CEAC's investments in Montenegro

CENTRAL EUROPEAN ALUMINUM COMPANY

Andrey Petrushinin* explores the twists and turns in the KAP story.

Initial acquisition of shares 2005 to settlement 2010

In November 2005 the Cyprus-based Central European Aluminum Company (CEAC, a wholly-owned subsidiary of En+) acquired 65.43% of the Podgorica Aluminjum Kombinat (KAP) smelter, as well as a controlling stake in Bauxite Mines Niksic (RBN), a nearby bauxite mine. A Sales and Purchase Agreement (SPA) with the government of Montenegro and other Montenegrin institutions was signed that contained mutual obligations. CEAC's obligations included:

- A five-year (2006-2010) equipment modernisation investment programme totalling €55m
- A five-year environmental investment programme totalling €20m
- Maintaining a headcount of not less than 2,150 employees by end 2008 (KAP at that time was two times overstaffed compared to industry peers)

The Montenegrin government's obligations were to:

- Guarantee a long-term (2005-2010) contract for electricity supply at a price linked to the London Metal Exchange (LME) aluminium price with the state-controlled energy producer
- Warrant that all pre-2004 accounts that were provided during due diligence were correct and accurate
- Provide obligations related to inherited environmental issues in KAP and RBN Bauxite Mines Niksic

CEAC's intention in making this considerable investment was to build a leading aluminium producer in Central Europe to meet the growing demand for this metal in the region. Following the purchase of KAP and the bauxite mine, the company also acquired a refinery in Romania to process bauxite to alumina, and won the tender of the government of Montenegro to build a second block of the Pljevlya power plant in order to provide KAP with its own dedicated electricity supply. CEAC was considering acquisition of other aluminium smelters across Europe at this time.

All CEAC obligations were fulfilled in good faith until such time that it became evident to CEAC that KAP's initial financial situation had been misrepresented. In May 2006 various breaches of representations and warranties of the SPA were discovered by Deloitte, e.g.: KAP had "hidden" debts and obligations towards the state totalling tens of millions of euros, and the government-warranted 2004 accounts assessment of certain working capital and other assets was inaccurate.

In 2007 political disputes in the Montenegrin parliament led to the cancellation of the tender for construction of the second block of the Pljevlya Power plant (the formal reason given being that the power industry should remain under state control). As a result, KAP was left without the long-term supply of competitively-priced electricity. The prices for electricity supplied to KAP by the state-owned power producer EPCG skyrocketed from €20 to almost €80 per megawatt-hour.

CEAC submitted a proposal to the government of Montenegro to find an amicable solution. Failing an agreement between the parties, arbitration procedures under German law began in November 2007. In August 2008 the claim was submitted to the Arbitration Tribunal in Germany.

The October 2010 agreement

As the world economic crisis started unfolding in 2008, the cost of producing aluminium at KAP reached $3,500 per metric tonne, while the LME price was $1,800 per metric tonne. This extremely high cost derived from high price of electricity and overstaffing combined with high salaries of KAP employees (30% higher than the average in Montenegro). The government did not allow CEAC to reduce staff to economically viable levels or cut wages.

The economic downturn left CEAC and the government with no alternative but to start negotiations to avoid shutting down the smelter in order to keep KAP alive. A settlement was reached in 2009 and the agreement on the settlement became effective in October 2010, according to which the government agreed to issue sovereign warranties of around €130m for existing and new debt to be issued by KAP. The guarantees would be used to raise funds for the repayment of KAP's debts, for joint-financing of the restructuring programme concerning approximately 2,400 KAP and RBN employees , and to raise the plant's working capital.

For its part, CEAC agreed to transfer 50% of its shares in KAP and RBN to the government with the right to repurchase. CEAC kept three seats and the government of Montenegro obtained one seat on the KAP Board of Directors, with CEAC maintaining an operational and

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management role. In order to facilitate the settlement and in view of the government's confirmation that its "primary goal is to support the financial recovery" of KAP and RBN, CEAC also accepted to withdraw the claim against the government of Montenegro it had filed with the Arbitration Tribunal in Germany. CEAC and the government agreed to renegotiate the investment programme for KAP.

The Agreement set a new price formula for electric power supply to KAP by the state-controlled power company EPCG, establishing a tight link to the LME aluminium price until the end of 2012. In addition, the government agreed to endeavour foto achieve maximum production quantities and optimal price.

The settlement agreement also included a social programme whereby KAP was authorised by the government to reduce its headcount to 1,300, providing significant severance packages (average €15,000) in the process. This was the first time the government had agreed to restructuring.

Post-settlement: 2011-2013

As a result of CEAC's restructuring and modernisation , KAP reached break-even by 2011 (and actually started making profit by January 2012, the first time since 2006). However the issue of long-term electricity supply remained unsolved and undermined the long-term future of the business.

In mid-2011 CEAC suggested a restructuring plan to move KAP forward. The plan envisaged signing a long-term electricity supply contract as well as the conversion of KAP's debts – including those contracted to CEAC – into KAP equity. This would help reduce debt to an acceptable level and enable the plant to attract development loans. KAP's debt to CEAC and En+ at this stage totalled €86m, and both companies were prepared to fully convert that debt into KAP equity, provided that the government agreed to a similar conversion of an equal part of KAP's debt to other lenders. Additionally, the plan stipulated a further reduction of KAP's headcount to no more than 700.

An employee supervises the flow of melted aluminium at the foundry in Montenegro's Kombinat Aluminijuma Podgorica aluminium factory in Podgorica.

The Montenegrin government failed to respond officially, despite agreeing to the plan verbally in private talks. The government eventually took two decisions: namely, to make the unjustified request for a transfer of CEAC's remaining shares, and to seek a new foreign investor.

In March 2012 the electricity contract linked to LME expired as the government refused to pay in full to the electricity producer the so-called subsidies, stipulated in the Settlement Agreement. KAP was unable to pay for the electricity at the heightened prices EPCG was demanding, and made it clear that without a long-term contract linked to aluminium prices (normal practice for aluminium smelters worldwide) the firm would not survive. The government unofficially kept promising that it will find a solution.

EPCG, the state-controlled Montenegrin power supplier, was increasingly concerned by KAP's electricity consumption levels (70% of the Montenegrin base load) and its ability to meet that demand. Montenegro largely depends on hydroelectric power for domestic production and an exceptionally dry summer in 2012 meant EPCG was unable to generate sufficient supply internally and would need to import electricity at great cost.

In August 2012 EPCG, with implicit government approval, cut the electricity supply to KAP by 50%, resulting in the reduction of production volumes by 50% and further reducing KAP's revenues – and long-term viability. In September 2012 EPCG unilaterally terminated KAP's electricity contract. CEAC/KAP lawyers argued that a court order was necessary to do so, thereby extending the supply to end 2012. Despite its assurances, the government failed to support the KAP plant, and without electricity supply beyond the end of 2012 CEAC was obliged to recommend an orderly shutdown of the KAP plant, obligatory in aluminium production in order to avoid the destruction of production capacity. However the government representative on the KAP board vetoed this decision in December 2012.

As of January 2013 the situation was highly unusual and lacked clarity. KAP was now without a formal supplier contract for electricity, but electricity continued to be provided to the plant. KAP officially requested that the relevant Montenegrin authorities clarified who was supplying KAP with electricity, but received no

A general view of Montenegro's Kombinat Aluminijuma Podgorica aluminium factory in Podgorica.

answer. KAP was unable to honour payments of the electricity without a formal supply contract, which is why in February 2013 CEAC proposed the establishment of a formal electricity contract, or failing that, an orderly shutdown of the KAP plant's operations. Again the government representative on the KAP board blocked CEAC's initiative. KAP continued to operate until June 2013 without knowledge of who its energy supplier was: while invoices were being received from CGES, another supplier was claiming to provide KAP with electricity.

During this period, the European Energy Commission discovered unauthorised Montenegrin energy consumption drawn from interconnectors in Serbia, Bosnia and Croatia. Upon this discovery, the Montenegrin government asked KAP for immediate payment of its energy consumption, an impossible request considering no formal contract with a provider was in place.

In June 2013 the Montenegrin government suddenly initiated bankruptcy proceedings of the smelter (breaching the settlement agreement in the process). KAP was instructed to sign a contract with Montenegro Bonus – a company 100% owned by the Montenegrin government – to take over the interim management of KAP. Montenegro Bonus appointed as the new CEO of KAP the former government representative board member (the same person who had vetoed the orderly KAP shut-down), now a Montenegro Bonus employee, suggesting this was a premeditated move. After this, the government had to pay all KAP's creditors with state guaranties (€60m to VTB Bank Austria AG and €40m to OTP).

In July 2013 KAP insolvency procedures started and during interim procedures a bankruptcy administrator was appointed, the same person who had dealt with the insolvency of the Zhelezara metallurgical plant owned by Dutch company MNSS. The administrator had no independent power and was at the service of the government and the new CEO.

KAP is today operating at 50% capacity, with a risk of immediate and full shutdown. Fundamental issues still remain: electricity supply and debt. KAP debt to CEAC stands at €50m, a further €44m to En+, and €26m to VTB Bank Austria AG. Other creditors are the government of Montenegro (which paid out €130m to KAP creditors under state guaranties) and EPCG (€40m).

Legal questions

According to Montenegrin bankruptcy law, the supervisory agent is the board of creditors. The five biggest creditors can comprise a board of creditors, composed of one member for each creditor. No board of creditors can be created if there are fewer than three creditors. In the framework of the dispute En+, CEAC and VTB Bank as three of five largest creditors (total debt is close to €120m) would have theoretically had an outright majority. However the allocation of seats and votes in the board of creditors was disputed by the administrator. The board therefore was strengthened through employee legal representatives, ensuring that the administration of KAP kept three votes, a decision which was contested by CEAC in commercial court in Podgorica, as it went completely against the Montenegrin insolvency law. The company filed two claims disputing the actions of the bankruptcy administrator. These claims were rejected.

Detention of Dmitry Potrubach

KAP was declared bankrupt on 8 July 2013. Immediately upon the commencement of the bankruptcy process, the employment contract of Mr Potrubach, KAP's then CFO, was unilaterally terminated. In light of the fact that Mr Potrubach's contract provided the legal basis for his stay in Montenegro, on 10 July 2013 he departed his temporary residence in Podgorica by car in the direction of Serbia.

However Mr Potrubach was detained on the Montenegrin side of the border crossing with Serbia and several hours later detained by the Montenegrin police who stated they were investigating the "theft of electricity from the European grid" via the regional (Serbia/Albania/Croatia) interconnector.

Following an initial refusal to allow bail, Mr Potrubach was eventually released after posting bail of €100,000. The putative charges Mr Potrobach faced were of stealing electricity, which served to showcase to the European Energy Commission that Montenegro itself was innocent of stealing electricity. This charge was absurd: KAP had no direct connection to regional interconnector and could not consume electricity without authorisation from CGES, the state-owned operator of the electricity market in Montenegro, as well as from key Montenegrin government officials. Moreover, KAP had no say over whence any energy supplier sourced its energy. Lastly, the CFO had no decision-making power in relation to electricity supply, the power over which rested with the Board of Directors.

Mr Potrubach was detained under house arrest for for seven long months, until 11 February 2014. During this time his lawyers had made repeated requests and judicial appeals to allow for his free movement throughout the territory of Montenegro, every one of which was routinely ignored. It was only after Mr Potrubach had lodged a complaint with the European Court of Human Rights that the spurious charges levelled against him were formally withdrawn.

Legal actions

The major CEAC claim against Montenegro is based on the Montenegro-Cyprus treaty protecting foreign investments. CEAC initiated ad hoc arbitral proceedings against the State of Montenegro and other Montenegrin entities, the principal subject matter of the arbitral proceedings being various breaches of the agreements on KAP signed by CEAC and the State of Montenegro, followed by the insolvency of KAP.

In 2011 MNSS, a Dutch-based company, former owner of Montenegrin second-largest enterprise metallurgical plant Zhelezara, faced a similar problem – its removal from the management of the company via insolvency procedures initiated by the government – after heavily investing in the plant. In 2012 MNSS filed a claim with the International Centre for Settlement of Investment Disputes. Separately VTB Bank Austria, one the largest creditors of KAP, has filed a claim with The London Court of International Arbitration (LCIA) based on the breach of the agreement under which KAP should have a collection account at VTB Bank Austria to secure its debt to the bank.

We believe that actions of the government of Montenegro represent a pattern of behaviour in relation to foreign investors that cannot go unchecked. ■