A natural resources project

(central and eastern Europe)

January 2012

Evaluation department (EvD)

European Bank
for Reconstruction and Development

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Executive summary

The project involved a loan to one of the leading oil and gas companies in central and eastern Europe. The loan was to finance the completion of an underground strategic gas storage facility (UGS), and refinance shareholders' loans for related expenditures. The project was prompted by new legislation that required the client to develop strategic natural gas reserves to ensure security of supply. The client selected Company A through an open tender as partner in a special purpose vehicle, to construct and operate the project. At the time of the loan approval the project was reported as nearly complete. Company A's largest shareholder was a Russian company (Company B).

Overall, the physical delivery of the project was successful, completed in a very short time, on budget and to a high technical standard. Both the project and Company A have performed well operationally and relatively well financially (although well below projections made at approval). This evaluation has identified several issues, of which the three most important are:

– Integrity risks posed by unknown beneficial owners. Company B became Company A's largest shareholder shortly before the project was approved. Its beneficial owners were unknown to the Bank at the time of Board presentation, and it refused to disclose this information to the government. For this reason, Company B was unable under the country's law to register its shares and exercise its ownership rights, and ultimately sold its stake in Company A to the government in July 2011. As a principle, the Bank should not finance ventures with unknown beneficial owners. This is a potential cause for concern, and raises the question of why the company preferred to forgo an important investment, rather than disclose its owners, and whether the Bank exposed itself to an unacceptable integrity risk.

– Compliance with policy on retroactive financing and clarity on application of the loan proceeds. At the time of concept review all project-related costs had already been contracted under an Engineering. Procurement, Construction (EPC) contract and thus been incurred. In effect, the proceeds of the Bank's loan were entirely used to refinance shareholders' loans. This was not fully in line with the description of the use of proceeds presented in the Board report. The Bank's policy permits only the expenses incurred after the Concept Review to be retroactively financed.

– Appropriate transition monitoring benchmarks. Some of the transition impact (TI) benchmarks presented for the project were standard project requirements such as construction completion, revenue generation, Environmental and Social Action Plan (ESAP) implementation. These are operationally important but not the best TI benchmarks.

Table: Ratings summary

Overall rating	*Successful*
Company financial performance	*Good*
Achievement of objectives	*Good*
Additionality	*Largely Verified*
Transition impact	*Satisfactory*
Bank handling	*Satisfactory*

Overall assessment ★★★☆ *Successful*

Overall, the project is rated *Successful*, albeit with qualifications. The project is strategically important, was completed in record time and on budget, and has registered good operational performance. However, at the time of the Bank's intervention, the project was essentially completed and the loan refinanced the shareholders' loans. The Bank was not involved in the project preparation or its implementation. The transaction seems to have been prepared under substantial time pressure; the Board report had few details regarding the use of the Bank's financing (for example, it lacked a table clearly indicating sources and application of funds) and did not properly explain the rationale behind the project costs. Several of the proposed transition impact monitoring benchmarks were weak. Some of the TI objectives have been achieved. However stronger transition impact could materialise only in the future. For example, the breaking of the monopoly in commercial gas storage could bring benefits in the longer term, if and when the gas storage market is liberalised. The contribution of the project to such market liberalisation (mentioned in the Board report, however not set as a formal TI monitoring benchmark) has not been pursued. In effect, realised TI is rated as *Satisfactory* with *Good* future potential*.*

The environmental performance of the project is rated as *Satisfactory*, while the environmental change is rated as *Some*, as the project had essentially been completed by the time of the Bank's involvement and therefore the scope for the Bank to make an impact was limited. The Bank handling is rated *Satisfactory.* The Operating team prepared the project in the record time of three months (from Concept Review to signing), however this adversely impacted the quality of the preparation and the Board report. Some of the transition impact monitoring benchmarks were weak, while the description of the application of loan proceeds, cost justification, and the description of the market could have been presented better. Importantly, liberalisation of the country's energy market, promised in the Board report, was not pursued.

Additionality ■■■□ *Mostly Verified*

The Bank's additionality is rated as *Mostly Verified* due to the general unavailability of long-term financing following the financial crisis and its particularly adverse impact on the country. However the Bank's intervention was in essence a refinancing of the shareholders' loans, which indicates that some kind of financing (although not ideal) was indeed available for the project. Moreover, as the largest "blue chip" corporate in the country, Company A was probably in the best position of all companies in the country to tap into the commercial loan market as soon as the financial crisis started receding.

Effectiveness

Achievement of objectives ●●●●●○ *Good*

The achievement of overall objective of the physical delivery of the project is considered *Good*, although effectively the Bank's loan only refinanced the loans provided by Company A's shareholders to finance the construction of the UGS. The construction of the strategic gas storage facility took only three years, which is considered a very short time compared with an average of four to five years to complete other similarly large gas storage facilities. Some of the additional objectives set at the approval have been achieved, while others failed to materialise, in particular:

– *Enhance competition in commercial gas storage in the country by increasing the available commercial storage capacity.* The project fell slightly short of the target. However to date the additional commercial gas storage has had no visible impact on competition, at least with respect to pricing, as storage fees remain regulated by the government. While measures supporting gas storage market liberalisation were contemplated in the Board report, they were not pursued by the Bank. Still the existence of two different gas storage operators ought to encourage the authorities to liberalise gas storage market in the future. Current achievement of this benchmark is rated *Marginal*.

– *Contribute to energy security by mitigating supply risks.* The UGS project is the first strategic gas storage facility in the country and contains substantial reserves. The project's importance for improving the country's energy security has also been confirmed by an external organisation. This objective is considered *Achieved*.

– *Additional strategic gas storage capacity delivered by the private sector on the basis of EPC and operation contracts allocated on the basis of open tenders in (i) the country; (ii) at least one other country in the EBRD region (by the end of 2015).* These two benchmarks are not yet due, however based on the additional commercial storage capacity delivered during the project's implementation, the first benchmark is considered *Achieved*. On the regional level, one gas storage reservoir was completed, however by a state-owned company. There are 17 gas storage projects in central Europe in various stages of planning, therefore it can be assumed that some will be completed with private sector participation. The likelihood of this benchmark being achieved by 2015 is considered high.

– *Support further liberalisation of the country's energy market.* The Bank expected that when other companies entered the market, the government would automatically free gas storage tariffs to foster competition. However, gas storage tariffs still remain set by the government, therefore this objective is considered *Not Achieved*.

– *Play an important balancing role and provide flexibility to the regional energy supply.* Regional gas pipeline inter-connectors are being actively pursued, however most of them are still in the planning phase. This objective is *Partly Achieved*.

Company financial performance ●●●●○ *Good*

Due to the year-on-year increase in the oil price Company A was able to remain profitable.

The 2010 revenues were below the projections made at approval and the net profit was almost three times lower than the projected level. This risk was identified but not forecast in the financial model.

Efficiency

Bank handling ●●●○○ *Satisfactory*

The Bank prepared the project in the record time of three months (from Concept Review to signing). However, this adversely impacted the quality of the preparation and the Board report, which lacked adequate information on many key aspects of the transaction, prompting requests for clarifications. Most importantly, the details regarding the use of the Bank's financing (sources and application of funds table) were missing. The Board report stated that the project was nearly completed, however the nature of the proposed financing (standard/refinancing/retroactive) was not clearly explained, prompting questions in the run up to and during the Board discussion. In the process of responding to the Directors' Advisers' questions, the team missed some fine points in the Bank's policy on retroactive financing. Some of the transition impact monitoring benchmarks were relatively weak as they could be viewed as standard project requirements (project completion, revenue generation, compliance with ESAP). Moreover, the project costs (which were very substantial) were not well explained, prompting additional questions. The Operation team should be commended for the generally good standard of Company A's financial and operational analysis. A high risk related to Company A's substantial foreign exchange exposure was identified, however due to the complexity of the company's revenue structure, it was not included in the financial forecast.

This transaction also raises a question of "opportunity cost", as it was a large loan, made to a "blue chip" company in an advanced country at a time of high demand for the Bank's financing due to the global crisis. In January 2009 the Board approved an additional budget specifically for application in central Europe. Subsequently, the Bank undertook marketing, and then preparation, of a relatively large number of "crisis response" projects in this region. However, by mid-year two loans to "blue chip" companies in the country have nearly completely used up this budget. This drastically shrank the pool of funds available for projects with a longer preparatory lead time, forcing some Banking teams to abandon them.

This opportunity cost, in terms of lost transition impact potential and wasted resources, is difficult to calculate now. However, it needs to be taken into account when assessing the Bank's decision to pursue one large refinancing project with the region's leading company, at the expense of many smaller projects, which could have had a broader impact on the region's economy.

Impact/sustainability

Overall transition impact ●●●●○○ *Satisfactory*

Company impact

The project had a rather weak impact on Company A, which before the project already had a reputation as a highly efficient, well-run private company. Also, the company's corporate governance standards have been generally in line with those in advanced countries. However the Bank could have tried to address the lack of ownership transparency of the company's new dominant shareholder. Shortly after Concept Review, a stake in Company A was bought by Company B, which is considered a very non-transparent oil and gas company. The Bank was aware of this integrity risk, however decided to go ahead with the financing due to mitigating factors, such as the provisions of the country's law, Company A's charter and the expected additional clauses in the loan agreement to limit Company B's control. Ultimately, due to its unwillingness to disclose its ownership, Company B was unable to register its shares and exercise its ownership rights and decided to sell its shares to the government. Thanks to this development, Company B's shareholding in Company A no longer affects the Bank. However, it raises the question whether, by lending to a company whose largest shareholder's beneficial owners were unknown, the Bank did not expose itself to unacceptable integrity risk. In this context, the return of the government as the largest shareholder in Company A is welcomed; however it could be also seen as a reversal of transition impact.

Industry and wider impact

The project has had a clear impact on the improvement of gas supply security in the country. Energy security is not *sensu stricto* a transition indicator, though energy shortages can adversely affect growth and investment, and therefore transition. The country is one of the most energy dependent countries in the EU. Strategic storage was needed to address major external risks, mainly associated with dependence on imports. The completion of the project provided the country with additional strategic storage capacity, ensuring the gas supply in the case of an interruption.

The project may also have some impact on the commercial gas storage industry in the future. By breaking the effective monopoly in gas storage in the country, the project might eventually contribute to the gas storage market expansion if and when gas storage tariffs are liberalised.

Environmental and social impact ●●●●○○ *Satisfactory* (tending to *Good*)

The Bank did prepare both a Stakeholder Engagement Plan (SEP) and an Environmental and Social Action Plan for the project. The latter was relatively limited in scope as Company A already had well-developed environmental and social practices and procedures. The Bank worked closely with the client on resettlement and land allocation issues, and the company improved its approach to public disclosure and enhanced its grievance procedures. The project presented potential carbon trading opportunity to the client, and therefore the Bank. This opportunity was investigated but not pursued.

Findings and recommendations

– Transparency of clients' ownership as a fundamental requirement for the provision of the Bank's financing. Company B became Company A's largest shareholder shortly before the project was approved and signed. The Board report admitted that the beneficial owners of Company B were unknown. Despite being aware of the controversies surrounding Company B, the Operating team pursued the project. Measures to mitigate reputational risk were to be introduced to the loan agreement to justify the approval, however they did not go beyond the Bank's standard provisions. The most effective proved to be legislation that requires full disclosure of beneficiary owners as a condition to share registration. Company B refused to disclose its beneficiary owners to the government and was therefore unable to register its shares and exercise its ownership rights. Ultimately, it preferred to sell its stake in Company A to the government, rather than disclose its owners. This is a potential cause for concern, and raises the question of why the company preferred to forgo an important strategic investment, rather than disclose its owners.

  Recommendation: As a principle, the Bank should not finance ventures with unknown beneficial owners. Although this issue no longer affects the Bank in this case, Company B's stubborn refusal to disclose its owners at any cost indicates that the Bank might have been exposed to extremely high reputational risk.

– Providing full and correct information on the proposed application of the Bank's financing. The Bank has a policy on retroactive financing, which must be followed and is also applicable to "crisis response" projects. At the time of Concept Review all project-related costs had already been signed (that is, all costs incurred), making them ineligible for the Bank's retroactive financing. However, in its response to the Directors' Advisers' questions, the team referred to retroactive financing. A clear description of the application of the loan's proceeds in the Board report would have prevented this confusion.

Recommendation 1: Application of the Bank's financing should be correctly described in the Board report and the financing plan presented. The Bank's Operation Policy on Retroactive Financing must be followed if there is a case for such financing. It allows for refinancing of only those expenses that were *incurred* (contracted) after the Concept Review (not to be confused with the expenses to be "paid for" after the Concept Review).

Recommendation 2: The Bank should add a provision to its policy on retroactive financing that better defines when project costs are considered to be incurred. The timing of costs being actually incurred can be interpreted in different ways (for example, in respect of EPC contracts, which usually have a number of sub-contracts). Although the framework EPC contract is signed at the beginning of a project, sub-contracting might be spread over time. If the Bank intends to finance a part of the EPC contract retroactively, the unsigned sub-contracts might be interpreted as costs not yet incurred, therefore eligible for such financing. Clarity in this matter would help improve consistency of the policy's interpretation.

– Setting meaningful transition monitoring benchmarks. The client's compliance with the Bank's standard requirements (project completion, revenue generation, ESAP implementation, and so on) are weak transition impact monitoring benchmarks and should be avoided.

  Recommendation: Operating teams should avoid proposing standard operational requirements (project completion, revenue generation, compliance with the loan agreement) as transition monitoring benchmarks. A meaningful, fairly ambitious but at the same time achievable set of monitoring benchmarks should be worked out for each operation in consultation with the Office of the Chief Economist (OCE).

– Interdependence of actions leading to transition impact. The breaking of the monopoly in the commercial gas storage market in the country was hailed as the main transition impact the project. The physical delivery of a new gas storage capacity by Company A was to be combined with the Bank's support of gas storage market liberalisation. Although new capacity was delivered, no action was taken to support market liberalisation. In effect, gas storage market in the country remains regulated (with fees set by the government), so the transition impact of additional storage capacity has not yet been realised.

  Recommendation: The Bank should ensure that a comprehensive set of actions leading to the desired transition impact is implemented as planned. The completion of a single measure (for example, physical delivery), unsupported by proper policy reforms, rarely yields required results.

– Importance of incorporating potential foreign exchange losses in the financial projections, particularly for highly indebted clients. Company A had extensive long-term liabilities, most of it denominated in US dollars or euros and most due within a year or two. Due to the acute impact of the financial crisis on the country's economy, devaluation was highly possible, which could have a profound impact on the level of the company's debt service obligations. The risk of foreign exchange loss was identified and analysed in the Board report, however it was not factored into the financial projections. Even with a relatively minor devaluation, the impact on the company's debt service obligation was profound, with foreign exchange losses nearly halving its net profit.

Recommendation: The risk of foreign exchange losses should be reflected in the financial projections or sensitivity analysis (particularly for clients with high foreign currency debt) and measures to mitigate it should be undertaken.

Ratings table

General

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

Additionality

■■■■ Fully Verified
■■■□ Mostly Verified
■■□□ Partly Verified
■□□□ Not Verified

Overall ratings

★★★★ Highly Successful
★★★☆ Successful
★★☆☆ Partly Successful
★☆☆☆ Unsuccessful