ICR Review

Operations Evaluation Department

Report Number: ICRR10778

1. Project Data:		Date Posted: 08/18/2000		
PROJ ID:	P044444		Appraisal	Actual
Project Name:	Electricity Market Development	Project Costs (US$M)	370.6	88.18
Country:	Ukraine	Loan/Credit (US$M)	317.0	76.41
Sector(s):	Thermal	Cofinancing (US$M)	5.50	4.82
L/C Number:	L4098			
		Board Approval (FY)		97
Partners involved:	USA, UK, Netherland, EBRD	Closing Date	12/31/1999	09/23/1999

Prepared by:	Reviewed by:	Group Manager:	Group:	

2. Project Objectives and Components

a. Objectives

The overarching objective of the project was to support the development of a competitive electricity market by providing working capital to thermal generators for the purchase of fuel and spare parts, and installing metering and communications equipment needed for the proper functioning of the settlements system. The rules embedded in licenses and agreements governing participation in the operations of the electricity market were intended to (a) adjust prices automatically to reflect changes in costs; (b) allocate electricity supply to distribution companies in proportion to their collection ratios from customers; (c) reduce incentives for barters and administer remaining barters, expressed in monetary terms, in a transparent manner; and (d) improve billing and collection systems. The underlying objectives were contained in about 60 loan covenants and other conditions, largely financial, which were designed to: (i) restructure the financial conditions of the generators and the dispatch company in parallel with the introduction of the competitive market; (ii) ensure industry's profitability by removing price caps and Government-imposed constraints and requiring that full costs of electricity be recognized by the regulator; (iii) improve the liquidity of the industry; (iv) ensure industry's sustainability by complying with key performance indicators; and (v) introduce International Accounting Standards.

b. Components

The objectives were to be met by: (a) building up fuel stocks at 14 thermal power plants to levels that were consistent with standard industry practices (about 40 days of stocks for coal and mazut); (b) building up the stocks of spare parts and carrying out deferred maintenance at 14 thermal power plants; (c) installing metering and communications equipment to improve recording and billing of electricity flows at key wholesale market delivery points; and (d) providing technical services and training for project implementation, financial management, and the development of a privatization program.

c. Comments on Project Cost, Financing and Dates

At the time the project was cancelled in September 1999, after loan disbursement was suspended for 26 months, actual project expenditures were US$88.18 millions (compared to the SAR's total project cost estimate of US$370.60). Of this amount, US$76.41 million were financed by the Bank loan (US$75.96 million for fuel and US$0.45 million for metering and communications equipment), US$4.82 million by co-financiers (for technical assistance), and US$6.95 millions by the Government for fuel purchase.

3. Achievement of Relevant Objectives:

Although the project provided the equivalent of coal and fuel oil needed to meet the 1996/97 winter (which were delivered late in March 1997 because of late ratification of the Bank loan by Ukraine) and installed metering equipment, none of the principal project objectives were achieved. Once the fuel was delivered and burned, the distributors proved to be unable to pay for power. By October 1997, the fuel stocks were depleted (resulting again in lack of competition, black outs, and poor service) and the generators found themselves without working capital and indebted with the Ministry of Finance demanding payments in cash. The competitive market did not materialize because price caps were imposed to generators in order to maintain affordable retail tariffs, authority to set household tariffs was withdrawn from the regulator, and its instructions were not always followed by distributors. For example, some of the distributors contributed to worsen sector finances by charging below the authorized electricity

rates. Moreover, collection levels declined to 60 percent in 1999 (only 7 percent in cash) from the 90 percent (20 percent in cash) prevailing at Board presentation of the loan. The industry has not been able to maintain key performance indicators and one generator borrowed long term without prior consultation with the Bank. Further, the barter practice plaguing the economy has created a serious lack of liquidity in the power sector. International Accounting Standards are in an early stage of implementation.

4. Significant Outcomes/Impacts:

None.

5. Significant Shortcomings (including non-compliance with safeguard policies):

The project was selected for Quality at Entry assessment by the Bank's QAG after loan disbursement was suspended in July 1997. In December 1997 the QAG found quality at entry to be only marginal. The project, by not addressing in a major and direct way the fundamental issue of the sector (i.e, strong private participation in generation and distribution) preserved the old payments/collection/barter system which continues to undermine the operation of the Energomarket. Attempts made by the Bank to revive the project was hindered by the effects of the Russian financial crisis of August 1998 resulting in a large devaluation of the Ukrainian currency, and a cancellation request by the Ukrainian eventually occurred in September 1999 when the Parliament intervened and withdrew from the regulator the powers to adjust household tariffs. The technical assistance program funded by the USAID, British Know How Fund, CIDA, EU/TACIS and the EBRD was of poor technical quality and did not address the specific needs of Ukraine, as reported by a 1999 USAID sponsored detailed review of the TA program.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Highly Unsatisfactory	Highly Unsatisfactory	None of the principal objectives were achieved. The project was cancelled upon request of the Borrower.
Institutional Dev.:	Modest	Negligible	The Ministry of Power is still in control of the sector. The regulator is established and has acquired considerable expertise but its powers have been limited by the Parliament and the Government. Thermal generation companies are in precarious financial conditions, have excess capacity and under-maintained facilities. Privatization of seven (out of 27) distribution facilities mostly involved speculative investors without any record in the international power distribution business.
Sustainability:	Unlikely	Unlikely	Lack of liquidity of the economy (a country issue beyond the reach of the project), impedes the financial rehabilitation of the power sector. Sustainability will remain unlikely as long as current collection levels in cash is 5-10 percent of billing.
Bank Performance:	Unsatisfactory	Unsatisfactory	Project appraisal was unsatisfactory as the project did not address directly the main issue (privatization of the sector) and failed to take into account the very unfavorable underlying macroeconomic environment. These failings outweigh the proactive (though ineffective) supervision efforts made by the Bank to revive the project during the 26 months of loan disbursement's suspension.
Borrower Perf.:	Unsatisfactory	Unsatisfactory	Project implementation failed because of a lack of liquidity of the basically barter-based Ukrainian economy combined with political intervention by the Government and Parliament annulling the functions of the power sector regulatory agency.
Quality of ICR:		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

In a country where the economy is basically barter-based and the Government condones the culture of non-payment, the introduction of an advanced model of a competitive power market is bound to fail .

The Bank should not finance the purchase of fuel as a way to create working capital of a power utility, unless there exists a genuine *force majeure* transient circumstance. Working capital should be financed through short-term borrowing, suppliers' advances and equity.

Peer reviewers' opinions should be given more weight in the project approval process, specially when they are critical of an operation. In this case, peers expressed reservations about the project, particularly about generation companies borrowing long-term to finance fuel, the role of the regulator when the power enterprise are in the public sector, and the insufficient emphasis on privatization

8. Assessment Recommended? ● Yes ○ No

Why? Only if clustered with other lending operation in the power sector in Ukraine .

9. Comments on Quality of ICR:

The ICR is satisfactory. It presents a clear and concise description and evaluation of project preparation and implementation. There appears to be a minor inconsistency between the actual fuel cost and the amount financed by the Government Apparently the Government financed US$6.95 million and not US$10.40 million as reported in Annex 2.