Summary of the Operation Performance Evaluation Review
Review evaluation of a company in the energy sector
May 2007

THE PROJECT

This company is the largest in the energy sector in its country and a former state monopoly. After its establishment, phased public offerings by the country's government's privatisation agency made it a publicly-owned company, listed on the local Stock Exchange. In order to streamline its businesses, the company placed an international tender for bids to upgrade the waste-water treatment plant (WWTP) in a design-build-operate (DBO) scheme at one of its refineries in the country. The Bank provided €13.4 million loan as part of a syndication to finance the upgrades. The works for the construction phase as the full responsibility for operation and maintenance were defined for 15 years in compliance with the required discharge limits.

The works commenced with a five-month delay and several unanticipated events occurred. Nevertheless the works were completed only one month behind the scheduled completion date. Unanticipated works included the disposal of large quantities of sludge from the lagoons, incurring extra costs of several million euros. Upgrading of the WWTP was completed successfully and the quality of works is highly satisfactory, in full compliance with the country's and EU environmental regulations.

PROJECT RATIONALE

The major rationale of the Bank's participation in the project was to introduce efficiency and positive environmental benefits into the company's non-core industry functions. The Bank's sector agenda matched the company's financing needs at appraisal to implement the environmental improvements using the latest technology.

ACHIEVEMENT OF OBJECTIVES

Improve the refinery's environmental performance regarding waste-water discharges into the Danube. The companies involved dealt with several technical problems during the upgrading in a constructive and positive manner. Changes in specifications and design were undertaken based on negotiations for better design and quality of the facilities. The delays and cost-overruns occurred as a result of seeking good industry practices. It is considered that this objective has been achieved satisfactorily.

Ensure compliance with European Union (EU) requirements for water quality and air emissions from its solid waste incinerator. The aim was to enforce good industry practices beyond minimum compliance levels in country and EU legislation. Most of performance indicators imposed are higher than those regulations. The final acceptance of the works, after testing, demonstrated the project facilities have satisfactorily passed the good industry practices. This objective is therefore considered fully achieved.

OVERALL ASSESSMENT

The overall performance of the project is rated *successful*. Achievement of objectives is considered *good*. The project has delivered *outstanding* positive environmental changes. The environmental performance of the project is *excellent*. However, transition impact of the project is rated *satisfactory,* achieving only technology-driven results. Difficulties in encouraging transition within an unrivalled former monopoly meant that the important transition agenda for the sector was not realised. The degree of risks is assessed *medium*. Financial performance is overall rated *marginal* derived from marginal returns for the Bank and for the company. The company's financial performance is considered to be more than *satisfactory* despite the volatility of its businesses. The Bank's additionality is *verified* vis-à-vis the borrower but only in part since there was little need for external financing. Bank handling is assessed overall as *good* due mainly to thorough environmental handling.

TRANSITION IMPACT AND BANK'S ADDITIONALITY

The OPER team considers the project's transition impact to be *satisfactory* with *medium* risks associated with transition potential. Transition impact at company level was considered to be *satisfactory*. The impact on industry and economy at large was considered *limited* due to the lack of replication of similar investments and the unrealised sector agenda – a long-term financing scheme – which had been discussed at appraisal. Major difficulties in spreading transition impact are attributable to the monopolistic status of this firm in the industry in this country. Nevertheless, some positive impact has already emerged. This included market expansion through outsourcing, changes of market framework by raising environmental standards in the sector and the country, new business standards and private sector involvement in non-core businesses.

Environmental impact is considered *excellent* in both quantitative and qualitative terms. The extent of change is, without a doubt, *outstanding*. The environmental authority in the country confirmed the OPER team's view.

The Bank's additionality has been *verified only in part*.

BANK HANDLING

From the design and structuring of the project to the monitoring of construction, covenant compliance and environmental performance, The agent bank, which was also the arranger of the syndication, has dealt with the investment in a professional manner. The Bank's environmental handling was excellent. The project philosophy and objectives were properly mirrored in the environmental action plan. Overall, the operation team has exercised sound banking practices throughout the investment. The Bank's handling is therefore assessed as *good*.

MAIN OPER ISSUES AND LESSONS LEARNED

Outsourcing the activity of a former monopoly in emerging markets presents an important challenge. In the early stages of a private sector involvement framework, contractual arrangements can be erratic when unanticipated events occur. Outsourcing to an international contractor has widened the exclusive market. However, the former monopoly, while receptive to ideas of transition, still maintains the rigid corporate culture, operating according to its own norms. In unexpected events, a power gap between the former monopoly and the private sector service provider emerges and hampers fair risk allocation. Market expansion should be promoted through a fair risk allocation for the sake of transition. Although clear and thorough contract terms can mitigate this risk, the Bank must realise that it is difficult to exclude all upfront ambiguity or anticipate all potential adverse events.

Advantages and limitations of a DBO scheme. A well-implemented DBO scheme facilitates the entrance of international contractors in an exclusive market, thereby helping to achieve the market expansion. On the other hand, incorporating the cost-recovery principle into the DBO scheme with a former monopoly can lead to tension, and therefore needs the Bank's extra attention. In this case, the Bank was instrumental in brokering agreement among parties.

Inducing Transition into the Cost Centre as a Challenge of Moving a Monopoly toward Higher Environmental Standard

Legislation to bring the country into line with the EU *acquis communautaire* has forced the enterprises to raise environmental standards. A command-and-control mechanism proves to be most effective in moving former monopolies toward sustainability. Market forces, including regional competition, and the Bank, should work with this former monopoly to further improve its sustainable industry practices. However, domestic market forces do not always provide sufficient incentives to dominant enterprises for improving environmental performance, thereby limiting the positive impact of the company in raising overall environmental standards.