Operation Evaluation

Summary

Power project (central Europe)

(A public sector investment operation)

June 2011

Evaluation Department (EvD)

European Bank
for Reconstruction and Development

The project

In 2006 the EBRD provided a senior debt facility to a state-owned electricity company ("the Client") in central Europe to construct a new power generation unit and refurbish and modernise existing units ("the Project").

Electricity consumption in the country started to rise in the mid-1990s, although by European standards per-capita it is still low. The country is a large user of coal and lignite in power generation and is a large relative and absolute emitter of CO_2 in the EU power sector. A large percentage of power stations there have been in operation for more than 30 years and it is expected that many of the existing plants will have to be decommissioned by 2015.

Table: Ratings summary

Overall assessment	♦ ♦ ♦ ◊	Successful
Achievement of objectives	●●●●○○	Satisfactory
Additionality	■■■■	Fully verified
Bank handling	●●●●●○	Good
Transition impact	●●●●○○	Satisfactory
Environmental and social impact	●●●●●○	Good

Overall assessment ♦ ♦ ♦ ◊ Successful

The overall performance of the Project is rated "*Successful*". The rating accounts for the fact the Project had largely been on course to achieve the physical objectives established at project appraisal, but was derailed by the Client's technical default and the subsequent deadlock in negotiations between the lenders and the borrower.

Effectiveness

Achievement of objectives ●●●●○○ Satisfactory

The achievement of objectives is rated "*Satisfactory*". The transition impact objectives are summarised below:

Objective	*Benchmark*	*Achievement/rating*
Demonstration effects	– Implementation of at least two similar turnkey engineering procurement and construction contracts in the national market. – Financial closure on two semi-merchant/merchant financings in the national market.	- Delayed, but likely to be achieved in the near future. - Not achieved: no independent merchant-type power plant built or planned to date.
Increased competition and transparency	– Convergence of wholesale prices to benchmarks from EU power markets.	- Not achieved: the wholesale market still lacks liquidity and transparency.
Increased efficiency and competency	– Adoption of risk management and internal control/accounting systems. – Completion of training programmes. – Adoption of improved pricing models following the technical cooperation (TC) advice.	- All benchmarks were met, but achievements have not been sustainable.

Demonstration effects

Measured by the first benchmark, it can be expected that the desired demonstration effects will be achieved; although judged by the second benchmark, the objective has not been reached.

Increased competition and transparency

Measuring and evaluating this objective against the benchmark of wholesale price convergence is difficult because the country's wholesale electricity market is still at an early stage. Arguably, price convergence is constrained by the lack of cross-border transmission capacity and the vulnerability of the country's transmission network to loop flows from neighbouring countries. In principle, however, new entrants could substitute for import competition, but the barriers to entry are high.

Increased efficiency and competency

All benchmarks have been met. However, the achievements made did not prove sustainable in all respects. Electricity pricing and trading became the responsibility of the parent company and the new pricing strategy departed from the pricing mechanism/trading strategy adopted by the Client. Moreover, most of the staff trained under the Project either left the company or were assigned new positions.

Regarding the physical objective of commissioning the new unit and modernising existing facilities, at the time of writing the Project was not yet completed, so no performance data was available for the new unit.

Additionality ■■■■ Fully verified

The Bank's additionality is "*Fully verified*". The Bank's support to the Project was crucial in that it ensured project preparation and implementation in line with international standards and helped facilitate a structured corporate loan meeting the needs of the Client, notwithstanding the Client's decision to prepay the facilities before project completion.

Efficiency

Bank handling ●●●●●○ Good

Bank handling is rated "Good".

Impact/sustainability

Overall transition impact ●●●●○○ Satisfactory

Transition impact is rated "*Satisfactory*". The Project brought about skill transfer/diversion and demonstration effects in relation with turnkey engineering procurement and construction but not so much with regards to the financing structure as no replication has taken place to date, helped enhance efficiency and competency and market expansion via competitive interaction, and set new yardsticks for business conduct and corporate governance.

The overall impact is acceptable at best because not all benchmarks defined at project appraisal have been met and the progress made with regard to competition and market-driven sector development did not measure up to expectations.

Environmental and social impact ●●●●●○ Good

The environmental performance of the Project and the Client was "*Good*" and the extent of environmental change facilitated by the project was "*Substantial*". A main objective of the Project was to ensure that the power plant complied with EU environmental standards and regulations. The investment programme entails a substantial reduction in emissions and waste. Environmental due diligence was performed during project preparation and the resulting Environmental Action Plan was properly implemented to date.

Findings and recommendations

Policy risks

Care should be taken when the achievement of project goals is tied to sector policies that are beyond the Bank's control. By imposing a corporate strategy on the Client suited for an independent market player, the Bank bet on sector policies geared towards decentralisation in generation and a fast move towards competitive markets. The fact that sector restructuring eventually proceeded in a different direction was evident at project appraisal through, for example, the Project's long gestation period. At the time the Project was first conceived, efforts had already been under way to restructure the country's power sector towards horizontally integrated groups and the chance that this trend would lead to the creation of conglomerates was high. When the Client eventually became part of a vertically integrated national champion with different thoughts about its role in the group's business concept, the Bank had no leeway to accommodate this undesired development without losing face.

Lesson

For projects with extended gestation periods the validity of assumed policy framework conditions need constant monitoring.

Ill-conceived conditionality

The trading strategy that the lenders encouraged the Client to adopt was misplaced because it attempted to replace market forces that would otherwise have imposed efficient trading in a liberalised environment once the proper institutions and incentives were in place, and because it mixed up concerns for the financial performance of the Client with the objective to give birth to the first merchant power plant in the country. As it became clear that the merchant power concept did not square with sector development and when the Client's parent company did not strictly adhere to what the lenders thought to be the appropriate trading strategy for the Client, technical default was inevitable. Moreover, it seems that the participating commercial banks were misled, as the conditionality related to the alleged merchant power risks suggested a higher degree of market risk than was justified. In fact, standard financial covenants would have been sufficient to mitigate performance risks on the part of the Client.

Lesson

Transition Impact conditionality should be commensurate with what can reasonably expected from the Client's performance in light of market imperfections and volatile policy frameworks.

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General

●●●●●● Excellent
●●●●●○ Good
●●●●○○ Satisfactory
●●●○○○ Marginal
●●○○○○ Unsatisfactory
●○○○○○ Highly unsatisfactory

Extent of environmental change

✱✱✱✱ Outstanding
✱✱✱∗ Substantial
✱✱∗∗ Some
✱∗∗∗ None/negative

Overall performance

♦♦♦♦ Highly successful
♦♦♦◊ Successful
♦♦◊◊ Partly successful
♦◊◊◊ Unsuccessful

Additionality

■■■■ Fully verified
■■■□ Mostly verified
■■□□ Partly verified
■□□□ Not verified