Telecommunications Company

Summary of the Operation Performance Evaluation Review

THE PROJECT

The Company is the dominant provider of telecommunications services in one of the EBRD's countries of operations. While the company's licence gave it exclusivity over some services, competition in certain services has reduced its share of the total market.

In December 1999, the Bank's Board approved the Project as "an integrated investment package" comprising:

(i) a debt operation to be executed by the Bank's Telecommunications Team: a term loan to the Company for US$ 50 million (€46.3 million equivalent). Half of this loan, however, was cancelled and then refinanced by a new EBRD loan.

(ii) an equity investment to be executed by the Financial Institutions Team: the purchase of about one third of the Company's capital stock in ordinary voting shares for no more than US$ 70 million, subject to a put agreement to the State.

(iii) a technical cooperation (TC) assignment: the Bank prepared a TC programme to develop the telecommunications regulatory and legal framework and the sector policy.

PROJECT RATIONALE

The project allowed the Bank to directly influence essential market reforms in the country's telecommunications sector, strengthen corporate governance and promote market change. The loan pricing mechanism would stimulate the government to promote reforms, e.g. tariff rebalancing and privatisation.

ACHIEVEMENT OF OBJECTIVES

The project's approved objectives were to:

- further develop the telecommunications infrastructure in the country
- strengthen the Company's corporate governance and commercial independence
- achieve further progress towards attracting a foreign strategic investor.

The project's overall achievement of objectives was *Good* despite the abandonment of the equity deal, which did not unduly block progress on other objectives. The corporate loan contributed mainly to enhancing the physical infrastructure, but it also stimulated improvements to financial management and reporting. The second objective was achieved only in part, but the TC has enhanced commitment to regulatory reform and promises great benefits if implemented. The third objective, privatisation to a foreign strategic investor, was not achieved. In fact, the government had proposed restricting foreign ownership to 49 per centof a telecommunications firm, although the outcome of that proposal was uncertain. The proposal changed the outlook for privatising the Company to a foreign strategic investor; it is now unlikely that further privatisation will take that form. The follow-on loan operation promised to continue the work to improve infrastructure and contained incentives to implement the TC-guided sector reforms, a valuable feature.

OVERALL ASSESSMENT

The project was rated *Successful* overall, giving weight to the initial impacts of the TC programme; i.e. creation of an independent regulator and announcement of the liberalisation plan. These steps are valuable outcomes of the TC programme. Furthermore, these outcomes support the *Good* rating for potential transition impact, albeit with a *Medium* risk given the challenges of implementing the liberalisation. Overall transition impact was rated *Satisfactory* as the Company is still a government-controlled near-monopoly, the outlook for further privatisation is unclear, the market has not been liberalised as hoped and regulatory reform remains a promise yet to be fulfilled. Achievement of objectives was *Good*, environmental performance *Satisfactory*, bank handling *Good/Marginal*, project and company performance *Good*, and additionality was *Verified at large.*

BANK HANDLING

The evaluation rated bank handling as *Good/Marginal*. The rapid upswing in the country's and the Company's performance made the Bank's complex equity and loan structure largely unworkable. While this constrained success, the main causes were the government's decision to restrict the privatisation of the Company and the delayed liberalisation of the telecommunications sector. The Bank vigorously pursued the equity deal with the government. As for the loan, the Bank dealt firmly with the Company during the disbursement phase. Events overtook the loan structure, making it obsolete for the needs of the Company in a very short time. The Bank refinanced the loan with a new loan in late 2003. That project may be evaluated separately in the future.

The equity deal structure was complex and contributed to delays in the disbursement of the loan and to the failed closure of the equity investment. The put option protected the Bank against the risk that the privatisation might not go ahead due to the company's poor performance. The additional call option increased the Bank's return in case of success, although the Bank took little downside risk on the portage equity structure. The Bank's risk-averse approach to this operation increased the implementation risk. During the project review, the Bank did not assess the risk that the equity deal might not close, leaving the Bank committed under the loan agreement to a firm that would not undergo the promised change of ownership, which is what took place.

Post-approval legal due diligence identified the risk that a direct sale of the government's shares in the Company to the EBRD might breach the tender provisions of the country's privatisation law. This risk materialised because the authorities could find no clear way around this problem, which contributed to the deal not closing.

LESSONS LEARNED

Risk mitigation and commitment to transition must be balanced. The Bank's risk mitigation structures can signal its level of confidence in a project. When the counterpart is the government, strong mitigation measures can signal a lack of confidence in the promised reforms. Such mitigation measures, if too complex, can lead to a delay in implementation and distrust of motives. When dealing with a member state government, it is better either to reach a simple deal that the Bank strongly believes in, or to make no deal at all, than to construct a low risk, complex deal that signals little confidence in the project or the reform outlook.

Commitment in memorandums of understanding should be included in project documents. A memorandum of understanding (MOU) which details the government's broader reform issues is an excellent feature. It is important to carry the commitments of the MOU into the mandate letter and especially the loan documents in a creative way to reinforce achievement of objectives. An interest rate step-up can be such a feature, as can limitations on dividends and other restrictions. These may not be enough to keep progress on track. It may be best to sequence the loan to follow other stages of the project, such as completion of an equity investment, as conditions precedent.

Presidential decrees could be used to approve the terms of EBRD projects. MOUs with leading ministers do not always bind the authorities to an agreed plan of action. Consequently, the Bank should consider requiring a Presidential decree or equivalent instrument that approves the basic terms of major projects as a condition for project approval by the Board of Directors. Such a practice could reduce the risk that projects, whose principal purposes have been agreed with the authorities, lose momentum due to subsequent changes of policy or personnel.

Other shareholders should be made aware of the potentially conflicting roles of the Bank. During a short caretaker period, such as a pre-privatisation equity investment, there may be little conflict between the benefits of monopoly power and the objectives of furthering liberalisation and competition. However, the recipes for how to handle various situations need to be thought through at the outset. There may be two options: (i) in the name of transparency, the other owners should be made well aware of the multiple roles of the Bank; or (ii) the Bank should simply stay away from board memberships – even if it has a big equity stake – and let the other owners decide what is best for the shareholders.

Financing provided to the incumbent dominant providers in the telecommunications sector should be limited. Financing should only be offered once to the incumbent if the transition impacts of the first deal do not come about as planned. Financing a challenger helps to develop market competition, while supporting the incumbent may stifle competition. It is often the case that only the incumbent offers services at the early stages of transition and that direct investments in the incumbent's network can lead to quick improvements in services. The lack of competition, however, may allow the incumbent continue its "lazy life". One way to reduce this risk is to make it clear from the beginning that, next time, the EBRD will finance new competitors rather than the incumbent.

Transition should be promoted at the sector and company levels. Transition should be promoted at several levels simultaneously. This means that some of the transition tools of earlier stages, such as reinforcing the basic infrastructure and regulatory reform TC, remain fundamental, while preparations are being made for the later stages in the process.

Financing should be linked with regulatory reform. It makes sense to offer financing for certain types of basic infrastructure independently of regulatory progress; examples include the backbone network and satellite terminals to support rural access. Even if it is difficult to prove that the investments in such basic infrastructure are commercially viable, the positive secondary effects on the overall economy should dominate. Any other projects which have a commercial rationale should receive money only when the appropriate regulatory regime has been developed.

A sequence of project elements should be developed around reform levels. Keep the overall goals of the multi-level approach constantly in mind. The purpose of the Bank's involvement in any country is to contribute to the overall development and speed of transition. It may sometimes be necessary to stick to a set sequence of transactions, and delay some secondary elements of support such as financing capital expenditures, until the major steps have been achieved, such as regulatory reform and pre-privatisation equity investments.