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Models of Rent-seeking and Cronyism in the Hungarian Energy Market

The Analysis of the Hungarian Government – MVMP - MET Story

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Theoretical Models of Rent-seeking and Cronyism in the Hungarian Energy Market. *The Analysis of the Hungarian Government – MVMP - MET story*

Supporting partner:

3gteam kft.: http://www.3gteam.hu/

Authors:

István János Tóth and Klára Ungár

Staff:

Kornélia Csimma	intern
Elvira Herczog	economist
Szilvia Hudácskó	intern
Sándor Kollár	intern
Samuel Markson	analyst
Balázs Molnár	analyst
Klára Ungár	analyst
Eszter Purczeld	intern
Bálint Szalai	intern
Márton Tury	intern
István János Tóth	managing director

Experts:

Katalin Andor	economist
Jenő Gyenese	computer scientists
Magda József	lawyer
Zoltán Kelemen	lawyer
Attila Székely	public procurement expert

Corruption Research Center Budapest
e-mail: info@crcb.eu
internet: http://www.crcb.eu/

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„…crony capitalism not only permits rent seeking, it requires rents to be earned and distributed”

[Stephen Haber]

Do not think this pile of legislation we are surrounded with was created by accident. I have learned since I was appointed minister a year ago that this legislation serves the purpose for interest groups to enforce their agenda. When I say the legislation, it is not merely laws I have in mind – laws are maybe the most transparent in this respect. Instead, it may be a government decree or an executive decree where an architect from Kecskemét stands up and asks me – and I blushed with shame, and I felt the ground open up beneath me – to explain why it is not allowed to use small bricks to build chimneys? Why did the Fidesz government adopt a regulation three years ago which specifies that only two types of bricks can be used to build chimneys in this country? What is the reason for that? It took me two days to find out which two foreign companies achieved this feat in Hungarian legislation. I blushed with shame, and I felt the ground open up beneath my feet at the gall we were capable of. This happened sometime in 2011 or 2012. It is precisely at this level of legislation that funny things happen sometimes, things that people just wave off because, make no mistake, the minister who signs it will never read it simply because it is not at his level.

[János Lázár, Minister of the Prime Minister’s Office, 2015 http://bit.ly/29lyEly]

In Hungary, preparatory work for legislation means that the law is written by market players.

[a Hungarian Member of Parliament in the summer of 2009]

Summary

Objectives and Theoretical Framework

1. The paper, as a case study, examines the impact of a regulatory decision of the Hungarian government on two market players: the state-owned MVMP cPlc and a partly state-owned and partly privately owned group of companies (the MET group). Individual aspects and lessons of the story are interpreted in terms of government failure, rent-seeking, and cronyism.

The story can be considered a critical case in modern Hungarian economic history, one in which aspects of (i) government failure and (ii) rent-seeking appear, while one element of the story can be interpreted as a manifestation of (iii) cronyism.

In the first part of the study, we summarize the story of links and transactions amongst the Hungarian government, the MVMP cPLc, and the MET cPlc, followed by a description of the case's actors and details in chronological order. After that, we deal with what individual actors got from the deal; then, we analyze business and personal relationships between the major players based on social network analysis. In the second part of the study, we examine some features of the Hungarian energy market regarding institutional economics's theoretical concepts. Finally, we outline a few theoretical models that may help understand the story presented.

2. Our work was greatly facilitated by IT developments implemented by Hungarian governments in recent years. These developments include online access to the Business Register, profit and loss accounts, and balance sheets.

3. The paper outlines scenarios and uses theoretical frameworks that, in our opinion, contribute to a better understanding of the story and the motives of the actors. We describe several theoretical models that cannot be ruled out a priori. We believe that in the case of the story, it is worth examining all theoretical concepts whose creation and existence cannot be refuted by rational arguments and facts.

4. Regarding the theoretical concepts we use, it is essential to distinguish between state capture and cronyism.

State capture takes effect through rent-seeking whereby individuals or groups of companies achieve that the government or state institutions make legislation or regulations that benefit them and grant them privileged positions. When this happens, the state becomes a servant and prisoner to narrow interest groups, regulating economic processes by their interests. In this way, the state capture automatically results in the distribution failures of public goods, leading to government failures. In the event of the state being captured, well-organized groups of economic actors (citizens, companies) face and act on a relatively weak and non-integrative (i.e., corrupt) state and enforce their interests.

On the other hand, cronyism is also an interaction between the state and economic actors (citizens and companies), but through a completely different mechanism than the previous one.

Cronyism is also created through rent-seeking. Rent-seeking is "the system itself" in this case, where the state's primary function is to confer the resources of society on those (friends and family) surrounding the political leader (in extreme cases, the dictator). The more powerful that leader, the more significant share of the resources are allocated in this way. Rent-seeking is an immanent feature of cronyism as "cronies" need favorable market and regulatory conditions to be created for them by all means and at all times. If the state is based on cronyism, then the allocation of resources to cronies is the goal of politics par excellence.

This goal can be implemented in various ways such as: (i) customized tax benefits; (ii) state loans under exclusive conditions; (iii) calls for tenders restricted to cronies; (iv) creating monopoly markets and transferring them to the buddies; (v) eliminating market players deemed undesired by the regulator; (vi) direct commissions from the government; e.t.c.

Cronyism implies a powerful state where the regulator/administration selects those considered "friends" according to its intentions and preferences. Friends are then benefited, granted rent and business opportunities.

A summary of the MET story

5. In the mid-2000s, essential changes took place in the European gas market. Gradually, the weight of oil-indexed gas wholesale pricing decreased, and so did, due to technological development, market diversification. Following market liberalization, the proportion of spot trading volumes grew in the market in Europe. An essential institutional manifestation of change was the Dutch gas exchange launch in 2005; besides, long-term contract prices began to adjust to the stock market prices.

6. Thanks to amended laws and regulations on gas trading, E.ON Földgáz Trade cPlc and MVM Partner cPlc (MVMP), a subsidiary of Magyar Villamos Művek cPlc (MVM), enjoyed privileged positions from the summer of 2011 to the summer of 2015, i.e., from the gas year 2011-2012 to the gas year 2014-2015.

7. MVMP cPlc was granted almost exclusive use of the Hungarian-Austrian Pipeline (HAG). The HAG pipeline capacity, i.e., the Austrian-Hungarian cross-border gas pipeline had doubled by 2010, reaching 4.6 billion cubic meters a year. Of this capacity, government decree 13/2011 (IV.7) and its annual extensions (in 2012, 2013, and 2014) allowed the two actors mentioned above to import 2.9 billion cubic meters of gas annually, excluding all other potential competitors. In March 2015, the European Union launched infringement proceedings against Hungary for, among other things, the regulation relating to the use of the HAG pipeline. As a result, the Hungarian Government repealed these regulations in 2015.

8. Rather than taking advantage of its newly acquired business opportunity, MVMP cPlc concluded contracts between 2011 and 2014 with METI (MET International AG) and MOL Energiakereskedő cPLc. (from 2013 known as MET Hungary cPlc, a name we will use after this), which ensured a significant part of the profit to be generated by the MET Group (a majority privately owned company).

9. According to the online income statement data, between 2010 and 2012, MET Hungary cPlc paid dividends of approx. HUF 78 billion to its shareholders (http://e-beszamolo.im.gov.hu/). The other participant, state-owned MVMP cPlc, paid a dividend of HUF 13.7 billion to its shareholder MVM (http://e-beszamolo.im.gov.hu/) between 2010 and 2012 of which after-sales profits from the gas business can be estimated at a negligible 1-2 billion forints.

10. MET was established as a limited company in 2007 by MOL with 100% ownership. In 2009, it was converted into a joint-stock company with 50% of its stakes transferred to a company (Normeston Trading Limited) registered in Belize, an offshore tax haven, and allegedly owned by Russian private individuals or Russian state-owned companies. Two and a half years later, Normeston Trading Ltd sold its stake to RP Explorer Liquid Fund. Subsequently,

MOL Plc and RP Explorer Liquid Fund also sold 10% shares to the company's CEO, Benjámin Lakatos. Subsequently, in the second half of 2013, MET Holding, established in Switzerland, became 100% stakeholder of MET Hungary. The ownership structure of MET Holding in January 2017 was as follows: István Garancsi 10%, György Nagy 12,665%, Ilya Trubnikov 12.665%, Benjámin Lakatos 24.665%, and MOL Plc 40%.

11. Of the shareholders of MET Holding, Ilya Trubnikov's role is the most puzzling. According to information from the Offshore Leaks Database, he also owns (via S.M. Systems Limited, Moscow) shares in Commonwealth Trust Limited, another offshore company incorporated in the British Virgin Islands. According to Offshore Leaks, Ilya Trubnikov is domiciled in Flat 8, Trubnaya street 26/1 Moscow, Russia. According to information in the Panama Papers and Offshore Leaks Database, the director of S.M. Systems Limited, the shares of which are owned by Trubnikov, is Dubai resident Matthew Charles Stokes well as the Guardian compilation, has undertaken leading positions in some 1,256 offshore businesses.

12. Personal relations between major actors in the story were analyzed using social network analysis. Networks of personal and business connections and positions within that network can provide important information as to which actors occupy central positions in the network. Whose connections are strong enough to have had a decisive influence on the course and results of the MET deal, even though their position within the network? According to a friendship and business network analysis between the top ten actors in the story, two actors are at the smallest distance from the other players: *Sándor Csányi* (CEO of the OTP Bank) and Zsolt Hernádi (CEO of the MOL Plc). Their standardized actor closeness index is the highest. These two actors are the most central within the network connected to the deal; they are related to other network players through the shortest path. Based on their position within the network, they were theoretically the most likely to have influenced the government/MVMP/MET transaction; other players within the network would have (had) a much harder time playing a central role in the deal.

13. During 2011-2013, the Hungarian and Russian governments conducted intensive negotiations on (i) the repurchase of MOL shares, (ii) the extension of the long-term gas contract, and (iii) the construction of Paks II. That agreements resulting from these negotiations had to do with the reshuffling of MET Holding cPlc's ownership structure.

Theoretical Considerations

14. The energy market is unique: the state heavily regulates it. One of the peculiarities of this market is the frequent emergence of a natural monopoly – a feature that also justifies regulatory constraints in the market. Further characteristics of the energy market include (i) frequent presence of state ownership; (ii) contracts between state-owned and private companies; (iii) market structure is often characterized by oligopoly and oligopsony; high barriers to entry; (iv) the frequent passage of managers and experts from one market player to another and the resulting cohesive personal networks; (v) the specific jargon and language of the actors which partly serves the purpose of maintaining exclusivity. The sector is particularly exposed to one form of corruption: the revolving door phenomenon, which consists of personnel from positions with the regulatory authority to employment with the companies affected by the regulation.

15. Three features of the government/MVMP/MET story are to be emphasized. First of all, it is a story of government failure. The government sought to place MVMP, owned by the government, in a privileged position; MVMP, however, failed to take advantage of this; thus, the government decision taken can be assessed as a failure. On the other hand, the regulation can be considered a failure because it was inherently deemed short-lived: it did not meet the conditions of market conform regulation promulgated by the EU, which was why the EU initiated infringement proceedings against Hungary concerning the case. Besides, it was economically disadvantageous for the Hungarian state. Why should we expect a company in a monopoly position to effectively solve the problem of purchasing natural gas at the stock exchange price and selling it to Hungary in the long run? In such a case, one should consider the social welfare loss due to monopoly rent and deadweight loss.

Another feature of the story is the relationship between a weak state-owned company vs. a profit-oriented private company. While the management of state-owned MVMP sought to pursue security and considered the risks associated with the transaction too high ("they chose not to run the risk of this option, because the cross-border capacity itself was an option"), the profit-oriented private company was willing to take a much higher risk in the hope of achieving a significant rate of profit. The question here is whether or not the MVMP could or would have corrected the state's anti-competitive action, realized by transferring the HAG pipeline to MVMP and E.ON, by calling, under rules that would guarantee competition, for bids from as many competitors as possible, for the capacity in question?

The third feature of the story relates to MET exclusively. MET introduces itself as a clean, innovative, dynamic, and market-oriented company. This is also suggested by the promotional video embedded in the company's website: a young, purposeful, motivated, professional team with a vision. This image, however, is in complete contrast to (i) the way its shareholders own the company and (ii) the way they acquired their shares. The complex ownership structure, which is also published on the company website, Cypriot offshore companies' dominance (five shareholders own shares in MET Holding through ten companies, five of which are offshore) reminds one of the companies' ownership patterns involved in illegal transactions. Companies engaged in illicit trafficking, money laundering, and tax evasion prefer holding shares through offshore companies. Obviously, MET Holding does not deal with any of the above activities, which is precisely the source of tension between the company's above two features: (i) an open-dynamic-market-oriented company, and (ii) a significant role of offshore companies within the ownership structure. Besides, (iii) ownership through offshore companies – apart from MOL Plc, which alone is not associated with offshore business relationships as a shareholder of MET – makes fully formal the existence of the “ultimate beneficial owners” and the changes in the ownership structure between them.

Models

16. The paper outlines four models which can be associated with the story analyzed. These models include (Model 1) natural monopoly, market competition; (Model 2) monopoly and government failure; (Model 3) the state capture; and (Model 4) cronyism, or the kleptocratic state.

18. The first model shows how the distribution of free capacities of the HAG pipeline should have taken place under market conditions through a bidding contest. The situation is then relatively straightforward. The government will act to maximize the wealth of taxpayers. For the free capacity of the pipeline, private companies compete at an auction where regulation excludes collusion. Consequently, there is no welfare loss, and this solution is implemented in the way recommended by the EU. The EU authorities (such as the EU Commission) can interpret the story in the context they use (the distinction between non-market and market regulation).

19. The second hypothetical model describes a situation very similar to the one where the Hungarian state-regulated access to the HAG pipeline between 2011 and 2015, placing a state-owned company (SOE) and a private company (PC) in privileged positions. The model assumes that the intention of the regulator was for SOE to take advantage of this opportunity. According to the model, the company did so in the end: taking advantage of the capacity it had been granted, it went on to purchase natural gas at a stock exchange price; concluded contracts with gas retailers, imported gas at a much lower price than usual, and sold it in the domestic market. Thus, welfare loss was generated because monopolistic companies had access to the cross-border capacity, but SOE made a significant profit on the deal as well, which, in turn, SOE being a state-owned company indirectly benefited the wealth of taxpayers.

The model can be briefly summarized as follows. The government will act to maximize the wealth of taxpayers. It regulates how the free capacity of the pipeline is made available to two companies, placing them in privileged positions. One of them is a state-owned company. As a consequence of this monopoly situation, there is already a welfare loss. The procedure is not implemented in the manner recommended by the EU. The EU Commission can interpret the story within the context of its terms (differentiation between non-market-conform and market-conform regulation).

20. According to the third model, the government places a state-owned company (SOE) in a privileged position similar to the one described in Model 2, which then enters the gas market and makes a significant profit benefiting from the situation. The situation here is not simply government failure. The government acts on the initiative and in the interest of a hidden principal (HP1, a corrupt private company or individual). In this model, the hidden principal

(HP1) influences the government and the SOE management, so both act on behalf of HP1. Taking advantage of its privileged position, SOE enters the international gas market and imports gas purchased at stock prices, thereby increasing SOE profits and the hidden principal's wealth.

21. In the fourth hypothetical model, a private company acquires a privileged position. This situation may occur (i) due to the regulator's intention, or (ii) through pure market transactions with the state getting involved only after having witnessed developments in this model. Two cases need to be separated here: cronyism (4a) and the kleptocratic state (4b).

In the first case, the crony (CR) maintains an excellent relationship with the government or may even be a government member. If this is the case, then the restrictive regulation itself has been designed to benefit the company under the influence of CR [C(CR)]. The regulator itself chose by the CR; the relationship between the regulator and the CR is reciprocal. Of course, the greater the authority of the regulator, the more it can dominate the relationship. This latter is namely the difference between cronyism and state capture: in the former, the regulator (in extreme cases, the dictator) has the final word – the regulator decides who is a friend and who is not, whom to favor and whom to oust from the market. Besides, the cronies also do or may influence the regulator's decisions.

By contrast, in the kleptocratic state model (4b), the regulator initially has no role in the success of the private company. As a starting point, a private company makes significant profit by taking advantage of an opportunity that may have arisen in the market from a regulatory failure. This situation whets the appetite of the regulator (who may, in this case, well be the hidden principal) who then makes an offer to the company "to get involved in the deal", that is, to have a share of the profits or help kins or cronies (CR) have a share.

The fourth hypothetical model can be summarized as follows. The state is not acting in taxpayers' interest; instead, it acts in cronies' interest. The state imposes a regulation or creates a situation, which creates a business opportunity for cronies selected by the political leader or, in the case of the kleptocratic state, for the political leader and his family members. One way of achieving this may be creating monopoly positions resulting in rent gained by privileged companies. In the case of cronyism, the selected private company acquires a privileged position and achieves considerable profits. Consequently, society must reckon with significant welfare losses arising from three sources:

1. inefficient allocation of resources;

2. deadweight loss due to a monopoly;

3. the market-distorting effect of the crony company through the encouragement of rent-seeking.

The implemented legislation is not EU compliant, but the EU will only see that resources have been allocated by restricting competition in the market. The EU will not perceive the underlying cronyism or the kleptocratic state.

22. One of the study's conclusions is that several aspects of the Hungarian Government/MVMP/MET story cannot be explained merely in terms of the market economy's logic (the companies are seeking to maximize profit, the government seeking to maximalize public welfare by regulation). Therefore, we must assume other than merely market impacts and mechanisms when trying to understand the government/MVMP/MET story.

23. One of the relevant models is the monopoly model associated with government failure (Model 2), state capture (Model 3), and cronyism or the kleptocratic state (Model 4). Based on the facts presented in the paper, none of these can be excluded a priori; in fact, we have found several aspects which imply mechanisms corresponding to one model or another. Indeed, in the government/MVMP/MET story we set out to analyze, various models may apply in succession: it may have started with government failure (Model 2); then the story took a turn so that the models of state capture or cronyism are not to be ruled out eventually (Models 3 and 4). The case under review is likely to include several separate stories hidden in it.

24. The first thing we have to say is that government failure is one of the central elements of the story being investigated. Its mechanism is best described in Model 2. Out of Models 2 to 4, we consider state capture (Model 3) as the least relevant case under review.

25. We did not find any evidence that the primary beneficiary of the transaction (the MET or its owners at the time) intervened to influence the regulation's passing in 2011. The 2011 regulation, and its subsequent survival, can be seen as a manifestation of government failure: a government decision that has significant undesirable effects and which, by restricting the market, eventually led to significant welfare losses. In this respect, the profit MET has gained thanks, in part, to the implemented regulatory solution, presumably amounting to several tens of billions of forints, is nothing but the cost of government failure. MET as a for-profit market player, naturally took advantage of the chance offered: the size of the profit is gained from the transaction also highlights the magnitude of losses that may arise from poor governance.