Power sector restructuring loan

Summary of the Operation Performance Evaluation Review (February 2005)

THE PROJECT

In October 2001, the Bank signed a loan agreement with the Company for €100 million. This was to provide the Company with working capital to complete the restructuring of its balance sheet, and to finance investments to improve the efficiency of the transmission and despatch systems. A small part of the loan was earmarked for the energy carbon fund set up by the Company to improve energy efficiency and to develop renewable energy projects. The Bank's loan included a B loan of €50 million arranged with six participating banks.

Russia's power sector was privatised during 1992. The holding company was subsequently formed. The Bank's loan was presented to the Board as the first step in a long term involvement in the sector, giving a signal to the investment community that the first moves toward reform would be taken. The Bank insisted that a 'restructuring working group' was set up that was open to minority shareholders. It also signed a memorandum of understanding (MoU) with the Company, setting out the principles of the reform process.

The project contained the following components:

(a) The refinancing of payables (working capital) of €49 million;
(b) Refurbishing eight substations for €40 million;
(c) Creating a digital multi-service corporate network (€9 million);
(d) Setting up an energy carbon fund (€1 million);
(e) Funding a digital mobile network pilot. This was subsequently cancelled.

PROJECT RATIONALE

The main rationale of the project was to actively support the restructuring of Russia's power sector. The sector was highly inefficient, with substantial transmission and distribution losses. The Bank believed that substantial investments were needed to improve the quality and efficiency of the power sector, which was vital to the development of Russia's economy. The Bank wanted to engage with the key parties to ensure that sector reforms were implemented, in order to achieve an efficient, competitive and well-regulated power industry. The Company as is the key player in the restructuring process, as it is currently the main shareholder in almost all the key sector companies. The Bank felt that the loan would give it leverage over the Company and allow it to influence the restructuring process. The Bank may subsequently expand its operations in this sector.

ACHIEVEMENT OF OBJECTIVES

The project objectives and the achievement ratings are as follows:

(i) To complete the restructuring of the Company's balance sheet as an essential requirement for the successful implementation of the power sector restructuring programme. This has been **achieved.**

(ii) To finance priority investments to improve the efficiency of the transmission system, in accordance with an agreed project implementation plan, and supervised by the Bank's engineer. This has been **achieved**.

(iii) To establish and finance an energy carbon fund to improve energy efficiency, and to develop renewable energy projects with the potential to generate CO_2 emission reduction credits. This has been **achieved**.

(iv) To support the restructuring of the country's power sector. This has been **partially achieved**.

OVERALL ASSESSMENT

Based on its independent review of the project, the Bank's Project Evaluation Department (PED) rated its performance as ***Successful***. The overall transition impact was rated ***Good***. This rating is based on the fairly ambitious transition objectives defined in the Board document. There is still a high risk to the transition impact due to the complex restructuring process and the conflicting political positions of the government, regional power companies and users.

The financial performance of the Company has improved. In the last two years its balance sheets and profit and loss statements have significantly improved. Today the company is financially stable and developing rapidly, with an annual turnover of US$ 19.7 billion and a net profit of US$ 900 million in 2003. This is an excellent achievement, considering that only seven years ago Russia's electricity industry was close to collapse. The environmental performance of both the project and the sponsor was rated ***Excellent,*** and the extent of environmental change was rated ***Some.***

TRANSITION IMPACT AND BANK'S ADDITIONALITY

The PED rated the overall transition impact as ***Good.*** Using the categories of reform outlined in the MoU as a yardstick, Russia has achieved substantial progress on the legal and regulatory framework. The Company has unbundled a large number of its operations and expects to complete this process in 2005. This leadership has had a galvanising effect on regional power companies and on government representatives. However, the crucial steps towards a liberalised market - the privatisation of generation assets and the introduction of a wholesale market – will take a few years yet and are by no means certain.

At the time of Board approval the commercial banks showed a limited appetite for long-term risks in the power sector without export credit agency (ECA) cover or co-financing structures with international financial institutions (IFIs). Furthermore, the planned restructuring of the Company, which would ultimately reduce it in size, also made it more difficult for commercial bankers to lend money. The Bank was able to structure a sound security package and to involve commercial banks as B-loan participants. The Company was attracted to the value added by the Bank, not only for the loan itself but also because it implied that an IFI had approved its restructuring plan. The Bank's additionality was classified as ***Largely Verified.***

BANK HANDLING

The Company said it was very pleased with the motivation and professionalism of the Bank's power team. The team contributed to the loan structuring and put in place excellent security. It also achieved a good price, taking into account the market conditions at the time and the particular uncertainties surrounding the outcome of the company's restructuring.

In December 2004, the power team signed a loan agreement for a further transaction with one of the Company's subsidiaries. This illustrates the excellent working relationship established by the team, and the Company's desire to continue working with the Bank. Bank handling was rated ***Good***.

MAIN ISSUES AND LESSONS

Enforcing new procurement rules can act as a catalyst for change. The Bank's request to change the procurement rules relating to a specific investment may lead to improvements in the whole procurement system for a large infrastructure client, such as a utility. Using internationally accepted procurement standards will increase transparency and can result in significant cost savings. It will also promote fair competition between the equipment, services and works suppliers.

A realistic timetable for sector reform needs to factor in time for setbacks and delays. There may be significant delays to complex sector reforms compared with the initial plans. When setting objectives for the Bank's influence on reforms, the Bank should prepare a realistic estimate of the potential impact of the allocated resources. Commitments to the sector over a longer period of time may foster a dialogue with the government, as well as other IFIs.

The Bank's environmental mandate must always be actively pursued. The Bank should push for the adaptation of innovative features, in accordance with its environmental mandate. By nurturing ideas at the right time, the Company's carbon fund was able to establish itself quickly. In this case, the Bank had to demonstrate intellectual leadership and convince the borrower it was a good idea. As a result, the Bank has gained a higher profile and enhanced its reputation.

It is important to take appropriate security measures where ongoing reforms may change the creditworthiness of the remaining Company. In lending to infrastructure companies that are being restructured, the Bank runs the risk that, if the restructuring is successful, the borrower may become less creditworthy due to the unbundling of its assets. It is therefore important that adequate security is put in place, regardless of the outcome of the restructuring progress. It may be particularly important to establish revenue streams from creditworthy third parties over a period of time.

Projects must be classified properly for later analysis. Projects are classified at the outset to enable the Bank to analyse its portfolio by different criteria for accountability purposes. The range of standard industry coding (SIC) needs to be expanded to include fairly detailed categories, including integrated utilities and their components. Furthermore, the system should allow for the fact that different sub-components may be attributed to different SIC codes.