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WATER INDUSTRY PRIVATISATION IN THE CZECH REPUBLIC: MONEY DOWN THE DRAIN?

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WATER INDUSTRY PRIVATISATION IN THE CZECH REPUBLIC: MONEY DOWN THE DRAIN?

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INTRODUCTION

Transparency International – Czech Republic (TIC) focuses its activity on advocating transparency in decision-making processes and on mapping the scope and depth of corruption. These efforts are carried out in a number of ways, chief amongst them research and analysis, the provision of free-of-charge legal advice to victims of corruption, and anti-corruption education. The water industry is one area to which TIC has opted to devote closer attention.

In the attached analysis, we describe the process of privatising state enterprises in the years 1993–1994 and the subsequent transfer of assets without consideration to cities and municipalities, including two mechanisms for preserving the state's influence over basic municipal waterworks operation (golden share; restrictions pertaining to companies' Articles of Association and share transferability restrictions). This process throws light on the manner of the water management industry atomisation that followed. We furnish several examples of water management company privatisation that occurred prior to the Czech Republic's EU accession through the sale of a shareholding in the respective company (Praha, Severomoravské vodovody a kanalizace) or the sale of shareholder rights (Zlín). We provide a further example of a privatisation executed after Czech EU accession by means of what is called a shareholder agreement (Kroměříž). We describe the consequences of these waterworks privatisations in the final chapter.

The transfer of government assets to municipalities in the early 1990s resulted in water management industry atomisation and a lack of transparency in both ownership rights and long-term operator agreements. Contracts with water supply and sewer system operators have from the outset been attended by a host of ambiguities.

Operating models are often formulated in a manner that places the public infrastructure owner at a disadvantage. The operating model lacks transparency from the perspective of determining price and profit (profit is set as a mark-up on warranted costs) and fails to motivate private operators to enhance efficiency. All infrastructure operating costs are often deducted for tax purposes by operating companies whose profit is generally calculated as a surcharge on these costs. Hence, operating companies are more motivated to spend than to adopt savings measures.

The contracts were concluded for long periods of time — predominantly more than 15 years (sometimes even for periods exceeding 25 years). This promotes the monopoly position of some companies and guarantees above-standard operator conditions; while costs remain with infrastructure owners, i.e. cities and municipalities, profits go to private businesses. Public investment in infrastructure is de facto transformed into indirect private operator support. This fact has also led to a halt in financing from EU structural funds.

These examples of water industry privatisation adumbrate a privatisation method utterly lacking in transparency, while further documenting the volume of financing lost by the public sector.

Water management privatisation would make sense in the Czech Republic if economic indicators were to point to an eventual drop in public sector participation in infrastructure financing costs accompanied by an increase in revenue for the public coffers. In actuality, however, the public sector has lost not only a source of profit-generating operating activity, but also the possibility of receiving EU sources. Moreover, all the costs are gradually being passed on to the consumer and taxpayer.

Given the need to renew and expand existing capacities (primarily in the area of wastewater treatment) it is plain enough that the price of water will continue to rise. Private operators have no incentive to enhance operating efficiency and quality and infrastructure investment is slowing; thus, high operating costs are clearly the primary reason for present price hikes. Furthermore, the current system fails effectively to assure long-term water management infrastructure sustainability and the concomitant reduction in this industry's "dependence" on subsidy financing.

All data in this document are publicly sourced. Sources have been listed in summary at the publication's end.

PRIVATISATION AND ATOMISATION OF STATE WATER MANAGEMENT ENTERPRISES AFTER 1993

The end of the state enterprise

Until 1993, there were a total of 11 state enterprises (9 regional and 2 Prague-based) in the Czech Republic that operated the water supply and sewage systems and were tasked with renewing and developing the water management infrastructure. Czech Government Resolution No. 222 dated 3 July 1991 concerning the principles of reforms and transformation processes for drinking water supply, sewage and wastewater treatment systems initiated the process of preparing for state enterprise privatisation. Act No. 92/1991 Coll. on the transfer of state property to other persons was drafted and approved in 1991. In connection with the foregoing government resolution and the approved Act on the Transfer of State Property to Other Persons, the Czech Ministry of Agriculture drafted Principles for the Privatisation of State Enterprises in the Field of Public Water Supply and Sewage. These principles comprised a basic observation: "Expertises performed by foreign consultancies together with experience gained from the operation of public water supply and sewage systems in developed European countries confirm the benefits of larger organisational structures able to ensure better quality and less expensive services while operating and advancing this field for its users, most importantly the general public."

However, the execution of these privatisation projects led to the splintering of what were sizeable, logical and well-functioning organisational structures. Approximately 40 district water management companies as well as more than 1,200 small operators with various forms of ownership structures arose out of 11 large state enterprises.

Establishment of water management business companies and transfer of property without consideration to cities and municipalities

In 1993, the Czech state delegated the administration of the water management monopoly to cities and municipalities. In the manner set out below, the state privatised the operation of water supply, disposal and treatment services. As part of this transfer of the assets of former state enterprises without consideration, the state also transferred decision-making and management rights and responsibilities to the self-administrative authorities of respective regions.

New water management business companies ("WMBCs") were established based on approved state enterprise privatisation projects. These new WMBCs were meant to ensure the operation and development of water supply and disposal and wastewater treatment services. These projects were proposed to include a system ensuring the decisive influence of municipalities over WMBCs. Municipalities were to be assured long-term majority participation in the WMBCs. The participation share of a municipality in the assets of a new WMBC, which the municipality would receive without consideration, would be proportional to the value of the infrastructure assets transferred to the municipality pursuant to Czech National Council Act No. 172/1991 Coll. and would exclusively serve a single municipality or correspond to a share in communal property serving multiple municipalities. Municipalities were obliged to issue consent to participation in the WMBC and the respective privatisation project was to include draft versions of the Articles of Association and Memorandum of Association. As early as the years 1992-1993, the state was counting on the possibility of WMBCs taking a combined or stand-alone form. Stand-alone WMBCs were to provide operations-related services and, where required, water management systems development based on contracts with natural persons or corporate entities. The remit of combined WMBCs,

which own and operate infrastructure, was to be addressed in the Memorandum of Association, Articles of Association and through the due management of a business company pursuant to Act No. 513/1999 Coll., the Commercial Code.

Preserving state influence over essential waterworks operation — the golden share and Articles of Association

As the privatisation projects were being implemented, the state administration became aware that owing to the monopoly nature of the industry, functioning control mechanisms and a regulatory (legislative/legal) framework for WMBC conduct had to be put in place vis á vis government policy on water source protection, the water management systems development concept, environmental protection, economic tools and the impact of foreign capital.

By executing the privatisation projects for state enterprises operating in water management, the state forsook the proceeds from selling the 11 regional water management enterprises, proceeds that were expected to amount to billions of crowns. Instead of a financial injection in favour of the state budget, it gave priority to the transfer without consideration of state enterprise infrastructure assets to self-administrative authorities of individual cities and municipalities. At the same time, it declared its plan for public services in the area of water management to be executed in future via WMBCs over which the self-administrative authorities of individual regions would exercise long-term control and management (the limited transferability of WMBC shares and creation of golden share powers).

The government privatised the state enterprises in this manner while concurrently creating an insurance policy against possible attempts at further water management monopoly privatisation. The privatisation projects include agreements enabling the state administration to exercise its influence in WMBCs in the form of a “golden share” whereby the state may block unsuitable or undesirable changes in a WMBC concerning essential matters in which a 66% or 75% quorum of all types of issued shares (registered shares, bearer shares and the golden share as well) would have to be achieved in general meeting voting to approve a given resolution.

The state, with city or municipality consent, also significantly restricted the possibility of selling WMBC shares. A provision limiting the transferability of registered shares and the rights thereto attached was incorporated into the WMBC Articles. The waterworks ownership structure was closed and stabilised. Around 90 % of the shares of all WMBCs were owned by cities and municipalities and these shareholdings were only transferable with general meeting approval and, moreover, only among existing shareholders, owners of registered shares. Registered shares were obtained by cities and municipalities when the respective company was established, but later, too, against an in-kind infrastructure contribution to a WMBC and subsequent subscription of shares in that WMBC. The insurance policy restricting share transferability virtually eliminated the possibility of privatising WMBCs without the provisions of the Articles of Association or Commercial Code being violated.

In this manner, nearly 40 district waterworks arose in the years 1993–1994. These predominantly owned the infrastructure and ensured the water supply for more than 90 % of the Czech population. The remaining 10 % of the water market was covered by small operators that arose from municipalities which had decided not to contribute assets to the district WMBCs, but to administer the assets separately or entrust their operation to a private firm in which the municipality held an interest or on whose company bodies it was represented.

PRIVATISATION OF WATER MANAGEMENT COMPANIES VIA THE SALE OF SHARES (IN THE PERIOD PRECEDING CZECH EU ACCESSION)

In the late 1990s, waterworks in the Czech Republic were privatised in the form of direct share purchases. This primarily entailed purchases of shares of waterworks in big cities supplying high-density populations (Pražské vodovody a kanalizace, a.s., Ostravské vodárny a kanalizace, a.s. and Brněnské vodovody a kanalizace, a.s.) or regional waterworks (Severomoravské vodovody a kanalizace, a.s. and Severočeské vodovody a kanalizace, a.s.) conducting operations for large territorial units and promising investor profits. We shall describe this method of privatisation using the examples of Pražské vodovody a kanalizace and Severomoravské vodovody a kanalizace.

EXAMPLE 1

PRAŽSKÉ VODOVODY A KANALIZACE

The establishment of Pražské vodovody a kanalizace, a.s. and privatisation decision

Pursuant to a decision of the Czech Finance Ministry, two joint stock companies arose on 1 April 1998 out of two original state enterprises — Pražská kanalizace a vodní toky s.p. and Pražské vodárny s.p. Pražská vodohospodářská společnost, a.s. (PVS), with basic capital of CZK 5.5 mio, became the owner of the water management infrastructure in the Capital City of Prague (CCP) and part of the Central Bohemia region. The largest joint stock water management company in the Czech Republic was also established: Pražské vodovody a kanalizace, a.s. (PVK) carried out water supply, disposal and treatment services for more than 1.2 million inhabitants of the CCP and Central Bohemia region. PVK had basic capital of CZK 792 mio.

The National Property Fund of the Czech Republic (NPF) was the founder and sole shareholder of the companies PVK and PVS. The Czech Finance Ministry decided pursuant to Act No. 92/1991 Coll. on the requirements for the transfer of state property to other persons to privatise 100 % of the shares of PVK as follows: (a) the sale of 66 % of shares in a public tender, (b) the transfer of 34 % of shares to the Capital City of Prague without consideration. A 100% shareholding in the company PVS was transferred to the CCP.

Sale of a majority share in PVK in a public tender

The sale of the state's majority share in PVK was conducted on the basis of a public commercial tender. The first step in this tender was the evaluation of submitted business plans for company development, which had to include unconditional accession to the existing contract on sublease, lease and operation executed by and between PVK and PVS (the infrastructure owner whose founder and majority shareholder was, and is, the CCP). The contractual lease relationship between the original PVS and PVK was valid through 2013. An important business plan evaluation criterion was the presentation of binding total planned expenses of PVK for a period of 5 years subsequent to the transfer of shares to the tender winner, specifically as a sum total of all expense and revenue items in the income statement. The tender conditions included a stipulation that all parameters be specific and be formulated and quantified so as to be measurable and reviewable. It was determined in advance that general proposals would not be deemed evaluable. As a result, the NPF tender

committee had precise information about the revenues, expenses and profits that a future operator intended to achieve in the five years after purchasing 66 % of the shares of PVK from the NPF. The tender committee members included two Prague city assemblymen, Jan Kasl and Radovan Šteiner,¹ meaning the pertinent information was available to the Prague City Assembly. A second evaluation criterion for the tender was the share purchase price.

A total of 522,902 shares were sold in this manner, representing 66 % of total PVK basic capital of CZK 792,276,000. The minimum price per share was determined to be CZK 1,379.

The winning bid tendered by the company Vivendi Water (today, Veolia Voda) offered CZK 11,665 per share. Thus, Vivendi Water paid a total of CZK 6,099,651,830. A sale of the same number of shares for the minimum price set by the NPF would have garnered a mere CZK 721,081,858. Other offers were CZK 4,972 per share for a total offer of CZK 2.6 billion from the company ONDEO and CZK 5,928 per share for a total offer of CZK 3.1 billion from the company International Water. The winning bid was thus more than double the next highest bid. In light of further developments and the subsequent sale of a blocking share in PVK, this fact warrants further attention.

Transfer of a blocking share without consideration to the Capital City of Prague and subsequent sale thereof

On 27 June 2002, some 269,354 shares, i.e. a 34% interest in PVK, were credited to the account of the CCP on the basis of a Contract for the Transfer of Book-entered Securities Without Consideration concluded by and between the NPF and CCP.

In connection with the acceptance without consideration of the shares from the NPF, the CCP had the firms EPIC Securities and Deloitte & Touche prepare economic analyses expressing an objective market valuation of the interest in PVK held by CCP. According to the first of these companies, the value of the 34% interest in the company PVK was approximately CZK 797 mio. Deloitte & Touche valued this business share at approximately CZK 880 mio. Another valuation of the 34% interest in PVK was ordered in September 2002 from the company HZ Praha, spol. s r. o., which valued this share at CZK 869.3 mio. The maximum valuation of the 34% interest in PVK (CZK 880 mio) determined the share value to be CZK 3,267. All the foregoing valuations based their determination of the value of a 34% interest in PVK on the Operating Contract in place through 2013.

In October 2002, i.e. four months after the NPF transferred the PVK shares to the CCP, the City Assembly approved the sale of the shares to the company Vivendi Water. The share sale was effected without a tender and in great haste. There was no apparent violation of law from a formal perspective, but from the point of view of its logic, the sale of a strategic interest in the company managing the water supply monopoly for the CCP was far from standard practice, leading as it did to a situation preventing the sale of the shares for the highest possible price. The CCP thus surrendered any influence it may have had over water management operations while also forsaking a sustainable resource that could have ensured a part of infrastructure renewal funding.

As stated in the weekly publication Euro, the Prague City Assembly received the documentation concerning the proposed sale of the 34% interest in PVK on the evening of Wednesday, 2 October 2002 and voted on the sale on the morning of Thursday, 3 October 2002.² The company Vivendi Water had originally offered the city of Prague some CZK 840 mio to purchase the 34% interest in PVK, but increased the offer to CZK 880,044,858 pursuant to subsequent negotiations. The Prague City Council submitted the explanatory report on the sale of the blocking share in PVS to the existing majority owner to city councillors on 3 October 2002. The report proffered not one argument against the sale of the shares; nor did it anywhere state that the share sale would further involve the extension of the lease agreement with PVS by 15 years, a key fact which meant

¹ Lidové noviny, 14 October 2002, Policie: trestní oznámení na Kasla může být politická hra.

² Euro, 29 October 2002, Něco za cibuli, něco zapřem.

that Vivendi Water would, as sole owner of the company PVK, operate the water supply and sewage system for the Capital City of Prague through 2028.

The explanatory report averred that the reason for the sale of the blocking share in PVK was, *inter alia*, that the CCP had no interest in maximising the potential profit of PVK generated on the basis of the collection of water and sewerage fees from city residents. The fact that a majority interest was sold by the state for more than double the price offered by other tender competitors was also furnished as another reason for selling right away at a lower price and thereby not providing any further reason to increase water and sewerage fees. According to the explanatory report, the CCP, on the contrary, had an interest in PVK profits being reasonable and so representing the least possible burden on city residents. Moreover, a private operator is always interested in earning back its initial investment. The argument for a “cheap” sale in an effort to ensure lower water and sewerage fees does not, in fact, present a counter-argument to the effort to sell the shares for the best price, but rather flies in the face of a plan to privatise a company operating on a natural monopoly market.

Nowhere does the explanatory report state that the agreement on the operation of the water supply and sewage systems owned by the CCP is to be extended by 15 years. This information could only be ascertained from the Framework Agreement on the Operation of the Water Supply and Sewage Systems owned by the CCP, which formed an attachment to the explanatory report, and only then after a detailed look at Item 4.9 of the agreement.

It is logical that in the case of waterworks operation the value of shares of the operating company would be derived from the length of duration of the respective contract on lease and operation. Were the contract duration to be doubled, this would mean no less than a doubling in value. None of the expert opinions prepared by the expert companies performing valuations for the CCP reflected the 15-year lease contract extension in their valuations.

Overview of PVK, a.s. results of operation

An overview of profits achieved by PVK (refer to Table 1) in individual years and their translation to a 34% interest in profit attests to the fact that the sale for a price of CZK 880,044,858 was financially disadvantageous for the CCP. If the city had not sold the PVK shares, it would by the year 2008 have received the same amount from its share in profit alone as it had received in 2002 for the irrevocable sale of the shares. Moreover, it would have continued to own the 34% interest in PVK and thus been certain to collect additional income in the hundreds of millions of crowns from water supply infrastructure operation for the municipal budget.

TABLE 1: Overview of PVK, a.s. results of operation

<i>Year</i>	<i>Total profit (CZK mil.)</i>	<i>Profit corresp. to a 34% share (CZK mil.)</i>
2004	468.458	159.276
2005	528.761	179.779
2006	579.299	196.962
2007	728.253	247.606
2008	623.084	211.849
Total	2927.727	995.429

Source: PVK Annual Report, www.justice.cz

Conclusion

By privatising a 66% interest in PVK, the state gained a one-off revenue item of CZK 6.1 bn and the CCP obtained CZK 880 mio from the sale of a 34% interest. Of course, by signing the long-term lease agreement with PVK through 2028, the CCP effectively precluded the possibility of receiving EU subsidies for the company PVS (i.e. for infrastructure overhaul) as, in the opinion of the European Commission, such a subsidy would constitute a hidden subsidy for a private company.

Based on the foregoing information, we can only ask why the CCP surrendered a revenue-generating share in the company PVK, which could have assured the company long-term financial resources for infrastructure overhaul. It is clear from a comparison of the hitherto rise in water and sewerage fees charged by the large waterworks in the Czech Republic that the price of water in Prague has grown relatively slowly as compared to other large waterworks (28.94 % over 5 years). The question remains, however, of whether this moderate price development is only temporary.

The price of water in Prague may in future be influenced, inter alia, by the construction of new wastewater treatment plants (WTP) for the CCP and unavoidable investment in infrastructure, which is in critical need of work in many parts of Prague, but for which no funds are available. Amounts necessary, for example, to reconstruct and step up operation of the WTP on Císařský ostrov (Emperor's Island) or to construct a new WTP are estimated at CZK 10–30 bn according to the chosen project variant.

The circumstances of the share sale elicit questions as to the degree to which negotiations reflected the interests of the city of Prague and its inhabitants. Among other things, what is bewildering is:

- The speed of the sale of 34 % of the shares of PVS, a. s. The city sold the shares four months after acquiring them without consideration from the NPF.
- The manner of determination and amount of the selling price of the PVK shares. The expert opinions failed to reflect the impact of extending the operating lease agreement by 15 years in their valuation of the 34% interest in PVK.
- The failure to organise a public tender while knowing the expected and achievable price in the NPF tender for the sale of a 66% interest in PVK, where the minimum expected bid was CZK 1,370 per share and the winning bid offered CZK 11,665 per share.
- The failure to inform the CCP city councillors that the selling price based on expert valuations did not reflect the 15-year extension of the operating lease agreement.

Actual profits enjoyed by the company PVK in later years (refer to Table 1) also testify to the disadvantageousness of the PVK share sale under the agreed conditions.

EXAMPLE 2

SEVEROMORAVSKÉ VODOVODY A KANALIZACE OSTRAVA

Establishment and operating principles of the company SmVaK

Severomoravské vodovody a kanalizace Ostrava (SmVaK) was established by the National Property Fund of the Czech Republic in 1992. It was the largest combined water management company in Moravia with basic capital of CZK 3,534,057,000. It ensured water supply, disposal and treatment for the districts of Frýdek-Místek, Opava, Karviná, the city Ostrava, Havířov, Studénka and Hlučín.

From 1992 to 1999, SmVaK was a logical and integrated business company owning and operating the water supply infrastructure throughout virtually the entire Moravia-Silesia region. With roughly a 90% ownership interest, cities and municipalities had a dominant position in SmVaK, which was

therefore eligible for state subsidies. Had the company maintained this ownership structure, it could have applied for subsidies from pre-accession funds (ISPA) and, today, from EU structural funds. The ownership structure had a fundamental impact on the company's business policy.

Until 1999, the city-controlled company paid no dividends, as most revenues generated by operations were reinvested in infrastructure development or allocated to retained earnings. Municipal self-administrative units advanced this business strategy through their representatives on SmVaK company bodies. The cities subscribed to these principles for managing SmVaK until 1999, several times contributing newly built (and city funded) infrastructure to the company and gaining additional shares in exchange. For 1 share with a nominal value of CZK 1,000, the city made a capital asset contribution to SmVaK worth CZK 2,100. The issue price of SmVaK shares in 1999 included a share premium of CZK 1,100. Simply put, the city received 21,000 shares in exchange for infrastructure assets at a value of CZK 44,100,000. This practice meant that the city directly financed infrastructure development and renewal in the region, while at the same time entrusting the future administration and operation of its investment to the company SmVaK and bolstering its share in this company.

Share sale and ownership changes

In 1999, the infrastructure operating system in place collapsed in terms of cash flows from consumers, cities and municipalities to the waterworks and back into infrastructure. The reason was the injudicious sale of SmVaK shares, a process started by some larger cities in 1999. This led to panic among the small municipalities, which feared that their shares would no longer yield any income. This in turn precipitated an uncontrollable sell-off of shares. SmVaK shares were sold without benefit of tenders or expert valuations to the multinational concerns Anglian Water and ONDEO first for CZK 200–400 per share and later for CZK 600–800 per share. Other cities that had subscribed shares for CZK 2,100 per share joined the sell-off. This means that a city that received 21,000 SmVaK shares in exchange for contributed infrastructure assets valued at CZK 44,100,000 and then sold them for CZK 500 per share gained a total of CZK 10,500,000 from the sale of its shares. Only those cities that waited to sell their shares until it was decided whether the majority stake in SmVaK would be obtained by ONDEO or Anglian Water received the market price for their SmVaK shares. At this time, cities received some CZK 2,200 per share.

Through this non-standardised and unprofessional share sale, cities and municipalities first forfeited their blocking share and then their majority shareholding in SmVaK, and in late 1999 SmVaK was wholly controlled by the aforementioned concerns. Anglian Water acquired a 54.30% share from municipalities and ONDEO Services a 43.57% share. Over the course of two years, this change gave rise to a fundamental shift in the SmVaK business policy.

As of the year 2000, no city or municipality had contributed its infrastructure assets to SmVaK. In the period 2002–2008, all generated profits were paid out in the form of dividends as were the retained earnings from previous years that had been generated by the cities. Ownership changed hands several times during these years. In 2004 the Anglian Water share was transferred to Waterfall Holding B.V., a wholly-owned subsidiary of Penta Investments Group. In this year, this company also acquired the minority interest belonging to the firm Suez Environnement (the former ONDEO) and came to hold 98.45 % of the shares of SmVaK Ostrava a.s.

Penta Group then carried out so-called “restructuring liabilities”, which meant assuming a loan of CZK 1.750 bn that had been taken out in July 2004. Repayment was to begin in 2005 and the loan was to be fully repaid in 7 years. The loan was used to pay out the capital fund (which arose through in-kind contributions of cities and municipalities in 1999) and retained earnings. Penta paid out CZK 2.223 bn from SmVaK in 2003. In 2006, Penta Group sold 100 % of its interest to the Spanish company Aqualia.

Consequences of the changes

As a result of the 1999 privatisation, the company SmVaK forfeited the opportunity to finance infrastructure development through subsidies. The amount of investment required to fulfil EU environmental directives is estimated at CZK 12–15 bn in northern Moravia. In this context, we must look at the SmVaK financial policy and the amount of funds disbursed through 2009. It is apparent that the SmVaK privatisation yielded a system whereby the water supply industry was milked for profits from the sale of water (comprising consumer payments) as well as the funds earlier generated by cities and municipalities that had contributed infrastructure. Moreover, it has also come to light that private companies have contributed none of their own resources to the water supply industry. A fundamental question, therefore, is how the situation is to be conceived in future. Rent for infrastructure paid to the company SmVaK no longer covers even depreciation costs, and cities and municipalities will thus lack future resources for infrastructure renewal. Moreover, they have lost their access to subsidy funds.

The justification given for the current low infrastructure rent amount is the common interest of politicians and private operators to keep water and sewerage fee growth down for consumers. This seems logical, but in fact water and sewerage fees billed by SmVaK have risen by 40 % over 5 years and the company has recorded the fifth highest price increase in the country for water and sewerage fees for the given 5-year period (2004–2008). If the need to finance infrastructure investment is to be reflected in water and sewerage fees in future, consumers will see a huge jump in the price of water.

TABLE 2: **Overview of profits and capital funds paid out after SmVaK privatisation in 1999**

<i>Year</i>	<i>Controlling company</i>	<i>Majority owner of SmVaK (data in CZK mio)</i>	<i>Municipalities and small shareholders (data in CZK mio)</i>	<i>Total paid</i>
2000	Anglian Water	0	0	0
2001	Anglian Water	0	0	0
2002	Anglian Water	128.6	2.8	131.4
2003	Penta	2 223.0	35	2 258.0
2004	Penta	199.6	3.1	202.7
2005	Penta	589	9.3	598.3
2006	Aqualia	241.5	3.2	244.7
2007	Aqualia	381.6	5.1	386.7
2008	Aqualia	345.3	4.6	349.9
Total paid out in the period 2000–2008		4 108.6	63.1	4 171.7

Source: www.vodarenstvi.com, www.smvak.cz

TABLE 3: **Overview of 5-year increase in water and sewerage fees in the years 2004–2008**

<i>Company – OPERATOR</i>	<i>% growth over 5 years</i>
VaK Chrudim – Vodárenská společnost Chrudim – ENERGIE AG	49.05
VaK ZLÍN – Moravská vodárenská – VEOLIA	45.09
VaK Hradec Králové a Královéhradecká provozní, a.s. – VEOLIA	40.61
Severomoravské vodovody a kanalizace – AQUALIA	40.13
VaK Náchod	40.11
Severočeské vodovody a kanalizace – VEOLIA	39.91
VaK Vsetín	37.60
VaK Trutnov	37.07
Vodárny Kladno-Mělník a SČV – VEOLIA	36.00
Ostravské vodárny a kanalizace – ONDEO	35.47

Source: www.vodarenstvi.com

Conclusion

As a consequence of the injudicious steps taken in the process of selling SmVaK shares to private owners, this combined water supply company forfeited the opportunity to apply for financing from EU funds to carry out infrastructure investment.

As things stand, the cities and municipalities are forced to cover infrastructure building costs out of their own budgets and with subsidy funds for which they directly apply. By executing the above described sale, the cities and municipalities lost a direct and logical source of financing that would complement subsidy co-funding, i.e. profit from water and sewerage fees. At the same time, they lease the infrastructure to the company SmVaK, which only pays a symbolic amount of rent.

PRIVATISATION VIA THE SALE OF SHAREHOLDER RIGHTS (IN THE PERIOD PRECEDING CZECH EU ACCESSION)

EXAMPLE 3

VODOVODY A KANALIZACE ZLÍN

Introduction

The privatisation of some water management companies in another manner began in 2001. After the SmVaK privatisation, there were no further direct purchases of waterworks shareholdings in the Czech Republic. This change was clearly aided by the fact that as a result of the sale of the waterworks shares, the combined water management companies or cities owning only infrastructure lost their eligibility for European Union subsidies. Interest in purchasing infrastructure declined, but not interest in the operating – and revenue-generating – parts of the waterworks. An operating model has arisen on the water supply market whereby the city maintains ownership of the water supply infrastructure, while water delivery, sewerage and treatment are entrusted to a private company. A highly complicated example is the launch of this operating model in the city of Zlín. Confusion still surrounds the process due to protracted ongoing litigation, and many questions concerning the circumstances that attended the transaction remain unanswered.

Preparation for the entry of a strategic partner into VaK Zlín

In 1994 the National Property Fund founded the mixed joint stock company Vodovody a kanalizace Zlín (VaK Zlín), which was created by three groups of shareholders. The chartered town of Zlín owned 47 % of the shares, small municipalities together owned 40 % of the shares and the remaining 13 % was held by small shareholders whose interests had been acquired in the second wave of coupon privatisation.

The privatisation of the revenue-generating part of VaK Zlín, i.e. the company's operations arm, began in 2001. The VaK Zlín Board of Directors announced a public tender for operators of the infrastructure that they were starting to prepare for strategic partner entry. A total of four companies tendered bids. Despite the fact that one of them, Jižní vodárenská, a.s. (a subsidiary of Vivendi Water Group; today Veolia Voda), was rejected by two of the three advisors, this firm was announced the winner by the VaK Zlín Board of Directors. This fact aroused suspicion that the winner had been chosen in advance. The entry of Jižní vodárenská into VaK Zlín was to have been approved at the VaK Zlín General Meeting of Shareholders that took place on 17 April 2002. However, the shareholders rejected the entry of this strategic partner at the General Meeting.

Project Moravia for “waterworks consolidation” in Moravia

In 2001, the savings bank Česká spořitelna, a.s. (ČS) joined the waterworks privatisation process. ČS and the company Česká infrastruktura, a.s. created a joint project called “Project Moravia”, which was designed for water management companies whose majority owners were municipalities and cities. The stated goal of the project was to acquire majority interests in most of the water management companies in Moravia, to consolidate these companies and, where applicable, to prepare for strategic investor entry. At the same time, ČS stated it would provide banking services

and the possibility of obtaining cheap financing for development plans connected, inter alia, with the Czech Republic's accession to the European Union and the performance of its obligations in the area of water purity and protection. A similar project called Project Bohemia was launched in the Czech regions. In light of later events, we cannot rule out the possibility that ČS was only representing a group of companies that expressed interest in acquiring the profit-generating components of the monopoly in the given regions.

ČS offered to purchase the VaK Zlín shares at 80% of their purchase price, which had been set at CZK 160 per share,³ and further offered to assume the investor obligation not to increase water and sewerage fees in an amount exceeding the rate of inflation for the duration of the shareholder agreement, to obtain long-term advantageous loans from ČS and the assurance that access to EU and Czech government subsidies would in no way be affected by the mechanism of the executed contracts. The actual share transfer was to have taken place as soon as was permitted by the VaK Zlín Articles of Association.

The contractual documentation comprised a contract on a future share purchase contract, a share purchase contract, an adhesion contract, a power of attorney to exercise shareholder rights and a power of attorney to register the suspension of disposition rights at the Securities Centre. Furthermore, ČS offered the city of Zlín and other shareholders to sign a shareholder agreement stipulating the basic principles and rules of co-operation. This agreement regulated mutual shareholder relations and conduct within the company. These rules governing shareholder relations included shareholder representation on the Board of Directors and Supervisory Board and in management, rules governing any purchase of shares or basic capital increase and guarantees pertaining to water and sewerage fee amounts.

Purchase of voting rights for CZK 160 per share and execution of a shareholder agreement

Before the VaK Zlín General Meeting that failed to approve the operating model with Jižní vodárenská, a.s., the Zlín City Assembly had approved a plan to sell its share in this company to Česká spořitelna and the company Stredoeurópský makléřský dóm on 4 April 2002 and enjoined the Zlín City Council to execute the above mentioned contractual documents – all on the condition that the entry of a strategic partner would fail to be approved at the VaK Zlín General Meeting. Nine days later, when the shareholders at the VaK Zlín General Meeting of 17 April 2002 rejected the operating model involving the company Jižní vodárenská, a.s., the Zlín City Council accepted the ČS offer.

Upon executing the shareholder agreement, the chartered town of Zlín obtained cash in an amount of 80% of the agreed purchase price, i.e. CZK 128 per share. At the same time that it signed the shareholder agreement, the city entered into an adhesion contract and executed powers of attorney transferring the exercising of voting rights attached to the shares. As a result, it was left with “hollow” shares. The city, as the hitherto majority shareholder in VaK Zlín, from that moment on had no authorisation to execute an adhesion contract or a power of attorney with ČS. Sanctions for breach of contract were set at 100% of the purchase price of the shares plus compensation for damages. The city lost the right to participate on its own behalf in VaK Zlín General Meetings and lost the right to vote. In the one year following the launch of “Project Moravia” several other cities and municipalities acceded to the ČS offer. ČS thus acquired first a blocking minority and then a majority of voting rights and the possibility of participating in strategic company growth, which was in violation of the VaK Zlín Articles of Association prohibiting any transfer of shares and the attached rights to third parties outside the existing shareholder structure.

The set of contracts executed by the city of Zlín and other municipalities addressed the limited transferability of the shares by circumventing this restriction. The cities and municipalities

³ Česká spořitelna originally offered CZK 200 per share in 2001. In 2002, it changed the offer to CZK 160 per share.

continued to hold shares (hollow, i.e. bearing no rights), but transferred all decisive rights to a private company. These rights included deciding on Board of Directors, Supervisory Board and management appointments. It is perplexing that the VaK Zlín Board of Directors failed to raise any protest against this procedure.

The procedure executed by the Zlín City Council is also perplexing in light of information that was later revealed, as the Council had actually received a second offer to purchase the shares of VaK Zlín. This offer of CZK 200 per share put forward by an association of cities and municipalities was not only a better offer than that of ČS, but would also have ensured that VaK Zlín had the possibility of obtaining subsidies from the ISPA pre-accession fund because the association would have remained the owner of the shares (or voting rights), leaving VaK Zlín in the position of an eligible subsidy applicant. This offer was underscored by a bank guarantee for performance of the given liability. Nonetheless, the city administration failed to discuss this offer in the City Assembly.

Transfer of voting rights to a strategic partner

Česká spořitelna subsequently transferred its rights and obligations arising from the contract with the cities and municipalities to a partner from the Vivendi Water Group (today Veolia Voda), the company Jižní vodárenská a.s. Thus, Česká spořitelna was attached for less than one year to the project it had presented as a plan to acquire the shares of joint stock water distribution companies, consolidate these companies and prepare them for strategic partner entry. At the same time, the contracts had been concluded for a 20-year period. As such, Jižní vodárenská a.s. found itself in the position of waterworks manager. Subsequent development led to the sale of the profit-generating segment of the waterworks (the operations arm) to a private subject without a public tender and without setting any operator criteria (the lease of infrastructure). This led to a precipitous decline in the value of VaK Zlín shares held by cities and municipalities, which lost operating income and so, too, funds to finance the infrastructure they owned.

Sale of the operating arm of the company

The day before the Czech Republic's accession to the European Union, the VaK Zlín shareholders were submitted a plan to sell the operating arm of the waterworks to the company Zlínská vodárenská a.s., another member of the Veolia Voda Group, and then a contract on the lease and operation of water supply and sewage systems, for their approval. The submitted Board of Directors report set out the benefits of the operating model and the reasons for the choice of operator. It furnished as the primary reason for introducing this model the obtaining of EU subsidies, but shareholders were also promised inflation-capped water and sewerage fee growth and investment spending as a priority. The outcome of the public tender held in 2001 was given as the reason for not announcing a tender for an operator and for negotiating exclusively with Veolia Voda Group companies. The report went on to state that the economic benefit of selling the enterprise's operating arm would range from CZK 40–60 mio.

The VaK Zlín General Meeting thus approved the operating model that completed the de-merger of the company VaK Zlín into infrastructure and operating arms. The operating arm was sold to Zlínská vodárenská for CZK 80 mio, while the infrastructure arm is leased to Zlínská vodárenská for CZK 85 mio annually (in essence for depreciation charges and overhead). This contract has been approved for a 30-year period.

Subsidies for VaK Zlín

At the time the contracts between ČS and the city of Zlín were being concluded, a subsidy project called “The Zlín region — wastewater treatment for Europe” worth an estimated CZK 600 mio from the ISPA pre-accession fund was under preparation. The project was at that time in the approval phase at the Ministry of the Environment. The Ministry asked Zlín city councillors to revoke the decision to sell the VaK Zlín shares to Česká spořitelna, given that accepting this offer had pre-

empted subsidy project approval. The Zlín city administration failed to convey this information to city councillors while discussing the transfer of voting rights to Česká spořitelna, though the issue could have significantly influenced the vote on the share sale. Neither VaK Zlín nor the project obtained any subsidy funding.

Subsequent operating model implementation in April 2004 prevented VaK Zlín from obtaining a subsidy from the EU Cohesion Fund for the 2005–2006 period, as the operator agreement was skewed in a manner that failed to assure protection of the public interest. Thus, since 2004 the VaK Zlín shareholders, municipalities and cities, have financed infrastructure from public budgets and are receiving a minimal profit share. For the 2004–2007 period during which the operating model was implemented, VaK Zlín earned some CZK 21.7 mio and the operator, Veolia Voda, CZK 85 mio. In this same period, VaK had to finance investment of CZK 522 mio.

NPF golden share administered by the Czech Agriculture Ministry

How the government acted during preparation of the operating models is evidenced by the manner in which it exercised its golden share vote. The National Property Fund's golden share could have prevented implementation of the disadvantageous operating model at VaK Zlín. In 2002, the NPF voted against the sale of the operating arm of the enterprise VaK Zlín. In 2004, when the conditions for the sale of the operating arm of the enterprise VaK Zlín were worse than in 2002 (e.g. a selling price that was CZK 20 mio lower), the NPF representatives voted in favour of the sale at the General Meeting. The conduct of these government representatives could not have been born of a lack of familiarity with the issue, as the NPF was authorised to vote and the system in place for General Meeting voting by the authorised NPF representatives meant that points were voted on individually.

Further development and consequences of the operating model

The Securities Commission decided in 2004, after the introduction of the operating model in Zlín, that the city of Zlín and the company Jižní vodárenská, a.s. had violated the law in 2002 and could not exercise their voting rights. A fine was also imposed for this breach of law. Nevertheless, in 2005 this Securities Commission decision was reversed owing to formal shortcomings. Some shareholders brought suit against the city of Zlín and the VaK Zlín Board of Directors for their conduct. In 2007, the Regional Court in Brno ruled that the VaK Zlín General Meetings held from August 2002 through April 2004 were invalid. This judgement was upheld by the High Court in Olomouc. The company Veolia Voda lodged an appeal with the Supreme Court. At the time of this study's preparation, no ruling had yet been handed down.

Consequences of the operating model:

- Owing to the operating model, VaK Zlín received no EU subsidies. The European Commission specifically criticised the non-standard operator selection, the non-existence of criteria for monitoring operational efficiency and the non-standard duration of the lease and operating agreement.
- Currently, infrastructure renewal and construction are publicly funded and the public sector has a significantly smaller share in operating profit than does the private operator.
- In the last five years, VaK Zlín has recorded the highest growth in water and sewerage fees in the Czech Republic – by 45 %. Moreover, this growth does not reflect the impact of financing deferred investment. Investment in VaK Zlín still lay ahead and shall have to be fully reflected in water and sewerage fees, if no subsidy funding is available.

PRIVATISATION BY SHAREHOLDER AGREEMENT (IN THE PERIOD AFTER CZECH EU ACCESSION)

EXAMPLE 4

VODOVODY A KANALIZACE KROMĚŘÍŽ

The company Vodovody a kanalizace Kroměříž

Until the end of 2002, Vodovody a kanalizace Kroměříž (VaKro) was a combined water supply company more than 90 % municipally controlled and owned. Only about 10 % of the company's shares were publicly traded. Pursuant to the privatisation project and the company's Articles of Association, 90 % of registered shares could only be transferred among existing shareholders, i.e. municipalities and cities.

First attempt to privatise VaKro in 2002

Česká spořitelna, a.s. (ČS) made a first attempt to privatise VaKro in August 2002. It sent the municipalities of the Kroměříž region an offer much like the one it had sent to Zlín (see preceding chapter) to purchase shares (CZK 160 per share, payment of 80 % of the purchase price) and prepare the company for strategic partner entry. Share transferability was restricted, making it virtually impossible to acquire registered shares, hence the offer to "purchase" shares contractually, whereby the shares would continue to be held by the municipalities, but the shareholder rights attached to them would be exercised by a private entity. ČS thus acquired the shareholder rights of the cities of Holešov, Hulín, Bystřice pod Hostýnem and Chropyně, and the municipalities of Kvasice and Bezměrov, comprising altogether a blocking minority (34 %) in VaKro, which it then transferred to the company Moravská infrastruktura, a.s. (MI).

In June 2003, Moravská infrastruktura notified the VaKro Board of Directors that its share in the company's voting rights had reached 36.91 %. The city of Kroměříž controlled, and further purchased from some municipalities, enough VaKro shares to assure its position as the party controlling VaKro with an interest of roughly 47 %. Its majority at VaKro General Meetings was secured in collaboration with the smaller municipalities of Dřínov and Morkovice.

VaKro thus remained under the control of cities and municipalities and continued to be eligible for EU subsidies. The only problems the city experienced concerned some resolutions for which a two-thirds or three-fourths majority of votes was required, such as those concerning in-kind contributions to company infrastructure. The city of Kroměříž resolved this situation by executing a lease agreement between VaKro and the respective municipality in order to pre-empt any threat to water supply and sewage system operations.

The city of Kroměříž controlled the VaKro company bodies and identified all operating priorities. Profits were reinvested into infrastructure renewal and dividends were not the objective of VaKro's business.

Second attempt to privatise VaKro Kroměříž in 2006

After 2003, Moravská infrastruktura found itself in a situation in which it was unable to control VaKro; it had been unable to effect any substantive changes in the company in the preceding three years. It had a significant investment in VaKro, but did not actually own, and could not sell, VaKro shares. Thus arose the second attempt to privatise VaKro in 2006. Moravská infrastruktura, represented by the company Penta, attempted to sell its 34 % shareholding while at the same time

endeavouring to persuade the city of Kroměříž to sell its shares, too. The shares were to have been jointly sold to the foreign company Aqualia.

The city of Kroměříž responded to the Penta offer by announcing a public tender for the sale of its VaKro shares. Selection criteria were determined, i.e. the price per share and form of future co-operation. Three parties expressed interest in the shares, of which two tendered bids. Aqualia offered CZK 450 per share. Hanácká sladovna Kroměříž, a.s. offered CZK 1300 per share and to maintain the city's participation in managing VaKro.

In 2006, the city of Kroměříž faced an important decision:

- To sell the VaKro shares for a lucrative price to Hanácká sladovna Kroměříž, but with the risk that VaKro would forfeit the possibility of obtaining EU subsidies, even if the city were to continue its involvement in managing VaKro.
- Not to sell the VaKro shares and jeopardise the possibility of obtaining EU subsidies.

In 2006, the City decided not to sell the VaKro shares and thus to assure the company's eligibility to apply for EU subsidies.

Third attempt at privatisation — shareholder agreement as a “masked” operating model

The privatisation of VaKro finally occurred on the basis of what was termed a shareholder agreement approved by the Kroměříž City Assembly in October 2008. The second party to the shareholder agreement, the company Energia AG Bohemia s.r.o. (Energia AG), was not a VaKro shareholder.

In 2006, there were management changes in the Kroměříž civic administration; these were followed by changes in the VaKro company bodies in mid 2007. The incoming city leaders at first held to the same line as the outgoing administration. It struck a task force to secure the city's position as a shareholder with a 52% interest in VaKro and established practices to be employed against companies attempting a takeover of VaKro.

On 10 October 2007, the company Penta sent a letter to the city of Kroměříž. It offered a way to resolve the situation, warning that, in order to limit the damage it was suffering, it would minutely examine the actions of company bodies, management and shareholders if no agreement were to be reached. It proposed to the city of Kroměříž, i.e. the majority shareholder of VaKro, that a new operator, the company Energia AG, be introduced. Although it was not a VaKro shareholder, Energia AG submitted a draft shareholder agreement to the city of Kroměříž. Energia AG was interested in replacing the company Moravská infrastrukturní and then maintaining a long-term minority shareholder position in VaKro, together with the city of Kroměříž, on condition that a shareholder agreement be executed to regulate their mutual positions. The objective of the shareholder agreement was mutually to regulate shareholder rights so as to ensure accord in the objectives and methods of managing VaKro. One of the proposals comprising the shareholder agreement was that Energia AG have four members on the seven-member Board of Directors of VaKro and that it also see to the operational running of the company at the level of management. Previously, Moravská infrastrukturní had no representation on the VaKro Board of Directors.

In late 2007, the task force of the city of Kroměříž led by the mayor evaluated the shareholder agreement and found it to be wholly unsuitable, unbalanced and greatly restrictive on the majority shareholder (the city of Kroměříž) and to provide the company Energia AG with undue advantages. The Kroměříž City Assembly voted down the agreement on 15 November 2007.

The Kroměříž city administration changed its position in 2008. The mayor three times submitted city councillors for approval a formally amended draft shareholder agreement based on the agreement that had been submitted by Energia AG in 2007. After a further series of changes, the City Assembly approved the shareholder agreement on 9 October 2008 by a very slim margin of votes. The resulting agreement stated that the Board of Directors of Vodovody a kanalizace Kroměříž would comprise a total of 7 representatives, of which 3 from the company Energia AG,

3 from the city of Kroměříž and 1 representing the small shareholders. A representative of Energia AG was appointed Board of Directors chairman and conclusions of Board of Directors discussions were first to be approved by a so-called meeting of parties, at which Energia AG would have 3 votes and the city of Kroměříž 3 votes.

Sanctions of tens of millions of crowns for the city and the loss of independent decision-making

Under the shareholder agreement, if the city of Kroměříž, as the party controlling VaKro, wishes for any reason to increase or change the city's representation in VaKro company bodies other than as stipulated in the shareholder agreement, it shall suffer a contractual fine of CZK 10 mio. This penalty also applies should the city refrain from voting or vote against persons proposed by the company Energia AG.

The city of Kroměříž is also obliged, under threat of a CZK 30 mio contractual fine, to remove voting on a basic capital increase or reduction, authorisation of the Board of Directors to increase basic capital, the changing of the Articles etc. from a General Meeting agenda should it fail to come to an agreement with Energia AG.

Under threat of a contractual fine of CZK 15 mio, the city of Kroměříž representatives are further obliged to vote at a General Meeting as has been agreed by the meeting of parties, irrespective of any facts that may come to light at the General Meeting. Also under threat of a contractual fine of CZK 15 mio, the city of Kroměříž must vote to transfer registered shares to Energia AG from another shareholder, if the holding of Energia AG is less than that of the city. On the other hand, no contractual fine or ban is stipulated in the agreement with respect to Energia AG that would prevent it from taking joint steps with other shareholders to obtain a greater share than is held by the city of Kroměříž.

Should the parties twice fail to agree at meetings of parties, Energia AG is entitled under the shareholder agreement to request that the city of Kroměříž grant consent at the General Meeting to the transfer of shares owned by Energia AG to a third party. Such third party would not be bound in this conduct by any agreement, but would be a shareholder with registered shares, i.e. would be able without limitation to acquire VaKro shares from other shareholders. The city of Kroměříž would thus be unable to prevent such third-party share from eventually exceeding 50 %.

Loss of access to EU subsidies

VaKro has applied for a subsidy from EU funds, specifically from the Operational Program — Environment, in an approximate amount of CZK 400 mio. In late 2008, the Ministry of the Environment sent VaKro an opinion on the adopted shareholder agreement, stating that eligible support recipients are business companies that are more than 50 % owned and controlled by municipalities or other public-law entities, i.e. where such entities factually or legally, directly or indirectly, exercise controlling influence in enterprise management or operation. However, in the case of VaKro the executed agreement clearly stipulates that the Board of Directors shall act in accordance with what has been agreed by a meeting of parties. The consent of Energia AG is necessary for all fundamental matters of running VaKro. Neither the city nor any other party to the agreement has the option of deciding without Energia AG, i.e. the condition that a municipality must exercise controlling influence in the management and operation of VaKro is not met. The opinion of the Environment Ministry indicates that VaKro has forfeited the possibility of receiving EU subsidies.

The mayor of Kroměříž was asked about the risk of losing subsidies at the public meeting of the City Assembly called to ratify the shareholder agreement on 9 October 2008. He assured city councillors and the public alike that everything was fine. He informed neither the councillors nor the shareholders of the Ministry opinion that was at his disposal.

Conclusion

In accepting the offer made by Hanácká sladovna Kroměříž, a.s. in 2006, the city of Kroměříž could have generated almost half a billion crowns in budget income by selling the shares. However, owing to concerns that the company VaKro would, as a result of the sale, forfeit its eligibility to apply for subsidies, the city administration of the time decided against selling the shares.

The new city administration entered into a shareholder agreement, which assured that Energia AG would exercise substantial influence in VaKro decision-making without having to pay a penny. Moreover, VaKro likely forfeited its entitlement to some CZK 400 mio of EU subsidies as a result of executing this agreement.

The city of Kroměříž now finds itself in a position in which it must agree on everything with the company Energia AG. It also faces the threat of losing its position as the party controlling VaKro, as Energia AG may withdraw from the shareholder agreement and sell its shares to a third party, which will not be bound by any agreement. At the same time, the city of Kroměříž is obliged to vote in favour of such share transfer. Both the city of Kroměříž and VaKro face the threat that owing to the shareholder agreement, the cities and municipalities will lose their majority in VaKro. Should this actually occur, it will surely constitute the first case of waterworks privatisation in the Czech Republic in which cities and municipalities enjoy no financial gain from the forfeiting of their controlling influence. The fact that the city enjoys no financial benefit whatsoever from the executed shareholder agreement, which is first and foremost of benefit to private companies, begs the question of why the process of privatising VaKro ever took place at all.

CONSEQUENCES OF THE PRIVATISATION OF WATER SUPPLY COMPANIES IN THE CZECH REPUBLIC

The preceding chapters described cases of waterworks privatisation that in virtually every instance illustrate the same public sector and consumer consequences.

From the perspective of the public sector, i.e. the state, cities and municipalities, these privatisations meant:

- 1) the loss of existing infrastructure development financing sources, i.e. income and profit from the sale of water;
- 2) the loss of direct control and of decision-making powers in all substantive matters pertaining to the sale of water, frequently accompanied by significant water and sewerage fee hikes in contrast to waterworks remaining in municipal hands;
- 3) loss of the entitlement to government and EU subsidies for waterworks, meaning that investment financing must come from municipal or municipality association budgets;
- 4) loss of the ability independently to decide on regional water supply infrastructure development, including decisions on water supply infrastructure construction priorities in industrial zones.

Waterworks privatisation generally yielded one-off financial windfalls for cities and some waterworks; these resources were reinvested in water supply infrastructure, even where cities no longer owned the respective waterworks. In the case of the 2008 privatisation model being implemented in Kroměříž, not even this short-term benefit is available.

From the perspective of cities and municipalities and of the state, in the late 1990s the plan to privatise waterworks could have appeared to be the right thing to do. The prevailing opinion was that costly and necessary industry investment could be covered in part by private sector involvement. The reality of the privatisations of SmVaK, PVK and VaK Zlín, however, clearly showed the opposite to be true. Agreements between cities or waterworks and operators failed to include operating criteria, sanctions for excessive operating cost increases or failure to fulfil promises of inflation-capped water and sewerage fee increases. The agreements contained neither a mechanism for public sector participation in operating profit, nor a principle for public sector participation in profit growth arising from increased operating productivity as a result of city-financed new water supply infrastructure construction. Cities must lease any water supply infrastructure that they build to existing operators, as no other option is open to them.

The government took note of this trend in 2003 and moved to address this adverse situation. A joint committee comprising representatives from the Ministry of Finance, Ministry of the Environment, Ministry for Local Development, Ministry of the Interior, the National Property Fund, the Ministry of Agriculture and expert advisors agreed that if the private sector is to participate in the running and profits of waterworks, it must be contractually bound to contribute investment financing. A draft privatisation model was formulated in which waterworks management, profit sharing and capital investment share should be financed in equal parts by the public and private sectors which should, moreover, enjoy precisely the same rights and obligations. However, this proposal was not approved.

In 2004, it had become clear that waterworks privatisation would not relieve the public sector of having to finance water supply infrastructure development. At the same time, during pre-accession negotiations with the European Union, the Czech Republic pledged to meet EU environmental directives, which meant the need to invest some CZK 60 – 80 bn in the water industry over six years. Water management privatisation would make sense in the Czech Republic if economic indicators were to point to an eventual drop in public sector participation in infrastructure financing costs accompanied by an increase in revenue for the public coffers. In actuality, however, the public sector

has lost not only a source of profit-generating operating activity, but also the possibility of receiving EU sources. Moreover, all the costs are gradually being passed on to the consumer and taxpayer.

Given a non-privatised water industry, the Czech Republic would stand to receive EU funding totalling some 70 % (i.e. CZK 56 bn) of the above mentioned 80 billion in investment, while having to rely on its own resources, or funds from consumers, for the other 30 % (i.e. CZK 24 bn). The provided examples of water industry privatisation describe non-transparent and unsuitable privatisation methods and attest to the amount of financing that has been lost by the public sector and instead paid out by private operators as dividends, profit or capital funds. In relation to these companies, the water industry has lost at least CZK 7.5 bn. The amount lost by the public sector through other privatised water supply companies is estimated to be no less than CZK 1.5 bn. Had these water supply companies not been privatised, a sum of roughly CZK 9 bn would have been available to finance necessary investment and the Czech Republic would only have had to contribute some CZK 15 bn.

The change in how the water industry does business, whereby operating profits are not reinvested into the industry, is attended by a very large problem that taxpayers and consumers shall have to face in the not-too-distant future. This problem is the need to find financing to cover requisite water supply infrastructure investment (both for refurbishment and new construction) in the Czech Republic. The rents that cities receive from private waterworks operators for infrastructure often fail even to cover depreciation charges. Neither cities nor the state will generate sufficient resources for future infrastructure renewal and development. Disadvantageous contractual terms and conditions between infrastructure owner and operator have led to the privatisation of profits and nationalisation of expenses.

Moreover, as a result of these long-term agreements cities and municipalities — the usual infrastructure owners — forfeit the possibility of obtaining subsidies from EU funds. Thus today the Czech Republic must find a way to finance infrastructure without benefit of subsidies. It is currently in talks with the European Bank for Regional Development, while also endeavouring to obtain state budget financing and negotiating an extension with the EU for its fulfilment of water industry obligations.

Water supply regulation

One possibility that offers itself in answer to the questions that plague the water industry is to ensure effective and balanced regulation. Proposals for regulating a market that in essence is a natural monopoly have long appeared in Environment Ministry materials. They are inspired by experience abroad and experience with other network monopoly industries, where regulation has appeared to be necessary. An Environment Ministry study reveals that water industry regulation is common throughout the world, especially where a high degree of private sector involvement exists. The world trend in water industry regulation consists in the establishment of an independent regulator. In the opinion of the Environment Ministry, the regulator's primary role is to achieve a balance between the public interest and the interests of the private operator from a position of greater independence than that of a political appointee. The separability of the regulator from politics can have a positive impact on the economic sustainability of the sector, on advancing the incremental application of a cost-covering tariff and on reducing the sector's dependence on subsidies from public budgets.

The existence of an independent regulator can also mean a greater degree of transparency in the behaviour of private water supply companies, e.g. through the application of a formula to calculate water and sewerage fees that provides motivation for savings instead of cost increases or by comparing the quality of provided services by monitoring selected standards. The existence of an independent regulator can also ensure protection of the public interest against private interests, primarily with regard to the balance of contractual relations, setting the proportionality of private company profits or ensuring a public sector share in operating profit.

Of course, a regulator is not a saviour and cannot totally prevent non-transparent privatisation. What is required here is both a process whereby the public is kept informed and a proactive approach by citizens and the competent institutions.

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