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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED LOAN
TO THE
ELECTRICITY AUTHORITY OF CYPRUS
FOR THE
THIRD POWER PROJECT
WITH THE GUARANTEE OF THE REPUBLIC OF CYPRUS

December 10, 1969

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED LOAN TO THE ELECTRICITY AUTHORITY
OF CYPRUS FOR THE THIRD POWER PROJECT

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to U.S.\$5 million to the Electricity Authority of Cyprus.

PART I. HISTORICAL

2. The Bank has made two loans to the Electricity Authority of Cyprus (EAC). The first loan (335-CY) of \$21 million was made in 1963 to help the EAC carry out its First Five-Year Development Program (1962-1966), consisting of the construction of the Moni steam power station with two 30 MW generating units and the expansion of transmission and distribution systems. Since the scope of the project was reduced and some of the equipment required was eventually financed by the United Kingdom, \$5.7 million of the Bank's loan was cancelled. The project was completed in 1967. The second loan (494-CY) of \$2.8 million was made in 1967 to expand the Moni station with a third 30 MW unit which was part of the Second Five-Year Development Program (1967-1971). Progress of this project is satisfactory; on November 30, 1969 U.S.\$643,000 of the loan remained to be disbursed.

3. The EAC has now requested the Bank to finance the foreign currency requirements of the Third Power Project, consisting of a fourth 30 MW unit at Moni and the extension of transmission facilities.

4. Negotiations for the proposed Bank loan were held in Washington between November 20 and 28, 1969. The delegation from Cyprus consisted of Mr. L. G. Anastasiades, Chief Engineer and General Manager of the EAC and head of the EAC delegation, Mr. L. Demetriou, Chief Accountant of the EAC, Mr. G. Cacoyannis, Legal Adviser to the EAC, and Mr. T. Theophilou of the Treasury Department in the Ministry of Finance, representing the Government.

5. The Bank has made three loans to Cyprus totalling \$29.6 million equivalent net of cancellations. As described above, two of them totalling \$18.1 million net of cancellations have been made to the EAC. A third loan (\$11.5 million) was made in June 1969 for the Cyprus Ports Project; it became effective on October 1, 1969. The projects for which these loans have been made have been or are being carried out satisfactorily, and their status as of November 30, 1969 was as follows:

<u>Loan Number</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (US\$million)</u>	
				<u>Bank</u>	<u>Undisbursed</u>
335	1963	Electricity Authority of Cyprus	Electric Power	15.3	-
494	1967	Electricity Authority of Cyprus	Electric Power	2.8	.6
628	1969	Republic of Cyprus	Ports	<u>11.5</u>	11.5
Total (less cancellations)				29.6	
of which has been repaid to Bank and others				<u>1.9</u>	
Total now outstanding				27.7	
		Amount sold	2.0		
		of which has been repaid	1.3	<u>.7</u>	
Total now held by Bank				<u>27.0</u>	<u> </u>
Total undisbursed					<u>12.1</u>

6. The Bank also has under review a project for the development of the sewerage systems in Nicosia and Famagusta which is likely to come up for consideration by the Executive Directors in mid-1970.

PART II. DESCRIPTION OF THE PROPOSED LOAN

7. Borrower: Electricity Authority of Cyprus
- Guarantor: Republic of Cyprus
- Amount: Various currencies equivalent to U.S.\$5 million
- Purpose: To finance the foreign exchange costs of generating and transmission facilities
- Amortization: In 20 years including a 3-1/2 year period of grace, through semi-annual installments beginning July 15, 1973 and ending January 15, 1990
- Interest Rate: 7 per cent
- Commitment Charge: 3/4 of 1 per cent

PART III. THE PROJECT

8. An appraisal report entitled "Electricity Authority of Cyprus: Appraisal of the Third Power Project, Cyprus" (PU-25a dated December 5, 1969) is attached.

The Project

9. The Project proposed for Bank financing consists of:

- a) Expansion of the Moni generating station with the installation of a fourth 30 MW steam turbo-generator, similar to the three existing units financed with earlier Bank loans;
- b) Construction of 87 miles of 132/66 kv transmission lines; and
- c) Expansion of the existing Moni substation with two 45 MVA transformers, and construction of a new substation at Athalassa.

10. The installation of a fourth 30 MW steam turbine unit at Moni is the most economical step to meet the projected increase in demand. The only practical alternative would be the installation of a gas turbine which would have a somewhat lower capital cost but disproportionately higher operating costs. The extension of the transmission system follows the orderly development recommended in the long-range plan prepared by the consultants who were retained with the Bank's approval under previous loans. It is needed to maintain satisfactory service standards consistent with the load growth.

11. On the basis of international bids received for the equipment required, the total estimated cost of the project is \$6.2 million equivalent, of which the proposed \$5.0 million loan is the foreign exchange component. The proposed loan would cover 25 per cent of the EAC's total investment expenditure from 1970 through 1972 and would complete the financing plan for that period. The other funds required would be obtained mainly from EAC's internal resources.

The Borrower:

12. The EAC was established in 1952 as an independent agency to centralize the power supply for Cyprus, until then the responsibility of the municipalities. It has a Government-nominated Board of Directors, who, in turn, appoint the executive management. The present chief executive has been in charge since 1961.

13. The EAC raises capital by borrowing and its equity consists entirely of retained earnings which at the end of 1968 amounted to \$9.7 million. Long term debt, other than the two Bank loans, consists mainly of five Government loans totalling \$18.9 million made between 1953 and 1959 and bearing interest at 4.9 per cent per annum on the average.

14. Under the two earlier Bank loans, the Government agreed not to ask for repayment of its loans to the EAC during the life of the two Bank loans. Since then the EAC's financial situation has improved and the Bank has informed the Government and the EAC that it would be prepared in principle to approve a schedule for repayment of the Government loans which would be consistent with the maintenance of a sound financial position by EAC.

15. The EAC's financial position should continue to develop satisfactorily. Projections show that during the period 1970-1973 earnings produce a return of over 9 per cent on net fixed assets in operation, and internal cash generation would cover debt service over twice.

PART IV. LEGAL INSTRUMENTS AND AUTHORITY

16. The draft Loan Agreement between the Bank and Electricity Authority of Cyprus, the draft Guarantee Agreement between Republic of Cyprus and the Bank, the report of the Committee provided for in Article 3, Section 4 (iii) and the text of the Resolution approving the proposed loan are being distributed to the Executive Directors separately.

17. The draft Loan Agreement and draft Guarantee Agreement follow the pattern of agreements for power projects in general and those of the two first loans to the Electricity Authority of Cyprus in particular.

PART V. THE ECONOMY

18. The report "Current Economic Position and Prospects of Cyprus" (EA 174a), circulated to the Executive Directors on October 31, 1968, recorded the impressive growth of the economy under the First Five-Year Plan (1961-1966) in spite of political difficulties. The Bank concluded that the economic performance and prospects of Cyprus justified continued Bank lending and that Cyprus, in view of its excellent debt service record and low debt service payments, was creditworthy for the port loan then pending.

19. An economic mission visited Cyprus in February 1969. A "Memorandum on the Economic Situation of Cyprus" (EC/O/69-52/1) dated June 5, 1969 was distributed to the Executive Directors in June 1969. The mission's findings confirmed a favorable assessment of Cyprus' economic prospects formulated in the previous report. Another updating economic mission visited Cyprus in October 1969.

20. The political climate has improved this year. The two communities, Greek and Turkish, are beginning to meet and discuss problems whilst the growing demand for labor is providing increasing opportunities for Turkish workers to be employed in Greek enterprises. There is general agreement on the need for a negotiated solution of the political problem, but no breakthrough has yet been achieved, and the situation must still be regarded as unstable.

21. Against the background of an improved political climate, there is expected to be a very large increase in GNP in real terms of 10-12 per cent in 1969. This is considerably more than the average growth rate target (7 per cent) of the Second Five Year Plan (1967-71). Agriculture and tourism, and to a lesser degree mining and manufacturing, will contribute to further development. But there are also signs of economic tensions and inflationary pressures. These stem from lack of skilled manpower, a large wave of wage increases arising from agreements falling due simultaneously for renewal, an excessive expansion of credit arising from high domestic liquidity, a large public sector cash deficit, a high rate of investment and a large temporary inflow of capital due to speculation, particularly in real estate. All of these factors have contributed to the emergence of substantial purchasing power in excess of real production. Due to this increasing purchasing power there has been a rapid growth of imports resulting in a deterioration of the balance of payments on current account. The overall balance, however, has showed a large surplus due to the large inflow of what appears to be speculative capital.

22. The Government has been concerned and has taken steps to meet this situation by resorting to traditional monetary and fiscal policies and to other measures designed to encourage savings and to discourage

speculation. So far any significant increase in prices which would affect competitiveness has been avoided. Whilst the Government of Cyprus is entering a period in which it may face major economic difficulties and have to develop new methods for controlling the economy, there is no reason - aside from the internal political problems - why it should not succeed.

23. At the end of 1968 Cyprus' foreign exchange reserves were equivalent to eleven months' visible imports and with the inflow of capital in 1969 these appear to be growing. However, the openness of the economy, the requirements for rehabilitation which are likely to draw heavily on domestic resources once the political situation becomes more stabilized, the eventual reduction in military expenditures by the U.K. (which maintains a base on the island), the need for increasing development expenditures and diversifying the economy are all factors indicating that Cyprus may have substantial foreign exchange requirements in the near future. Hence the present relatively high level of foreign exchange reserves should not be regarded as more than an adequate safeguard. Cyprus has an excellent debt service record and the amount of outstanding external debt of about \$30 million is modest. Assuming that it will borrow on conventional terms the \$40 million of external financing required under the Second Plan, its debt service in 1971 would still be only 4 per cent of gross current foreign exchange earnings. In spite of the political uncertainties, Cyprus is considered creditworthy for Bank loans.

PART VI. COMPLIANCE WITH ARTICLES OF AGREEMENT

24. I am satisfied that the proposed Bank loan complies with the requirements of the Articles of Agreement of the Bank.

PART VII. RECOMMENDATION

25. I recommend that the Executive Directors approve the proposed loan.

Robert S. McNamara
President

Attachment

Washington, D.C.

December 10, 1969