BACKGROUND INFORMATION

MAJOR STRUCTURAL REFORMS IN 2000

The economic growth recovery and more stable external environment than before set favourable conditions to continue with reforms.

Although implementing the reforms in the first half of 2000 the progress has been significant, they are not completed yet. The early-2000 has singled out some bottlenecks in the structural development in the past. Both the strategic concept of the privatisation of power plants as well as that of the pension reform have been included in strategic development plans years ago already. ***Unfortunately, these documents did not catch enough attention immediately. Therefore the discussion accompanying the implementation of the reforms was not limited to implementation concerns but tended to challenge already approved key concepts.***

This is especially true in the power plants' privatisation process in which discussions on sales transaction details led to challenging the entire strategic development scheme of energy (maintenance of oil shale energy, separation of electricity production undertakings from the distribution system and selling thereof to a strategic investor). Also a couple of years' old debate was revived whether negotiations with only one potential privatiser could lead to an optimum solution.

The energy development committee set up by the government had reached the following position and recommendations by 1998: 1) Estonia's oil shale resources are larger than currently known and would last quite long; 2) disappearance of oil shale industry would bring along major social problems in Ida-Virumaa; 3) oil shale power plants should belong to one common operator; 4) energy production and mining of the required oil shale will be merged into one concern; 5) AS Eesti Energia *(Estonian Energy Ltd) together with a strategic investor will establish an affiliate business undertaking based on Estonian and Baltic power plants with* AS Eesti Energia *owning at least 51% of the shares. Because of the lack of government capital it was considered important to involve a strategic investor into the development of oil shale energy. The above position was expressed in the energy strategic development scheme and the public seemed to agree. The choice of the privatisation method caused more discussions, although the experts' proposal was preferred not to have public tendering due to the specificity of the case. It was expected to ensure necessary flexibility during the negotiations as well as to achieve terms best for Estonia's interests.*

By the summer of 2000 NR Generating International BV supported by its parent companies NRG Energy Inc and Northem States Power Company had become Estonia's negotiating partner and the agreement framework was nearly ready. All of a sudden both Estonian business community as well as the public voiced their concerns about the terms and conditions according to which the Republic of Estonia undertook through AS Eesti Energia to purchase annually a certain quantity of electric power (the only guarantee given by Estonia) at a fixed price[1]. The concerns focused on future quantities and prices, substantially on the future electricity price in Europe whereas using various input, different experts have reached conflicting results. On one hand the prices are subject to an upward revision due to the demand-supply increasingly strenuous relations and the high significance of non-renewable resources in energy production. The energy market developments exercise strong counteraction. The stability or even a slight drop of the world's electricity price have been characteristic of the last 10–15 years (mainly for industrial consumers). The current balance of demand and supply, privatisation of power plants as well as opening of the energy market are outlined as main reasons for the price fall. Contemporaneously it has to be stressed that the energy market has just started

[1] It would be about 75% of total electric power consumption of Estonia until 2006 and 50% during the next seven years.

and it is quite unclear how stable the above processes would be. As regards the interest to maintain oil shale industry it is arguable whether without a restrictive clause of the intended agreement it would be possible to import more than half of the consumed electricity.

Upon the enforcement of the framework agreement signed this August both the corporate as well as individual consumers would have stable price for a longer period of time, although no one is able to forecast whether it would be below or above that of the immediate neighbours. *In the agreement the price of electricity is fixed at a certain volume. Let's suppose that it is 15% above the current price. This would mean a slightly higher than 0.4% increase of the producer price on the average whereas at the consumer's level as goods and services the consumer price index would grow up to 0.3%. A similar price increase for the electricity sold directly to households would yield a total of 0.7% of the consumer price index.*

Current discussions about the electricity price have focused on the price for the end user. Therefore it is impossible to say whether the price increase (about 20% for households) next year is caused more by production or distribution costs[2].

As regards the electricity price development in future, an asset of the NRG deal lies in the fact that at least one component of the ultimate price will be fixed – the electricity purchased by Eesti Energia *– if the conditions are enforced. The further price increase will depend on contractual provisions providing the price for the electricity sold by* Eesti Energia *to distribution networks and the mark-up added by the distribution networks.*

In privatising power plants, despite of the discord in the society, previous strategic development schemes were implemented whereas in case of the pension reform a very significant change took place in the concept.

Several years ago drafting the pension reform, the government intended to replace the current pay-as-you-go system with the so-called three pillar system. The objective of the reform was to secure a more-or-less similar replacement rate (the ratio of the average wages and pension) also in future when the demographic situation will deteriorate and there will be less taxpayers per beneficiary. The voluntary retirement savings plan, ie the third pillar was finally launched in early 1999, the publicly managed pay-as-you-go, the first pillar, only at the beginning of this year. The fully-funded tier, ie the second pillar was intended to be implemented beginning from 2001 but implementation provisions brought along a debate what kind of reform-related expenditure would be acceptable and which generation or social group would cover them. As no political consensus was achieved, the government decided to make contributions to the second pillar voluntary. The difference from voluntary pension insurance would lie in adding to the contributions into the second pillar (2% of the wages) also a part of the payroll social tax (4% of the wages) at the expense of the first pillar. The social tax will not be increased. It is possible that the pension reform will be revisited in future.

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[2] Eesti Energia *has prepared a large number of price packages both for domestic and corporate clients, consisting of the fixed connection fee and the price of the electricity consumed, which in case of reduced cross-subsidisation would also mean a change in the sales strategy.*