SUMMARY OF OPERATION EVALUATION

# An electrical distribution company

Eastern Europe and the Caucasus

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EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

The Evaluation Department (EvD) at the EBRD evaluates the performance of the Bank's completed projects and programmes relative to objectives in order to perform two critical functions: reinforcing institutional accountability for the achievement of results; and, providing objective analysis and relevant findings to inform operational choices and to improve performance over time. EvD reports directly to the Board of Directors, and is independent from the Bank's Management. Whilst EvD considers Management's views in preparing its evaluations, it makes the final decisions about the content of its reports.

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## Executive summary

In February 2009 the Bank approved a loan to an electricity distribution company ("the Client"), to partly finance a multi-year infrastructure modernisation effort to cut losses and increase supply quality after years of underinvestment. The Project was expected to contribute to the sector reforms by supporting implementation of a transparent tariff approach and introduction of third-party access (TPA) to the grid. The evaluation presents the following main findings:

- While project appraisal documents provided benchmarks for substantial efficiency improvements, actual results fell well short. It appears that relative to the size of the network and its poor state the investment programme was too small to achieve better service and reduce technical losses in a broad scale. A more cautious approach regarding expected outcomes might useful when the existing infrastructure creates uncertainty about expected achievements.
- The Project's operational objectives were focused on technical issues and the performance benchmarks (that is, reduction of losses and outages) clearly identified, but the source of measurement of such benchmarks was not properly specified, leaving room for ambiguity. Quantitative benchmarks/indicators, especially when focused on technical rather than institutional issues, should be rooted in clearly defined, referenced and reliable source data.
- The Project's impact on market structure and the regulatory framework was to be accomplished through a complementary technical cooperation (TC) operation. In the event, however, there was no uptake by the relevant authorities. Some of the pre-conditions for the implementation of TPA (such as the existence of export capacity and competitive alternative power supply) are not yet in place. TC operations that are intended to be a primary vehicle for achieving transition objectives should be preceded by an adequate assessment of the feasibility of such actions being implemented and the strength of commitment by the relevant authorities. A clear connection at approval of TC objectives with the Project objectives, and an effective integration of the TC into a wider strategy, provides a more reliable way to assess the presence (or absence) of key commitments and linkages.

Bank-wide policy-related issues:

- The Bank's transaction reinforced a substantially diminished ownership role of the private sector in the Client. Two years after being privatised through international competitive bidding, the Client was purchased by a company that is majority owned and controlled by the state ("the Parent"). It is the case that under the Bank's accepted definition, projects with companies owned or controlled by a state other than that of the country of operation of the transaction are classified as "private", meaning the Project was categorised in line with the Bank's policy. However, this should not obscure the fact that in this case the Bank's support went to an entity whose ownership was significantly less private that it had been. For the sake of transparency and a ready understanding of the ownership structures with which the Bank becomes associated, a case can be made for circumstances such as this to be flagged clearly for the Board.

The investment programme was completed on schedule in late 2010, although with some changes in the scope, and achieved some loss reductions and service quality improvements; for the most part, though, the investments prevented further network deterioration. From a transition perspective, the Project had some positive demonstration effects regarding the introduction of a new tariff methodology, and helped to set new standards for business conduct with the introduction of new indicators to the Regulator and promoting new environmental and corporate governance standards in the Company. However, the important expectations regarding the introduction of TPA and market liberalisation could not be accomplished yet, as some of key prerequisites are not yet in place.

Table 1: EvD ratings summary

| | |
|---|---|
| Overall performance<br>(Highly successful, successful, partly successful, unsuccessful) | Partly successful |
| **Project relevance** | |
| Additionality<br>(Fully verified, largely verified, partly verified, not verified) | Fully verified |
| **Project effectiveness** | |
| Achievement of operation objectives<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| Company/Project financial performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Excellent |
| **Project efficiency** | |
| Bank handling<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| Bank investment performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | [Enter Text] |
| **Project impact and sustainability** | |
| Transition impact<br>(Excellent, good, satisfactory, marginal, unsatisfactory, negative) | Satisfactory/Good |
| Environmental and social performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory/Good |

# 1. Relevance / Additionality

The Bank provided long-term finance that would otherwise not have been accessible to the Client. Country and regulatory risk, in tandem with the global financial crisis that took hold in 2008, would have made it virtually impossible for the Client to obtain long-term finance from commercial sources. While syndication of the loan was not possible at the time given market lack of appetite, the Bank's efforts led to parallel lending on the part of a state-owned bank.

Table 2: Additionality ratings

| | EvD |
|---|---|
| Additionality<br>(Fully verified, largely verified, partly verified, not verified) | Fully verified |

# 2. Effectiveness

## 2.1. Achievement of objectives

Table 3: Effectiveness ratings

| | EvD |
|---|---|
| Achievement of objectives<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| Company financial performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Excellent |

The purpose of the loan was the "upgrade and modernisation of the obsolete low-voltage infrastructure and installation of meters in order to allow reduction of commercial and technical losses and an improvement of the quality of supply". Implementing the planned investment programme was a necessary condition for success, which the project quantitatively met since actual investments in the period 2007-10 were much greater than the EBRD project, which represented a slice of the larger capex plan approved by the Regulator. However a deviation took place in the scope of the investment plan with higher weight being put on substations versus transmission lines.

The indicators of success regarding reduction in losses and improved quality show mixed results. The main impact of the investments has been to stem the trend for deteriorating service quality, while reduction of losses has been moderate.

Reduction of network losses – Despite unreliability of official data it seems, after adjustments, that the overall reduction has been moderate and due mostly to reduction in commercial losses, while technical losses actually increased. This could in part be explained by a shift in priorities during project implementation, leading to the reallocation of capital towards substations at the expense of lines and transformers.

Improvements in quality of supply – The level of improvement compared to set goals has been moderate (outages per month reduced from 800 to around 750 compared with set goal of 400). The slow rate of success can be partly attributed to improvements in outage monitoring increasing the number of recorded disruptions, making statistics from different years not readily comparable.

## 2.2. Company financial performance

The client has an exclusive licence for electricity distribution with a service area covering a large number of customers. Retail electricity supply as well as power purchases from domestic sources are subject to tariffs regulated on a cost-plus basis. The financial standing of the company has steadily improved in recent years. While sales as of 2011 where behind project levels at appraisal, EBITDA significantly outperformed projections thanks to a growing asset base accounted for in regulated tariffs.

## 3. Efficiency / Bank handling

**Table 4: Efficiency ratings**

| | EvD |
|---|---|
| Bank handling<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |

Project selection and design were based on extensive due diligence and conformed to country strategy and operational objectives. The Bank went to great lengths to bring on board co-financiers willing to lend on a parallel basis. Risks were prudently assessed and mitigated as much as possible. Monitoring was adequate, with the assistance of the Lender's Engineer.

Some inconsistencies across the Bank's documents regarding project budget and the Bank's financing slice should be avoided in the interest of clarity, and setting measurable and reliable benchmarks for monitoring performance should be targeted in project definition to allow a reliable assessment of project results (see Findings section).

## 4. Impact and sustainability

**Table 5: Ratings of transition, environmental and social impacts**

| | EvD |
|---|---|
| Overall transition impact<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory/Good |
| Environmental and social impact<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory/Good |

### 4.1. Transition Impact

The overall transition impact is 'satisfactory/good', with 'good' potential and 'medium' risk. Although not all transition benchmarks have been met to date, the Project generated some positive demonstration effects regarding the introduction of a new tariff methodology, helped set new standards for business conduct with the introduction of new indicators to the Regulator and promoted new environmental and corporate governance standards and transfer of skills. The impacts on market liberalisation and competition (TPA) expected through the TC provided, however, did not live up to expectations.

### 4.2. Environmental and social impacts

Environmental impact is rated 'satisfactory/good' as the combined result of 'satisfactory' environmental performance with some environmental change and good prospects for future impact due to the implementation of an environmental and social action plan (ESAP) agreed by the Bank and the Client. The implementation of the ESAP is by and large on track as many of the actions are scheduled for years to come. The Company's weak institutional capacity is the main challenge but the Company is taking actions and reorganising its structure to respond to the challenges of the ESAP.

# 5. Findings

## 5.1. Overestimation of investment impacts

At project appraisal, the Bank believed, backed by technical due diligence, that the planned investment programme would result in substantial efficiency improvements as indicated by benchmarks on network losses, power outages and electricity sales per employee. The expected results did not fully materialise, however. In particular, technical network losses failed to decline and the investments did not turn around quality of service. The main reason why no progress was made with respect to technical losses is that during project implementation planned expenditure on lines and transformers were trimmed in favour of measures to improve reliability of supply. Moreover, as argued in the Lending Engineer's final report and confirmed by the Client, the investment programme was, relative to the size of the network and its poor shape, too small to achieve better service quality on a broad scale. Rather, the main thrust of the investments was to prevent further deterioration of service quality.

A cautious view should be taken in determining the expected physical and performance outputs of projects, especially when a project is part of measures taken to reduce a long-term backlog of investments, and when corporate loan fundability allows for changes in investment priorities.

## 5.2. Consistency across the Bank's project documents and defining clear sources of measurement for performance benchmarks

A number of statements were made in the Board report create some difficulties from a post-evaluation perspective. Namely:

- Estimated project costs differ across Bank documents. While the Board Document refers to one amount over the period 2007-10, other Bank documents unequivocally quote another. The discrepancies may be due to the fact that project costs formed part of a larger, multi-year variable investment programme, creating some ambiguity about the slice taken as reference for the Bank.
- The BR stated that "to the extent such financing is forthcoming from the Client, the EBRD Loan will be reduced…". This provision was, in EvD's view, a logical consequence of the new and adequate approach taken by the Operations Team to obtain parallel co-financing in substitution to the initially planned syndication. However, despite the Client financing taking place, the Bank's loan was not diminished as a result of further negotiations with the Client after Board approval.
- The Board report stated the goal of reducing losses would be a decline from 18 per cent to 12.5 per cent. However, as acknowledged by the Operations team, measurement of this performance indicator, both at the beginning and at the end of the reference period, is prone to a significant degree of inaccuracy.

Notwithstanding the project's complexity and the need for operational flexibility on the part of the Operations team after Board approval, there should be consistency and clarity across the Bank's documents in the interest of measuring achievements. When setting specific quantitative benchmarks/indicators for monitoring performance or transition impact monitoring/evaluation, the source of reference data should be clearly defined in advance, with a thorough assessment of data reliability.

## 5.3. Alignment of TC operations with committed sector reforms

In order to enhance the impact on the sector's market structure and regulatory framework, the Bank completed the Project with a parallel TC operation that was hoped to spur pending reforms towards market liberalisation. This was done through a study on TPA that was expected to trigger immediate actions by the Regulator, as indicated by the tight deadlines set. Based on information available to the Operation team at the time of approval it was expected, as expressed in the BR and other documents, that TPA would be introduced by 2013 and the TC provided was meant to support such tasks in defining the effective terms. In retrospect, it seems that market condition for the implementation of TPA, as reported by the Consultant, were not in place and the Regulator had not made any commitments to embark on fast-track reforms to be recommended by the study. Deeper analysis of market conditions, stronger commitment of the Regulator, clearer connection of the TC objectives with the Project objectives and integration of the TC as part of a wider strategy might have helped to secure the success of the technical assistance provided.

TC operations are unsuited to induce sector reforms that lack commitment on the part of policy makers and regulatory authorities. When launching TC operations for the sake of transition impacts, the Bank should ascertain that they are feasible and in line with the objectives of the policymakers, and that the potential effects are properly assessed and subjected to realistic benchmarks.

## 5.4. The Client's private ownership

The Client was privatised to a trading and investment company that two years later sold it to the Parent, a majority state-owned company. In this way, this transaction, which predates the Bank's project in 2009, effectively represented a return to public ownership.

Unbundling of generation, transmission and distribution had been a key element in the reform of the country's power sector since 1995. Ownership of the distribution company by a company owning generation assets effectively represented a step back in that strategy, with potential implications for the functioning of the market and competition. These might have deserved further analysis from a wider strategic perspective and eventually taken into consideration in the Project design in the context of the technical assistance provided to the Regulator. Highlighting these issues for discussion by the Board of Directors might have also prompted a useful debate about the EBRD's role in a strategic sector with important public implications.

While the Bank's definition allows projects with companies owned or controlled by a state other than that of the transaction to be classified as "private", it should not obscure the fact that in this case the Bank's support went to an entity whose ownership was significantly less private that it had been. There may be a case to revisit classification norms for future projects.