

Restructuring Loan to Energy Supply Company

Summary of the Operation Performance Evaluation Review

(November 2004)

THE PROJECT

In July 2002, the Bank approved its second loan to the Company for US\$ 70 million. The Company supplies an important region of the country with electricity and heat. The first loan, in 1998, was US\$ 30 million to complete a pump storage project. Another bank signed a parallel loan of up to US\$ 20 million. This was the Bank's first loan to a privatised utility in the country.

The second project has two components:

- (i) A physical component, including the rehabilitation/modernisation of a complete steam turbine generator set. This includes all its auxiliary systems and allocated power plant components such as: condensers; pre heaters; condensate pumps; heat exchangers of the process energy; air to water coolers; piping and valves; the steel structure and foundation; medium and low voltage distribution; a generator breaker; a step up transformer; an auxiliary transformer; and the instrumentation and control-system.
- (ii) An institutional development component. This includes supporting the Company's restructuring group, which is responsible for splitting the organisation into separate, business-oriented companies, to prepare for a liberalised, competitive energy market. The Bank also approved a TC to help the regulatory authority to implement the complex distribution tariff methodology developed under a TACIS programme.

PROJECT RATIONALE

The main rationale of this project was to replace an aging turbo generator group with state-of-the-art steam turbine technology. The Bank also wanted to support the restructuring of the Company from a vertically organised entity into a group of business oriented companies with their own separate organisations and accounts. These separate units would then be established as new joint stock companies. The ultimate aim was to prepare the Company for a liberalised market, and to attract private investors.

ACHIEVEMENT OF OBJECTIVES

The main objectives of the operation were: to improve the energy efficiency of power generation (fully achieved); to increase the reliability of the power supply (achieved); to improve the project implementation process (achieved); and to restructure the Company (the signs are hopeful, but it is too early to judge if the restructuring process will be continuous and thorough).

The Bank has also approved a TC for the Company's distribution tariff methodology study, to be developed in close cooperation with the regulator. The contract for this consultancy assignment was not signed until early October 2004, due to delays caused by the institutional restructuring of the regulatory body. The consultancy assignment will take place from October 2004 to May 2005.

OVERALL ASSESSMENT

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

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The project's overall transition impact was rated as *Good*. The project resulted in the refurbishment of the steam turbine generator unit as planned. The Bank had limited influence on the implementation of the refurbishment project within the Company. The Company's team followed its own standard process from previous projects, together with some additional requirements from the EBRD, which in the team's view reinforced its own high standards. The environmental performance of the Company was rated as *Good* and the extent of environmental change *Substantial*. The Company's performance was rated as *Marginal*. The technical performance was good and the rehabilitation was successful, but restructuring is still continuing, aiming at higher operational efficiency. Furthermore, the regulator will have a key influence on future profitability levels. Tariff adjustments will need to reflect expected gas price increases and to include a larger component for maintenance and upgrades/replacements. The Bank's investment performance was rated as *Satisfactory*.

At the time of board approval there was a limited appetite from commercial banks for long-term risks in the power sector without export credit agency cover or co-financing structures with international financial institutions. Considering the risky investment climate in the country's power sector prior to the start of the sector's restructuring, it is unlikely that other external sources could have been found to fund the project. The funds provided by the Bank helped to improve the project execution by reducing the lead time. The Bank was also able to involve commercial banks as B-loan participants. The PED therefore rated additionality as *Verified in all Respects*.

BANK HANDLING

The Bank's power and energy team has correctly targeted the Company as the most important "Energos", and one which will be a model case for the reorganisation of the other smaller "Energos" in the country. The Banking team has established an excellent working relationship with the company at all levels and it is likely that further opportunities for Bank operations will arise. The Company has expressed its satisfaction with the quality of the power and energy team's work. Bank handling was rated as *Good*.

MAIN ISSUES AND LESSONS

It can be useful to link a project's progress to the overall restructuring of a power company. It would be worthwhile to link, through clearly defined benchmarks, the physical and restructuring elements of a project, to keep up the pressure on both. For this reason, it may be useful to split the refurbishment work into "closed" phases with clear intermediate milestones, for example:

- Engineering and preparation of procurement;
- Dismantling of existing equipment;
- Procurement and delivery of equipment;
- Installation and commissioning.

It would then be possible to insist on the concurrent execution of the project itself and the restructuring of the company.

There must be adequate investment in power plants in order to ensure a reliable and competitive power supply. In order to be competitive in an open market for electrical power, a company must have a reliable and safe production and distribution system. It is crucial to maintain the technical standard of physical assets and to plan replacements well ahead of time. As this project has demonstrated, local technical expertise is available to implement replacements successfully and within a tight timetable once the financing is secured.

The work should be monitored to ensure that it meets the targets set. As part of the refurbishment project procedure, targets should be set. Clear and measurable goals should be defined and means determined to verify how and when the achievement of those targets should be measured and registered. Part payments for work and the release of additional services to the project should depend on the project hitting its agreed targets.

Successful sector restructuring depends on clearly defining the rules of the free market and appointing a strong independent regulator. The lack of clear market regulations is a critical obstacle to successfully privatising the country's energy market. As long as the government has not established the rules of the market, it is impossible to carry out an adequate due diligence of any "privatised" company. Until this is clarified, an investor will find it hard to make decisions on the basis of hard facts.

The company must be profitable enough to attract domestic and international investors. The company's medium and long-term expected return on equity will influence both equity investors and lenders. The company needs to have a better understanding of electricity and heating tariff increases, which will need to be both affordable to users and attractive to investors. Assessing the need to invest in maintenance and replacement equipment will also be important.