

Energy Efficiency Project

Summary of the Operation Performance Evaluation Review (March 2005)

THE PROJECT

The second multi-project facility for energy service companies (ESCOs) was approved in October 2001, consisting of a four year debt and/or equity facility of up to €150 million. The EBRD's aggregate participation in any MPF sub-project (debt, equity or guarantees) is capped at 40 per cent of total funding requirements, with additional funds provided by the sponsor and local commercial banks. Proceeds go towards financing ESCOs, which carry out energy performance contracts (EPCs), with the objective of recovering the investment through energy savings.

This summary focuses on one ESCO, a subsidiary of the sponsor, which operates in the areas of district heating, network improvement and cogeneration in different towns of the country. The Bank is both an equity partner and debt holder in this ESCO. In December 1998, the Bank invested €0.87 million as an initial 30 per cent equity participation in the company and also extended a €3.99 million seven-year amortising term loan for capital expansion requirements. The company operates as a lessee of district heating generation and distribution equipment owned by municipalities. As the company signed up more contracts, the sponsor increased its equity contribution, resulting in a dilution of the Bank's participation. In agreement with the sponsor, a new equity issue reserved for the EBRD took place in December 2003. New investment amounted to €3.8 million. Along with the remaining outstanding loan facility of €1.7 million, the Bank's total exposure to the company is €6.4 million.

PROJECT RATIONALE

Through this project, the Bank contributed to the sponsor's growth in the country's ESCO market as evidenced by several new contracts signed with municipalities since 2001. These contracts called for network improvement and new biomass heat and power generation. This ongoing commitment of the Bank was meant to support a number of key transition impact objectives of the project. These included privatisation (through asset management as opposed to acquisition), a client-oriented approach, and an environmentally conscious and economically managed fuel substitution initiative. This was to be reinforced by legislative improvements to tariff regulation where the Bank, as a significant shareholder in the project, would be expected to play a role through policy dialogue if required. As an equity shareholder, the Bank also anticipated an adequate return on its investment through its put option on the shares in the company which may be exercised from end of 2004 onwards.

ACHIEVEMENT OF OBJECTIVES

Expansion of the ESCO model in the country. Through its recent equity contribution, the Bank has fully supported the project company's expansion in the country's market. Having started in 1998, the company is currently operating nine heating networks in the country, two of which were added in 2003 and became operative in 2004, each under 15 year lease contracts. Total investment, including replacement and growth amounting to €5.5 million in 2003, was estimated at €7.8 million in 2004 and forecast at €7.7 million in 2005.

Fuel substitution policy. The company's portfolio of boiler houses was predominantly gas powered. Burning gas is relatively clean in comparison with heavy fuel oil (HFO), the second largest alternative fuel in use. Generally, this has led to the substitution of wood for primarily HFO but also shale oil and gas in fuel consumption. The company's share of gas has decreased from 80 per cent to 74 per cent of total fuel consumption from 1999 to 2005; over the same period, wood fuel has increased from 0 to 20 per cent while HFO has gone down from 15 per

cent to 4 per cent and shale oil from 4 per cent to 1.3 per cent. The availability to the company of carbon credits illustrates the successful implementation of its fuel substitution policy.

Improve customer satisfaction through privatisation. Ownership of assets has no relevance to the privatisation process from a client satisfaction standpoint since, by nature, a district heating system would be granted a geographical monopoly of the distribution of centralised heating and sanitary water. The company has experienced a negligible level of unsubscribing from clients and is very active in promoting energy savings at the client's level (buildings) in order to be regarded as a provider of service and not just a commodity seller. Client loyalty is the best indication that privatisation through concession achieved the objective of customer satisfaction.

Securing an adequate return on the Bank's equity. The objective of securing an adequate return on the Bank's equity is only partly achieved through the promise of dividend payments from 2005 onwards and the likelihood that an ongoing profitability trend should deliver the range of equity returns that was anticipated at approval. The Bank's put option is ultimately subject to negotiations on fair market value (FMV) determination unless exit is achieved through a successful IPO.

OVERALL ASSESSMENT

PED's overall rating of this operation was *Successful*. This was based primarily on the *Excellent* ratings achieved under transition impact and environmental performance while the extent of environmental change is rated as *Substantial*. PED did not carry out an extensive review of the sponsor's other subsidiaries. The sponsor's operations outside the country, through promotion of energy efficiency and savings, would very likely deserve a *Good* to *Excellent* environmental performance rating and a *Substantial* rating of the extent of environmental change.

Although the financial performance of the different subsidiaries of the group (forming part of the MPF) was uneven, the *Satisfactory* rating given to the company could also apply to the MPF. This takes into consideration that poorly performing operations take a longer period of time to reach profitability but have not been identified as structurally loss making situations. The Banking Team assessed fulfilment of objectives as *Excellent*. PED would revise that rating down one notch to reflect those areas where business plan achievements are behind schedule, as is the case in the Slovak Republic and Romania. Even with a *Good* rating of fulfilment of objectives the overall rating of *Successful* is justified for the MPF as it is warranted in the case of the company.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

PED's rating of overall transition impact was *Excellent*. This was justified by the leading position acquired by the company in the privatisation process. The success of the operation from a technical and financial standpoint should have, over time, a very positive demonstration effect and encourage other investors to take a more active part in remaining privatisations. A significant aspect of the company's contribution to the economy and environment is its successful implementation of wood-fuelled boiler houses and its simultaneous promotion of the wood collection industry which optimises the use of the country's natural resources and workforce.

The Bank's shareholding in the company provides greater visibility for the company in a country where the EBRD is better known than the foreign sponsor. At the time of the Bank's first investment, the country's banking sector was facing a serious crisis and, according to the company's financial director, it would have been difficult for the company to raise financing and impossible to do so for the maturity offered by the Bank. On the debt side, it is clear that the

Bank's additionality is no longer verified. Although the Bank's lending activity is no longer additional, it certainly was so at approval stage. The Bank's presence as an equity holder has actually contributed to making the company a more attractive client to local banks, which enhances the Bank's additionality from the equity side. PED therefore regards the Bank's additionality as *Verified at Large*.

BANK HANDLING

The relationship established by the Banking Team is highly valued by the sponsor and contact is maintained on a regular basis, including at senior levels. The Bank has actively supported the sponsor's efforts to capitalise on its energy savings and fuel substitution investments. The Bank has selected a first class sponsor to promote energy efficiency in district heating in five countries of operations. A mutually rewarding relationship has been established and is expanding with new operations possibly taking place in additional countries in the near future. Most investments involve primarily an equity stake, a priority of the Bank. Uncertainties due to the absence of a definition of FMV and the time consuming nature of the MPF are likely to negatively affect the programme's profitability. It is however designed to deliver high transition impact which ought to compensate for marginal profitability. This justifies PED's *Good* rating of bank performance.

MAIN ISSUES AND THE LESSONS LEARNED

Concession may be an effective legal system to privatise infrastructure. The primary advantage of such a system, when infrastructure exists but needs renovation, is that the private operator will concentrate its investments on such improvements instead of assuming upfront the acquisition cost of the assets. The success of the concession will, however, depend on the implementation of a negotiated tariff and of the reliability of ongoing regulation. This element of political risk, often significant, may be better mitigated when the Bank is an equity partner in the operating company than a lender.

The Bank should pre-agree the framework of a FMV when this is the basis for exercising a put option on its equity participation. This may be met with objections from the party granting the put option, particularly when it is a controlling shareholder who looks at the strategic value of its investment in non-quantifiable terms. Furthermore, a majority shareholder saddled with a known obligation to buy back shares at a higher price than the historical book value carried in its balance sheet may be required by its auditors to set a provision for future loss. A methodology may, however, be devised to overcome such problems by determining some parameters (such as the future discount rate) by reference to data which will only be available at the time the option is exercised. Thus, the future option cost to the sponsor may remain sufficiently random to not require provisioning.

Special care must be used in the promotion of the Netherlands Carbon Fund for projects where the Bank is a shareholder. This rule must be even more strictly adhered to when the Bank holds a directorship in the project company. It should not deter representatives of the Fund from marketing their services which are in the interest of the project. It would be preferable if the Bank could ascertain whether other bids were also considered and the Bank should request documented evidence that whichever bid is retained was in the best interest of the company.

It is important for the Bank to weigh the significance of transition impact relative to the risk return aspect of investments. This may be more important when a portfolio of individual and relatively small operations result from business development under a framework agreement. Less quantifiable costs such as senior management time dedicated to directorships may make such investments less attractive to the Bank. When transition impact is significant, the overall justification of the framework becomes clearer, even though such impact may not be delivered evenly across all operations.

Reliance on sophisticated technological investments to achieve transition impact is often less effective than promotion of managerial skills. Better operating efficiency may be obtained from investments in standard equipment, coupled with improved operating know-how provided by an experienced foreign sponsor. This leads to the broader transfer of skills and also greater opportunities for local content investments than foreign sourced state-of-the-art technologies.