

Ostrołęka C: Enea's and Energa's Board Members' Fiduciary Duties to the Companies and Shareholders

19 December 2018

Introduction

1. This briefing concerns Enea's and Energa's proposed Ostrołęka C coal-fired power unit (the "**Proposed Project**") and follows from ClientEarth's briefing of 19 September 2018.¹ It refers in particular to:
 - a. Media reports on 21 November 2018 reporting the conclusion of the financing structure for Ostrołęka C (the "**Reported Financing Structure**"); and
 - b. The main capacity market auction due to take place on 21 December 2018, in which Elektrownia Ostrołęka Sp. z o.o. (the "**SPV**") is expected to participate (the "**Upcoming Capacity Auction**").
2. The Reported Financing Structure would significantly increase the financial risk of the project to Enea, Energa and their shareholders, which in turn would also materially increase the legal risks to the companies, their Management Boards and Supervisory Boards of proceeding to the construction stage. This risk is underlined by Fitch's specific warning to Enea that an equity contribution of more than PLN 1bn (as would appear to be contemplated by the Reported Financing Structure) could lead to negative rating action.
3. The proposed participation in the Upcoming Capacity Auction also carries significant risks. Energa itself has acknowledged that the capacity market is "*not perfectly suited for Ostrołęka C*".² In particular, the plant will not be constructed in time to provide the contracted capacity, leading to foregone payments and inevitable penalties. If the "*very challenging*"³ financial milestone is not met, the capacity contract will be terminated.
4. The Reported Financing Structure and the risks associated with the SPV's proposed participation in the Upcoming Capacity Auction have a further, direct negative impact on the regulatory and economic context of the Proposed Project. That context has fundamentally changed since Energa relaunched the project in May 2016 and Enea announced its participation in September 2016. It is now entirely apparent that the

¹ ClientEarth, Briefing: Ostrołęka C: Energa's and Enea's Board Members' Fiduciary Duties to the Companies and Shareholders, 19 September 2018, <https://www.documents.clientearth.org/library/download-info/ostroleka-c-energag-and-eneas-board-members-fiduciary-duties-to-the-companies-and-shareholders/>.

² Energa, Current Report No. 45/2018, 24 October 2018, <https://ir.energa.pl/en/pr/409065/current-report-no-45-2018>.

³ Energa, Current Report No. 45/2018, 24 October 2018, <https://ir.energa.pl/en/pr/409065/current-report-no-45-2018>.

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Proposed Project is not viable. In our view, Enea's and Energa's continued pursuit of the Proposed Project remains in breach of its Management Board and Supervisory Board members' duties of due diligence and to act in the best interests of the companies and their shareholders. This would include further steps consenting to the SPV incurring further liabilities by participating in the 21 December 2018 capacity market auction.

Reported Financing Structure

5. On 21 November 2018, the Polish Press Agency reported that the Minister of Energy, Krzysztof Tchórzewski, stated that:
 - a. *"Talks about financing the new bloc in Ostrołęka ended, although they were not easy, many foreign banks and some of our domestic do not want to finance projects based on coal"*⁴; and
 - b. *"Credit financing will account for 30-35%, which is an unusual solution", "Equity from Energa, Enea and TFI Energia will account for over 60%"*.⁵
6. Neither Energa nor Enea have informed the market of the conclusion of financing discussions, nor the terms of any such financing structure. It is not clear why, or how, Enea's and Energa's controlling shareholder has access to any such information in the absence of its availability to the companies' other shareholders. This is of particular concern because the financing structure referred to by the Minister of Energy on 21 November 2018 would, if confirmed, significantly increase the financial risk of the project to Enea, Energa and their shareholders.
7. Energa's current report dated 4 September 2018 refers to a preliminary financing structure under which (a) Energa and Enea would contribute share capital of PLN 1 billion each, (b) Fundusz Inwestycyjny Zamknięty Aktywów Niepublicznych Energia ("**TFI Energia**") would contribute "*maximum PLN 1 billion*" share capital and (c) the "*remaining amount will be contributed by other forms of financing*".⁶ According to Energa's current report, the Memorandum of Understanding that sets out the above preliminary financing structure is no longer effective, having expired on 30 November 2018, and there has been no further company report since that date, despite the apparent conclusion of financing discussions.

⁴ PAP, Udział banków w finansowaniu bloku w Elektrowni Ostrołęka wyniesie 30-35 proc., 21 November 2018, https://energetyka.wnp.pl/udzial-bankow-w-finansowaniu-bloku-w-elektrowni-ostroleka-wyniesie-30-35-proc.334727_1_0_0.html.

⁵ Posadzy Magdalena, Banks to finance 30-35% of new power block in Ostroleka; owners, 21 November 2018.

⁶ Energa, Current Report No. 42/2018, 4 September 2018, <https://ir.energa.pl/en/pr/401224/current-report-no-42-2018>.

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8. The market had already reacted with alarm to the preliminary financing structure. Bloomberg reported on 5 September 2018:⁷

Concern over PGE's potential involvement in the contested project helped send its shares down by 4 percent to 8.69 zloty by 12:35 p.m. in Warsaw. Energa dropped 3.4 percent, Enea 4.5 percent while Warsaw's WIG-Energy index declined 3.5 percent.

"At the first sight, the deal seems to stand for all-positive news to Energa and Enea, as an independent fund support should actually lower two companies' own spending, Pawel Puchalski, an analyst at Bank Zachodni WBK SA, wrote in a note. "However, we had never expected that 6 billion zloty investment might require such amount of equity, as it might further weaken two utilities' short-term outlooks."

FIZAN may demand Energa and Enea to guarantee certain payoffs returned in yearly instalments in exchange for provided equity, which would make reaching break even on the Ostroleka project even more difficult, according to Puchalski.

9. In addition, Fitch has since specifically warned Enea that an equity contribution of more than PLN 1 billion would be negative for the company's credit profile and could lead to negative rating action:⁸

Ostroleka C Project: ENEA will likely participate in the construction of the new coal-fired block in Ostroleka with Energa S.A. (BBB/Stable). The exact structure of the project is unknown yet, but both ENEA and Energa declared that their stakes in the project would not exceed PLN1 billion each with another up to PLN1 billion likely to be provided by a local investment fund managed by TFI Energia. The remainder (about PLN3 billion) could be provided either in form of equity or non-recourse debt by investors at the project company level. In Fitch's rating case we assume that ENEA will contribute PLN1 billion to the project in form of equity. A higher contribution would be negative for ENEA's credit profile and could lead to negative rating action.

10. The Reported Financing Structure would appear to anticipate a higher equity contribution from both Enea and Energa (as equal joint venture partners), of up to c. PLN 1.6 billion each if credit financing were only to account for 30% of the total c. 6 billion investment and TFI Energia's contribution were to remain at PLN 1 billion. This would significantly increase the exposure of, and therefore the financial risk to, Enea and Energa in relation to the Proposed Project.
11. There is a high degree of market concern about Enea's and Energa's proposed investment in Ostrołęka C and the legal risks of Enea's and Energa's actions in

⁷ Konrad Krasuski, Mystery Investor Emerges for Poland's Last Coal-Power Project, 5 September 2018 (emphasis added).

⁸ Fitch Ratings, Fitch Affirms ENEA at 'BBB'; Outlook Stable, 1 October 2018, https://www.investors.enea.pl/file/attachment/1325055/67/press_release_fitch_affirms_enea_at_bbb_outlook_stable.pdf (emphasis added).

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relation to it. The legal risks of proceeding to the construction stage of the project are heightened significantly by the terms of the Reported Financing Structure, particularly in light of Fitch's specific warning above. We would regard proceeding to the construction stage in such circumstances as plainly contrary to board members' duties of due diligence and to act in the best interests of the company and its shareholders.

12. In light of the above, we have requested that Enea and Energa confirm:
 - a. The status of financing discussions for Ostrołęka C; and
 - b. Why Enea's and Energa's controlling shareholder has apparent access to information in relation to financing discussions, in the absence of its disclosure to Enea's and Energa's other shareholders.

Upcoming Capacity Auction

13. The SPV intends to participate in the capacity market auction planned for 21 December 2018.⁹ This auction relates to capacity provided from 1 January 2023. Enea has reported that the following steps will require resolutions by the general meeting of the SPV (and therefore require Enea and Energa, as 50% shareholders in the SPV, to vote for such resolutions):¹⁰
 - *approval of the form of financial collateral or exemption from the requirement to put up such collateral in the meaning of Chapter 8 of the Act on the capacity market of 8 December 2017,*
 - *definition of an auction strategy by 20 December 2018, specifying an exit price for the main capacity market auction planned for 21 December 2018,*
14. Enea has stated that the above "control mechanisms" are to protect the interests of Energa and Enea as shareholders.¹¹
15. However, the SPV's participation in the capacity market auction planned for 21 December 2018 carries significant risks that do not appear to have been taken adequately into account. These include:
 - a. The construction schedule would mean Ostrołęka C would be unable to provide capacity when due. This would both limit the capacity payments to which it would

⁹ Enea, Extended consolidated quarterly report of the Enea Group for the third quarter of 2018, 20 November 2018, p 37, https://investors.enea.pl/file/attachment/1346911/1a/extended_consolidated_quarterly_report_of_the_enea_group_for_the_third_quarter_of_2018.pdf.

¹⁰ Enea, Extended consolidated quarterly report of the Enea Group for the third quarter of 2018, 20 November 2018, p 37, https://investors.enea.pl/file/attachment/1346911/1a/extended_consolidated_quarterly_report_of_the_enea_group_for_the_third_quarter_of_2018.pdf.

¹¹ Enea, Extended consolidated quarterly report of the Enea Group for the third quarter of 2018, 20 November 2018, p 37, https://investors.enea.pl/file/attachment/1346911/1a/extended_consolidated_quarterly_report_of_the_enea_group_for_the_third_quarter_of_2018.pdf.

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otherwise be entitled and require it to pay penalties for failure to provide the contracted capacity. This impact would increase in the event of delays in construction.

- b. The "financial milestone" would require proof of very significant expenditure within 12 months of the final results of the capacity market auction, in the absence of which the capacity agreement would be terminated.

Ostrołęka C will be unable to provide capacity when due

- 16. Ostrołęka C will still be under construction on 1 January 2023, when it would be required to begin providing capacity should it succeed in the capacity market auction. The final results of the capacity market auction will be announced on Monday 14 January 2019 (the first working day following the 21st day after the end of the auction).¹² Until then, all capacity contracts are conditional. Energa has previously confirmed to the market that a notice to proceed with construction ("NTP") will not be issued until after the capacity market auction.¹³ GE Power, the lead construction contractor, stated on 12 July 2018 that "*Ostrołęka C will start operating within 56 months after the notice to proceed*".¹⁴
- 17. On the assumption that Enea and Energa could authorise the SPV to issue the NTP within two weeks of the final results of the capacity market auction (i.e. by 28 January 2019), Ostrołęka C would not start operating until 28 September 2023 on the current 56-month construction schedule, nine months after the date on which it would be required to begin providing capacity. Energa itself has also confirmed that "*the time span between contracting the capacity and the day the capacity must be actually available is shorter than the duration of the construction phase*".¹⁵
- 18. As a result, it would be ineligible for capacity payments for at least the first nine months of the contract.
- 19. In addition, Ostrołęka C would face penalties for each month it fails to provide the contracted capacity at a value of 15% of the unfulfilled capacity obligation, calculated on the basis of the highest capacity market clearing price for a given delivery year.¹⁶

¹² Act on the Capacity Market, Article 39(3).

¹³ See Dybińska Katarzyna, "Energa and Enea commence construction works at Ostroleka plant", 16 October 2018 ("The Notice to Proceed will be formally issued after the capacity market auction slated for December 21, Energa's acting CEO Alicja Barbara Klimiuk said"). See also letter BSF to Energa, 19 September 2018, para 14.

¹⁴ GE Power, GE Power signs contract with Elektrownia Ostrołęka to build Ostrołęka C, Poland's next Power Plant, 12 July 2018, <https://www.genewsroom.com/press-releases/ge-power-signs-contract-elektrownia-ostro%C5%82%C4%99ka-build-ostro%C5%82%C4%99ka-c-poland%E2%80%99s-next-power>.

¹⁵ Energa, Current Report No. 45/2018, 24 October 2018, <https://ir.energa.pl/en/pr/409065/current-report-no-45-2018>.

¹⁶ Act on the capacity market, Article 47(2).

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20. The 56-month construction timeline is also highly optimistic and therefore at clear risk of delay. Such delay could have two important consequences:
 - a. It could add to the number of months for which Ostrołęka C is not entitled to capacity payments and is subject to penalties.
 - b. The capacity agreement will be terminated if the SPV fails to submit to the transmission system operator (“TSO”) documents confirming that the unit is able to deliver at least 95% of the contracted capacity (for at least one hour) by the end of the third delivery year covered by the capacity agreement (at the very latest). If the capacity agreement is terminated, the SPV will lose or will have to pay the equivalent of financial collateral at a value of PLN 43 per kilowatt offered at the capacity market auction.¹⁷

Financial milestone

21. If the SPV fails to submit to the TSO, within 12 months from the announcement of the final results of the capacity market auction (i.e. by 14 January 2020), documents confirming incurring financial expenses in the amount of at least 10% of the total planned financial outlays and the conclusion of agreements in the amount of at least 20% of the total planned financial outlays, the capacity agreement will be terminated.¹⁸
22. Energa itself has stated that “*the requirement to meet the so called ‘financial milestone’ is very challenging with regards to the construction schedule*”.¹⁹
23. If the capacity agreement is terminated, the SPV will lose or will have to pay the equivalent of financial collateral at a value of PLN 43 per kilowatt offered at the capacity market auction.²⁰

Legal Risks of Proceeding

24. ClientEarth regards Enea's and Energa's continued pursuit of the Proposed Project as in breach of its Management Board and Supervisory Board members' duties of due diligence and to act in the best interests of the companies and their shareholders for the reasons set out herein and in our briefing of 19 September 2018.²¹ Potential breaches include Enea's and/or Energa's voting in favour of resolutions at a general meeting of the SPV consenting to the SPV's incurring further liabilities by participating

¹⁷ Act on the capacity market, Article 47(1) and Regulation of the Minister of Energy on the financial collateral provided by capacity providers and participants of preliminary auctions, para 2(1).

¹⁸ Act on the capacity market, Article 46(1)(1).

¹⁹ Letter Energa to BSF, 23 October 2018.

²⁰ Act on the capacity market, Article 47(1) and Regulation of the Minister of Energy on the financial collateral provided by capacity providers and participants of preliminary auctions, para 2(1).

²¹ ClientEarth, Briefing: Ostrołęka C: Energa's and Enea's Board Members' Fiduciary Duties to the Companies and Shareholders, 19 September 2018, <https://www.documents.clientearth.org/library/download-info/ostroleka-c-energias-and-eneas-board-members-fiduciary-duties-to-the-companies-and-shareholders/>.

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in the Upcoming Capacity Auction. The proper course is for Enea and Energa to withdraw from the Proposed Project, as each is entitled to do before proceeding to the construction stage.

25. Whatever the merits of Energa's decision to relaunch the Ostrołęka C project on 24 May 2016 and Enea's decision to cooperate with Energa on the project from September 2016, it is clear that circumstances arising since then have made the Proposed Project unviable. For example, and in addition to the concerns outlined above:
- a. Carbon prices have more than tripled, from a closing price of €5.78 per tonne on 24 May 2016 to €19.35 on 29 November 2018.²²
 - b. The price of alternative investments in renewable energy sources has sharply declined.²³
 - c. Poland has strengthened its aims to reduce the share of coal in power generation. On 3 October 2018, Reuters reported a senior government official stating that Poland sought to reduce the share of coal in power generation from 80% to 50% by 2040.²⁴ Since then, the Ministry of Energy has published a draft national energy including an aim to reduce the share of coal to 60% by 2030 (and double the share of renewable energy sources in that time to 27%). Ostrołęka C would undermine those aims.

The reduced share of coal will also have important consequences for the ability to pass on the high carbon costs of power from Ostrołęka C. For example, Bloomberg recently quoted Enea's and Energa's competitor Tauron's Chief Financial Officer as follows:²⁵

Key to all investment profitability analysis is the correlation between the CO2 and power price -- once it's gone in the future, everything will change in the models," the CFO said. "The energy mix will change in Poland and the wholesale electricity price will decline and will be less dependent on CO2. It won't happen in two or three years, but surely in a longer perspective.

²² See https://markets.businessinsider.com/commodities/historical-prices/co2-emissionsrechte/euro/24.5.2016_3.12.2018.

²³ See <https://www.irena.org/costs>.

²⁴ Nina Chestney, Poland's power from coal seen down at 50 percent by 2040 - government official, 3 October 2018, <https://www.reuters.com/article/us-poland-energy/polands-power-from-coal-seen-down-at-50-percent-by-2040-government-official-idUSKCN1MC2FM>.

²⁵ Maciej Martewicz, Polluting Giant Turns to Green Energy to Escape EU Carbon Risk, 11 October 2018, <https://www.bloomberg.com/news/articles/2018-10-11/polluting-giant-turns-to-green-energy-to-escape-eu-carbon-risk>.

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26. For all the reasons set out in this briefing, ClientEarth has urged Enea and Energa to exercise their ability to withdraw from the project before the NTP is issued, thereby avoiding irreparable damage to the company and its shareholders.
27. ClientEarth has reserved all of its rights and remedies.

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ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers, finding practical solutions for the world's biggest environmental challenges. We are fighting climate change, protecting oceans and wildlife, supporting sustainable forestry, greening energy, making business more responsible and pushing for government transparency. We believe the law is a tool for positive change. From our offices in London, Brussels, Warsaw, New York City and Beijing, we work on laws throughout their lifetime, from the earliest stages to implementation. And when those laws are broken, we go to court to enforce them.

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