Environmental loan

Summary of the Operation Performance Evaluation Review

August 2005

THE PROJECT

In 2003 the Bank provided a large senior unsecured loan facility to the Company, a private sector company which was privatised during the 1990s. In parallel, the Company raised a significantly larger syndicated corporate loan. The Bank's operation was to enable the implementation of an investment programme aimed at upgrading the environmental performance of the Company's operations.

PROJECT RATIONALE

The Bank's rationale at the time of approval was to support environmental retrofit projects in the energy sector and also to support local corporates without foreign strategic investors. The project could also be prepared and closed in a relatively short time and would provide an acceptable contribution to the Bank's profitability. The Bank worked closely with the Company to prioritise a number of sub-projects with an environmental focus. The overall project was expected to demonstrate good practice and set standards of good corporate behaviour with respect to environmental compliance. For the Company, the various upgrading investments financed by this facility and also by the separate syndicated loan were important to enable the Company to continue using higher sulphur and cheaper Export Blend (Urals) crude oil to process products to European standards.

ACHIEVEMENT OF OBJECTIVES

The Company's focus on sustainability and the highest health and safety standards has clearly had a demonstration effect in the country and possibly beyond. The Bank's focus on the environmental action plan (EAP) and the continuous monitoring and reporting obligations may have caused some extra burden on the Company. This has, however, supported the strong in-house environmental team in prioritising investments in line with the EAP and the evolving regulatory targets. The Company has stipulated in the loan agreement that all new acquisitions and subsidiaries will be brought in compliance with the environmental laws of its jurisdiction and with EU regulations. This is of particular interest with the various upstream and downstream investments by the Company in the surrounding countries. The Evaluation Department (EvD) believes that a large, listed company would normally give high importance to meeting EU standards even without such an undertaking in the Bank's loan agreement. EvD rates the achievement of objectives as *Good* and the environmental performance of the project and sponsor as *Excellent*. The objective of preparing and closing the project in a short period of time and achieving an adequate profit contribution was achieved. The large size of the transaction, the familiarity with the company and the fact that a commercial bank facility was being raised at the same time facilitated this.

OVERALL ASSESSMENT

Based on its independent review of the operation's performance, EvD assigns it a *Successful* performance rating. The EAP was a key element in the project structuring and focused on the reduction of sulphur in diesel fuel and reduced sulphur emission at the plant itself. The financed plant had a significant skills transfer component. The Company has been able to reduce the sulphur levels in the fuel to below the EU standards. The plant emissions to air and water have been reduced substantially and are complying with current local regulatory limits. The shut down of smaller outdated refineries and the concentration of production at one refinery has had a positive environmental impact. The Bank was able to offer a slightly longer maturity and established a link with the environmental action plan.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The OPER Team rates the overall transition impact *Good*. The Bank agreed an environmental investment plan and reporting/supervision system which supported the Company's well established environmental department. The agreed environmental investment plan enabled the Company to meet the EU directives regarding sulphur levels in diesel fuel somewhat earlier than the country's EU deadline. Regarding sulphur emissions at the refinery itself, it appears that the required further investments will only be undertaken and completed shortly before the EU deadline. This unit was not included in the Bank's environmental loan. This is also the reason for the Company's reluctance to provide any further clarifications to specific questions raised by EvD regarding this topic. EvD was able to verify during its in-depth site visit to the refinery that EAP improvements have been made successfully. It was also clearly established that the quality and focus of the environmental specialists is very good. The company is aiming for best international practice. Considering the track record of the well established sponsor who closed large commercial bank syndicated loans around the same time, the Bank's additionality is rated as *Verified at Large*.

BANK HANDLING

The Banking Team was able to efficiently structure and close the transaction. The move from the initially requested working capital facility to an operation financing specific upgrades with high benefits for environmental performance and safety was important and very positive. Subsequently, the Banking Team performed normal financial monitoring of a listed company. The Evaluation Department performed more detailed monitoring of environmental action plan investment projects, as agreed with the Company. There may be future business opportunities in the region or possibly in upstream oil and gas projects in connection with joint ventures where the Bank may be asked to participate and assume certain risks. The Company stated that the Bank's participation was useful, but outlined that the necessary reporting created a duplication of work. The Company also highlighted that other (commercial) lenders do not have such extensive reporting requirements. EvD is of the view that given the Bank's main focus on the environmental investments such reporting requirements are important and could possibly be better linked with the Company's new internal data base/management information system. The Bank's requirements, however, did provide some additional support and visibility to the Company's environmental specialists. The financial department of the Company now has access to many funding options and appears reluctant to provide to the Bank any more than the standard information. The Bank's handling is rated *Good*.

MAIN OPER ISSUES AND LESSONS LEARNED

Lesson: Timing and focus of privatisations in the natural resources sector needs to consider local strategic advantages. The structuring of refinery privatisations is challenging given that refinery margins can be negative over extended periods of time and few large refineries survive as stand alone units. More typically they are integrated into large upstream and downstream activities of international oil and gas groups. The early focus on the strategic advantages and requirements of the domestic market may facilitate investment by local groups as was the case in this operation.

Lesson: In-house technical capabilities are essential for successful upgrades design and implementation in capital intensive industries. The involvement of the same project leader and specialists during project preparation, tendering and construction/start-up ensures that the objectives of the project are fully realised, improves efficiency of project execution through continuity and provides exposure and training opportunities to highly experienced staff.

Lesson: Building on a strategic advantage with long-term investments can underpin market leadership. The Company's focus on upgrading its largest refinery, enabling it to continue using lower cost Ural blends and still meeting the EU standards, turned out to be a highly successful strategy. This was assisted by the integration of a major local petrochemical producer, a network of distribution outlets and an environment of rising crude oil prices which meant generally positive refinery margins.

Lesson: An environmental matrix organisation can enhance an internal working culture which recognises the environment as a key objective. Selection of the most appropriate organisational structure of the environmental department is important. Balancing the advantages of a matrix organisation where each environmental officer is part of a different team with the challenge of maintaining the strength of a bigger environmental team in one location is an ongoing effort. It is too early to judge in this case which organisation style is best suited for a refinery/distribution company.

Lesson: Plant performance data should be integrated directly into the company's management information systems. The design and implementation of plant monitoring systems should focus from the outset on integration with management information systems. The use of experienced specialists in coordination with external sub-contractors can reduce cost overrun risks.