise control over the privatisation process. Case-by-case parliamentary control can also be exercised. However the details of individual privatisation procedures are not disclosed to the public as is not the lobbying and game which is played in behind the scenes.

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