EBRD strategy for Estonia 1997-98: a summary

Operational priorities

Estonia has made significant progress in both macroeconomic and structural reform. Consultations with industrialists, banks and government representatives point to the following remaining issues:

- lack of medium- and particularly long-term capital, both debt and equity;
- a need to upgrade key infrastructure, especially transport, telecommunications and energy;
- the need for know-how transfer to the enterprise level;
- further integration into the international community; and
- concerns about the environment.

Accordingly, the operational work of the European Bank for Reconstruction and Development (EBRD) will continue to focus on the following areas:

- **Financial intermediaries:** The small size of private sector enterprises makes the local financial institutions the most effective mechanism to deliver financial products to the private sector. The strength of the Estonian banking sector has permitted the EBRD to ensure broad coverage through this mechanism. The Bank's interventions will continue to be increased and diversified, covering debt, equity and other products. The Bank will aim at having a catalytic impact by continuing efforts to syndicate existing debt transactions, thereby recycling some of the funds already committed to the sector while further opening up Estonia's banking sector to the international debt markets.
- **Infrastructure:** Privatisation is the most likely area for larger private sector projects in Estonia and for the diversification of the EBRD's portfolio. The Bank is prepared to support the investment requirements of the utilities and related enterprises as part of their privatisation. Consideration will also be given to direct financing of selected state-owned infrastructure projects where the Bank's presence has a significant transition impact, can assist with the restructuring, commercial-isation or privatisation of infrastructure-related utilities and enterprises, or can facilitate private sector participation.

Other concerns that will guide the Bank's activities will include:

- **transfer of know-how:** The EBRD has developed unique and cost-effective tools, such as the TurnAround Management (TAM) programme and the Business Advisory Services (BAS) Fund project, which will continue to be used extensively in Estonia.
- **Environment:** The Bank has undertaken pioneering work in the municipal and environmental sector, and will continue this work. In addition, all EBRD projects in Estonia are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence. This is in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects.
- **Advancing transition and integration in the international economy:** In consultation with the European Union, the EBRD will continue to support Estonia's process of integration in the international community, of which accession to the EU is a major component. The Bank will explore ways of financially supporting the regional integration of energy sector grids (e.g. electricity, gas) and is involved in coordination efforts for the Via Baltica regional transport corridor. It will continue to give priority to activities and conditionality related to environmental improvements. Commercial-isation of utility services in ways compatible with Western regulations will be emphasised.
- **Direct support for private sector enterprises:** Apart from support for the financial sector and the privatisation of key utilities, and other state-owned infrastructure-related enterprises, there will be only a limited number of transactions that will be of a

sufficient size to justify direct EBRD financing. These will continue to be pursued actively.

- **Mobilising other sources of financing:** In addition to syndications in the financial sector, the EBRD will continue to seek to mobilise external sources of financing, including export credit agencies (ECAs), the Export Import Bank of Japan and the European Investment Bank (EIB), as appropriate. The second phase of the Baltic Investment Programme will make further funds available for co-financing of EBRD projects in support of the development of small and medium-sized enterprises (SMEs). Co-financing with local financial intermediaries will be encouraged. Further support for equity schemes should also help to mobilise local savings for investment.

Financial and banking sector

In the latter part of 1996 the EBRD changed the focus of its efforts from traditional SME credit lines to enabling the banks to become full-service institutions. More sophisticated and longer-term products, such as housing loans, preferred share issues, and subordinated debt, have been introduced, or are under discussion. These products represent areas where the EBRD continues to be highly "additional" and are in keeping with the commercial and strategic needs of its clients.

Two credit lines granted to Estonian commercial banks have been partially syndicated by the EBRD on the international debt market. This opened the international market to Estonian banks and reduced the Bank's exposure to existing projects, thereby allowing the Bank to consider new and more innovative products where its additionality remains high.

The EBRD will continue to seek opportunities to syndicate more of its existing SME credit lines exposure. It will also expand the number of financial intermediaries with which it works and will progressively focus its product range on more sophisticated products.

Enterprise sector

The EBRD will continue to rely on local financial intermediaries to reach the corporate sector and will increasingly give emphasis to the provision of equity capital to the economy through different investment vehicles. As part of this effort, the Bank may seek to reach smaller companies by establishing a small capitalisation investment fund (on a regional Baltic states basis) to target enterprises which are now out of reach for the existing investment funds.

The EBRD will also continue to work on larger stand-alone projects. As the infrastructure privatisation process moves ahead, financing opportunities will be sought in the privatised or privatising entities involved with energy, telecommunications, railways and the port terminals. The TAM programme and BAS Fund will be continued and expanded where possible.

Legal transition

The EBRD is currently undertaking a legal reform project, using technical cooperation funds, involving telecommunications legislative and regulatory development to improve the regulatory framework for investment in the sector.

Due to the relatively advanced state of commercial law development in Estonia, the EBRD will limit its legal transition activities to those which directly support the facilitation of specific Bank investments. The Bank would also be prepared to offer assistance to improve and refine the law and practice regarding the taking of security over moveable property.

Energy sector

The EBRD's operational strategy will continue to focus on the rationalisation of energy use, privatisation of utilities and on catalysing private sector participation in the energy sector. The Bank will also endeavour to support programmes which reduce the negative impact of power and heat generation on the environment. Particular attention will also be given to strengthening regional cooperation in the electricity, oil and gas sub-sectors. Whenever possible, new operations in the sector will be developed on a limited- or non-recourse financing basis involving private sector sponsors.

Future projects will involve direct lending to Estonia's main energy utilities and if required, equity participation (including underwriting) as part of their privatisation, as well as direct funding of private enterprises operating in the sector.

Transport sector

The EBRD will pursue infrastructure projects in the transport sector which promote restructuring and commercialisation, trade, regional integration, private sector participation and private sector development.

The Bank's immediate strategic priority will be to lend its support to the measures for the fundamental restructuring of Estonian Railways, with the separation of its freight and passenger operations into two distinct entities, and for the privatisation of the freight services. In the longer term, continuing support will be given to improving the capacity, increasing the efficiency and reducing the costs of rail freight services. The EBRD is also assessing the scope for support, through a rail concession project, for privatisation of the rail freight services

The EBRD remains prepared to support private sector initiatives in the port sector where the Port Authority would act as a landlord and possibly undertake its own investments for the infrastructure, e.g. channel dredging and quay structure. Such investments would be ideally suited for co-financing with other international financial institutions, with the Bank focusing on the private sector elements, such as the superstructures and equipment. Following the successful completion of its first operation at Tallinn Airport, the EBRD will consider the refurbishment of the passenger terminal to handle the ever-increasing international traffic.

Telecommunications

The EBRD remains ready to finance on a limited recourse basis the modernisation and expansion of the telephone network in Estonia, and participate in the privatisation of the sector.

Municipal and environmental infrastructure

The future EBRD strategy is to continue the pioneering work in the municipal and environmental sector by contemplating private sector projects with strong demonstration effects. Companies providing municipal services which are active in Estonia and with which the Bank has concluded multi-project facilities may be a source of projects suitable for financing.

Environment

A National Environmental Strategy has been prepared with EC Phare assistance. Based on the Strategy, a National Environmental Action Plan (NEAP) is being prepared.

Considerable importance is attached to establishing a sound financial sector. The EBRD has conducted environmental due diligence training for the staff of three banks in Estonia (Estonian Investment Bank, Hansapank and Uhispank) under the Phare Environmental Due Diligence Framework Contracts so that the EBRD's environmental requirements can be incorporated into the banks' existing credit procedures.

The EBRD will contribute to providing environmental due diligence training for financial intermediaries in Estonia. It is planned that staff from an additional three banks will be trained in 1997. Another training scheme from which Estonia has benefited is the Financial Intermediary Environmental Consultants Training Programme. This technical cooperation operation trained local environmental experts in environmental due diligence techniques and has contributed to the development of environmental consulting skills in Estonia.

Cooperation with other multilateral institutions

Projects co-financed with other multilateral institutions will include the Estonian railway project (to be co-financed with the European Investment Bank and EC Phare). The EBRD cooperates with a number of other institutions in the Estonian Investment Bank, in which the EBRD is a shareholder and provider of credit lines, including the Nordic Investment Bank and the European Investment Bank.

Resources provided by the Nordic countries to the EBRD under the first phase of the Baltic Investment Programme have been fully committed. A second phase of the Programme covers the period 1996-99.

Other cooperation included the participation of the Nordic Investment Bank with the EBRD in financing a forest industry sector study in the region and funding a study of emissions from agriculture in the Baltic states. It has also co-financed (with the EBRD) a preparatory study for the Via Baltica roads project.

This document is based on the EBRD's Strategy for Estonia, approved by the Board of Directors at its meeting on 12 February 1997.