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**Bratić, Vjekoslav; Pezer, Martina; Stanić, Branko**

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## Public procurement integrity and governance in the energy sector in Southeast Europe

**Vjekoslav Bratić, Martina Pezer, Branko Stanić**

*Public procurement processes are prone to some form of corruptive activities. The most common form of irregularity recorded in Southeast Europe (SEE) countries is preferential treatment of companies due to political connections of their owners. For instance, in Croatia, around half of the total contract value is won by bidders which are not private entities, but companies partially or fully owned by the state, which makes it typical breeding ground for certain abuses. For this reason, transparent governance of state-owned enterprises is extremely important, especially of those in the energy sector, as they are faced with numerous challenges, particularly with regard to governance deficits in public procurement. Resolving these challenges would contribute to a better socio-political environment which would prevent*



*irresponsible financial management of state-owned enterprises and the implementation of inefficient or damaging investment decisions.*

The Institute of Public Finance is a partner in the project **Implementing shared anti-corruption and good governance solutions in Southeast Europe: innovative practices and public-private partnerships**, whose objective is to improve existing anti-corruption policies in the public sector. The present Note aims to raise awareness of the public and decision makers about the shortcomings in the public procurement system and energy sector, in order to increase accountability of institutions and strengthen the rule of law.<sup>1</sup> The analysis singled out two most testing governance vulnerabilities in the region: public procurement integrity and governance of state-owned enterprises in the energy sector. We present both vulnerabilities below, with special focus on Croatia, including recommendations.<sup>2</sup>

### **Public procurement integrity in SEE**

Even though corruption in public procurement can take many forms, there is a defined set of corrupt techniques with the aim of siphoning out public money for private gain: favouritism and clientelism, overpricing of contracts, tender specifications tailored for a specific bidder, conflict of interest in the tendering process, high share of non-open procedures and contract modification in

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<sup>1</sup> The Note is based on the report **Public Procurement Integrity in Southeast Europe** drafted within the project referred to above.

<sup>2</sup> The analysis included Bulgaria, Croatia, Hungary, Romania, Albania, Bosnia and Herzegovina, North Macedonia, Montenegro and Serbia.

the implementation phase. Many private companies across SEE whose owners are closely linked with high-ranking politicians are often the winners of public procurements that had almost exclusively been tailored for their profile. For instance, in the past 11 years the ruling Hungarian party has created a new economic elite whose corporations receive large subsidies in sectors such as tourism. In Hungary, 90% of public procurement projects are overpriced by 25% on average. Investigators in North Macedonia have found large differences between market and contract prices of some products with identical specifications, such as protective gear for police and communal workers. Cases of “high-level” conflict of interest were not rare in Serbia in the past years and became even more frequent since the outbreak of the COVID-19 pandemic. The most pronounced case of conflict of interest in Bulgaria is the use of in-house procedures, in which budget funds are provided to a state-owned enterprise without tendering. Resorting to closed or restricted public procurement procedures is sometimes justified (for example, if revealing the content of the tender would pose a risk to national security or if the value of the tender is small enough not to pose significant corruption risks). Nonetheless, SEE contracting authorities often overuse restricted procurement procedures in cases where they would not be necessary or appropriate. However, all malpractices are hard to track due to limited information that can be found on most of the official procurement websites.

In addition, the research has shown that the number of “urgent” procedures that circumvent the usual public procurement legislation increased in the pandemic period. For example, Bosnia and Herzegovina purchased ventilators for a much higher price than their estimated market price, which, on top of that, were not suitable for use on patients. During the state of emergency in

Hungary, the Prime Minister had the power to decide which procedures are related to the COVID-19 pandemic hence could be purchased through direct awards.

### **Governance of state-owned-enterprises in the energy sector in SEE**

The energy sector is of crucial importance for SEE, due to its status as a natural monopoly (often owned by the state), the social sensitivity of the people to price increases and the large investments and financial interests at stake. Numerous cases of lack of public accountability in state-owned enterprises in the energy sector have been uncovered by investigative media reports, civil society reports or audits of relevant public authorities in all nine countries covered by the present analysis. These issues contribute to a socio-political environment which tolerates poor financial management and the implementation of inefficient or damaging investment decisions. The absence of a solid legal framework is a key factor that enables limited financial transparency and widespread political meddling in day-to-day management of state-owned enterprises.

In addition, key governance risks for state-owned enterprises in the energy sector include:

- *Non-compliance of the legal framework with OECD Guidelines on Corporate Governance of State-Owned Enterprises.* The SEE EU Member States perform better in terms of law implementation; however, this implementation remains limited and slow.
- *Limited financial transparency.* Financial data transparency in SEE remains particularly poor, especially when it comes to

companies in a worse financial shape. One way to improve their transparency is to launch an initial public offering, which has been the case for Romgaz and Hidroelectrica in Romania. In another positive example, MOL Group, a listed company in Hungary, posts its financial statements and discloses the amount of shares each Board Member holds.

- *Financial vulnerability.* State-owned enterprises in the energy sector in the nine countries under study show a varying degree of financial vulnerability, revealed by their large debt exposure and high debt ratios, as well as low liquidity and falling current ratios. These financial difficulties have been particularly pronounced in companies whose activities are oriented around fossil fuels as they have struggled to cope with constantly rising prices of raw material. The efforts of the governments to keep energy prices artificially low to avoid a social backlash were taken at the expense of the financial health and political independence of state-owned enterprises, as well as the impartiality of the regulatory authorities.
- *Political appointments.* The rules on the appointment of board members and other company leaders in SEE state-owned enterprises in the energy sector are often unclear, especially when considering potential political influence. The business activities of state-owned enterprises are often influenced by or could even serve the interests of companies or individuals with strong political ties, at the expense of the state-owned enterprises' financial performance.

The energy sector also shows particularly strong governance deficits in public procurement. Some of these deficits coincide with the

general procurement risks, but some are even more pronounced and/or unique to the sector, due to its size, natural monopoly status, and technical complexity.

### **Key issues in public procurement and governance of the energy sector in Croatia**

Public procurement irregularities in Croatia revolve around favourable treatment and clientelism in the tendering process.<sup>3</sup> Even the highest-value tenders are of questionable integrity due to low administrative capacities, single-bidder issue and lack of public call for tender.

Between 2013 and 2020, around half of the total contract value was won by bidders which are not private entities, but companies partially or fully owned by the state. The general feature of public procurement in Croatia is frequent use of simple procurements procedures, i.e. without announcing a public tender for certain values of goods, services and works. Since this type of procedure is guided only by internal acts and controls, it is often implemented by circumventing the regulations, which ultimately leads to the direct contracting issue.

With regard to governance irregularities in the energy sector in Croatia, the major issues are breach of trust in economic operations and money laundering, especially during the worldwide energy crisis (INA) or receiving and giving bribe, illegal favourable treatment and pre-arranged tenders, which leads to services being

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<sup>3</sup> E.g. [Corruption in the allocation of Advent houses](#) in Zagreb or the programming of the [Cijepise](#) platform.

overpaid, i.e. higher than market prices (JANAF). These affairs involved high executives with strong political ties, which once again points to the highly entrenched problem of preferential treatment of companies due to political connections, which can be an endless source of corruption.

The analysis of **public procurement data** shows that between 2013 and 2020 as many as 31% of tenders included a single bidder, while in some tenders the duration of the announcement and decision-making periods point to a corruption risk. The corruption risk has been further enhanced in the pandemic period – between Q1 2017 and Q2 2021, the Corruption Risk Index<sup>4</sup> at the COVID-19-related products and services market increased by around 10%.

### **Recommendations for Croatia**

The National Development Strategy and the Integrated National Energy and Climate Plan of the Republic of Croatia by 2030, accompanied by the implementation and operational documents, are the foundation for meeting the long-term energy strategy. Promoting and developing renewable energy sources would stimulate the growth of the Croatian economy, development of sustainable local communities and reduction of both energy and general poverty of Croatian citizens. Any strategy, the one related to energy in particular, should not be changing every time the government changes. Projects in the energy sector, which are often large-scale and expensive, and the accompanying development

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<sup>4</sup> The Corruption Risk Index considers the duration of the tender, number of bidders, whether a public call has been announced, whether the selected bidder is registered in a tax haven or is a start-up company etc.



strategy, should not be compromised by politics after a government has finished its four-year term.

Since the legal and regulatory framework of Croatian state-owned companies is fragmented, existing rules should be consolidated into a single, comprehensive legal act on state-owned enterprises. This act should provide a clear definition of 1) state ownership, 2) roles and responsibilities of all stakeholders in charge of state-owned enterprises, 3) selection and nomination of supervisory board members and 4) other relevant corporate governance issues such as transparency and reporting. In accordance with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, the efficiency of the internal control systems of state-owned enterprises needs to be enhanced through measures for securing autonomy of internal and external auditors; also, professional, independent and politically uncompromised supervisory boards need to be set up, at least in the largest state-owned enterprises.

On top of that, external audit should play a more important role in public procurement, especially the State Audit Office, since the control mechanisms currently in place, especially in simple procurement procedures, are not efficient. When irregularities are found in public procurement procedures, penalties and fines should be implemented in a systematic manner because they foster responsible and law-abiding behaviour and dissuade from abuse. Finally, all competent public authorities should keep working on enhancing transparency and accountability in all stages and procedures of public procurement, encourage all potential bidders to compete, thus increasing competition as well as the efficiency and effectiveness of individual projects.