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PRIVATIZATION LESSONS FROM ACROSS THE GLOBE AND FROM UKRAINE

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Ranked one of the five most respected firms in all of Ukraine by the prestigious European Legal 500, the Kyiv office of Squire, Sanders & Dempsey L.L.P. provides fully integrated, international legal advice on agribusiness, corporate, corporate finance and securities law, banking and financial securities, emerging business and venture capital, real estate, communications, intellectual property, infrastructure project finance, energy, environmental law and commercial services, including international transactions, mergers and acquisitions and joint ventures. Since its opening in 1992, the Kyiv office has helped both Ukrainian companies and multinational companies in Ukraine meet their strategic objectives. Squire Sanders has also worked with the Government of Ukraine and all the major international institutions on their privatization programs in Ukraine.

I. INTRODUCTION

We have been involved in privatizations in Ukraine since 1992. My remarks will examine how other countries, as compared to Ukraine, have privatized their large industrial and infrastructure sectors. Drawing on these examples, I will outline what I view as the fundamental elements of a successful privatization. The challenge and the goal is to design a privatization process that gains the greatest possible value for the shares that are sold. My challenge is to tell you how to do that in less than 10 minutes.

II. TRENDS

A. Early Years

- Lease Buyouts
- Worker Buyouts

B. Mid Years

- Mass Privatization
- Certificate or Voucher Privatizations

C. Recent

- Non-Commercial to Commercial
- Voucher to Cash

D. 2002 and beyond

- Large Companies in Industrial and Infrastructure Sectors
- Natural Monopolies (energy and telecommunications)
- Land Privatization

Time will not allow me to speak about Land Privatization today, suffice it to say that the sweeping new Land Code now makes that possible. Additional implementing regulations still need to be adopted, however.

III. 2002: A FIRST AND CRITICAL STEP - IDENTIFY THE GOALS OF THE PROPOSED PRIVATIZATIONS

As a first and most critical step, Ukraine must specifically define the goals that it seeks to achieve through privatization of its industrial and infrastructure sectors, as well as the natural monopolies in the energy and telecommunications sectors, and it must formulate the standards by which it will measure to what extent these goals have been met.

A. There will Be Both Immediate and Long-Term Goals of Privatization

Let's first discuss key short-term goals.

Short-Term Goals of Privatization:

- Ukraine will want to ensure the safe, efficient, and reliable operation of any privatized asset especially in energy and telecom sectors.

- Ukraine will want to attract capital and expertise from strategic investors with the desire and the technical and financial ability to invest in large industries and utilities.

- Of course, Ukraine will want to obtain the highest possible price for the assets.

B. Long-Term Goals of Privatization

Now let's examine some important long-term goals.

Long-Term Goals of Privatization

- CEER and CIS Governments use large-scale industrial and infrastructure privatizations as key to building international investment reputation.

- Large scale privatizations generally attract greatest international attention:

    - Purchase price and investment amounts are very large;
    - Bidders are major, global companies whose activities draw attention;
    - Sectors remain closely associated with modernisation, change and economic growth.

- Ukraine will want to enhance its attractiveness as a country in which to make further investment, specifically, for the construction of new facilities and rehabilitation on old facilities.

- Ukraine will want to position itself to become a full participant in broader markets, such as EU markets.

- Ukraine will want to position itself to be both a reliable local supplier, as well as an exporter.

- As another long-term goal, Ukraine will want to create confidence in the absolute integrity of its privatization process.

In establishing its goals, Ukraine must be aware that it is competing for private investment. Foreign investors interested in emerging markets now have a wealth of attractive investment opportunities outside of Ukraine. Further, the recession in Europe and the U.S. is likely to affect short term investment decisions. Energy and telecom present special problems but also unique opportunities. In sum, Ukraine's privatization process must be competitive or rational investors will invest elsewhere.

IV. ELEMENTS COMMON TO SUCCESSFUL PRIVATIZATIONS AROUND THE WORLD.

A. Five Issues Best Addressed <u>Before</u> Privatization.

Successful privatizations have taught us that there are five issues that are best addressed prior to privatization. These are: regulatory issues; labor issues; valuation of assets; long-term supply contracts and debt obligations; and environmental liabilities.

1. As we learned from last years oblenergo sales, regulatory issues are the most important.

2. The regulatory system must:

   a. establish prices that enable investors to recover their costs and earn a profit, and
   b. protect consumers, so that they do not lose faith in the privatization process.

As you know, various state bodies and generation and distribution companies in Ukraine are currently debating how to organize the sale of electricity at the wholesale market. The debate about how to buy electricity (directly from generation companies or through a wholesale market, or both) and the uncertainty related thereto affected the oblenergo privatisations and will certainly affect future sales. Whichever way the current debate is resolved, these regulatory issues are best resolved <u>before</u> privatization. Negotiating regulatory conditions with individual investors is <u>not</u> a desirable part of any privatization process.

Hungary and Ukraine's experience illustrates this point. In 1993, Hungary's first privatization attempts failed because the proper regulatory and pricing regime was not in place. Ukraine's oblenergo privatizations were affected by the last minute decisions on regulatory issues and did not ultimately bring in the large number of potential bidders nor the prices expected.

B. Labor, Valuation, Debt and Environmental Issues.

In the interests of time, we will simply say that the other four issues, that is, labor issues, valuation issues, issues of bad long-term supply contracts and debt, and environmental pollution issues also must be clearly resolved prior to privatization.

1. <u>Labor concerns</u>. Labor concerns will be minimized by strengthening the safety net with retraining programs.

2. <u>Valuation</u>. Valuation of an asset by an independent auditor helps to establish a benchmark against which to evaluate bids. However, establishing a minimum bid price generally tends to drive down the price. (A bottom price brings down the top price.) Ultimately, if the sale is competitive, the market will establish the market value of an asset. Strategic investors need the time and full information to make their own valuation assessments.

3. <u>Debt and Long-Term Supply Contracts.</u> Debt and long-term supply contracts that are no longer economically feasible will affect privatization unless a public policy on how to deal with them is adopted prior to privatization. Some countries write off debt in the process of privatization. The debt restructuring agreements offered to investors in the oblenergo privatizations were very helpful to the process.

4. Environmental Issues. Significant environmental liabilities will drive down the price. Thus, environmental clean-up prior to privatization will improve the attractiveness of an asset.

In this regard, there are clear lessons to be learned from the privatization experiences of Tunisia, Venezuela, New Zealand, Japan, Hungary, and Ukraine.

C. Creating and Maintaining Investor Confidence in the Integrity of the Process

The government must create and maintain investor confidence in the integrity of the privatization process. It is essential to recognize that the process itself will affect the price.

1. Establish and Publish Good, Rational, Clear and Specific Rules For the Process That are Free From Political Interference.

The criteria to evaluate bids must be very clear. If price is the determining factor, this must be very clear. If other criteria will be used, the weight given to each factor should be published before the bid proposals are submitted. I will return to the relative merits of the evaluation standards a bit later. My first point on process may be an obvious one, but it bears emphasizing: Investor confidence in the privatization process depends upon the creation and advance publication of highly detailed, clearly defined, rational privatization procedures.

Ukraine enacted new and detailed regulations on privatizing the electricity sector. The new regulations were a significant improvement leading to a selection process that was both literally and figuratively transparent. This is a model that should be built upon as it instilled confidence in the fairness of the selection process.

Even if there is no manipulation or favoritism, the mere perception that these are possible will undermine the bidders' confidence in the integrity of the process.

It should be noted that the electricity sector rules were specifically applicable to those privatizations. Other privatizations are currently subject to other regulations which are not as transparent.

2. Adhere to the Published Rules and Procedures.

Detailed rules published in advance will of course mean nothing if potential bidders do not believe that those rules will be followed. Strict adherence to the rules increases investor confidence in the process only if the rules are clear and evenly applied. Mexico does this very well.

Bidder confidence is also bolstered when bidders know that they can appeal the bid award. Because there is a perception that Ukrainian arbitration courts may be manipulated, foreign arbitration of appeals should be permitted.

3. Establish A Commercially Reasonable Bid Process.

The concept here is straightforward: Investors are likely to pay more for assets whose value they have had the opportunity to assess, and they will pay less for assets about which they know relatively little. This is a key requirement.

First, potential bidders must have a reasonable amount of time to conduct due diligence in order to value the assets for themselves. Second, they must have adequate time to prepare a meaningful and competitive bid proposal. A central criticism of Hungary's energy privatization was that it did not grant sufficient time for thorough due diligence. Ukraine's process in the oblenergo privatizations, arguably provided sufficient time.

The real problem, however, was having real access to reliable information. A major issue in Ukrainian privatizations is the fact that the seller, SPF, does not control disclosure of information. Thus, SPF is usually also unwilling to give appropriate representations and warranties which will protect investors in cases where they relied on incorrect information provided by the companies. Moreover, SPF is usually unwilling (and legally not capable of) contractually binding itself to certain government guarantees. Thus, in large-scale industrial privatizations, complete government support is essential. The other lessons from the oblenergo privatizations are that strong local financial and industrial interests do not always allow the Government to behave consistently.

There must be full disclosure to bidders of all information which might effect the value of the investment. Company management needs to support the privatization process.

Balanced against the need for adequate time to examine an asset is the need to maintain the momentum of the privatization. If the waiting period is too long, business may suffer as management waits for the change in ownership.

4. Establish Rigorous Financial and Operational Qualifications for Bidders.

If the government's long-term privatization goals are those I identified earlier, it will want to attract bidders with the expertise and the resources to pursue these goals through good times and bad. Tender regulations and rules should establish specific, clear technical and financial requirements for bidders, which will permit disqualification of bidders that lack such expertise and resources. The rules were clear in the oblenergo privatizations.

5. Maintain Bidding Transparency.

Lack of transparency will lead to an outcry over unfairness that can threaten not only privatization, but reform in general. Competitive bidding ensures transparency. The perception of transparency is enhanced by the full disclosure of the winners, and the reasons for their selection.

D. Standards for Selecting the Winning Bid.

The determination of the appropriate standard or standards for selecting the winning bid is often the most disputed and controversial element.

Many analysts favor a multi-factor standard for selecting the winning bid. Other analysts argue that the selection standard should be based on one factor only: price. This is the factor utilized in the oblenergo privatizations and applauded by the investment community.

When a multi-factor standard is employed, each bid is evaluated on the basis of the bidder's experience and qualifications, proposed business plan, and willingness to make future investments. One problem with the multi-factor approach which is found in Ukraine's general regulations (applicable to current large scale privatization) is that it does not specify what the bidder receives in return for its future investments (not clear whether additional shares are available for the investment; and the liability for taxes on the investment are bad potential consequences). Another problem is that investors are forced to make investment promises that will be hard to keep even if made in good faith.

When bids are evaluated based in part on bidders' investment projections, bidders have the perverse incentive to inflate those projections. When they win, the bidders then try to renegotiate. A better strategy is to establish a regulatory regime that gives the new owners the proper investment incentives.

Using the price-only system makes the selection process simple and more transparent.

Hungary has successfully employed the single-factor, highest-bid criteria, giving little or no weight to bidders' proposed business plans. To date, Hungary's power sector privatizations have earned it over US$1.5 billion.

E. Issue is Negotiating Control of the Enterprise

1. The tension between government and investors

In any privatization, there arises a fundamental tension between the government and the investors. The government wishes to maintain control, while the potential investors wish to obtain control. In Ukraine, Russia and many Newly Independent States, governments have been reluctant to relinquish their control, and have offered potential investors only minority ownership interests. Latin American countries, on the other hand, have tended to transfer majority or total ownership and control of an enterprise for a limited term, at the end of which ownership reverts to the government. This can be done through concession, leasing or other contractual arrangements.

2. Deciding how much to sell

Bidders need assurance that the winning investor will acquire sufficient control to manage the company to profitability. From the bidder's point of view, earnings must not be threatened by unexpected costs, changing tariffs, or disruptions of customer collections, or government intervention.

Where the government retains a majority stake, it retains the ability to interfere with company operations.

Hungary was successful in giving investor's management control even where they held minority stakes. This is an option permitted by Ukrainian law and regulations by way of

Share Management Agreements which permit the investor to manage some portion of the state-owned shares. However, current regulations and model contracts do not give any real meaningful control over the State-Owned shares. This should be changed.

As noted, Ukraine has not addressed the problems that will arise when the government maintains a stake of 26 per cent or 51 percent but at the same time requires additional investments, investments for which no new shares will be issued.

V. CONCLUSION

In conclusion, to conduct a successful privatization, Ukraine must:

A. Identify it's privatization goals;
B. Create the proper regulatory framework;
C. Create and maintain investor confidence in the integrity of the privatization process;
D. Establish clear standards for selecting the winning bid; and
E. Determine the degree of control to be granted to the new owner.

Thank you for being such a good audience!

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