

## ZE PAK SA IPO exposes investors to major risks

### Summary of key financial risks for investors

1. Analysts have already expressed concerns about “the company’s ageing assets, high capex needs and trailing financial margins”<sup>1</sup>.
2. The political risks of investments in ZE PAK are significant given the government's objective of privatizing the company in 2012. The Treasury is under pressure to sell ZE PAK. To do that, we expect it will understate its risks before transferring them to private hands.<sup>2</sup>
3. ZE PAK already suffers financially from significant constraints on its coal supply. The company's proposed mine expansions face strong resistance both locally and from the Minister of Agriculture. An un-finalised EU Commission infringement procedure has found breaches of environment law at the Tomislawice mine.
4. ZE PAK power plants are substantially overvalued given their large environmental costs and liabilities, their low and decreasing capacity factors and high capex needs.
5. ZE PAK air pollution emissions are estimated to be responsible for 258 deaths every year. ZE PAK’s high CO<sub>2</sub> emissions put it at a competitive disadvantage in the European electricity market. The annual economic impact of emissions is estimated to be €993 million, higher than the valuation of the company based on the current IPO price range.
6. ZE PAK's plans are unclear for raising the necessary capital for the substantial investments it says it will make to extend the life of its lignite plants and to expand its mines. How will it raise this capital and manage its new debts when it already has problems with one of its lenders?

Based on these key concerns – detailed below - it would be prudent to avoid this share issue.

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<sup>1</sup> Bloomberg: PAK Utility Could Struggle to Find Sound Investor Base: RenCap by Piotr Bujnicki, October 11, 2012

<sup>2</sup> Poland mulls limiting listings as ZE PAK price guidance hits bottom, BNE, October, 2012:  
[http://www.bne.eu/story4087/Poland\\_mulls\\_limiting\\_listings\\_as\\_Ze\\_Pak\\_price\\_guidance\\_hits\\_bottom](http://www.bne.eu/story4087/Poland_mulls_limiting_listings_as_Ze_Pak_price_guidance_hits_bottom)

## **Investor risks - details**

ZE PAK is the fifth largest electricity company operating in Poland. It also owns two subsidiaries that mine lignite – Kopalnia Węgla Brunatnego Adamów (KWBA) and Kopalnia Węgla Brunatnego Konin (KBWK).

The company initiated an initial public offering (IPO) and published its prospectus last week<sup>3</sup>. On 30 October, 2012 ZE PAK is to finalize its IPO on the Warsaw Stock Exchange. Currently, the company is in the process of attracting domestic and foreign institutional investors.

## **Constraints on earnings**

ZE PAK relies on local lignite mines for its operations since lignite cannot be economically transported over large distances. The lignite production from its KWBA mine is declining. The reduction in output from the company's mines is already constraining electricity production, with the result that revenues and operating profits are reduced. During H1 2012, lignite production at KWBA fell by 780,000 tonnes from H1 2011 levels<sup>4</sup>. Income from the company's electricity sales fell by PLN 104 million<sup>5</sup> and gross profits by PLN 39 million<sup>6</sup>.

The reserves and deposits of the current open-pit mines will only last – even in the optimistic, reduced production scenarios until 2026 for KWBA) and to 2030 for KBWK. ZE PAK needs new open-pit mines and expansion of the current ones for its continued operations.

The approval of new coal mines has significant regulatory and approval hurdles which means the lignite supply the company needs cannot be guaranteed. The KWBA and KBWK open-pit mines and planned expansions are already causing wide-scale public protests, including from the Association Nasz Dom of Wielkopolska. The expansion plans have also been criticized by the Agriculture Minister for the negative environmental impacts they will have on the region's agricultural activities. The expanded mines would affect the areas with the best soil in Poland, and would be in the direct vicinity of the river Warta<sup>7</sup> risking pollution events.

ZE PAK also has a major unresolved court case concerning its Tomisławice open-pit mine. The EU Commission is running an infringement procedure against the Tomisławice mining project (of the KBWK), which has found it is in breach of the EU environmental legislation and the jurisprudence of the European Court of Justice in Luxembourg (due to threats to the EU Natura 2000 protected sites, breach of the EU Habitat Directive etc). The EU Commission has sent a letter of formal notice and the Reasoned Opinion to Poland urging the state to comply with the EU legislation. The EU environmental commissioner Janez Potocnik has also confirmed the breach of law.

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<sup>3</sup> Prospekt ZE PAK SA, 10th October, 2012: <http://ri.zepak.com.pl/pl/pierwsza-oferta-publiczna/prospekt-emisyjny>

<sup>4</sup> IPO Prospectus p. 84.

<sup>5</sup> IPO Prospectus p. 90.

<sup>6</sup> IPO Prospectus p. 95.

<sup>7</sup> IPO Prospectus p. 40.

## **High environmental costs and liabilities, low capacity factors and high capex needs**

The company owns and operates three power plants; Patnow (I + II), Adamow and Konin. The plants are lignite-fired with very high carbon emissions and emit substantial levels of air pollution.

The company is heavily exposed to the risks of carbon pricing. The combined CO<sub>2</sub> emissions of its plants in 2010 were over 10 million tonnes. This equates to approximately 1 000g CO<sub>2</sub>/kWh one of the highest rates in the European Union. This is not a favourable competitive position on the European electricity market. The emission factor is also significantly higher than the limits referenced in The Climate Principles guidance on financing new coal-fired power plants and the policies of individual banks, including HSBC and BNP Paribas.

The annual air pollution from the three plants is estimated to result in 258 deaths, 118 cases of chronic bronchitis, 76 hospital admissions and over 267 000 lost working days from sickness.<sup>8</sup> The annual economic impact of air pollution and CO<sub>2</sub> emissions from the three plants is estimated to be €993 million<sup>9</sup>, higher than the valuation of the company based on the current IPO price range. These large health and economic impacts can create substantial financial liabilities for the company.

Despite operating as baseload generation outlets, the plants have rather low capacity utilisation factors. This may further shrink with the fast expansion of renewable electricity in Poland and the neighbouring markets. The Fraunhofer Institute has shown how the expansion of renewable energy will diminish the requirements for baseload electricity in Germany, projecting a decline from 44GW in 2011 to 25 GW in 2020.<sup>10</sup> These calculations are based on Germany's earlier renewable targets that are lower than the recently announced new target of 40% renewable energy by 2020.

## **There are also a range of other substantial risks noted in the prospectus**

- Potential costs associated with dust and ash from boilers being classified as hazardous waste.
- Ongoing risks of not being able to maintain permits, such as for the Drzewce open-pit mine, and of not being able to obtain new permits.

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<sup>8</sup> Greenpeace calculations based on 2010 emissions data and using factors from DG Env (2011), EEA (2011) and Holland et al (2005):

DG Env (2011). European Pollutant Release and Transfer Register (E-PRTR) - Summary tables. European Commission Directorate-general for Environment, Brussels.

EEA (2011). Revealing the costs of air pollution from industrial facilities in Europe. EEA Technical report No 15/2011. European Environment Agency, Copenhagen.

Holland, M., Pye S., Watkiss P., Droste-Franke B. & Bickel P. (2005). Damages per tonne emission of PM2.5, NH3, SO2, NOx and VOCs from each EU25 Member State (excluding Cyprus) and surrounding seas. AEA Technology Environment, Didcot, UK

<sup>9</sup> Ob. Cit.

<sup>10</sup> Fraunhofer: Dynamische Simulation der Stromversorgung in Deutschland nach dem Ausbauszenario der Erneuerbaren-Energien-Branche, December 2009: [http://www.bee-ev.de/downloads/publikationen/studien/2010/100119\\_BEE\\_IWES-Simulation\\_Stromversorgung2020\\_Endbericht.pdf](http://www.bee-ev.de/downloads/publikationen/studien/2010/100119_BEE_IWES-Simulation_Stromversorgung2020_Endbericht.pdf)

- Costs of adapting to new air pollution standards beginning in 2016. In the 2010-2012 period, the Adamów power plant has already exceeded monthly and 48 hour SO<sub>2</sub> and dust emission levels of current standards.
- Potential for changes in the investment plans for the lignite mining subsidiaries leading to contract fines from the unfinished and previously agreed to contracts.<sup>11</sup>
- Risk of BRE Bank S.A. withdrawing credit or raising rates to KWBK. Based on the financial data as of 30<sup>th</sup> of June 2012, the bank stated that the conditions of three of the credit agreements had not been met.<sup>12</sup>

We believe the risks outlined above and elsewhere make ZE PAK shares an unattractive and high-risk prospect. Purchase of these shares will create financial and reputational risks for your company. We urge you to consider avoiding this IPO. We also point out that investing in ZE PAK through its IPO is inconsistent with your position to take action on climate change.

We would be happy to discuss these matters further at your convenience.

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<sup>11</sup> IPO Prospectus p. 35.

<sup>12</sup> IPO Prospectus p. 39.