DIVESTMENTS AND JOINT VENTURES IN POWER SECTOR RESTRUCTURING THE CASE OF ENERGOREMONTS

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POWER SECTOR RESTRUCTURING AND PRIVATISATION
THE DIVESTMENT AND JOINT VENTURE OPTION

CASE STUDY: THE EXPERIENCE OF ABB-ENERGOREMONTS [1]

1 Introduction: the Pros and Cons of Divestments

Divestment has become a major management fad in market economies worldwide since the mid-1980s. In the restructuring of the public sector, it is used as a means to privatise part of the activities. In private firms, the main reason for divestment is to gain *productivity advantages from functional specialisation*:

* The firm which divests is assumed to become more efficient because management can focus its time and effort on the *core* activities of the firm, that is, the activities where the firm has its comparative advantages.

* The activity which is divested is assumed to become more efficient for the same reasons - the benefits of trimness (focus, responsiveness, low overheads) and of scale (because it can offer its services to outsiders after divestment it can increase its size of operation within its speciality of operation).

Another reason is *flexibility*. It is for example easier and cheaper to absorp fluctuations in a company's demand for special services by relying on outside firms to supply extra workers to handle "larger emergency repairs" instead of taking on extra maintenance workers on the payroll who are underemployed during "routine maintenance periods".

However, *divestment has also potential costs:*

* When an activity is outsourced, there are *transaction costs* in the form of contracting for the service, in losing 100% control of destiny in terms of the timing and the quality of the service provision (although non-performance of suppliers can be sanctioned through contract provisions for payments and by seeking alternative suppliers)

* When the provider of the service is in a *monopoly position*, the ability of the contracter to grasp advantage in the form of lower prices from potential performance improvements may be jeopardised (to rebuild in-house expertise may take time)

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[1] The author of the paper was project manager of the PHARE financed "Latvia Energy Sector Restructuring Project" during its lifetime from October 1992 to August 1993. The team worked closely with the top management of the energy utilities to develop appropriate strategies for restucturing. The divestment of Energoremonts was one of the conclusions of the work. The evaluation of the experience is the result of a PHARE financed visit to Latvia in September 1994 to review what general conclusions could be drawn from it.

* When divestment becomes so prevalent that the *core* activities of the firm are touched, there may be a loss of strategic know-how leading to a reduction in the quality of the work and the long-run potential for development.

2 Use of Divestment in the Restructuring of Eastern European Power Companies

In the Eastern European economies, divestment is used in the restructuring of the "natural monopolies" to further the general policy aim of demonopolisation, decartelisation and privatisation. A distinction is made between *activities which are natural monopolies*, such as electricity networks, and *sectors which should be competitive*, such as equipment supply. As a first step in the identification of divestment options it is useful to classify the activities in the industry as:

X **core** - activities that lie directly within the value chain for the industry. This includes generating plants, transmission grids and distribution networks.

X **related** - activities which are major stakeholders in the industry and contribute significantly to the infrastructure but are an input to the value chain rather than being a part of the value chain. This may include maintenance workshops, spares supplies, equipment manufacturers, fuel suppliers.

X **ancillary activities** - activities which have a minor impact or are totally unrelated to the core functions of generation, transmission and distribution. These will include holiday camps, blocks of flats, schools, transport operations.

Making the supply of *ancillary/related equipment or services* competitive allows for greater flexibility for both the supplier and the entity supplied. The equipment manufacturing arm, for example, has a much greater incentive to make the most efficient use of its productive resources by serving other customers as well and by quoting prices to the original parent company that reflect the actual costs. The parent company, on the other hand, has the ability to source from the most efficient provider and is not tied to using its own facilities [2].

The divestment of *ancillary activities* is relatively easy and can provide important advantages to the regulatory authorities and for the divesting firm. The *non core ancillary activities* often employ many people but with low levels of asset utilisation.

Divesting *related activities is* more complex. An example is asset maintenance. Traditionally,

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[2] Fears are sometimes expressed that loss of ownership of these facilities will make it impossible to maintain reliable essential supplies. In a competitive market these fears would be groundless, but in the immediate future in most Eastern European countries there are two real fears that may need to be addressed. The first is that, in the very short term, alternative suppliers for the particular needs of the power company may not be available. The second is that the power company may not be able to afford to pay the market price for the services of the divested activity because the company is not allowed to earn sufficient revenue from the sale of electricity. In order to address these short term concerns, one may require the suppliers, as separate joint stock companies, to contract to reserve a sufficient proportion of their capacity to meet sector needs, for a given period of (say) one year, at an agreed price with a guarantee to purchase. This is referred to as "maintaining the profile" of the supplying companies.

the carrying out of related activities has been seen as the only way to exercise control over supply. Even in the most advanced electricity enterprises in the world, the most cost effective approach to maintenance and asset management is a complex problem involving precise planning of operations and maintenance work and the coordination of a range of suppliers of labour, materials, plant and equipment. The effective control of maintenance activity will be a major issue to be addressed when considering activities to be separated and/or divested.

3 *Key success factors* which **determine the outcome of a divestment:**

The potential benefits from *partial privatisation* are highly correlated with the degree of competition that is introduced. The market structure for the concerned activity (the degree of potential competition) will be a major determinant for the advantages to be gained by the divesting firm and, ultimately, the energy users. Therefore, first of all, a *study of the market structure should be undertaken* covering the following issues as a minimum:

- Whether the *divesting firm can find other suppliers* on the market in the short to medium term, or whether it will face a monopolistic supplier of services in the form of the divested enterprise

- Whether the *divested enterprise will be able to find other clients* for its services in the short to medium term (and thus be able to expand its activities) or whether it will face a monopolistic purchaser in the form of the parent firm.

If the answer to both questions is yes, we find the ideal situation from the point of view of the Government's objectives of privatisation - competition will put downward pressure on prices and costs, and the national service infrastructure is improved [3]. If it is no to one or both, we have to verify what kind of regulatory action can be taken to compensate for the defect. Either in the form of long term contracts or in the form of monitoring by the antimonopoly agency.

Secondly, the attitudes of the actors to a privatisation proposal have to be clarified in a "stakeholder analysis" to identify the positive and negative reactions and to identify ways of reconciling differences of interests to the extent possible:

- Outsourcing of an activity is only of interest to the management of the affected firm if this leads to cost reductions and/or improvements in the quality of service.

- The workforce will be interested in the impact of privatisation on job security and on the level of wages.

- The managers of the privatised activity (provided they continue in their job) are only interested in turning private if it provides increased wages and salaries and a higher

[3] If further internal restructuring is necessary before the divested company has a potentially profitable future in a competitive environment its state enterprise status can be maintained while a hard budget constraint is imposed. Depending on the success of restructuring and the firm's commercial performance it can in the future be either liquidated or privatised.

degree of job satisfaction. Since this will be correlated to the income level of the firm, they, as well as the new owners will attempt to maximise prices as long as this increases overall income and profitability.

Thirdly, in order to realise the theoretical economic benefits from privatisation in practice, the management structure at both the divested firm and at the divesting firm has to be adjusted [4]. In the divesting company new management and operational procedures should be introduced to make maximum use of the new commercial opportunities. Staff in the divesting firm should be given training in financial and commercial thinking - corporate purchasing departments are low-grade, low-status outfits, accustomed to buying parts rather than managing contracts. Contracting has to be made more professional, and the contractors (in particular the divested firm) must be forced to re-invent jobs, not just to find cheaper ways of doing the same.

4 Joint-Ventures with a Foreign Partner

In capital starved Eastern European power sectors the joint-venture option is often considered by management and by the national authorities as a means to accelerate the modernization process. A foreign joint-venture partner, preferably a "strategic investor" is looked for to provide finance for investments and to introduce new management know-how to the firm which is about to be divested.

Typically, a *successful joint-venture* passes through three stages in its early life time (the first two to three years):

- A first short honeymoon phase of exaggerated expectations.
- Next, a phase of deception and disillusionment when exaggerated expectations are confronted with the reality of daily business life.
- Finally, a phase of realism when the foreign and domestic partner have both learned their own limitations, each other's strengths and weaknesses and the constraints that are posed by the market place.

There are several reasons for this life cycle. One is the general one of *"cultural clashes"* when a firm is taken over by another company; getting a foreign firm as a partner can accentuate this clash. But two more important factors play a role:

- The "speed up of the transformation process" is the primary motive for the joint-venture engagement. But transformation with and without a foreign partner takes time. *The very same financial and market constraints which make it attractive to look for a foreign investor also act as constraints for his*

[4] Ideally, the changes to be introduced in the divested firm should be clarified in a strategic planning process covering: (1) the strategic goals for the enterprise on the basis of a classic SWOT (strengths, weaknesses, opportunities, threats) analysis; (2) The optimal market, competitive and organizational foundation of the firm; and (3) strategic action plans for the implementation of the new structure

freedom of action. Investments are a function of profitability and if the latter is too weak, the level of investment will be low and the modernization process take a longer time than expected.

- The "Eastern" management is not psychologically sufficiently aware of that *the distinction between obtaining cash for investments and obtaining new management know-how is somewhat artificial*. A transformation process involves investments in "physical assets" as well as in "software assets", such as management, training of staff, etc. It comes as a surprise to the Eastern managers how expensive the latter is - both payment for management assistance as well as payment for software [5]. It seems particularly expensive because wages and salaries are artificially low in Eastern due to the price distortions that still prevail.

Since the "merger & acquisition adjustment process" is superimposed on the "divestment adjustment process" one must expect that the result after one year of operation of a successfull "divestment cum joint-venture" project will be judged as 40% positive and 60% negative by the involved national parties; after two years of operation as 50/50% positive/negative; and after three years 60%/40% (or more) positive/negative.

5 The Divestment of "Energoremonts"

The Latvian power company "Latvenergo"'s experience with the divestment of its repair division "Energoremonts" illustrates the above points. In the beginning of 1993, Latvenergo (then a state enterprise) owned and operated 520 MW of thermal power plants and 1085 MW of hydropower plants, transmission lines, distribution lines, 278 kms of district heating network, district boiler houses, energy repair and service companies [6]. Latvenergo was organized into 15 divisions supervised by a large headquarter [7]:

- one power transmission company
- four power production companies (two thermal, two hydropower)
- seven regional distribution companies
- one district heating company
- one consumer installations and billing services enterprise "Energokontrole"

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[5] The rule of thump that necessary software costs twice as much as the hardware you have bought was "painfully" learned by Western firms in the mid-1980s.

[6] Until 1990 the Latvian power supply system was part of the USSR North West Power System Nearly all the power plants, as well as the main transmission system were planned,built and operated for the need of the total system and not according to the needs of the individual regional syste. Within this system, Latvia was and is a net importer of electricity amounting to 50 percent of its consumption needs. Base load capacity is provided by shale oil based power plants in Estonia and some power is supplied from the Ignalina nuclear power plant in Lithuania.

[7] The construction company LATESA used to be a subsidiary of Latvenergo but was spinned off as an independent company in 1991. As the result of this divestment, Latvenergo's staff was reduced from 8100 to 6100 persons.

- a holiday house and a training and relaxation complex

The different divisions did not have status of independent juridicial person, although some of them had their own statutes. They were cost centres, not profit centres and their directors were nominated by the General Director of Latvenergo. Since revenues were insufficient to cover operating costs and monthly income could not easily be forecast due customer arrears headquarter management had to allocate available funds among the divisions on a monthly basis. Management did its best, but the division of funds gave rise to frustrations and accusations of arbitrariness by divisional managers. Some believed that a privatisation of their unit would increase their freedom of action.

As far as **the core activity of power production** was concerned, this belief was not well-founded as long as tariff policy did not allow full cost coverage (not even of short run marginal costs). A split up of the vertically integrated power chain into separate production, transmission and distribution enterprises would have led to inter-company debt between the former divisions without giving divisional managers the freedom of action they longed for. In fact, financial "arbitrariness" would have increased rather than decreased. Arguably a sale of the hydropower companies to foreign investors could have provided some cash to alleviate the debt problem of the power sector during the period of slow adjustment to full cost pricing. But to do this without an appropriate strategy (of which privatisation was an element) for solving the fundamental problem of sub-cost pricing and intercompany debt would have depressed asset prices and been politically impopular. In addition, it is likely that a PPA would have had to be prepared, providing the hydropower owners and operators full cost coverage, and thus, privileged access to the scarce revenues of the industry.

The side activity of district heating was a different matter. Already during the 1992/93 heating season the Government called for the separation and municipalisation of Latvenergo's "Board of District Heating" which supplied Riga and a few minor cities. Most of Latvenergo's financial losses were incurred by its district heating division, and by divesting it the situation of Latvenergo would have been improved. The muncipalities, however, were unwilling to accept the gift, as a transfer of assets also meant a transfer of responsibility for covering the financial losses i district heating. The staff of the board was against a transfer as municipal employeeship was considered to give lower prestige and possibly lower salary; management was hesitant to hand over Latvenergo property free of charge to the muncipalities. Therefore, at the beginning of 1995 this transfer of ownership has not yet been completed. Some minor boiler houses and local distribution systems have been handed over, but Latvenergo continues to control the important transmission system.

What remained as a privatisation possibility was the **divestment of ancillary and of supporting activities**. One possibility was *"Energo-kontrol"* the billing and consumer services division of Latvenergo with about 700 employees; the other *"Energoremonts"*, a large power maintenance & repair company with 585 employees.

"Energoremonts" had been established in 1962 and dealt mainly with repair of all types of equipment from boiler turbines to small electric motors. "Energoremonts" had its own statutes since 1991. The company was organized with Head Office in Riga and branch offices in Daugavpils, Liepaja and Cecis. All production activities were located in Riga, whereas the

branch offices dealt mainly with miscellaneous repair services. The company was headed by a Director assisted by a Chief Engineer (in charge of the workshops and laboratories) and three Deputy Managers (one dealing with transformers; one with material supply, repair and construction services; and one with administrative matters.

"Energoremonts" divided its activities into:

- "Repair works" (steam turbine plants and hydro generators; steam and water heating boilers; transformers; electric motors; pumps). Energoremonts repaired and maintained all kind of heat and power station equipment from the largest boiler turbines to the smallest electric pumps and motors.

- "Basic services" (regulation, laboratory, regeneration of transformer oil). Adjustment/regulation activities are mainly related to environmental problems of heat and power stations such as control of emission and adjustment of heating regime.

- "Production" (20/10/0,4 distributive transformers; spare parts for power equipment). Production was a recent activity and included production of distribution transformers for farmers.

"Repair works and basic services" represented 80% of the company's turn over and "production" 20%. About 60% of the turnover was derived from Latvenergo; the other 40 percent came from the sale of services and of equipment to commercial clients. In particular the district heating boiler stations were important customers.

The a priori commercial orientation of Energoremonts made it a prime candidate for privatisation. Although maintenance activity touches core functions, these could be easily "reintegrated" into Latvenergo before divestment by transfering routine maintenance workers from Energoremonts to the stations. The case for privatisation was further strengthened by the quality of Energoremont's management. Energoremonts' manager showed an attitude of strong "self-belief" and a wish for further autonomy. A three months' management training "stage" at ABB Denmark [8] had reinforced his belief that substantial improvements could be achieved at Energoremonts through privatisation. He had noticed the relative backwardness of Energoremont's management and technology compared to ABB. In addition, he was impressed by the strength of ABB's international network and could see potential benefits by getting access to it. He therefore became keen to privatise his company as a joint-venture with ABB and started informal discussion with ABB management.

The top management of Latvenergo was strongly committed to restructuring and to privatisation. Late summer 1993 Latvenergo was reorganised as a joint stock company with a new management structure; Energokontrol was to be commercialised; while Energoremonts was to be divested. Joint-venture negotiations were held with ABB-Sweden which in ABB's structure is responsible for the Latvian market. Both sides were eager to reach agreement rapidly - ABB wanted to gain a headstart on its international competitors and Latvenergo

[8] Financed by the Danish Ministry of Industry's "Eastern European Managers" training programme.

management wanted to show reform results to the public. A joint-venture agreement was signed between ABB and Latvenergo whereby ABB acquired 66% of the shares of ABB-Energoremonts while Latvenergo held the 34% Latvian state share. Valuation of Energoremont's assets was undertaken by Invest Riga Company. The land and the buildings of Energoremonts remained the property of Latvenergo; whereas the existing stock of tools and of equipment was transfered as Latvenergo's share contribution. ABB provided its contribution in cash.

6 The Aims of the Parties in reaching the Joint-Venture Agreement

International trends for the power equipment industry

The power equipment industry used to be characterised by close and usually long-term relationships between the supplier and the utility. Reliability of plant is an extremely important consideration in the industry, and reliability of the supplier is part of this. Supplying complete power stations is a complex *organisational task* and in the *technological development* in the generation industry learning by using is important; therefore, sharing of functions in these areas was and is common [9]. This sharing of function provided the utility with the capability to lead technological and organizational evolution, to specify technical standards and to know, and therefore control, the amount of work required by its demand of equipment.

International cartelization and geographical sharing of markets were the main features of the power equipment industry up to the end of the 1960s. In the 1970s, the collusive framework was weakened by the overall reduction of orders, by the trend of increasing plant size and by the emergence of national policies aimed at strengthening "national champions" strictly linked to the diffusion of nuclear technology. A wave of national mergers took place as the industry adjusted to the new demand conditions. The national utility - national supplier relationship was weakened in the second half of the 1980s: on the demand side by the 1990 EC directive on the opening up of the public utility procurement market (related to energy, transports, water and telecommunications); on the supply side by technological factors - the rapid increase in the share of gas turbine technology leading to the "off-the-shelf plants" which little lead of individual tailor making - and by the Asea Brown Boveri merger in 1987 which created a large transnational company with no specific large domestic markets. ABB is a huge organisation with about 140,000 employees and an annual turn over of US$ 30 billion.

The new market configuration requires a new kind of supplier, able to add the advantages of being "domestic" to the advantages of being part of a large, transnational group.

ABB's international structure

[9] In France and Italy these functions were "internalized" by the utility, while in Germany they are internalized by the supplier (the supply of turn-key plants was the norm).

ABB has adjusted to this situation (and is an international trend setter) in five ways. First of all, it seeks a truly global presense setting up local firms in "all" countries, in particular in the growth markets Asia and Eastern Europe. From 1990 to 1994, while ABB decreased its employment in the USA, Canada and Western Europe by 40,000 jobs, it created 21,150 jobs in the newly capitalist countries in the East. It owns 45 companies in Eastern Europe that generated well over US 2 billion in orders over the past years. Secondly, ABB's strategy is to acquire companies with a strong presence on the national market. Thirdly, ABB is highly decrentralised being organised into 1,300 separate operating companies and a total of 5,000 autonomous profit centres. The operating companies exercise considerable financial autonomy, control their own balance sheets, borrow money independently, and retain a substantial portion of their earnings. Corporate headquarters have fewer than 150 people, and the typical division office (business area in ABB terminology) only 5 or 6 [10]. Fourthly, the operating units function within a novel global matrix structure. Top management entrusts the operating units with the challenge of creating the competencies needed to pursue local opportunities. It limits its role to seeing that those competencies are shared through cross-unit flows of resources, knowledge, and people. ABB's matrix requires the managers of each frontline unit to report to both a regional manager and to a world wide business head. Fifthly, the whole organisation is based on a "purpose-process-people" doctrine of management [11]: that the organising task is to shape the behaviours of people and create an environment that enables them to take initiative.

ABB's motives

ABB's joint-venture with Energoremonts was a perfect move to establish a strong foothold on the Latvian market. With one stroke, ABB both gained a privileged relationship with the national power company, and a strong local repair & maintenance division which could service equipment delivered by ABB [12]. Due to this important advantage over competitors such as Siemens [13], it is not surprising that ABB won all of Latvenergo's relevant international bids during 1993 and 1994.

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10 They also control more than 90% of ABB's $2.3 billion research and development budget.See Sumantra Ghoshal and Christopher A. Bartlett, "Changing the Role of Top Mnagement: Beyond Structure to Processes", Harvard Business Review, Jan.Feb, 1995: By "recognizing the frontline units as the company's basic building blocks, top management laid a foundation that enables unit managers to act as entrepreneurial champions"

11 Term coined by Ghoshal & Bartlett to distinguish from the "strategy-structure-process" doctrine of management whose structural element is about allocvating resources, assigning responsibilities, and controlling their effective management.

12 The close relationship between ABB and Latvenergo is also physically demonstrated: ABB's offices are located at the premises of Latvenergo's headquarter in Riga.

13 The core of the power generation industry comprises eight companies: ABB, Siemens, Hitachi, Toshiba, General Electric, Gec-Alsthom, Mitsibubishi Heavy Industries and Westinghouse. In addition, Ansaldo, NEI and Fuji (in the small turbine range up to 100 MW) can be mentioned while Babcock International is active in the steam boiler market. For details, see Augusto Ninni's article "The Power Equipment Industry in Transition", Energy Journal 1992.

Energoremont's motives

Energoremont's management expected to get five benefits from the joint-venture: New technical know-how, new management know-how, new tools, new equipment and access to ABB network of know-how and of contacts.

Latvenergo's motives

Latvenergo's management saw the joint-venture as a means to introduce new methods of maintenance, of testing and of diagnostic in its organisation; that is, to get inspiration from the supplier.

Apart from this self-interest; the divestment and joint-venture project was also seen as a part of Latvenergo's contribution to the national restructuring policy; that is, a social obligation as a state enterprise.

7 The Experience of ABB-Energoremonts after one Year of Operation

7.1 Market structure for maintenance work

ABB-Energoremonts came to operate in a very competive environment. First of all, the main clients Latvenergo and the district heating companies were making financial losses (see Annex I for background) and had difficulties in paying their bills. Secondly, Latvenergo had the option of reintegrating maintenance functions into its own organisation if the prices of the free market were to reveal "monopoly-rent" elements. Thirdly, a number of competitors started to enter the market as soon as Energoremonts was divested from Latvenergo. ABB-Energoremonts lost some of its best technical staff, as these became independent operators offering maintenance services in direct competition with ABB-Energoremonts. One of the most important competitors is "Energoremonts" from Lithuania; which has a quality standard which few if any of the small companies can match. Finally, since the agricultural cooperatives were split up into smaller individual holdings, also the market for transformers for agriculture was sharply reduced.

Under these conditions, the profit margins were low, a factor which set narrow limits to the level of investment which ABB could invest profitably into the company. The managers at ABB-Sweden had to look narrowly at the profitability of their investments in Latvia [14]. Since the market conditions did not look good in the short term, it made sense for ABB to proceed cautiously with investments in the company. Therefore, the market conditions put a limit to the speed of the modernization process at ABB-Energoremonts.

ABB-Energoremont's share of Latvenergo's market for maintenance work fell from 60 percent to 30 percent. Yet, Latvenergo's importance as a customer increased beyond pre-divestment levels: Around 70% of 1994 turn-over came from Latvenergo, the remaining 30% from agriculture, industry and the municipalities. continued. The "Heat and Mechnical Department" plus the Power Deprtment accounted for about 70% of revenue as boiler plants stood for 68% of turn-over.

7.2 Organisational Changes at ABB-Energoremonts

(a) Management

The *management team* comprised three persons. An ABB director became Managing Director of ABB-Energoremonts with Energoremont's former director acting as co-manager with title of Executive Director. A further Swedish manager was appointed as responsible for quality assurance. The arrangement of co-management worked out to the satisfaction of both

[14] In the very decentralised structure of ABB International, investments in mergers and acquisitions are judged by the narrow profitablility of the acquisition itself. In more integrated companies managers can more easily get away with low-profit investments in for having "strategic value" and for building up a market in the long term.

directors. After a year, the start up phase was over and the ABB managing director was replaced by another ABB-director with specific experience in the maintenance of boilers [15]. This change of top manager signals that management focus will shift from the integration of ABB-Energoremonts into the ABB international structure to operational improvements.

The new managing director is expected to stay at least two years. His presence was wished by the executive director not only to ensure a continued transfer of managing know-how but, also because the international network of ABB could be exploited more efficiently by him due to his established contacts which the executive director needed to build up first. This shows that the executive director clearly understood that key requirement for success under ABB's structure and to make use of the potential synergies and know-how is to have the informal contacts in place first.

A strongly manned *Supervisory Board (Board of Directors)* was established consisting of seven persons, four from ABB, three from Latvenergo. It was chaired by the Vice President of ABB Sweden; the President of Latvenergo was Deputy Chairman. The other board positions were filled by the Managing Director of ABB Service in Sweden; by the Director of ABB-Latvia, by the Vice President of ABB-Service world wide located in Bruxelles, and by two Latvenergo directors.

(b) Organisation structure

Three major changes were introduced:

* The hierarchy became flatter with eight department heads reporting directly to the three senior management.

* The organisation of the company changed from a functionally-activity based structure (see organisation chart of Energoremonts) to a market-oriented structure (see organisation chart of ABB-Energoremonts). The client focused departments consisted of "Heat & Mechanical" (to serve district heating customers), "Power" (to serve the thermal power stations of Latvenergo) and "Electrical" (transformers, rotating machines & high voltage laboratory) and the regional offices of Daugavpils and Liepeja.

* The old "Planning-Economy" and "Bookkeeping" departments were joined into the "Finance & Economy" department. and substantial efforts were made to introduce a modern system of accounting and financial reporting (MIS). These changes were needed to satisfy both the "internal" needs of ABB-Energoremonts as well as the "external" needs of the financial reporting structure of ABB International [16].

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[15] This replacement illustrated the strength of ABB's international network. The director was drawn from an ABB company in South Africa which had a boiler-based activity structure which was rather similar to ABB-Energoremonts.

[16] The decentralised structure of ABB puts high demands on the quality of the management information and reporting system.

(c) Management information systems

Within less than a year, the ABB-Abacus reporting system had been i*mplemented;* and the company was able to respond to ABB's requirements for monthly and quarterly financial information. The sales, purchase and general ledgers modules were operational, and the stock control module was about to be installed.

Implementation had taken up all time; and the system was not yet used by ABB-Energoremonts for analysis. Primary attention had been paid to the invoices; effort was now going to be directed at cost reduction as well.

(d) Staff policy

The decline in activity led to an even larger decline in the number of staff from more than 585 at the beginning of ABB-Energoremonts to 370 a year later. That is, a productivity improvement took place.

The average level of wages and salaries at Energoremonts had been 10-15 percent higher than at Latvenergo. The development at ABB-Energoremonts followed the evolution of wages and salaries at Latvenergo. Reforms were about to be started to put salaries on "operating results", with a base salary of only 40 percent.

Thus, there is little doubt that the divestment experience of Energoremonts during the first year of operation was a disappointment and disillusion for the vast majority of staff at ABB-Energoremonts. Privatisation led to loss of job security and a sharp reduction of staff as the company adjusted to the conditions of the market; whereas the potential benefits which, presumably, had been hoped for in the form of higher wages and more modern work practices had not yet been turned into reality.

7.3 Investments

(a) Use of equity capital

Most of the ABB's cash contribution in equity was spent after 15 months of operation. To implement a major reorganisation is expensive and the cost of management assistance by ABB, software for MIS, education and training swallowed more than two thirds of the available investment finance. Thus, less than a third of the amount could be used for the purchase of new tools and technical equipment; and of this amount a third was used for PCs. This was a disappointment for Energoremont's management as well as for its general staff: New technical diagnostic tools and measuring equipment were seen as essential competitive paramaters. But although the market battle is won at the level of contact with the consumer; the vast majority of the investment had gone to the top structure of the company - the overwhelming majority of ABB-Energoremont staff did no see any changes in their work practices.

(b) Training

Since training was focused primarily on the top end of the company structure, it was also at this end that the best results were achieved. Combined with self-education and "learning-by-doing" training, the executive director and in particular the financial officer (who was exposed to the greatest changes) had benefitted greatly from the know-how transfer provided by ABB management and by technical consultants financed through the cash equity capital.

Since no middle level managers were brought in by ABB; the change processes took place at a level which was too far away from the client. At the technical workers level very little new training was provided. Some workers were sent to a short stay in Sweden to be exposed to ABB's work practices there. But since ABB-Energoremonts did not have the necessary tools and equipment, the workers were not able to apply the practices after return to Latvia. Thus, the training stay brought more frustrations than benefits. It was felt afterwards that better results would have been obtained if a couple of Swedish ABB workers had been sent to Latvia for a couple of months to work alongside with ABB-Energoremont staff on practical job assignments using the tools and approaches of ABB-Sweden. ABB-Energoremont workers would have been trained in this way and clients would have seen the advantages of new approaches demonstrated.

After one year very few staff had acquired some knowledge of English. The manager of the "Electrical Department", for example, still did not speak a word of English.

7.4 Cultural clashes and adjustments

The ABB management sent to ABB-Energoremonts did not have an easy task. Inter alia, it was faced with a dual language problem: The official language in Latvia is Latvian, but most of the staff at Energoremonts are Russian-speaking and the ABB managers and technical trainers spoke neither of the two languages. Since very few ABB-Energoremonts staff speak English; communication was a problem and was done primarly through the executive director (former Director of Energoremonts).

This (over)reliance on the executive director for communication had one advantage: it ensured a remarkably smooth cooperation between the former and the new managers. The executive manager felt that most of his suggestions for changes and observations were taken into account by ABB management. The disadvantage was that the ABB managers became rather isolated within the company. Although this factor is less important than the other factors listed above, this fact may have accentuated the topsided focus of the reform process.

Cultural clashes were very limited for two reasons: the shop floor and middle management postions were hardly touched by the changes and the top management team was too eager to learn. In addition, the Latvian ececutive director accepted his "second fiddler" role because he understood the "modus videndi" of ABB. Organisations like ABB are not so much single entities as fluid networks adding value by coordinating activities across geographical and

corporate boundaries. In a decentralised organisation, the bottom-up flow of ideas and proposals does not occur spontaneously. The executive director understood the clear message of Percy Barnevik, ABB's CEO and pesident that structure is only one instrument of organisational change and only a blunt one of that. The "organisational physiology" - the flows and relationships that link all the parts of the organisation to one another - must also be right[17]. In order to function as a value creating network, the informal relationships have to be very well developed - people must know each other to be able to draw on each other's strength. And the executive director understood that he had to get his personal networks and relationships established first in order to be able to draw on and to exploit the strengths of ABB's international know-how.

Since, however, the philosophy of ABB implies a change from structuring tasks and to shaping behaviour, it is likely that culture clashes will become more apparent once the restructuring process gets intensified and until the new thinking has been put into place.

7.5 Reaction and adjustments at Latvenergo

Although the divestment of maintenance - being located in the grey area between "related" and "core" activity - was a controversial decision, the reaction at Latvenergo management one year after the divestment was mainly positive (down the rank it was less so). Routine maintenance was done by Latvenergo's own staff; outside help was needed mainly for outage maintenance. Senior management did not question the wisdom of the decision to divest Energoremonts and to conclude a joint-venture with an experienced company like ABB. The reform was viewed as a step in the right direction.

The main benefit for Latvenergo was the expected "transparency" advantage from divestment: the operators and station managers had learned more about relative costs and become more financially minded in their decision taking. Latvenergo staff had not been given specific training to adjust to the commercial aspect of dealing with ABB-Energoremonts and its competitors on the market; the change in attitude came about automatic.

Since ABB-Energoremonts had not yet started to reform its practices at the "floor level", the hoped for *introduction of new tools, work methods and practices in the maintenance procedures at Latvenergo* had not yet taken place. Things continued to be done as usual. During Energoremont times, the organisation of maintenance work was done by Latvnergo and this practice had not been changed. Latvenergo claimed to know its maintenance needs better than ABB-Energoremonts [18].

Some concern was expressed over the *prices charged by ABB-Energoremonts*. But since

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[17] Sumantra Goshal and Christopher Bartlett:"Changing the Role of Top Management: Beyond Structure to Processes", Harvard Business Review, Jan.-Feb. 1995

[18] Partly, this had to do with the change of key technical staff at ABB-Energoremonts. An unusally high number of the most experienced staff had either just retired or was about to retire; in addition, important staff had left to start their own company.

competition was fierce, this concern probably had more to do with the financially tight situation of Latvenergo and with the general impact of inflation which made nominal price adjustments necessary. The prices charged by ABB-Energoremonts increased compared to the prices of the small companies. But the question is whether the work of the smaller companies would have been of the same quality. ABB-Energoremont offered to lower its prices in exchange for receiving larger orders; but Latvenergo management was concerned with the impact of such a policy on industry structure (eliminating potential competition by reducing the amount of orders to competitors) and thus the longer run effect on prices.

The most important discussions arose over *responsibility for the quality of the maintenance work*. As long as Energoremonts was part of Latvenergo, maintenance was the responsibility of Energoremonts; there was no question who was accountable if problems arose. After the divestment of Energoremonts, the work was done on the basis of contracts and according to specifications made by Latvenergo and maintenance was split between routine maintenance (the responsibility and work of plant operarators) and overhaul maintenance (the responsibility of outside firms). Latvenergo management was eager to get ABB-Energoremonts to provide guarantees for the work performed. But the Swedish management of ABB-Energoremonts was unwilling to take the risk and to provide the asked for guarantee. Instead of full guarantess, ABB-Energoremonts was willing to give part guarantees only. Presumably, ABB was concerned that it did not know enough about the quality of the work done by Energoremont staff; and was unwilling to give guarantees as long as the work practices had not yet been changed to ABB standards.
However, the provision of guarantees for the work could become an important competitive parameter for ABB-Energoremonts - the competitors are too small to have the financial muscle to give guarantees. Therefore, it can be expected that this problem will be solved within a few months.

8 Conclusion

Although there is some disappointment with the results internally at ABB-Energoremonts and in Latvenergo, the problems that are encountered are normal problems of transition. Privatisation and organisational changes are not enough to achieve positive results; they have to be followed up by changes in management practices and in culture. These changes take time to implement and are expensive as has been learned everywhere in Eastern Europe. The experience of ABB-Enerogremonts shows the three phases of honeymoon, disappointment and realism that are normal features of joint-ventures.

ABB management is aware of the specific weaknesses that have to be corrected, in particular, the top-loaded focus of the changes. During the second year of operation the restructuring of the company will continue and the so far "cosmetic" change of the company towards a market/client oriented organisation will be followed up by changes in management practices and in operational procedures. As the focus turns to the "ground floor" level, results will improve substantially and overall satisfaction with the experiment will increase at ABB-Energoremonts as well as at Latvenergo.

The loss of market share of ABB-Energoremonts is a success story for Latvenergo management. It proves that divestment of Energoremonts took place within the right non-monopolistic market conditions.

Two specific recommendations for divestment efforts in other countries can be drawn:

* During joint-venture negotiations one should take care to define not only the level of investment to be financed by the cash equity contribution of the foreign investor but also the composition of investment

* Both for practical results as well as for the morale of company staff, it is important that reforms are "spread throughout" the company from the very start although this will be at the expense of some "thinning" of efforts. At ABB-Energoremonts, for example, some of the equity cash should have been used to purchase new tools for workers to demonstrate that the changes will benefit "everybody" in the end.

ANNEX I: BACKGROUND

1. The Context for Privatization of Power in Latvia in 1993

After obtaining independence late 1991, the Latvian Government began to restructure its energy sector along the general lines of the Eastern European reform approach:

- At the *policy formulation and regulatory level* the functions are split up between (a) policy formulation by a small ministerial staff [19]; (b) policy implementation and monitoring by the Latvian Energy Agency, LEA, organised as a state enterprise; and (c) regulation of natural monopolies to be performed by an independent body.

- Reforms of the industry structure involve *decartelization* as well as *demonopolization*. The energy supply enterprises are split up into smaller less integrated units, which concentrate on performing their core functions, while other tasks were separated out into independent state or municipal companies.

_ At the *enterprise level*, the process involves the three stages of *corporatization, commercialisation and privatisation* [20].

The reform program was implemented under circumstances which were severe even by Eastern European standards. Latvia having few primary energy resources of its own was particularly hard hit by the rise in the imported fuel bill, which rose 53,000 percent expressed in Latvian rubles between January 1990 and September 1992. It created an *external financing problem* as foreign exchange had to be found to pay for imports [21]; and the shift in prices between domestic goods and services and fuels created serious *internal financing problems* for consumers, public institutions and energy supply companies. A breakdown of consumers

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[19] The (over)reaction against state interference in the economy lead to a reduction in number of the staff of the Ministry of Energy from 80 persons in 1990 to 20 persons in 1992 and 12 in 1993 (and a merger first with the Ministry of Industry, then with the Ministry of Economy).

[20] A prior stage involed to change the status of the state owned energy supply and construction enterprises from "state organisations" into "state enterprises".

[21] Latvia had little trade with "Western countries" and had from its former position as a republic within the USSR inherited a large structural deficit in its balance between imports and exports.

ability and willingness to pay for their fuel consumption as well as lack of payments for fuel from state owned industrial firms and institutions led to large financial losses in energy supply.

The result was an accumulation of intercompany debt from upstream to downstream companies in the fuel supply chain. Crisis management became the daily norm of life in the ministry as well as in the energy supply companies.

ANNEX IV: RECOMMENDATIONS FOR THE DESIGN OF DIVESTMENT PROJECTS IN THE PHARE AND TACIS PROGRAMMES

In order to promote a successful outcome of the implementation of divestment recommendations made in PHARE and TACIS projects, the work of the technical assistance team on restructuring should include the following:

First of all, a *study of the market structure for the divested activity should be undertaken* covering the following issues as a minimum:

- Whether the *divesting firm can find other suppliers* on the market in the short to medium term, or whether it will face a monopolistic supplier of services in the form of the divested enterprise

- Whether the *divested enterprise will be able to find other clients* for its services in the short to medium term (and thus be able to expand its activities) or whether it will face a monopolistic purchaser in the form of the divesting firm.

If the answer to both questions is yes, we find the ideal situation from the point of view of the objectives of privatisation - competition will put downward pressure on prices and costs, and the national service infrastructure is improved. If it is no to one or both, we have to verify what kind of regulatory action can be taken to compensate for the defect. Either in the form of long term contracts or in the form of monitoring by the antimonopoly agency. If further internal restructuring is necessary before the divested company has a potentially profitable future in a competitive environment its state enterprise status can be maintained while a hard budget constraint is imposed. Depending on the success of restructuring and its commercial performance it can in the future be either liquidated or privatised.

Secondly, the attitudes of the actors to a privatisation proposal have to be clarified in a "stakeholder analysis" to identify the positive and negative reactions and to identify ways of reconciling differences of interests to the extent possible:

- Outsourcing of an activity is only of interest to the management of the affected firm if this leads to cost reductions and/or improvements in the quality of service.

- The workforce will be interested in the impact of privatisation on job security and on the level of wages.

- The managers of the privatised activity (provided they continue in their job) are only interested in turning private if it provides increased wages and salaries and a higher degree of job satisfaction. Since this will be correlated to the income level of the firm, they, as well as the new owners will attempt to maximise prices as long as this increases overall income and profitability.

Thirdly, in order to realise economic benefits from privatisation, the management structure at both the divested firm and at the divesting firm has to be adjusted. In the divesting company

new management and operational procedures should be introduced to make maximum use of the new commercial opportunities. Staff in the divesting firm should be given training in financial and commercial thinking - corporate purchasing departments are low-grade, low-status outfits, accustomed to buying parts rather than managing contracts. Contracting has to be made more professional, and the contractors (in particular the divested firm) must be forced to re-invent jobs, not just to find cheaper ways of doing the same.

The changes to be introduced in the divested firm should be clarified in a strategic planning process covering: (1) the strategic goals for the enterprise on the basis of a classic SWOT (strengths, weaknesses, opportunities, threats) analysis; (2) The optimal market, competitive and organizational foundation of the firm; and (3) strategic action plans for the implementation of the new structure.

Fourthly, if the activity to be divested is planned to engage in a joint-venture with a foreign company, it should be strongly recommended to make use of a management consultant who is specialised in "mergers & acquisition" issues and has previous experience in the industry. This can both ensure a higher sales price, as well as a smoother implementation of the merger once the new firm becomes operational. In particular, one should note that higher prices can normally be achieved if the firm is commercialised and restructured prior to privatisation. This approach is refered to as "dressing up the bride".