Gas Supply Company

Summary of the Operation Performance Evaluation Review

(October 2004)

THE PROJECT

The Company was created as a joint venture in 1997, in order to upgrade a gas pipeline and increase delivery capacities. The Bank was chosen as the lender in 1998, and in October 1999 the Bank's Board approved the first financing of US$ 52 million. The Bank kept US$ 40 million on its own books and a parallel lender made a loan of US$ 12 million.[1] The main purpose of this loan was to construct a compressor station in the country (phase 1).

In 2001, the Bank approved a second loan for US$ 97 million. Of this, US$ 46 million was syndicated; US$ 6 million to the parallel lender, plus US$ 20 million each to the two B-Loan participants. This second loan was to finance the construction of two looping pipeline sections totalling 70km and an underwater crossing (phase 2). The project was successfully completed and is now operating in accordance with initial projections. This review evaluates phases 1 and 2.

PROJECT RATIONALE

The joint venture Company intended to create a transparent structure to expand the capacity of its existing pipeline infrastructure, in order to meet the gas delivery schedules agreed between the buyer and the seller. There were two main reasons for the Bank's involvement: first, the fact that the project – the first pipeline owned by a joint venture in the country - would have a strong demonstration effect on the whole economy; and second, the introduction of a highly efficient contractual management structure, together with transparent pricing for the transport and compression of gas, enabling the investment to be repaid from transportation fees.

ACHIEVEMENT OF OBJECTIVES

The two main objectives of the operation were to promote the private ownership of gas transportation systems, and to attract foreign direct investment. The project was also expected to promote regional cooperation in the gas sector. All three objectives have been achieved.

OVERALL ASSESSMENT

Based on its independent review of the project's performance, the Bank's Project Evaluation Department (PED) rated its overall performance as *Highly Successful*.

TRANSITION IMPACT AND BANK'S ADDITIONALITY

The PED rated the transition impact as *Excellent,* due to the innovative structure of the project, and the successful completion and start up of the facilities. The project's financial performance and its fulfilment of objectives were both rated *Excellent*. The environmental performance of the Company was rated *Good*, and the extent of environmental change *Substantial*. Additionality was rated *Verified in all Respects*, especially for the first loan. No other financial institution would have provided financing for this project.

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[1] This was the parallel lender's first loan as a newly established international financial institution (IFI). The EBRD therefore helped to advance the IFI's operating capabilities.

At the time of the second loan, additionality was slightly lower. However, the Bank facilitated the syndication to further B-Loan lenders and had the advantage of being familiar with the project's complex security structure. The operation team's handling of the project was rated *Excellent.* The close contacts between the operation team and the Company led to the second loan, and meant the modifications to the financing documents for the second phase could be handled efficiently. The operation team met regularly with the company, and the Bank's independent engineer also played a constructive role with regular site visits. He helped to develop the environmental standards for the general contractor, and to devise an efficient cost control system. The PED rated the overall transition impact as *Excellent*. The Office of the Chief Economist (OCE) rated the ex-ante transition rating as *Good*, with a *Medium* risk rating.

BANK HANDLING

The PED rated the Bank's performance as *Excellent*. The operation team actively influenced the size and shape of the project by suggesting a phased approach to its implementation. As this is not a greenfield pipeline project, a phased approach was acceptable to the Company's shareholders. The Company appreciated the fact that the Bank continued to support the project in the aftermath of the country's financial crisis, and the subsequent changes to the project's security structure. The transaction structure was considered complex and demanding but appropriate for the first phase. In the second phase, the client preferred to work again with the Bank and expand the group of lenders to include commercial co-financiers.

MAIN ISSUES AND LESSONS

Aligning the interests of the main shareholders in the special purpose company (SPC) is very important. Aligning the interests of all shareholders by using an SPC with transparent contracts for compression and transportation services was key to implementing the project efficiently and obtaining international financing. Using an SPC allowed the Bank to cut across all past and present difficulties among the various parties and simply focus on the planning, construction and operation of the new assets.

If appropriate, staged or phased development can reduce the size of the international investors' market mobilisation in the early phases. Staged or phased development can be useful, especially when international investors are reluctant to enter the specific market, or when the borrower or the host country have yet to establish strong credit ratings.

Project finance structures, while expensive and time-consuming, protect lenders' interests and facilitate co-financing. Project finance structures with extensive security packages are expensive, in terms of legal costs and in terms of the overall supervision required by the lenders. This could be an issue, especially where the facility amounts are rather small. Complex structures also require intensive monitoring, due to the relatively frequent changes caused by commercial considerations and by changes in the applicable law. However, in an uncertain legal environment, where the borrower is a SPC with no (or almost no) business track record, a limited recourse structure does provide additional comfort to the lenders and therefore helps to mobilise commercial co-financing.

International project finance syndications require a state-of-the-art security structure. While the documentation and corresponding legal costs may be substantial if initial project phases are relatively small, this approach provides more comfort to the project sponsors as the limited recourse nature is clearly defined. In a project with various stages and extensive longer-term capital requirements, the initial set up costs can easily be amortised in later stages.

It is important to have an independent engineer with a strong local presence. With this project, the acceptance of the independent engineer and his recommendations was substantially enhanced by his strong local presence. This included providing engineers with an excellent knowledge of local regulations, standards and procedures. They were supported by regular visits from headquarters staff.

Pilot projects can enhance transition impact and environmental change. The role of the Bank may evolve from an initial emphasis on a pilot project, carefully designed with insight into the entire sector, to a more syndication driven approach, providing enhancement for large international syndications. This happened with the project in the move from phase 1 to a larger phase 2. The Bank's additionality and transition impact can therefore be enhanced once the Bank's involvement reaches a certain critical mass within the sector.

It is essential to have an independent review of long-term off-take and other contractual arrangements. It is customary and highly useful to involve specialised independent consultants (technical and legal) to work with Bank staff to review key off-take arrangements, as well as the negotiation of EPC, operation & maintenance and sub-lending arrangements. The flexibility to review and adjust the security package should be built in from the outset.

It is important to have an experienced general contractor and to ensure independent supervision. An experienced general contractor adds value in complex construction projects involving a large number of subcontractors. The owners and shareholders also need to be involved, to be able to coordinate with the general contractor. During planning, international tendering and project implementation, independent supervision is vital. For gas pipelines, defining quality standards for welding is particularly important.

Structuring the project finance to allow disbursements for completed work helps the construction progress. Applying project finance standards with regular checks and disbursements for completed work enabled the joint venture to pay subcontractors as work progressed. This helped the project to be completed on time, and was appreciated by the subcontractors. A solid financing structure contributes to a project's successful completion. It is crucial that tight quality control systems based on regular inspections are in place from the outset, in order to avoid any abuse of regular project payments.