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# The application of cash pooling into business practice – ČEZ Group

## Abstract

The article below shows the way the largest Czech holding company – ČEZ Group, has set out. The article describes both the legal and tax environment for companies working mostly in Central and Southeastern Europe in the energetics business. The objective is to further expand the horizon of readers about the financial product possibility of real cash pooling, how it functions and consequently its introduction in the life of ČEZ Group. Comparing two variants, single-level and multi-level real cash pooling, with their advantages and disadvantages, gives the reader a brief view of the problems involved.

**Keywords:** Central and Southeastern Europe, cash pooling, cash management, energy sector.
**JEL Classification:** G32.

## Introduction

Like everywhere in the world, much treasury activity in the Czech Republic is concentrated on cash management. This includes financing the corporation, administration of debts (loans, bonds, commercial papers, etc.), good relationships with the banks, payments to suppliers and collections from customers, control of foreign currency and interest positions according to the company's needs for finance, and finally the reporting and technical support of all these functions. The use of cash pooling as a global standard for concentrating cash into the main bank account of the firm has very quickly found favor in corporations in the Czech Republic.

In regards to the legal aspects of cash pooling, there is quite a difference in the Czech Republic and in foreign legislation. The most remarkable difference in the case of pooling is in terms of the holding company, according to the Czech Commercial Law Code for trusts. In the case of one company the matter is simple. Pooling is only improving a two-sided contract for managing current accounts. In this way, some Czech banks have even a trust pooling set down in a contract (a type of notional pooling).

In the case of a trust, it is always necessary to fulfil some basic criteria in order for pooling to be carried out. The first condition is dealing with a company connected to the pooling structure. If the company would not be completely manageable, a potential clash would take place between the owners connected to the company and a bank could be brought to court as a final consequence. That is why banks limit trust pooling to groups where companies own more than 51% or where manageability has been proven.

Another problem is to show how pooling works in usual conditions for individual companies in order to not appear as some tax relief and also as a problem for minority shareholders. That is why some banks want pooling introduced in and agreed by the general meeting, the board of directors or in print as stated in a managing contract, which allows for the connection of company subsidiaries. A rather fundamental question for banks in the case of providing a current account framework is how to provide a guarantee in terms of pooling. The guarantee of the owner of the main account is common and he has the authority to redistribute overdraft limits for the individual accounts themselves. Only such a guarantee enables the use of pooling for real flexible management of financial requirements without the unstable negotiations with banks.

Banks which set up trust pooling for clients also commonly recommend, with auditors and tax advisors, to work out an intra-group management contract, which will fulfil some basic aspects. It should define in contact all those taking part for the purpose of pooling. It should define how the basics such as the pooling structure functions (account shifts, the periodicity of expressing interest in numbers, setting this amount, the principle of providing internal overdraft limits). It should define the pooled cash revenue and the principles of its distribution, the principles of sharing important information connected with pooling (limit changes, statements, interest calculations). The right of the owner of the main account to connect to other accounts or other pooling participants and the rights and duties of the individual pooling members (primarily liabilities adjusted to expressing debit interest in numbers and taking into consideration movements in accounts from the pooling title, which can significantly influence the availability of the free cash flow of the individual pool members).

The problem of Czech legal regulations is the non-existence of the concept of cash pooling. The Commercial Law Code only knows credit or loan with a defined amount and a period of payability. In the case of some kinds of cash pooling it is not possible to exactly determine. In cases where real transactions are carried out in the main account at the end of the day without a return transfer back, it is not possible to

exactly determine any amount nor the time of payability or such credit. Evidently, it is possible to go around this by means of a set contract with a determined amount limit and set date when there should be a settlement of mutual liabilities and receivables.

Further, there is the problematic issue of the necessity of closing managing contracts or obtaining the agreement of the general assembly. Everything is determined in our conditions by the setting-up company and commonly somehow accepts and provides loans subject to agreement of the general assembly. Because cash pooling is fundamentally repeated with loans whose amounts are not clear, cash pooling is often a problem to be introduced without changing the regulations. Another problematic point in our Commercial Law Code is the limitations for putting companies economically together in dealing with mutual crediting, if it is used for special purposes (for example, the purchase of treasury stock).

The last issue is the possible problem of mutually netting receivables and liabilities coming out of the cash pool, because the Czech law does not automatically know netting without contracts about credits. This problem is again possible to define in a managing agreement, where the entire mutual receivables and liabilities are stated coming from cash pooling that can be the subject of credit.

So cash pooling and mainly zero balancing are without legal settlement, creating a problem in cases of declaring bankruptcy for some of the companies connected to the pool. If it was one company accepting intra-company means for covering its liabilities it would go bankrupt at once, so the provided means from other companies would be lost up to the time of settlement. This only deals with the pooling of free resources (more or less of similar crediting according to the pooling type) in which it is not possible to manage credit risk, but the revenue of free resources. There presently exist two approaches. The first says that the bankruptcy of a company connected to the pool is simply missing a managing structure and that is why the bankruptcy should be processed by means of the owning bankrupt subject as for credit provided to a bankrupt subject. It is necessary to create an authorized entry and mainly to follow credit risk even in terms of the groups brought together. The second approach is founded on the principle that pooling is not observed as credit risk, but mainly as a pooling of resources that would say the payment means from pooling is a priority liability and according to this approach it would be suitable to amend the law about bankruptcy and settlement.

Banks also cover this unclear possibility and set into their pooling contract a provision that at the moment of a proposal or the declaration of bankruptcy they have the immediate possibility to stop pooling.

## 1. The ČEZ Group

Cash pooling itself brings many advantages for companies of a group arrangement. Going through the introductory process is more demanding financially and time-wise, and should not become a way of making the financing of company management easier, more transparent and more effective. The group mainly appreciates these advantages, in terms of reducing work with a large number of companies with a large number of independent accounts. Following the cash flow of the entire group is very demanding and considerably badly arranged in such cases. That is why they directly offer the use of cash pooling and it's not only for the reason of getting a better overview of financial flows of individual companies, but mainly because of the possibility of better using monetary means in the group and for cost savings. On the Czech market one of such groups is, for example, the ČEZ Group (Skupina ČEZ), for which the conditions in the following text will be set out using real cash pooling and a pool structure.

The ČEZ Group belongs to the biggest power trusts in Europe. In the Czech Republic, it is the main supplier of electrical energy, the operator of the distribution systems for most of the country and the most powerful subject on the wholesale and retail markets with electrical energy. In addition to its primary business activities, the ČEZ Group, which represents the production, distribution and sale of electrical energy is likewise dealing with the production and sale of heating and the processing of secondary energetic products. It also has further activities in the areas of telecommunications, IT, nuclear research, design, the construction and maintenance of power equipment and the excavation of raw materials. Thanks to the expansion of foreign companies the ČEZ Group serves almost seven million customers. Out of the total volume of electrical energy produced in the Czech Republic almost three quarters fell to the electrical energy produced by the ČEZ Group. Although a decisive part of electrical energy is determined for the domestic market, a considerable part of it is for export. After the French energy company EdF, the ČEZ Group is the second indirectly greatest exporter of electrical energy in Europe.

At the present time, the ČEZ Group works actively on the markets in Bulgaria, Romania and Poland. Trade representation of the ČEZ Group abroad is in Germany through the means of CEZ Deutschland GmbH, and also in the areas of Slovakia, Hungary, and former Yugoslavian countries.

**1.1. Application of the cash pooling as an important part of cash management in the ČEZ Group.** From the company numbers, which are part of the ČEZ Group it is apparent that managing the Group will not be an easy matter. That is why it is necessary to constantly look for methods on how to manage more easily, more transparently and mainly more effectively. In the areas of managing liquidity, space was also established for using the advantages of real cash pooling, whose introduction into a group company such as ČEZ could be very beneficial.

From the basic variants of cash pooling real cash-pooling was selected, in addition to the advantages of the real centralization of funds for individual accounts, which is not negligible for the volume of the financial parts of the ČEZ Group; it offers as well a higher valuation of financial means as a consequence of the non-existence of regulator costs. The following paragraphs will be devoted to the proposal of introducing real cash pooling in the ČEZ Group.

As pool leader, which is the owner of the pool account, the group will rise from the parent joint stock company ČEZ. Its task will be to administer accounts connected with the company, re-account interest between pool participants and account for all.

The connected companies will identify the proposed model with the process companies for which the model is possible to expand and for other companies which parent company would like to join the pool. In regards to planning the stoppage of the activities of the individual regional distribution companies, these companies will not be included in the proposal.

The transfer of balances between accounts will function on the basis of zero balancing, which means that the balances for connected accounts will be naught at the end of the day. The proposed variants are assumed to function on the basis of one-way cash pooling (which means that at the beginning of the second day a certain amount of financial means will not be transferred back to the connected accounts). According to the following expenditure, the individual accounts will set up technical limits into which an account amount can be in debit during the day. In the case of an exceptional need for higher expenditure than the set limit, it is possible to operationally change this limit, whether it be transferable or permanent. In connection with the permitted debit balance for individual accounts, it will be necessary to settle with a bank for a pool account the possibility of current account credit and its maximal possible amount that is in a current account framework.

In regards to the close communication between process companies and the joint stock company ČEZ, cash pooling will be proposed in terms of a single banking institution, that is intra-banking pooling. This type of cash pooling is also the cheaper variant for reducing costs in the creation of an inter-bank pool.

**1.2. A proposal for account structures connected to cash pooling in terms of the ČEZ Group.** Many methods exist for pooling financial means to a group account. Each company connected to a pool can have many various amounts and set up of accounts depending on the need to follow some cash flows separately. It is possible to base a special account for keeping records on the individual activities of company performance or, for example, split off the accounts through various groups of customers. Account set-up in the group then depends on whether the accounts are connected to the pool account directly or monetary means have been previously pooled in the company framework into the main account of the company and only then transferred to the pool account. In the following text, both variants will be worked out, that is the two-level cash pooling variant and the single-level cash pooling variant.

Globally, cash pooling is a bank product that enables a group to collect money and use it for either further investment or lending. The product is available to companies, which are part of a group of economically related parties. (We can't use the word 'concern' because the Czech codes do not recognize this word in a legal sense.) Related parties are business entities that are related by share ownership. For cash pooling business, it is necessary for them to sign a collective agreement to operate a so-called major (master) bank account. Other bank accounts are settled toward this master account. There could be an overdraft agreement with a bank, but this is not possible for either a master account or the other bank accounts in the pooling system. Nevertheless, credit or debt interest rates have to be defined for all accounts. There has to be an agreed level of interest rates between the bank and the companies involved in the cash pooling system and between each of those companies, too.

*1.2.1. Variant 1 – A proposal for using multi-level cash pooling.* A more well-arranged variant from the cash flow viewpoint in terms of the individual companies shows the pooling balances of accounts on several levels. The proposed model will illustrate the possibility of pooling on two levels – on the level of the company and on the level of the groups. In arranging a suitable structure of accounts for individual companies, it is good to have an idea about the monetary flow which passes through it. The following lines will be devoted to a proposal for account structures in the individual process companies of the ČEZ Group and their pooling into the main account of the given company.

*Cash flow and account structure in the process companies of the ČEZ Group*

Each of the ČEZ Group companies are specialized in various entrepreneurial activities. That is why for each of them different amounts and account set-ups would be suitable. Some of them, for example ČEZ Distribution (ČEZ Distribuce) or ČEZ Sales (ČEZ Prodej) are specific in their own activities, and it appears from this that the proposed structure of the amount in the accounts has to be "tailor-made". For other companies it is possible to bring out certain common features. The character of their cash flow and therefore the necessary number and structure of accounts will be similar. Thanks to this fact it is possible to fundamentally simplify the proposed model and instead of ten various account structures in terms of the process company to suggest only three, which will be applicable to the individual process companies. This deals with the following types of account structures:

- several banking institutions / several bank accounts – a company with a dominating connection to external clients – the company has one main account and some accounts divided according to the purpose for which they were established;
- one banking institution / several bank accounts – the company has one main account and one account divided up for specific purposes;
- one banking institution / one bank account – a company has only one main account, which serves for all direct debit relations.

*Interest settlement for two-level cash pooling*

It is connected with the idea that a group pooling account has two account levels under itself and a bank has to work on the individual levels in calculating interest. The first step of the bank in accounting interest consists in settling the pool on a company level that is determining the balance for the main account of a company. The bank then transfers the credit balance from the individual connected accounts to the main account and the debit balances are settled from the main account so that the final state of the connected accounts would be zero. In other words, a "cleaning transaction" is carried out. In this way, the financial means from the main account will be raised to the credit balance or reduced to the debit balance of the connected accounts. Adding up all transferred balances with the income and expenditure of the main account itself of the company gives the bank a final main account balance. In the following step, in the case of a credit balance in the main account its transfer to the pool account or in the case of a debit balance in the company's main account a transfer of financial means from the pooling account will be carried out so that no financial means stay in the main account of the company.

This process will be repeated for all companies connected to the pool. Adding up all net transfers, whether to or from the pooling account, will determine the final balance of the pooling account, which will be given interest according to its character with either a credit or debit rate. The interest rate for a given interest to the balances for the pooling account is settled in the contract between the pool leader and the bank. The amount of interest is derived from the reference interest rate, that is the rates used for the inter-banking market and from the amount of margin of a given bank. The credit balances are given interest through the PRIBID rate from which the bank subtracts its margin. The rate for debit balances is understandably higher and its size is set according to the PRIBOR relation + bank margin.

*1.2.2. Variant 2 – A proposal for using a single-level cash pooling.* It differs from the two-level cash pooling for which a kind of pooling of monetary means in the framework of the company on the main account in that it does not take place. The credit balances of all accounts existing in a given company are transferred to the pooling account. The debit balances are financed as opposed to the pooling account. The proposal of structuring accounts in the framework of a single-level cash pooling will come out of the cash flow going through the individual process companies just as the way indicated in the chapter about two-level cash pooling, the only difference being that the individual accounts will not be pooled into the company's main account, but will be directly connected to the pooling account.

*Settling interest for single-level cash pooling*

Just like in the case of two-level cash pooling the bank gives interest to the balance of the pooling account according to its character whether it be with a credit or debit rate. The difference as opposed to two-level cash pooling consists only in the fact that the balances of the individual accounts of the connected companies are transferred to the pooling account. The bank then first finds out the balances for the individual accounts of the process companies and a clearing transfer is carried out to the pooling account. The individual transfers are summed up in this account and the balance is obtained from which, according to its character, a credit or debit rate comes about.

**1.2.3. Comparing two proposed variants.** It is possible to reach the same results for the group using both methods. Both methods are then well used

in the same way. Naturally, there exist certain differences which after consideration could lead to the conclusion that one of the variants is just a little more suitable. The basic difference exists in the following parameters: the difficulty of determining the net position of a company in a pool, the number of transfers from connected accounts to the pooling account and the accessibility of a given type of cash pooling on the banking market.

The facility of determining the net position of a company in the framework of the pool is a great priority for multi-level cash pooling. Thanks to the pooling of balances into the main account the company has information about the amount transferred to the pooling account available at once. In the example introduced in the chapter about settling interest for two-level cash looping, it is suitable to have a net position of the individual companies with a clearing transfer from the company's main accounts to the pooling account, because the cash flows indicated are carried out in the framework of one day. The net position of a company in a pool however changes every day. Its updated amount is calculated by adding up the net position from the past and an updated clearing transfer. This parameter shows how much money of a given company is deposited in the pool account and it is important in particular for re-budgeting pool revenues.

As opposed to this, single-level cash pooling gives a company information about the amount of means, which are taken out of the pool account and is rather more difficult. The balance transfers of all accounts connected to the pool have to be added up. For a small number of accounts in a company this disadvantage is rather negligible. If it would be, for example the company ČEZ Prodej, a decision would be made to differentiate the accounts more for keeping records of its own customers and could make it easier to find mistakes in determining the net position of the company than in using two-level cash pooling.

From the single-level cash pooling plan, it is evident that there are many more transfers to the pooling account compared to multi-level cash pooling. It is possible to chalk another point up for multi-level cash pooling. Although a greater number of transfers for single-level cash pooling might apperar at a first glance as a banal and negligible matter, it is applicable in that it can determine a net position. In the greater number of accounts in a company, many more transfers to a pool account are established, which has a fundamental influence on the overview of cash flows also coming from the connected companies. Pooling on many levels not only ensures an overview, but at the same time helps to eliminate the possibility of mistakes in settling pooled revenues and interests on the part of the pool leader.

A considerably important parameter for deciding between introducing single-level or multi-level cash pooling is the availability of these types on the banking market. Although it comes from the previous number of arguments that two-level cash pooling is more suitable, a basic obstacle can arise during its introduction. Some banks do not offer two-level cash pooling at all. A group can repeatedly change its bank, but has to thoroughly consider if its choice is really advantageous. For example, it was shown that results for the group will be suitable in both variants proposed. There exists then the possibility of substituting two-level cash pooling with something less overseen, that functions just as well for single-level cash pooling.

Result summary of comparing both variants is illustrated in Table 1.

Table 1. Comparing the proposed variants of cash pooling

| Evaluation criteria | Single-level cash pooling | +/- | Multi-level cash pooling | +/- |
|---|---|---|---|---|
| Results in the framework of the group | same | | same | |
| Overview of company cash flow | less | - | more | + |
| Determining net position | more difficult | - | easier | + |
| Availability on the banking market | same | | same | |

## Conclusion

In regards to the complicated structure of the ČEZ Group the proposal is conceived for the joint stock company ČEZ, the parent company, and more than 10 process companies for which this model could be expanded in the future to other companies, which the Group would consider as a suitable candidate for joining cash pooling.

Real cash pooling was selected as a basic type of pooling means, and in particular for the reasons of the real centralization of financial means for an individual account, which enables the optimal use of the liquid position of the whole group and leads to a reduction of interest costs. Besides this, real cash pooling brings a higher pooled revenue than fictive cash pooling, for it is not connected to regulatory costs.

On the basis of cash flow analysis, an account structure was proposed suitable for three types of com-

panies into which it would be possible to put each of the ten process companies of the ČEZ Group. Two variants of functioning cash pooling were proposed for the Group, namely single-level and two-level cash pooling.

From the overview standpoint, the two-level cash pooling variant appears to be more suitable, because it enables a more convenient determination of the daily net position of the process companies in the pool, for which the distribution of pooling revenue is basically divided. The overview of these variants also increases a lesser number of transfers between accounts connected to the company and pooled account.

Despite this, a situation can take place when this variant will not be used, for some banks do not offer a multi-level cash pooling system. A substitute method, which often replaces multi-level cash pooling – single-level cash pooling – is a sufficiently equivalent previously-used variant. For example, it was shown that the use of whichever of these variants brings the company the same results. The difference consists in the fact that in the case of single-level cash pooling the result reached is through a method that is not overseen.

As for further research, it is possible to recommend cross-border or international cash pooling to deal with this problem in regards to widening the ČEZ Group in the foreign market and to the tendency of creating a company structure in individual countries similar to the Czech Republic. The most difficult part of introducing it consists in respecting the national settlements of foreign currency regulations and payment relation regulations. The countries, in which the ČEZ Group appears, are mostly members of the European Union, it follows herefrom that a unification of legal settlements should gradually come about, which could facilitate the implantation of international cash pooling, whose introduction would be another way of making liquidity management more effective.

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