

# THE PRIVATISATION OF PUBLIC UTILITIES IN CROATIA: AN ASSESSMENT OF THE MAJOR GAINS AND PAINS

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## **LSEE Papers on South Eastern Europe**

This paper is the third in the LSEE Papers series which, following two previous insightful papers on cultural and political developments in South Eastern Europe, addresses a topic of central importance to the region's economic development. The focus of Nevenka Čučković's paper is the privatisation of state-owned utility companies in Croatia in the telecoms and oil & gas industries. While the focus of the paper is on experience in Croatia, the argument presented also has a wider relevance for those countries in the region which are pursuing a similar privatisation of public utilities. The paper is the result of a research project carried out by the research team from the Institute for International Relations in Zagreb who were the winners of a competitive call for research project proposals issued in October 2009 within the wider LSEE Research Programme on South Eastern Europe, supported by the John S. Latsis Public Benefit Foundation.

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Dr Will Bartlett, LSEE

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## Introduction

In the last twenty years, many mature western market economies, as well as post-socialist countries, have pursued the privatisation of enterprises in the public utilities sectors (such as telecommunications, electricity, the oil and gas industry, water supply, railroads and railways) that were traditionally in state ownership and whose services had been provided by the state for many decades. Croatia has also followed that path, but with a considerable time-lag. A greater reliance on private enterprises in the provision of these services has brought some economic and social gains (improving efficiency, upgrading technology and innovation as well as an improved quality of services). However, this has been accompanied by some social repercussions (laying-off redundant employees, and increasing the prices of some subsidised services). The cost-benefit balance sheet seems uneven and differs across various categories of beneficiaries (consumers, employees, the state, private owners and shareholders). Apart from ownership transformation, the professionalisation of management was also a key consideration for improving their business performance and corporate governance, although this was often held back by entrenched interests and by direct political interference.

The privatisation of public utilities has been the most controversial component of the privatisation process because such enterprises were often natural monopolies which provided universal services. Also, public enterprises in these sectors were usually the most valuable parts of the

state portfolio. The privatisation of these sectors was thus often seen as “selling the family silver”, and governments have usually taken this decision only when they were driven to by EU accession conditionality or by desperate needs for additional budget revenues.

The aim of the research on which this paper is based was to investigate, and where possible measure, the effects of policies of marketization and privatisation of the telecommunication and the oil and gas industries in Croatia with respect to their business efficiency, employment levels, investment, service quality, diversity and prices. The paper questions whether the expected improvements in business performance actually occurred in the post-privatisation period and whether they improved consumer welfare. Both specialists and the wider public have opposing views about the changes which took place, and the paper therefore attempts to set out a considered analysis of the actual effects of the privatisation of these two public utilities in Croatia.

The paper provides both a quantitative and qualitative assessment of the privatisation impacts on business performance in the telecommunications and oil and gas industry, and provides a balance sheet of accomplishments in the post-privatisation period. The assessment is also based on a range of qualitative indicators from two case studies of privatised companies in Croatia. The field research was based on in-depth interviews with members of the executive and supervisory boards at Croatian Telecom (HT) and the Croatian oil and gas company INA, professionals working in the regulatory agencies in these two sectors, and major stakeholders such as trade unions, consumer and employer associations, and government and academic experts.

## **Some conceptual foundations**

The conceptual framework for the analysis is drawn from the fields of new public management, public choice theory, agency theory and transaction cost economics. In the last two decades the concepts of privatisation, restructuring, regulation, and competition in the public utilities sectors have been used to analyse both western and post-socialist reform packages (Vickers and Yarrow, 1991). The controversy has not been resolved despite a plethora of empirical evidence. The answers are still tentative and their categorisation into well founded “pro” and “contra” arguments depends very much on the specific case or sector or institutional framework underpinning the privatisation. Namely, many debates on the effects of privatisation have not been convincingly concluded and need more research. Some empirical studies have found evidence of the improved efficiency of privatised firms in the public utilities sector, while other empirical studies are less convincing. The so-called “New Public Management” theories (Hood 1995) have introduced a wider view of the problem and have linked the performance of such enterprises with general public management and economic governance problems. This paper contextualises its results within a growing literature which assesses the empirical evidence on both private and public ownership options and management concepts<sup>1</sup>. It also identifies examples of good practice relevant for the SEE region where improving services and efficiency of public utilities is still an unfinished reform agenda that affects general economic performance.

## *Why privatise public utilities?*

In the last two and a half decades, the public utilities that have traditionally been in state ownership have undergone a tremendous scope of privatisation in many countries throughout the world<sup>2</sup>. These sectors provide various essential public goods and services to households and firms and supply them with necessities, such as water, electricity, natural gas, telephone and internet communications (Nestor and Mahboobi, 1999). Often these products and services are provided by vertically integrated companies which include production, transmission and distribution and which hold a monopolistic position on the market. The aim of privatisation has usually been to improve their economic performance, and to change the incentives that influence their management, while keeping in mind that the provision of essential public goods is one of prime objectives of their operation. Public utilities have huge significance for national economies in terms of their contribution to the GDP, investment, employment, and budget revenues. Most significantly, their performance greatly affects the input costs of all other industries and economic sectors, as well as the general wellbeing of the population.

Why privatise public utilities at all? Is a change of ownership of these enterprises, which are often natural monopolies, really necessary? Or, could improvements of their business performance be simply accomplished by introducing greater competition and better management? Typically, there have been two main motivations for selling public utilities. Firstly, additional revenue from privatisation is often badly needed for the state budget, and secondly there is often a desire to improve economic performance through stimulating incentives to restructure. The crucial economic motivation behind it has also been the

expectation that by improving the efficiency of these companies a significant cascading impact would be achieved by lowering input costs into production in other sectors, thus raising total factor productivity and economic growth throughout the whole economy. Empirical evidence in many countries has suggested that organisational restructuring of public enterprises and their privatisation, combined with the regulation of markets, have made network industries and utilities more efficient both in terms of business performance and quality of service delivery.<sup>3</sup> Other arguments that have supported privatisation in these sectors over the last twenty years have been that private service providers who face competition have stronger incentives to control operational costs, to reduce prices of services in line with costs, to adopt new technologies, to innovate in business processes, and to adopt more efficient management practices. Although the most visible gains have been found in commercial utilities such as the telecom and oil industries, other infrastructure sectors have also made substantial improvements in corporate performance when faced with increased competition.

A further motivation behind the privatisation of public utilities has been the expectation that it would be associated with price reform, and that competition among providers would initiate a much needed downward trend of prices and an improvement in the quality of services (Megginson, 2005; OECD, 2009). Finally, it has also been expected to have a beneficial effect on income distribution due to wider accessibility and greater affordability of services to lower income households. However, these effects have been expected to vary considerably across countries depending on specific sectoral regulatory framework in place and the levels of household income (Wood, 2004). This paper examines if and to

what extent these expectations were met when privatising Croatian telecommunications and national oil and gas industry.

### *The 'visible hands' of the regulatory state*

While privatisation in other sectors has been based on a substantial process of liberalisation and deregulation designed to introduce contestable markets, the “visible hand” of the regulatory state was needed for sectors that were traditionally experiencing market failure. This has been particularly needed for sectors where competition is limited or absent (such as electricity, telecommunications, postal services, gas and water supply and similar) where regulation should support a desirable degree of competition.

Significant institutional preconditions and safeguards should be met if privatisation is to achieve its public interest objectives (Kessides, 2004, Nestor, 2005). Two principles should be especially respected: (i) separation of the sectoral regulator and the competition agency and (ii) separation of the ownership function and the regulatory function of the state. Replacing a state monopoly with a private one would be neither economically nor socially very meaningful. The regulatory framework should aim to encourage competition and ensure equal opportunities for all market entrants, prevent and discourage monopolisation and ensure that the dominant player does not abuse its market position at the expense of consumers or other providers of the services. This does not relate only to the regulated sector, as cumulative non-competitive practices usually have negative spill-over effects in other sectors. Therefore, before privatising public enterprises, two separate but closely

related regulatory institutions should be established: (i) a competition agency (anti-trust agency) and (ii) an independent sectoral regulator who deals with the specifics of each public monopoly.

The key benefits sought from independent regulators are to shield the enterprises from short-term political interventions in order to ensure long-term market stability and avoid the influence of particular interests, whether by the entities being regulated or other groups. They are expected to ensure market discipline while protecting consumer interests, to facilitate open access to the core infrastructure and to preserve social objectives (OECD, 2003). However, creating regulatory institutions that are both legitimate to citizens and credible to investors has proven to be the greatest challenge of every case of public utilities privatisation (Kessides, 2004).

Only if these regulatory frameworks are in place can privatising natural monopolies be expected to raise economic and social welfare (Lopez de Silanes, 2005). As many experiences have shown, especially in developing countries (Saha and Parker, 2002), replacing public monopolies with private monopolies would be unlikely to improve social welfare or spread economic benefits to all sections of the population in the absence of effective regulation. On the contrary, consumers would most likely be exposed to monopolistic prices for essential services, with a consequent increase in poverty for lower-income groups.

The separation of the ownership and regulatory functions of the state deserves special attention due to the potential “regulatory trap” which may arise if the regulative functions of the state are not carefully separated from its ownership interests (Kessides, 2004; OECD 2009).<sup>4</sup>The

problem is that regulation may have adverse effects if there are disincentives to regulate effectively in order to preserve the pre-privatisation employment levels and position on the market<sup>5</sup>. For that reason, it is of crucial importance that regulatory agencies are independent from entrenched political interests that could harm other market actors, leading to short term political gains but reducing the economic benefits from regulation, and increasing the costs for the economy as a whole (Vickers and Yarrow, 1989; Galal et al, 1994, Cook et al, 2003). An example of the Croatian energy regulatory agency (CERA) illustrates the case of a sectoral regulator that has until recently been heavily influenced by government decisions and political interests. The staffing of the regulators with influential members of the governing elite and political parties was a common feature of the early stages in the creation of sectoral regulators in Croatia.

## **The Privatisation of the Telecommunication Sector: The Case of Croatian Telecom (HT)**

The privatisation of public utilities in Croatia started in 1999 with the adoption of the first privatisation acts related to Croatian Telecommunications (Hrvatske telekomunikacije)<sup>6</sup>. In order to prepare for privatisation, the company was incorporated in December 1998 pursuant to the provisions of the Act on the Separation of the Croatian Post and Croatian Telecommunications. The Parliament adopted the Croatian Telecom Privatisation Act (1999) allowing the sale of an initial 35% stake of the state company's assets to a strategic foreign investor, believing that the most efficient market restructuring of the company could be done by a

reputable investor from the field. Also, it was estimated that such a transaction could generate the highest privatisation revenues for the national Budget. The winner of the initial privatisation tender was Deutsche Telecom which bought a 35% stake. Two years later, the Parliament adopted amendments to the Croatian Telecom Privatisation Act (2001) allowing the sale of a majority stake to the strategic foreign investor. The modifications enabled for selling an additional 16% of the shares in 2001, thus allowing Deutsche Telecom to gain majority stake (51%) of the company. This could be considered as a turning point with regard to ownership transformation which had a substantial effect on the corporate governance and business performance of the company in the post-privatisation period. It is worth mentioning that HT is still the only privatised public utility company in Croatia with dominant foreign ownership, in which the government has reduced its share to just 3.5%. Furthermore, at the end of 2010<sup>7</sup> the government gave up entirely its ownership stake and transferred its share to the Pensioners Fund (the first-pillar state-owned pension fund), thus exiting from any direct influence on the business activities of the company. The other companies that started the privatisation process in the public sector, such as the oil and gas company INA, did not manage to evolve towards majority private ownership for almost a decade following the sale of the initial minority equity stake.

### *Ownership transformation stages of Croatian Telecom*

As elsewhere, the privatisation of Croatian Telecommunications (HT) was implemented in several stages, allowing the government the time to develop and regulate the competition framework for the sector. The five

major privatisation stages and modes of divestiture of state-owned HT shares took place as follows:

- 1 The sale of 35% of the total shares to a strategic investor from Germany - Deutsche Telekom AG in October 1999.<sup>8</sup>
- 2 The sale of an additional 16% of the remaining shares, allowing Deutsche Telekom to gain a majority stake (51%) in 2002<sup>9</sup>.
- 3 In 2007 the government sold 32.5% of the remaining shares through an Initial Public Offering<sup>10</sup>, of which 25% were reserved for Croatian citizens. The other 7.5% of shares was sold to institutional investors.
- 4 Following the sale of a further tranche of shares to the present and former employees of Croatian Telecom and Croatian Post in June 2008, the government reduced its holding from 9.5% to 3.5%, while private and institutional investors increased their share to 38.5%.
- 5 In December 2010 the government decided to transfer its 3.5% ownership<sup>11</sup> to the state-owned Pension Fund, thus exiting entirely from the ownership of the company<sup>12</sup>.

The initial privatisation call for offers proceeded transparently through international tender and followed the procedures offset out in the Croatian Telecom Privatisation Act. Given the high value of the company and the bad public perception of many of the privatisation deals that had taken place in the 1990s, the government was keen to manage the

process in a cautious and transparent manner. With its offer of \$850 million for the first 35% of equity capital, and given its reputation and expertise, Deutsche Telekom (DT) was considered the best choice of strategic investor<sup>13</sup>, which could offer high quality, technologically advanced services and further investment in infrastructure. Some of the interviewees argued that the government preference for Deutsche Telekom was made on the basis of intensive Croatian economic and trade links with Germany, and also due its political significance for Croatia. Other interesting offers such as one from the main competitor Telenor of Norway were rejected, within this set of preferences. However, DT held the largest share of the telecom industry in Europe and was the third largest telecom company world-wide. Croatian consumers were expected to benefit not only from the better quality and diversity of services but also from lower prices, especially in fixed and mobile telephony, as well as through improved internet access.

After gaining the majority ownership of 51% by acquiring the further 16% of HT capital in 2002, DT established HT Mobile Ltd. as a separate legal entity. Mobile telephony was considered important for the company's future development. With foreign management skills DT has attempted to build an internationally competitive company able to cope better in an international environment of fast growing and profitable telecommunication services. HT mobile merged back to HT-Hrvatske telekomunikacije in 2009.

Apart from maximising the net proceeds badly needed for the Budget, the privatisation of HT also offered a good investment opportunity for domestic institutional investors, mainly the state and private pension funds, as well as to small shareholders through the offer of substantial

price discounts to former and present employees. Over 300,000 Croatian small shareholders bought shares in the initial public offering (IPO) in 2007. By 2009, the number of small shareholders had decreased to around 250,000, holding 24.2% of total shareholder capital, as many had sold their shares to cash the difference between the discounted offer price and the higher market price. Since 2008 this has been one of the most traded shares on the Zagreb Stock Exchange and has contributed significantly to the general volume of transactions.

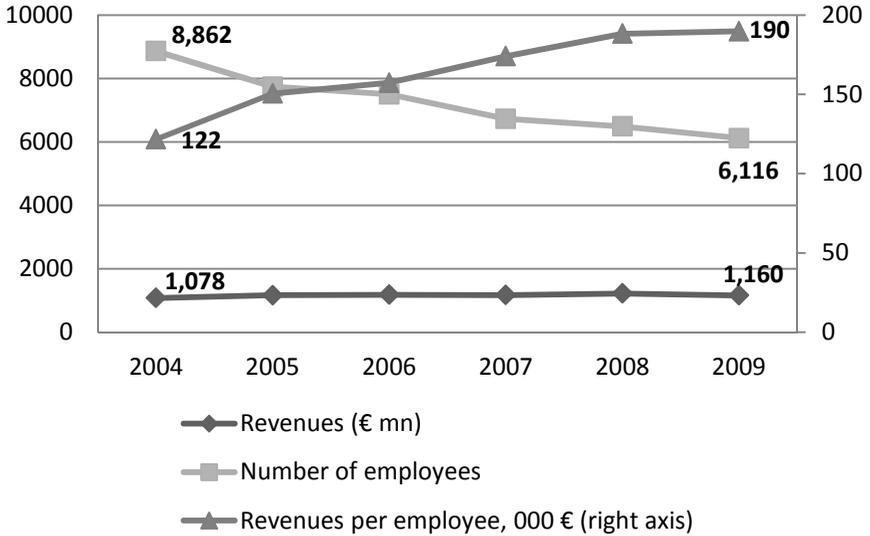
## **Selected indicators of HT post-privatisation business performance**

This analysis in this section investigates whether the change of ownership and management of HT accompanied by regulation has brought about the expected improvements in business performance, productivity, efficiency, management, quality of services, prices, and protection of customers from market abuse.

### *Business performance*

According to the performance data for 2004-2009, the total revenues of HT remained almost unchanged, at around €1.1 billion p.a. (see Figure 1). This suggests that its market position did not substantially alter within that period despite increased competition, regulation and restructuring of the market and the diversification of services in the post-privatisation period. In short, HT managed to maintain significant market power in most of its services.

**Figure 1. Croatian Telecom’s revenues, employment and productivity, 2004-2009**

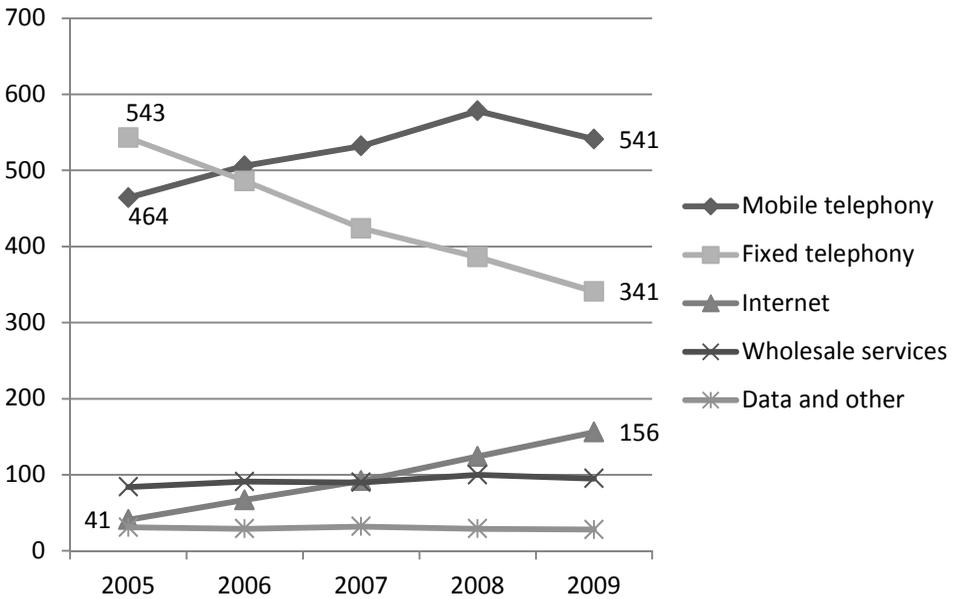


Source: HT Annual Reports 2004-2009

However, a significant change in the structure of revenues occurred in 2004-2009, with a strong decline in revenues from fixed telephony (-37%), an increase in revenues from mobile telephony (17%) and a very strong increase of revenues from internet services (184%) (see Figure 2). Additionally, in 2009, HT revenues in the mobile telephony segment decreased due to a decrease in real personal income in Croatia, the introduction of a “crisis personal income tax”, as well as a 6% tax on mobile telephony revenues introduced in August 2009.

Internet services have maintained their strong growth, with a value in 2009 that was nearly four times greater than in 2004, especially in broadband and IPTV (cable television), fuelled by increasing demand for internet content and for diversity in TV services, in line with world-wide trends. While in 2006, Croatia significantly lagged behind the EU in broadband penetration, it has since rapidly caught up, also in IPTV services.

**Figure 2. HT revenues by type of services, 2004-2009 (€ mil)**



Source: HT annual reports 2004-2009

The structure of the revenues of HT is mainly determined by the overall trends in the Croatian telecom markets, with stagnation in the number of users and a general fall in the use of fixed voice services, an increase in mobile services and a very intensive increase in internet usage.

Based on the number of subscribers according to the Central Bureau of Statistics and HT data, the overwhelmingly high market share of HT in fixed telephony and in internet services has only recently started to decrease slightly, while in mobile services, due to existence of two competitors, the share of HT is significantly lower and has been decreasing slowly for some time.

The partial liberalisation of fixed telephony services occurred only recently. By 2008-2009 nine operators were active in fixed telephony and these competitors were rather successful as indicated by the increase of HT services to other telecom companies.

Operator preselect facility which permits a consumer to decide in advance to use an operator other than the operator providing the access service is a significant feature of the market. Additionally, multiple telecommunications operators are allowed to use connections from the telephone exchange to the customer's premises, but further liberalization of an access service is still yet to come. Customers have responded actively to the new opportunities, as indicated by the increased use of "number portability" facility<sup>14</sup>, which allows a customer of a telecoms operator to change to an alternative operator while still retaining the same telephone number.

Since 2002 HT has held 'significant market power' (SMP) status in the markets for fixed public voice services, leased lines, interconnection and in voice, sound, data, documents, images and other transmission in fixed telecommunications network. Since 2004 T-Mobile has been designated as an SMP operator in the interconnection market and in the market for public voice services in mobile telecommunications networks. According

to existing obligations, the prices for retail public voice service in the fixed network and leased lines are subject to ex-ante approval by the Agency, whereas other retail pricing is subject to ex-post review.

The new Law on Electronic Communications has been in force since July 1st, 2008, and in 2009 the Croatian Agency for Post and Electronic Communications (HAKOM) decided to decrease fixed and mobile interconnection charges by up to 20%. Therefore a further gradual decrease of the HT market share is likely to occur.

### *Employment and labour productivity*

The improved post-privatisation business performance of HT in 2004-2009 led to falling levels of employment. By decreasing the number of employees by 31% (from 8,862 to 6,116 employees) the company managed to improve labour productivity (revenues per employee) by 56%. In short, productivity gains were mainly achieved by a substantial reduction of labour. It is even more obvious when these figures are examined over the period 2000-2009 when the number of employees was cut by almost a half (54.5%). This dramatic drop in the number of employees was of course unpopular, and was often disputed and resisted by both the trade unions and the government. However, the new management of HT dealt with this dissatisfaction with a generous severance pay plan, and by providing training and in-house assistance for job search for laid-off workers. In contrast, HT Mobile (a separate entity within the T-HT Group), increased the number of employees by 3% in 2003-2009, but this did not alter the general downward trend in the number of employees in the company as a whole.

Interviews with the executive board members indicated that company attempted *“to ease the situation with regard to the laying-off of workers, and to carry it out in a socially responsible and acceptable manner and so no major conflicts, strikes or similar trade union pressures have occurred in the process. The company introduced a severance package and a careful plan for assisting the redundant labour in finding new jobs outside company.”*

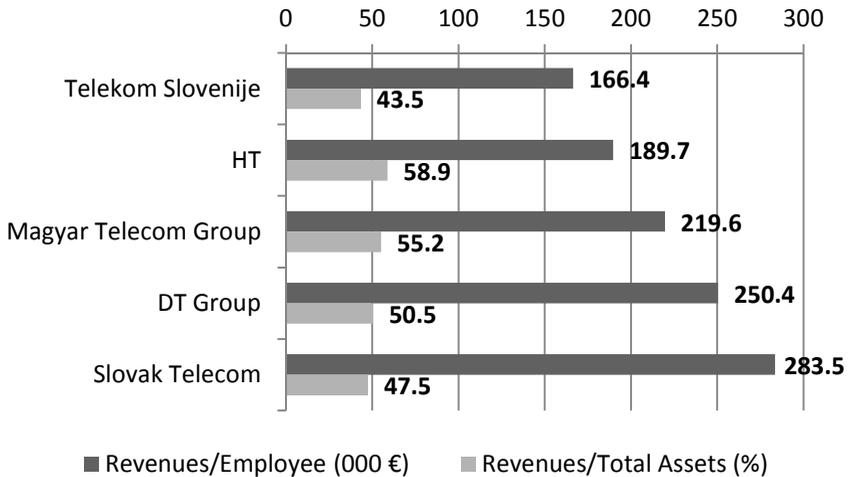
The productivity of labour has been further increased through the education and training of the company’s human resources, and in the period 2004-2009 the education structure of the employees was significantly improved (HT Annual Report, 2009).

However, despite of a substantial increase in labour productivity, it still lags behind the productivity level of selected benchmark companies from the EU new member states (NMS), surpassing only the leading Slovenian telecom operator (see Figure 3).

Public sector telecommunications have typically been overstaffed, and a reduction in employment has been a widespread phenomenon in most EU new member states (NMS) and countries of South East Europe. Regrettably, the repositioning of such companies in the newly regulated and competitive national markets meant substantial labour shedding, imposing a significant social cost in the countries in question, including Croatia.

The decrease in employment in HT has been more intensive than in the cases of Hungarian Telecom Group and Slovenian Telecom, while being less intensive than in the Slovakia, Bulgaria and Romania.

**Figure 3. Productivity in HT and selected companies from EU NMS**



Source: HT annual reports 2004-2009

### *Profit rate, earnings and investments*

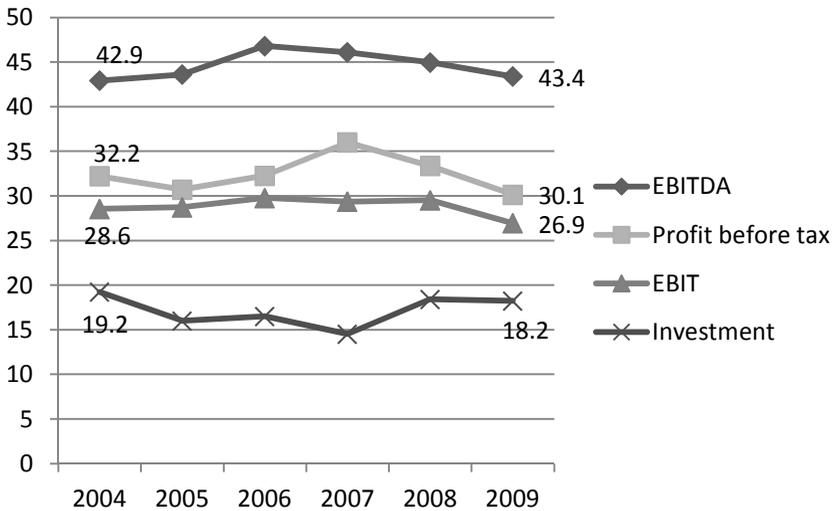
The business results of HT remained rather favourable, with the earnings ratio <sup>15</sup>well above 40% and profit margin exceeding 30%. However, in the last two years, the results deteriorated due to impact of the world economic crisis, stringent competition and regulative and fiscal pressure. It is interesting to note that the investment rate actually increased between 2008-2009 – following a downward trend in 2004-2007 – reflecting increased competition in the market.

The members of the executive board who were interviewed considered that the investment rate was exceptionally high (15-19%) from 2004-2009.

Other interviewees considered that Deutsche Telekom made a significant investment in infrastructure and other long-term capital assets.

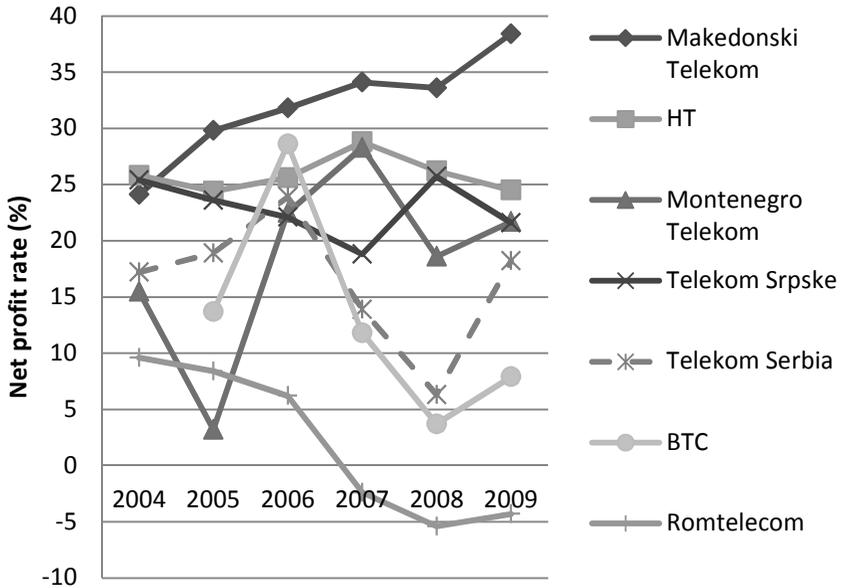
HT has been rather successful in increasing business efficiency measured by profit margins in the post-privatisation period when compared to similar companies in Central Europe (see Figures 4 and 5). HT also had a high profit margin (23.8%) and earnings margin (43.4%) only slightly behind Slovak Telecom (15% and 44.4% respectively). The DT itself was less successful with a net profit of only 0.6% of total revenues in 2009, and an earnings rate of 30.8%. The profitability of HT is rather high also when compared to other SEE telecom companies with only Macedonia Telekom showing more favourable results, while Romtelecom (Romania) has the weakest performance among the selected SEE countries.

**Figure 4. Croatian Telecom (HT) - EBITDA, EBIT, profit before tax and investment (% of total revenues)**



Source: Croatian Telecom (HT) Annual Reports 2004-2009

**Figure 5. Net profit rate of Croatian Telecom and selected SEE companies, 2004-2009**



Source: Annual Reports of the companies under review, 2004-2009

## **Institutional framework for regulation, competition and liberalisation of the telecommunications market in Croatia**

The creation of an independent national regulatory authority (NRA) is the basis of the EU regulatory framework for telecommunications which all EU accession countries must adopt. In Croatia, such an independent regulatory council was not established until several years after the first stage of privatisation of the Croatian Telecom. Actually, the initial

privatisation contract stipulated that the monopoly status of HT in fixed telephony would not expire until the end of 2004, five years after the initial privatisation deal was signed. Some of the experts interviewed at HAKOM considered that such a contract was rather too generous to DT and argued that the Contract enabled HT to perpetuate its dominant market status especially in fixed telephony, even to the present day as it still holds about 85% of Croatian market share.

The situation is well described by the one of the interviewees:

*“The privatisation contract granted a sort of five-year-long “regulatory holiday” for DT/HT on one side. On the other side, as a market player with accumulated experience and information from other regulated markets, this information asymmetry enabled the firm to use the potentials of unregulated markets to its maximum benefit. At the same time, the establishment of the independent regulator was slow, it was understaffed and lacked experts with a knowledge on such a complex regulatory process. In short, it was too weak to efficiently limit the market power of HT even when the regulatory framework was established and the liberalisation of the market started.”*

However, relative to other SEE countries, Croatia significantly increased the NRAs political independence, while in Serbia, Montenegro and BiH, the governments are still highly involved in adopting regulatory decisions (Cullen International, 2009).

Nevertheless, the privatisation of the state-owned monopoly assisted the introduction of competition by allowing the entry of new companies to the market in a sector that had previously been entirely dominated by the state monopoly in all segments of telecommunication services.

The Croatian Agency for Telecommunications (HAT) started to operate in 2004, and in cooperation with the Agency for the Protection of Market Competition (AZTN) has introduced market rules and regulation to liberalise the market and ensure fair competition for the new entrants in a situation of substantial dominance by one player i.e. Croatian Telecom (HT). Later on the Agency expanded its area of work to include postal activities, and in 2008 it changed its name to the Croatian Post and Electronic Communications Agency (HAKOM). In the period from 2004-2009 many regulatory improvements have been made to ensure competition on the market. The number of operators increased not only in mobile telephony but also in fixed telephony. Access to infrastructure improved for new entrants and the Agency started to take into account the satisfaction of consumers through improving the quality of services, and to speed up the settling of disputes between providers and users.

Since its establishment, HAKOM has worked towards synchronisation of the Croatian regulatory environment with the *acquis communautaire*, and to comply with regulatory requests stemming from the EU accession process. In order to do that, a new Law on Electronic Communications was adopted in 2008 (OG 73/08) which defined more precisely the role of regulator.

As a result of HAKOM's activities, by 2010 the telecommunications market in Croatia was successfully aligned with the EU *acquis communautaire*. The EC has praised Croatia's legislative alignment to EU standards and regulatory practice (EC, 2010).

## *Protection of consumers and other effects of the market regulation and competition*

The improvements in the protection of consumers and the quality of services has been visible since the adoption of the 2008 Law on Electronic Communications and the accompanying bylaws which regulate the behaviour of the service providers and increase the transparency of prices and different tariff packages. Also, regulation increased the transparency of consumers' rights for timely and correct information about the services provided. All of this has led to an increase in the general satisfaction of consumers and a greater consideration of users' experience of services by providers rather than simply focusing on company profits.

In the last decade, several measures which are common in mature market economies were introduced in Croatia for the first time. For instance, a 24 hour customer services' telephone line, an improvement in companies' communication skills with customers, and systemic analyses of consumer's behaviour and their habits, and of customer complaints. Also they increased cooperation with associations for consumer protection and other institutions whose role is to prevent consumers' abuse by the incumbent operator HT.

The total number of complaints has increased slightly in the last two years. Most complaints are about bills (73% in 2009), while the complaints about the quality of services have decreased substantially since 2007, indicating that consumers have benefited from an increased quality of services as a result of the increased competition between providers. Since its establishment HAKOM has invested in capacity building and improving the competence of its staff in settling disputes, . One of the interviewees

stressed that: *“Even now after so much training there is a lack of competent legal experts at the disposal of HAKOM to cope with complex dispute cases among service providers with dozens of very well paid and excellent lawyers on the HT side”*.

### *Impact of regulation on prices of services*

For many decades when the provider was under state ownership, inland calls on fixed telephone lines in Croatia were heavily subsidised so that they could be affordable to lower income groups. On the other hand foreign calls and other services such as internet access were usually overpriced. The liberalisation of prices and opening of competition have brought a more commercial approach to pricing. The regulator has played the balancing role between these two goals in order to ensure that privatisation does not harm the poorest consumers and has consequently provided for a gradual increase in prices.

HAKOM has succeeded in bringing some order into telecom prices, so that they better reflect underlying costs to the benefit of consumers of services while also enabling fair competition for new private entrants to the market so that they may operate on an equal footing. The existence of competition has stimulated price reduction and has thus produced benefits for the all consumers.

Regulation also ensures that relative tariffs are more in balance with the underlying relative costs, and investment decisions are not distorted by loss making services and the need for cross-subsidy. However, the rebalancing of the incumbent operator's retail tariffs is a continuing process in all the countries of the region and progress remains slow. So

far, only Croatia has approached the EU-27 averages regarding the cost-oriented charges for monthly line rentals (€14.7 per month) and 3 minute local call tariffs (13.8 eurocents) (Cullen International, 2009). In the market for local calls, there is still only a small degree of real competition which may reflect traditional under-pricing of local calls by the incumbent operators which then create barriers for alternative operators (Cullen International, 2009).

Although a cost-based approach is closer to the EU regulatory framework, a price cap approach which is easier to use predominates in the SEE region. However, new tariff regulatory methodologies are beginning to appear, replacing price caps. Croatia has a “price squeeze test” designed to ensure that retail prices cover the SMP operator’s own network and commercial costs (Cullen International, 2009).

When benchmarking the prices for various telecom services with the EU-10 NMS, a recent study for HAKOM (A.R.S. Progetti, 2009) concluded that prices for mobile and fixed telephony in Croatia are still high compared to the most EU NMS, although the broadband services among the lowest in the region<sup>16</sup>.

To summarise, the process of privatising incumbent operators in SEE has brought about an uneven convergence towards the liberalised prices which exist on the EU market. Croatia has come closest to the EU liberalised price level, as could be expected since the country is “soon to be” an EU member. In terms of the regulatory convergence of telecom, according to the EC Croatia Progress Report 2010, Croatia has fully completed the transposition of regulatory rules and standard practices.

## **Privatisation of the Oil and Gas Industry: the Case of INA**

Croatia started to privatise the oil and gas industry relatively late as compared to most advanced transition economies in Central and Eastern Europe (CEE) which joined the EU in 2004. For instance, Hungary privatised the first 8% of MOL shares in 1993, thus being the first oil and gas industry in the CEE to be privatised (Buzady, 2010; Antal-Mokos and Toth, 2006). Privatisation in CEE was to a large extent driven by the integration process with the EU. In Croatia, such a motivation was mostly absent since it stayed outside the mainstream integration process for the whole of the 1990s. Later on however, the privatisation of the large public enterprises also became vital for the Croatian reform agenda, particularly after signing the Stabilisation and Association Agreement with the EU in 2001 and especially after becoming a candidate country in 2004.

The possibility of privatising public utilities in Croatia was opened through the Privatisation Law (1996) which replaced the previous Law on Transformation of Socially Owned Enterprises (1991)<sup>17</sup> that had guided privatisation transactions in the early period of transition. The 1996 law mentioned the privatisation of public utilities (oil and gas company, energy production and distribution, rail and road transportation, water and forestry management.) for the first time. This had previously been outside the process, and they had actually been nationalised due to their strategic importance on the basis of governmental decree from 1991 (having previously been under 'social ownership'). The 1996 law acknowledged the need for restructuring and privatising these companies.

As for the energy sector, after a long period of preparations and discussions, the Parliament finally reached agreement on its initial privatisation and in April 2002 passed the Law on Privatisation of INA<sup>18</sup>, the state oil and gas monopoly. The Law allowed the sale of the first 25% plus one share to strategic foreign investor. The Law on Privatisation of HEP<sup>19</sup> (energy production and distribution), proposed its sale through an initial public offering. Both the laws on the privatisation of INA and HEP were prepared with the assistance of Price Waterhouse which was selected through an international public tendering process.

### *The motivations for privatisation of INA oil and gas industry*

For the whole decade of 1990s INA stayed outside the privatisation process as the government of Croatia declared it an enterprise of strategic importance for the economy and therefore kept it 100% owned by state.<sup>20</sup> The privatisation of the oil and gas industry was postponed until 2003 and the adoption of INA Privatisation Act (2002). At the time of privatisation, INA was by far the most valuable public sector company in Croatia and the leading regional petrochemical company. It remained very important for the Croatian economy after privatisation, especially in terms of its contribution to GDP, employment and generating tax revenue. In 2008, with EUR 3.8 billion of total sales revenues INA accounted for 9.5% of Croatia's GDP. The total VAT, excises and other taxes that the INA Group<sup>21</sup> paid in 2009 amounted to 4.6% of total tax revenues.

The company was however traditionally under the heavy influence of politics which influenced the selection of the top management through

political appointments, putting the company under the effective control of the political elite. Although such a position could indeed offer the company a powerful shield, it was not always in the company's best interest, as it was often used as a "cash machine" for government and the ruling party, the HDZ. Such a situation in turn affected the privatisation plans, which as shown above were much delayed, compared to the CEE transition countries.

The motivation for privatisation was somewhat different at the company level and at the level of the government as an owner. At the company level, the motivation was fuelled by the need for an intensive commercial restructuring of the state-owned company; the need to introduce modern corporate governance and improved efficiency, and for new capital investments for the technological modernisation of the company. Strong competitive pressures came from the Austrian OMV and MOL which had started to expand in Croatia, and to acquire stakes in other companies and develop production capacities in SEE and neighbouring CEE countries (in Slovakia, Slovenia, Romania, as well as in Croatia).

In the case of INA it was considered that the entry of a strategic partner into the ownership structure would not only be profitable for the company in the long run, but also for the state budget, both in terms of net proceeds from privatisation as well as earnings via dividends, notwithstanding the overall gain for the national economy if the company were to become more efficient.

At the government level, the main push and momentum for privatisation of INA was however built by the immediate need for increased Budget income as some of the substantial cost items (such as return of debt to

pensioners by the rule of Supreme Court<sup>22</sup>) could not be covered by ordinary Budget income and without increasing proceeds from privatisation. As elsewhere, both in the mature market economies and transition economies, many governments have enthusiastically embraced privatisation of large public utilities, mostly because they bring large revenues without having to increase taxes.

### *The privatisation of INA oil and gas industry: snapshot on stages*

The privatisation of INA was implemented in several stages, starting with the Law on Privatisation of INA in 2002. Under this legislation 25% plus one share<sup>23</sup> was to be sold to a strategic partner with 15% of shares was to be sold by a public auction at the stock exchange, 7% of the stock was assigned for war veterans and members of their families, while an additional 7% was to be sold to present and former employees at discounted prices. The Law on Privatisation of INA together with its Amendments of 2006 envisaged that the government would decrease its ownership stake, retaining only about a 25% plus one share after Croatia joins the European Union. The golden share would enable the government to veto any major strategic change in the company without its consent.<sup>24</sup>

In November 2003, the 25% plus one share was sold to the Hungarian oil company MOL for about \$505 million. After a long bidding and selection process, MOL was considered as the best strategic partner<sup>25</sup> and MOL acquired 2.5 million of INA's shares. In 2005, a further 7% by value of INA shares was transferred to the Croatian war veterans<sup>26</sup> and their family members without compensation.

In July 2005, the Croatian Parliament decided to continue with the privatisation of INA and formed a Commission to take care of it. The third stage of privatisation started in 2006, with an initial public offer of 15% of ordinary INA shares to the Croatian citizens on preferential terms.

The fourth stage was implemented in 2007 and involved the privatisation of a further 7% of INA's shares to the present and former employees at a discount to the nominal price of 1% for each working year. As a result, the Croatian government reduced its share below 50%.

In September 2008, MOL made a takeover offer to acquire additional shares of INA, which resulted in the increase of its ownership share in INA to 47.16%.<sup>27</sup> After five privatisation stages, the government stake was reduced to only 44.84% and it thus became only the second largest shareholder in the company.

MOL took operational control over INA in 2009, including the majority of the management board members, even though it does not own more than 50% of the company. This topic has provoked much political debate in Croatia as it was perceived that government betrayed national interests by transferring INA's management to MOL without the majority of ownership rights. The Parliament even formed a special Parliamentary Commission to investigate the privatisation process of INA, after the arrest of Damir Polančec, ex - Minister of Economy and Vice-President of the Croatian Government. The controversy further escalated after 10 December 2010 when MOL issued yet another offer for the purchase of yet more shares which would lead to its majority ownership. The government considered the latter offer to amount to a hostile takeover bid. It complained that it had not been notified about this strategic move by MOL, and announced

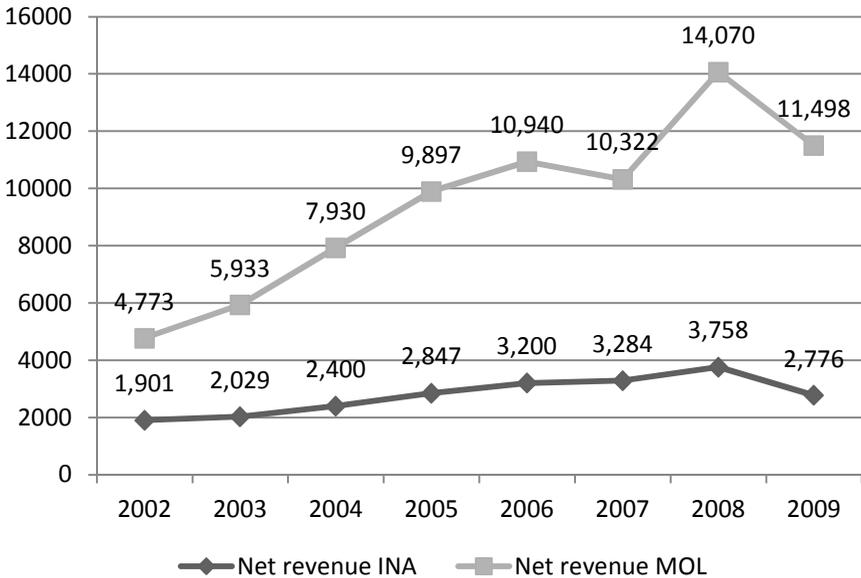
that this situation endangered the mutual strategic partnership of two largest shareholders of INA. At the end of January 2011 it was evident that MOL's strategy had failed as it managed to take over only 0.1% of the shares to reach a total of 47.26%, while the Croatian pension funds bought 4.15%. Furthermore, an investment fund originating in Cyprus acquired for MOL a further 1.6% of shares, following which on 15<sup>th</sup> of March 2011 Croatia's stock market regulator HANFA suspended trade in INA shares in order to identify the investors after the share price reached the all-time high. It is possible that this unknown private shareholding, together with the remaining 2.31% still held by other private investors could be sold to MOL, which could thereby reach the 50% plus one share target for majority ownership. The situation without a majority owner will be likely to continue until Croatia enters the EU, when the government stakes might be up for sale again, unless the government decides to introduce new legislation to prevent this, as it has recently announced.<sup>28</sup>

## **Selected indicators of the post-privatisation business performance**

### *Revenues*

Although new competitors entered the oil derivatives market prior to privatisation, INA continued to exploit its "close to monopoly" position on the even after MOL bought 25% of its shares, and its revenues almost doubled between 2002 and 2008 (see Figure 6). However, the growth of MOL's revenues was even faster than the growth of INA's, enabling MOL to capture some of INA's market share.<sup>29</sup>

**Figure 6. INA - Net Revenues, 2002-2009 (€ mln)**



Source: Annual Financial Reports of INA and MOL, 2002-2009

The reasons for the widening of the revenue gap between INA and the MOL Group were the relatively low prices of domestically produced gas (compared to the European prices) which were heavily regulated by the Croatian Energy Regulatory Agency (CERA) with final approval by the Croatian government concerned with the social consequences of increasing prices. An additional reason was that INA continued to import oil at higher world market prices, while MOL had better access to Russian oil and gas at much lower prices. Furthermore, by expanding its activities across the region and acquiring stakes of other companies with a vision to become a regional leader on the market, the MOL Group exploited its opportunity to increase its revenues and profits.

## *Level of employment and productivity of labour after privatisation*

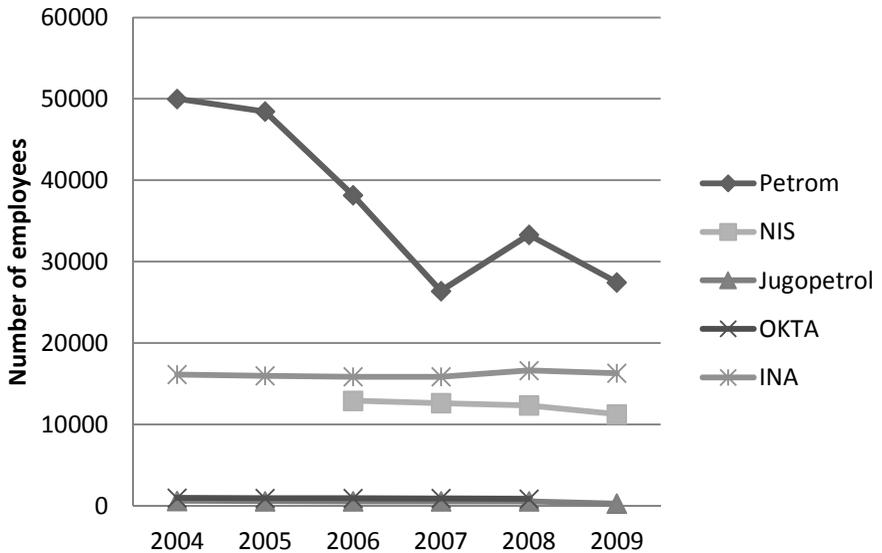
Throughout the post-privatisation period INA has maintained its level of employment at around 16,000. In the autumn of 2010, INA announced a plan to restructure and reduce employment by 9%. This is the first plan for laying off redundant workers since the company was privatised suggesting that privatisation had little influence in that area. However, it should be emphasised this was not a voluntary decision as there was a clause in the Privatisation Agreement with MOL according to which INA would not lay workers off within a five-year period after privatisation.

Nevertheless, even without layoffs significant labour productivity gains were achieved, with net revenues per employee doubling in 2004-2008, from €118,999 to €225,950, dropping only in 2009 to €170,265 per employee due to the effects of the global economic crisis. It is notable that these productivity gains were not achieved by decreasing the number of employees in the company.

Other privatised oil and gas companies in the SEE did not have such an agreement, and they experienced a large reduction in the number of their employees (see Figure 7). For example, after Romanian Petrom was bought by Austrian OMV, the number of employees was nearly halved from an initial 50,010 in 2004 to just 27,470 in 2009.

Similarly, the OMV Group dramatically reduced the number of employees following privatisation by 30% from 2005 to 2009, as a cost reduction measure to remain competitive. Consequently, INA's labour productivity remained significantly below its competitor, OMV.

**Figure 7. Decrease in number of employed persons, 2004-2009**



Source: Companies' Annual Reports, 2004-2009

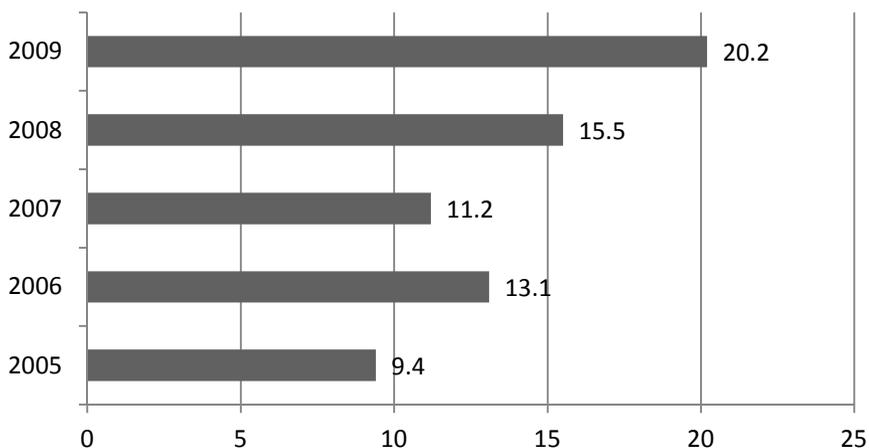
### *Capital investments*

One of the important motivations for privatisation and bringing in a strategic foreign investor was the need for advancing capital investments in both exploiting and refining of oil and gas in order to keep up with the competition on the market. Therefore, the scope of long-term investments is also an important indicator of expanded business performance in the post-privatisation period.

The financial reports indicate that contrary to widespread public perceptions INA has carried out significant investment in the oil and gas exploitation and production facilities at home and abroad.- In Croatia INA

invested especially in gas production and in exploration projects in the North Adriatic together with Italian partners. INA also made significant investments in the modernisation of two refineries in Rijeka and Sisak, especially in 2008-2009, doubling its investment in long term assets from 11% of net sales in 2007 to 20.2% in 2009 (See Figure 8). The privatisation agreement of 2003 actually obliged MOL to invest \$1.5 billion in R&D and in the modernisation of Rijeka and Sisak refineries within five years.

**Figure 8. Total investments in the long-term assets (% of net sales), 2005-2009**



*Source:* INA Annual reports 2005-2009

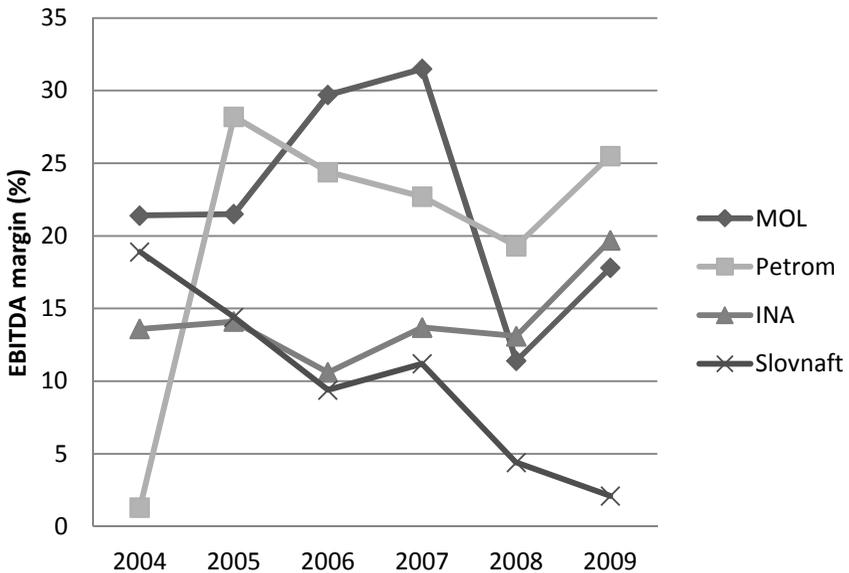
A different view was presented by some of the interviewees for this study who considered the level of investments in INA following privatisation was inadequate to ensure needed technological modernisation, in particularly in refinery Sisak. According to the interviewees, especially the academic and other experts, the reasons for the low capital investment rate in the

first years after privatisation could be found in the adoption of a “wait and see” attitude by both major shareholders until a majority ownership of MOL is achieved. An additional reason was the lack of sufficient profits for reinvestment, as the price policy of the government was led by the “social” prices of gas, which caused INA to suffer losses on this segment of the market. Also, between 2008 and 2010 the global financial crisis also led to a more cautious approach towards investment in long-term assets. Since the intensive capital investments were mostly financed by loans rather than by reinvested funds due to the slow growth of net revenues and the stagnating value of equity, the investment which was carried out led to a worsening of the a net financial position of INA and caused the steep surge in the debt/equity ratio. Besides the increased investment activities, another reason for this outcome has been a substantial fall of profits due to the effect of the controlled prices of natural gas and fuels. However, political economy factors provide a more reasonable explanation for the increase of INA's debt. Some of the in-depth interviews that we carried out with members of the supervisory and executive boards as well as with some independent analysts shed some more light on the possible reasons for that. The rate of capital investments almost doubled when MOL became the largest shareholder in 2008. This situation opened the doors for MOL to gain majority ownership. Consequently, investing in improving production capacities was a sensible business decision, and contrasted with the lack of investment when the majority ownership was in hands of Croatian government. It should be noted that OMV and MOL also experienced a surge in their debt to equity ratio in 2009, which was an especially hard year for INA.

## Earnings, profit rates and investment

The delayed restructuring and the large investment in production facilities, together with the subdued prices of natural gas which were controlled by the state, resulted in a worsening of the efficiency indicators especially in 2008-2009. In 2008, INA's ratio of earnings to net sales fell to just 7%, followed by a significant recovery in 2009. The company went into the red with an operating loss in 2008, recovering only slightly in 2009 and more significantly in 2010 when it managed to return to profitability<sup>30</sup>. INA's main competitors also recorded a significant worsening of earnings, although the figures remained relatively high (see Figure 9).

**Figure 9. EBITDA of INA compared with selected oil companies in EU NMS – MOL (Hungary), Petrom (Romania), Slovnaft (Slovak Republic)**



Source: Annual Reports of Mol, INA, Petrom, Slovnaft, 2004-2009

The views on responsibilities for such a situation vary and couple of the independent experts interviewed have stressed that:

*"INA has entered into a difficult downtrend in business performance precisely due to the profound impact of the state administration and politics on its top management. By insisting on low gas prices the losses for the company were unavoidable. It is unfair to expect a commercial company to implement the social policies that should be the responsibility of the state and solved by state bodies and instruments".*

Another interviewee, a former management board member argued that:

*"There is a misconception among the wider Croatian public that the responsibility for bad performance lies on the shoulders of INA's strategic partner MOL. On the contrary, the responsibility lies in the Management and Supervisory Board members selected by the government mainly through political appointments, who did not invest enough in the future of the company and followed a "wait and see" logic which considered that it would be unwise to reinvest into a company with an uncertain majority ownership".*

### *Increased competition on the retail market: the impact on shares and prices*

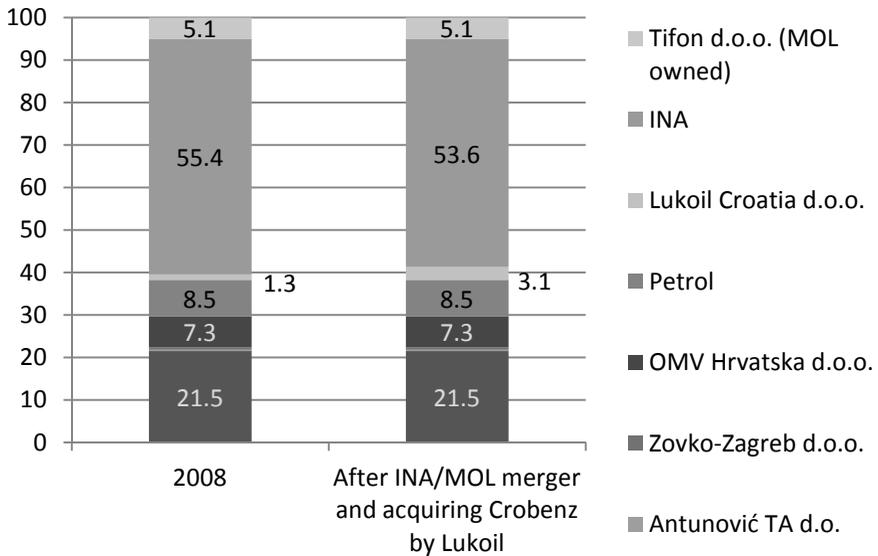
While the other segments of the business benefited from the involvement of MOL as a strategic partner, INA's retail services stagnated after privatisation. The management board also now acknowledges that the retail sector has been neglected and emphasises that more efforts will be put into developing this area in the future.<sup>31</sup>

Several interviewees singled out this area as the one where INA lost its competitive advantage on the domestic market over the last four to five years. The reasons mentioned include a low investment in the retail network, a loss of strategic locations of the filling stations as traffic shifted towards newly built highways where INA failed to invest enough in opening new petrol stations.

INA has been facing increased competition on the retail market in Croatia, especially in the retail of oil derivatives, losing its former exclusive position in oil refining, wholesale and retail. Although no new refineries have been built in Croatia, the opening to imports and the activities of competitors in building new filling stations led to an increased competition in the retail sector. While MOL has been rather successful in increasing its position throughout the SEE region, measured by the number of filling stations, INA has failed to increase its filling stations in Croatia and abroad beyond about 500.

After the privatisation of INA it was expected that MOL's market share of the petrol and gas-oil retail market, should have increased in Croatia from 55% to 65%, with a higher margin for highways stations. The Agency for the Protection of Market Competition did not allow that development and imposed the sale of Crobenz, an INA subsidiary with 14 petrol stations countrywide, while MOL was allowed to retain its subsidiary Tifon, with 40 petrol stations. In May 2010 the Agency finally approved the sale of Crobenz to the Russian company Lukoil. The market share of market leader INA has increased from 55.4% to 58.7% (INA and Tifon combined), while the share of Lukoil increased from 1.3% to 3.1% by acquiring Crobenz from INA (See Figure 10).

**Figure 10. Retail market shares (%) by number of petrol stations**



Source: MOL/INA decision, class: UP/I 030-02/2009-02/05 of June 9 2009, *Official Gazette* 113/2009

### *Corporate governance effects*

The performance of INA also mirrors the effects of privatisation on corporate governance and on the management structure of the company. Both quantitative and qualitative data collected for this study indicate that so called “strategic partnership” between the government and MOL had ambiguous impact on corporate governance of INA. The agreement to sell an initial tranche of INA (25% plus one share) to MOL also determined MOL’s participation in the management and supervisory boards, as INA had a two tier corporate management structure. However, MOL’s participation in company management through two leading positions on

the Board of Directors (finance and corporate services) was not proportional to its ownership stake in INA at the time. According to widespread public and media perceptions, the initial agreement was poorly designed and resulted in a weakening of the government's influence on the operational performance of INA and its business development.

However, one interviewee had quite a different opinion and argued that:

*“One could speak about the profound impact of the state on the management of INA for the whole period until MOL actually became the largest shareholder when it actually took the leading role in the management board. Since the privatisation of the first instalment of 25% plus one share the government continued to manage INA as it actually remained a public enterprise.”*

In October 2008, a new contract on the mutual relationship between shareholders was signed, with an Annex to the Contract being signed in January 2009, through which MOL gained the right to appoint five out of nine of the Supervisory Board members, while the Croatian government appointed only the Chairman of the Supervisory Board, and employees appoint one member. By becoming the largest shareholder, MOL also has the right to appoint the President of the Management Board and half of the six Management Board members. In the case of a balanced number of votes on the Management Board, the casting vote is that of the President of the Management Board appointed by MOL. Thus, under the strategic partnership contract of January 2009, MOL obtained a dominant influence on the business operations of INA. This change made it easier to manage the company on a daily basis as reflected in the improved performance

indicators for 2009 and 2010. However, the major source of controversy is that the new contract has granted MOL management control over INA which does not stem from his ownership rights. Since there is a suspicion that such a deal was made “behind the scene”, this will continue to burden strategic partnership between two major shareholders and perhaps even lead to some revisions of the partnership contract.

In analysing the stages through which MOL becoming a leading regional multinational company Buzady (2010) and Antal-Mokos and Toth (2006) stressed that MOL’s corporate governance strategy in the acquired companies in the region was to build up synergy and common interests stressing mutual benefits of partnership and eliminating “*we – they*” attitudes. However, this strategy was not an easy one in INA due to absence of a clear ownership majority, and the decision-making process was difficult due to the conflicting objectives of the two major shareholders. For instance, it was not possible to achieve greater cost-efficiency and improved retail competitiveness because the government would not permit a reduction in the level of employment in the company. Also, further liberalisation of the price of gas was introduced only gradually as social objectives outweighed the goals of improving business performance. However, having two major shareholders without a clear ownership majority continued to pose difficulties for the decision making process. The “*we and they*” divisions in the management and supervisory boards still exist in practice as demonstrated by the recent developments in December 2010 when MOL made another takeover offer to the small shareholders of INA.

## Regulation, competition and market performance

In Croatia the regulation of energy activities is implemented by the Croatian Energy Regulatory Agency (CERA) which was founded in 2004 as an autonomous, independent and non-profit public institution based on the Act on the Regulation of Energy Activities<sup>32</sup>. CERA is responsible for its work to the Croatian Parliament. Nevertheless, CERA is not fully independent in its decisions. While the EU regulatory independence principle of separation of the national regulatory authority from the regulated firms is fully respected the principle of isolation of the regulator from political intervention is not yet fully met at the time of writing, although the regulatory framework is in preparation.

The market of oil products is controlled by the regulator according to a defined reference price (Mediterranean CIF – Genoa) and by limiting trading margins and additional costs<sup>33</sup>, the gas sector is more strongly influenced by the government interests and its social considerations. Any increase of gas prices should be approved not only by CERA but also by the Ministry of Economy, indicating that there is not a complete separation of powers between the regulator and the government bodies in Croatia. This has led to controlled prices of gas for households and industry. This policy has harmed the business performance of INA, as mentioned above. While being beneficial for the lowest income population, it also benefited higher income households as the prices were not sensitive to incomes.

As stated by one interviewee: *“It does not seem logical that the state should subsidise the price of gas for higher income people. Even less logical is to provide preferential prices for some industrial enterprises which are very profitable and completely privately owned. Even more, what logic*

*could the government have to provide subsidised gas prices to private shopping malls or retail chains?"*

Changes in legislation enabled the liberalisation of prices in 2010 for industrial and other customers, except for households which still enjoy subsidised prices of natural gas.

The liberalisation of prices of gas is an important task for government prior to joining the European Union. So far, a gradual approach has been applied in order to avoid steep increase of prices which as a consequence would have a negative cascading impact on competitiveness of the industry, as well as on individual well-being, especially the poor. In the course of 2010 the government prepared the legislative framework for strengthening the electricity and gas market by application of the Third Energy Package of EU energy legislation<sup>34</sup>. On the basis of this package, CERA would become more independent from government in regulatory decision making and in regulating the formation of prices and tariffs of gas and oil derivatives for which no final approval by the government would be necessary. All the required laws are expected to be adopted in 2011 which would enable the implementation of the Third Energy Package.<sup>35</sup>

The regulation in the energy sector is complemented by the work of the Croatian Competition Agency (CCA) which monitors the implementation of the principles of the Competition Act (Official Gazette, no.79/09) and provides assessments of market concentration in the oil derivatives market. The CCA also controls the activities of the company with a dominant market position (INA) and identifies relevant markets of products<sup>36</sup>.

## **Conclusions and implications for policy**

Studies carried out over the last twenty years have shown mixed results and little consensus about the efficiency gains and social costs of privatising public utilities, and debate about it continues. It is difficult to isolate the effects of the change of ownership on business performance from other important factors such as the impact of regulation and competition (Bognetti and Obermann, 2009; Newberry, 2001). However, some utilities that are more "commercial" and "globalised" than others and which are extensively driven by advances in technology such as telecommunications and the oil and gas industry provide convincing evidence that business performance improves after privatisation (Broadmann et al, 2004; Kessides, 2004; OECD, 2009; Megginson 2005; Nestor, 2005).

Croatia has many similarities with the new member states of the EU in the regulatory framework guiding the privatisation and restructuring of companies in the telecommunications and oil and gas industries. Although the regulatory framework, institutional arrangements and timing have been country-specific, Croatia has followed a similar set of reforms converging to the experience of other EU and OECD countries (Sahlin-Andersson, 2004; OECD 2004; Kessides, 2004). Regardless the fact that regulatory harmonisation and the convergence of standards of business conduct is an important element of the EU integration process, there was a considerable amount of economic reform resistance in Croatia especially in the 1990s, but also by later HDZ governments in the 2000s causing significant lagging behind the NMS (Bartlett, 2008).

The first common feature of the privatisation of the telecommunications and the oil and gas industries in Croatia, the SEE and the EU NMS is that the process has been performed in a gradual and incremental way, i.e. by selling state assets in several tranches or stages. That may be prudent in terms of allowing sufficient time for establishing a complex regulatory framework to guide competition and price formation. Moreover, partial privatisation has enabled the government to benefit from efficiency gains without giving up control over the public utilities altogether (OECD, 2009). The other reason for privatising in stages is related to the political economy of the process. This highlights that the opponents of privatisation who resist the idea of selling strategic public enterprises tend to more readily accept the piecemeal sale of the “family silver” and keeping it under state control for as long as possible. Also, by selling a portion of shares to individuals at discounted prices in subsequent stages, the government expanded the “constituency in favour” of privatisation as widely as possible.

The other similarity of the telecom and oil and gas privatisations in Croatia with the EU has been the presence of a multi-national company (MNC) as a foreign investor. In this way the privatised companies were exposed to international business experience which assisted them in advancing technologically and in comparing their business performance internationally (Buzady, 2010; Bognetti and Obermann, 2008). Involving an MNC resulted in an easier integration into the international market for services and into technology supply chains, as well as enabling access to services and products at lower prices and to further investment in infrastructure to the benefit of the company, the state and the consumers.

The role of effective regulation has been crucial for spreading the welfare benefits of the privatisation of public utilities in Croatia and introducing competition into the sector. Although, the cost-benefit balance sheet seems uneven and differs between different categories of beneficiaries (consumers, employees, state, private owners, shareholders and stakeholders), the study has shown that corporate efficiency, management and accounting practices as well as the transparency of business have been substantially improved in both the telecommunications industry as well as in the oil and gas industry. This has been most significant in the telecommunication sector, as network industries are more exposed to global competition which forces them towards continuous and sometimes drastic cost-reductions (Maghisan and Maghisan, 2008). The example of Croatian Telecom as well as several other national telecom operators in SEE fits into this trend. The adoption of efficient management mechanisms, enforcement of corporate governance codes and rules is a key for the efficiency of privatised telecommunications and oil and gas industry in the region. This is especially the case where the foreign investor gained majority ownership, bringing accumulated expertise and international management practice and skills into the company.

Both telecommunications and the oil and gas industry are highly influenced by politics due to their strategic importance, the large number of people employed and the huge impact on the input costs of other economic sectors. The post-privatisation performance of Croatian Telecom, which has a majority foreign owner, has seen the effective removal of political influence on their top management. In contrast, INA, which retained a large state holding after privatisation did not manage to

make a clear break from pressures exerted by the political elite such as having members of political nomenclature in the supervisory and management boards, and the direct impact on formation of prices through various modes of final government approval. It is a good example of a company that was traditionally under strong political influence with management and supervisory boards being political appointees. In addition, company assets were used as a “cash machine” by different political interests that were labelled as “strategic national” interests. After MOL gained an operational majority of the management board in 2009, the direct impact of politics on the everyday business operation of company decreased. However, the indirect presence and control of the state over the business performance of sector continues through the process of price formation and the regulation of competition.

The financial performance indicators reveal significant improvements in the privatised Croatian utilities, but more in telecoms than in oil and gas industry, in terms of (i) better quality, diversity and coverage of services, (ii) improved efficiency of business performance, (iii) better corporate governance and cost-efficiency management, (iv) improved capital investments, (v) increased productivity of labour and capital, and (vi) protection of customers from market abuse. Some of these improvements have been backed up by insights from the interviews with key informants. These findings correspond to similar experiences of privatised public utilities around the world (OECD, 2009; Kessides, 2004; Megginsson, 2005) and in the EU’s new member states such as Hungary, Slovakia or Romania (Kalotay, 2010; Buzady, 2010).

When contextualising the performance of Croatian Telecom and INA in terms of wider welfare implications we have focused on employment

levels and consumers' welfare. The efficiency gains in both privatised utilities as measured by labour productivity have been significant. However, the efficiency gains in HT were achieved mainly through labour shedding, with the dismissal of over 45% of employees following privatisation. Similar measures were taken in Hungarian Telekom (MATAV), Czesky Telekom, and Romtelecom. This represents a significant social cost of privatising the national telecom operator, despite the fact that it was over-staffed in the pre-privatisation period. A similar situation could be found across the EU new members states which also improved labour productivity by reducing the number of employees. As for the INA oil and gas industry, compared to the region, cost-savings have not been achieved at the expense of the employees, and thus the social costs of privatisation were not as profound as elsewhere in the region especially in Romania and Bulgaria.

The consumer benefits of increased competition in telecommunications in Croatia have mainly been achieved through lower prices of fixed and mobile telephony and internet access, through the diversification of services in terms of various tariff packages, as well as through an improved quality of services. In the oil and gas industry however, privatisation led to a liberalisation of prices and to a general increase of oil derivatives prices and other products as these were previously under-priced. However, due to strict regulation and generous subsidies from state, the increase of gas prices both for private consumers and industry was slow and limited and did not impose a major shock to consumers.

The protection of consumers improved in both the privatised telecommunications and oil and gas industry in comparison to EU standards (Cullen International, 2009). This was primarily due to the

regulation of prices based on a standard cost calculation which prevented the dominant company from abusing its position on the market. The protection of consumers also increased due to the active involvement of the telecommunications regulators (i.e. national regulatory authorities) in tackling and solving the complaints of consumers and competitors. Croatia has now fully converged and transposed its legislation, standards and regulatory rules and practices to the *acquis communautaire*. As for the oil and gas industry, the adoption of the third package of the EU energy directives, which will further liberalise the prices in this sector, is to be implemented in 2011. This will significantly reduce the direct involvement of government in approving tariffs and prices which will be left entirely to the energy sector regulator CERA.

The findings of this study suggest that political economy factors have had a significant impact on the economic and welfare gains and pains from privatization of the public utilities in Croatia for the different beneficiaries. The two privatized Croatian utility companies illustrate the basic dilemma whether the provision of public goods and services within regulated markets should be left to dominant private companies motivated by business interests or whether the state as owner is a better protector of the “public interest” even though it is often difficult to separate its benevolent features from a tendency towards direct political interference and the appetites of the ruling elites. The influence of politics has been more profound in the case of partly privatized INA, whose ownership jigsaw is still very much a work in progress, than in the case of HT which was truly privatized with a majority foreign owner, and from which the state completely exited the ownership structure. INA is virtually torn between the opposing interests of the two largest shareholders (MOL and

government) with different agendas and whose performance swings between satisfying-often conflicting-commercial efficiency and political interests. The situation might change after the accession of Croatia to the EU in 2013, when the government stakes might be for sale once again and be reduced to just a single “golden share”. The other option of altering the privatization legislation so as to block the foreign investor from obtaining majority ownership would bring more pain than gain, as it would undermine the legitimacy of the legislative framework for investments in Croatia. For the benefit of business performance of the company, employees, and consumers, it would be wiser to solve conflicting interests over the operating control of the company through agreement rather than by open conflict between the two “strategic partners”. But it remains to be seen if politics will swing the pendulum in another direction.

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## Notes

1. Many studies have rehearsed the arguments for and against privatisation of public utilities including Nestor (2005), Nellis (2002), Galal et al. (1994), Hall (1997), Wallsten (2002), Wood (2004), Newberry (2001), Megginson (2005), Kessides (2004) and Bognetti and Obermann (2009).
2. The value of privatisation transactions in 2000-2007 in the public utilities and network industries in OECD countries are estimated at close to US\$ 487 billion, scaling down only during the financial and economic crisis. The largest share relate to countries such as France, Italy and Germany with a traditional dominance of state ownership in the public sectors.
3. Overviews of experiences of privatisation over the last 15 years have been provided by World Bank (2004), EBRD (2004), OECD (2009), Megginson (2005), Megginson and Netter (2001), Djankov and Pohl (1998), and Wallsten (2002).
4. In practice, the separation of the ownership and regulatory functions is far from perfect and often the interests of competitors, consumers and minority shareholders in the partly privatized entity may be endangered, especially in the early stages of privatisation (OECD, 2009). The solution is to set up an independent regulator to ensure that the regulatory functions do not lean towards ownership interests of the state.

5. Preserving employment levels in large state owned companies is a politically sensitive issue and has been an important non-economic objective for the state as an owner.
6. For comparison, most of the advanced transition economies in Central Europe had started to privatise their large public companies in the first half of 1990s.
7. The formal announcement was posted at the Zagreb Stock Exchange on 2 December 2010
8. Pursuant to the Act on the Privatisation of Croatian Telecom (Official Gazette 65/1999)
9. In accordance to modifications of the Croatian Telecom Privatisation Act adopted in 2001 (Official Gazette No. 68/01.
10. This IPO took place on the London and Zagreb Stock Exchange
11. The equity value was around €115 million.
12. The immediate motivation for the transfer of shares was the government's liability for the second instalment of debt to be paid to the pensioners.
13. Deutsche Telekom is also a dominant owner of telecommunications in Hungary, Slovakia, Montenegro, Macedonia, and Slovenia. This choice of strategic investor enabled Hrvatski Telekom to integrate into both the EU and regional SEE market at lower prices.

14. Telephone number portability while switching to another operator is a considered to be a key issue in the development of network competition by regulators throughout the world including the EU.

15. The earnings ratio is calculated as the ratio of EBITDA/revenues where EBITDA is Earnings before Interest, Taxes, Depreciation and Amortization and EBIT is Earnings before Interest and Tax. These are commonly used indicators of the operating profit and cash flow of a company.

16. A similar position is found in a recent analysis of the World Economic Forum, published in the Global Information Technology Report 2010/2011 which is based on data collected by the International Telecommunications Union (ITU). In this report, Croatia ranked relatively poorly in the level of prices for telecom service prices and was only ranked favourably for broadband Internet monthly charges (33rd out of 134 countries).

17. Zakon o pretvorbi drustvenih poduzeca, *Official Gazette*, 19/91, April 1991.

18. Zakon o privatizaciji INA – industrijanafted.d. *Official Gazette*, No. 32, 2002.

19. Zakon o privatizaciji Hrvatske elektroprivreded.d. (HEP), *Official Gazette*, No. 32, 2002

20. INA became a joint stock company in full state ownership in 1993

21. Calculated by the authors on the basis of data from INA Annual Report 2009

22. This debt was accumulated during the 1991-1995 war in Croatia as the government reduced the paid out pensions in order to finance the defence of the country. Later on after the rule of the Supreme Court in 1998 the debt was fully acknowledged and it was agreed that this should be returned to the pensioners in several tranches.

23. The reason behind this formula (stipulated by clause 4 of The Law on Privatisation of INA, 2002) is a wish to attract the foreign investor and enable its guaranteed direct impact on management of the company.

24. The veto concept in the Law on Privatisation of INA has followed similar solutions of retaining government interests in privatised oil and gas industry including the Privatisation Act of MOL in 1993. See Antal-Mokos and Toth (2006)

25. MOL outbid the Austrian OMV and ten other competitors including Russian bidders, thus confirming its plans for regional expansion and becoming a leading regional player in the petrochemical industry

26. The ownership entitlements were individual but later on Veteran Fund was formed in order to better represent and take care of their ownership interests.

27. MOL has invested in total \$1,167 million in INA, according to Sass et al. (2010)

28. This option was announced recently in an attempt by the government to block MOL from acquiring the majority ownership of INA. If carried out it would undermine the legitimacy of the legislative framework for investments in Croatia and would most likely bring more harm than benefits in the long run.

29. In 2002 the net revenue of MOL was 2.5 times larger than INA, and the ratio grew to 3.75 times by 2009.

30. According to unaudited and consolidated 2010 Financial Report INA reported a net profit of US\$283 million

31. As stated in "INA in 2009", by Bojan Milkovic, CEO of INA in a statement issued in 2010.

32. See the Official Gazette, 177/04 and 76/07.

33. Namely, a difference between the buying and selling prices.

34. 2010 Pre-Accession Economic Programme, Government of Republic of Croatia, January 2011.

35. The Third energy package was adopted by the European Parliament and the Council on 13 July 2009. It stipulates further liberalisation of the gas and electricity market, and strives to establish common rules for the internal market in electricity; common conditions for access to the network for cross-border exchanges in electricity; establishing an Agency for the Cooperation of Energy Regulators; common rules for the internal

market in natural gas and regulated conditions for access to the natural gas transmission networks. The key features of this legislative package will take legal effect between 2011 and 2013, as the member states have 18 months for transposition of this legislative package into their national legislation.

36. “Relevant markets” is a regulatory term which identifies and combines the most relevant product/service markets and geographic markets that are serving as orientation for prices for oil and gas products in Croatia.

See European Commission,

[http://eur-ex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209\(01\):EN:NOT](http://eur-ex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:NOT).