

Summary of the Operation Performance Evaluation Review (March 2007)

THE PROJECT

Background

The construction of the waste-water treatment plant started in the 1980s, but was abandoned when further funding dried up. About 40 per cent of the physical works had been completed (19 per cent in terms of value). Ten years later construction resumed when new financing became available from a number of different sources through bank loans, government grants and donations. The financiers involved included the European Bank for Reconstruction and Development (EBRD), and several other investment banks, environmental organisations and assistance funds.

The purpose of the project was to complete the existing unfinished facilities and thereafter to put the plant into operation. The pre-existing structures were partly of such poor quality that relocation of the site and/or demolition of part of the existing structures and their rebuilding were considered as options, but eventually refuted for technical, cost, political and other reasons. It was designed for an average sewage flow of 330,000 m³/d for a population of 700,000 (0.47 m³/person/day), a capacity that should comply with demand until 2015. It was ultimately meant to meet the regional environmental standards. And, it was also to demonstrate a successful private-sector involvement in a high-profile municipal infrastructure project in the EBRD's country of operations.

Bank's involvement

The Bank's official participation in this multi-party supported project came about relatively late and through the initiative of an investment bank, which acted as lead agency, although the EBRD had a longstanding relationship with the sponsor of the project. The principal concept design was already completed earlier and the main turnkey contract financed by the investment bank was awarded on a negotiated (that is, non-competitive) basis. This, together with the fact that it was virtually a public sector procurement project by nature, normally would not have attracted the Bank's initiative. However, given the project's high political profile and strategic importance for the region, the Bank was strongly motivated to participate.

Cost and design structure

Three quarters of the total estimated costs of the project have been allocated for the waste-water treatment plant, of which the Bank's share is 17.5 per cent. The construction of a sludge incinerator is supported by the EU/TACIS.

At the core of the waste-water treatment plant project are the following three entities:

- The client, a special purpose company and the borrower under the Bank's senior loan facility. The client was set up with the aim of attracting financing for the project and using it for the completion of the construction works by contracting and supervising a construction company under the turnkey contract.
- The sponsor, a company owned by the municipality. Following the completion of the construction, the plant was to be transferred from the client to the sponsor under a plant purchase agreement where the purchase price was to be paid by instalments over a 12-year period.
- The construction company, a consortium of three construction companies, contracted by the client to carry out the lump sum turnkey contract.

- The operating company, established as a special purpose company to operate the plant under a 12-year operational service agreement with the sponsor.

The project's structural complexity, the substantive financing required in view of its size, the dire economic situation in the country in general and for the sponsor in particular required the involvement of many financing sources for risk-sharing purposes. In turn, this translated into a protracted gestation period for project preparation and a substantive body of legal arrangements (some parties spoke of more than 80) to be made at a cost of €5 million.

Also included in the project scope was a sludge incineration plant (SIP). Although meant to be implemented in parallel with the waste-water treatment plant component, since process wise they were interlinked, the SIP was implemented separately. The implementation of this component incurred a delay of about two years and is expected to be commissioned in 2007.

Project implementation

When construction of the waste-water treatment plant was completed, ownership of the plant was transferred from the construction company to the client and further to the sponsor under a plant purchase agreement between the sponsor and the client. The purchase price was agreed to be paid by the sponsor by instalments over twelve years whereby each instalment was to match in amount and maturity the debt obligations of the client towards the Bank and the other lenders (i.e. the sponsor was repaying the purchase price to the client enabling the client to make regular repayments to the lenders and the shareholders). The municipality provided a guarantee for the payment obligations of the sponsor to the client under the plant purchase agreement. Further, in 2005 the operating company assumed its obligations to operate and maintain the plant under the said operational service agreement.

Following a joint request by the sponsor and the municipality, the project has recently been restructured: *“The main reason for this initiative is that [the client], upon completion of the plant, has served its main original purpose and is now considered a financially expensive vehicle for transfer of funds from the sponsor to the project financiers. Cost savings are estimated in the range of €2.5 million and are mainly related to savings from taxes, financing costs (including dividend payments), and [the client’s] salaries”*. As part of the restructuring, it was envisaged that all loans and share capital of the client would be fully repaid to lenders and shareholders respectively and the client would be liquidated at the end of the warranty period. Since operation and maintenance of the plant are with the operating company, of which the client is not a party, no immediate impact on the plant operation and maintenance is anticipated. However, some concerns exist as to the longer-term operational sustainability. Irrespective of the understandable economic rationale for the project's restructuring, the evaluation team notes that with the restructuring the Bank's client-ship *de facto* transfers from the client to the sponsor and thus the project turns from a private sector into an essentially public sector operation. It remains speculative whether the project would have received Board approval had its pre-mature re-transfer into a public sector operation been anticipated.¹

¹ MEI states that “the restructuring cannot be called pre-mature. The restructuring is just in time after completion of the plant. With regard to EBRD reliability, there is no violation of EBRD commitments *vis á vis* participants. It is clear, however, that the participants are not eager to lose their riskless investment.” For clarification, the evaluation team uses the term “pre-mature” in the sense that the change of structure was invoked before the originally envisaged maturity (i.e. 12 years after construction completion) was reached.

PROJECT RATIONALE

Addressing the untreated city sewage entering the nearby sea has been one of the priority objectives of the involved regional environmental organisation. The finalisation of the waste-water treatment plant was, therefore, regarded as an important mitigating factor towards reducing the level of polluting discharges into the Baltic Sea.

ACHIEVEMENT OF OBJECTIVES

The overarching main objective of this project was to complete the construction and facilitate the full commissioning of the waste-water treatment plant which was achieved.

OVERALL ASSESSMENT

The evaluation team assigns a rating of *successful* to this operation overall by adopting a development impact rather than transition impact perspective; with more prominence given to the latter, the rating is tilting towards a *partly successful* rating. This rating is very much driven by the achieving of the overall (physical) objectives of the project that received a *good* rating: the plant was completed in time and on budget and is performing according to most of the envisaged environmental standards. The promising recent results still need solidifying over a longer period and statistical validation. Given the option currently under consideration by the sponsor for complementing the (primary) biological fermentation with a (secondary) chemical treatment process, the full achievement of environmental performance standards is technically feasible.

The EBRD's role from an additionality design and functioning perspective was rather limited and confined more to that of a co-financier with a regional investment bank that was acting as lead agent. Its additionality overall is therefore regarded as *verified at large*. The limitation of its role also had a bearing on the project's transition impact (TI) which is rated as *satisfactory* only. At appraisal the main TI was accorded to the project's potential "in demonstration of successful private sector participation, both in waste-water treatment plant construction and operation – through a management contract – in a context where there has been very limited private involvement to date in the [local] municipal sector". This was only partly achieved as discussed in broader detail in the full report. Contributing factors include the Bank's acquiescing in accepting that the main construction contract was awarded on a negotiated (i.e., non-competitive) basis; the limited role the private sector plays in the operation and maintenance of the plant; and also the restructuring of the project by which the Bank's client changed from the private sector back to the municipal provider of all wastewater treatment services in the city's catchment area. Whilst the private sector's involvement in the construction completion work was pivotal, for the operation and maintenance its role is traditionally more that of a consultant without true managerial powers.

The environmental performance of the project is rated *satisfactory*. Evaluation argues that the project should have been classified as an "A" not a "B" category with implications for the environmental scrutiny process. The plant has been successfully constructed and is achieving targets for BOD₅. The evaluation team notes that construction related aspects – health and safety standards and waste management - were well managed. The environmental change resulting from this project is rated *outstanding*, since the level of untreated waste water has been significantly reduced. Bank Handling was *satisfactory*. The EBRD, although abreast of development, only came on board relatively late when the project preparatory process was

already well advanced. The client's financial performance was *good* with a satisfactory collection performance and tariff structure in place that allows full cost recovery and beyond.

MAIN OPER ISSUES AND LESSONS LEARNED

Appraisal realism needs more attention. Projects with high development impact but low TI credentials should not be 'over-sold' on TI grounds in order to attract EBRD approval. Projects with lower TI potential may well deserve appreciation through over-compensating elements, such as environmental benefits, delivery expediency in a critical situation, etc.

Completion of partly built projects should be considered the same as greenfield projects: Had the Bank carried out A-level environmental due diligence on this project and thus covered additional aspects, the case could arguably be made that a better, more all-inclusive and larger-scale project management framework may have resulted, which in the long term may have lowered overall costs to the citizens of the city.

Performance criteria should be part of the required completion tests of any major environmental infrastructure project. When undertaking an environmental infrastructure project, completion should be based on both physical and performance criteria.

Recommendation: For major environmental infrastructure projects, as part of the Bank's project completion procedures, the Environment Department (ED), or a contracted lender's engineer on behalf of ED, should review and certify that the project meets the Bank's environmental performance criteria.

Project restructuring must take an holistic, overall project perspective and not be confined mainly to financial and credit considerations. Projects normally have a variety of dimensions, including financial, technical, environmental and managerial aspects that all need to be properly (re-)considered during restructuring. Failing to do so can jeopardise the overall project's viability. By failing to go beyond financial matters only, the Bank missed a key opportunity to further advance its environmental (for example, sludge disposal and phosphorus reduction) and transition impact (private sector operation) objectives.