I. Project Context

Country Context

Uruguay is a small, open and high income country that has made marked progress in terms of combining macroeconomic stability, growth and shared prosperity. Uruguay is an open economy, with a trade to GDP ratio of close to 66 percent. Supported by favorable external environment, good governance and strong macroeconomic management, Uruguay’s economic growth performance has been strong averaging 5.6 percent annual growth since 2006. Uruguay achieved high income country status with a GNI per capita of US$15,180 in 2013 and is one of the most developed economies in Latin America. Growth and inclusive policies have resulted in marked progress in shared prosperity with the per capita income of the bottom 40 percent of the income distribution, growing at an annual rate of 4.9 percent growth over the 2006-2012 period well above the 2.4 growth rate of the total per capita income.

Notwithstanding the progress made on multiple fronts, the country faces challenges stemming from its exposure to external economic conditions. Due to its small size and increasing economic
openness, Uruguay is exposed to global economic conditions. Fluctuations in international commodity prices, including oil, and capital markets conditions affect Uruguay’s balance of payments and GDP growth.

No less important, given the dependence on agricultural exports and the strong reliance on hydropower in its energy matrix, the country is exposed to weather shocks. In particular, droughts have a strong direct negative impact on GDP growth and the trade balance. Although it is a cheap and clean energy source, strong reliance of the country’s energy matrix on hydropower means that energy production and costs are negatively impacted in drought years. In such times, electricity costs increase due to the need to switch to more expensive energy sources (mainly thermal that relies mostly on oil imports, or electricity imports). This means marked deterioration in trade and fiscal balances.

Indeed, droughts have sizeable negative impact on Uruguay’s fiscal position. Increased electricity generation and/or electricity import costs affect the balances of UTE. For example, in 2012 the combination of severe drought and high oil prices resulted in increased costs of meeting electricity demand of about 40 percent above the average observed in normal hydrological years (more than 1 percent of GDP) and caused a marked deterioration in UTE’s balance. Due to the importance of UTE in the consolidated public sector, fiscal deficits are negatively affected in drought years. In 2012, for example, the fiscal deficit increased to 2.8 percent of GDP up from 0.9 in 2011, partly on account a drought-related deterioration in the financial balance of UTE.

Being a small and open economy exposed to external shocks, Uruguay has adopted prudent fiscal policies and a very conservative risks management strategy to enhance its resilience to adverse shocks. Prudent fiscal policies and strong growth led to a significant reduction in indebtedness. Gross public sector debt declined below 60 percent of GDP by the end of 2013 down from 75 percent of GDP in 2006. The country has also accumulated sizeable international reserves and its proactive debt management has markedly improved the country’s debt profile, by reducing rollover, exchange rate and interest rate risks. Consistent with the country’s strong preference for risk mitigation, the Government of Uruguay (GoU) has also contracted contingent financing to build additional financial buffers to respond to potential adverse shocks associated with still uncertain global economic and financial conditions.

A fundamental part of the overall risk mitigation strategies at the sectoral level are the significant investments to diversify the energy matrix that will reduce vulnerability to weather shocks. In addition the GoU has deployed a battery of risk mitigating instruments to manage weather-related risks over the short run. This operation supports the Government efforts to mitigate the effect of adverse weather conditions on its fiscal position and enhance the efficiency of its risk management framework related to weather shocks that affect electricity generation costs. This proposed operation provides an additional buffer in the next three years, a critical period in which the energy matrix is evolving to a more diversified and resilient one.

**Sectoral and institutional Context**

Uruguay has substantial hydropower to meet a large portion of its energy needs at low costs, although the hydro-based electricity production has been volatile. The last 8 years hydropower represented between 43 to 81 percent of the electricity mix, varying with the weather conditions.
Supply has historically been complemented by thermal electricity and electricity imports to meet demand. Non-conventional renewable sources (biomass and wind) are also increasing their participation in recent years. The country has reached its hydroelectric potential which today represents close to 75 percent of the electricity mix. However, the hydrology of the river basins that connect to the hydroelectric system is highly variable and impacts directly the cost of producing electricity. At the same time it has no proven reserves of oil, natural gas, or coal.

The cost of electricity production varies significantly with the rainfall. The cost of producing electricity increases on average by approximately 75 US$/MWh between a rainy and dry year due to the shift to more expensive sources such as thermal energy and electricity imports. The cost of producing electricity through thermal generation is substantially higher. The rise in oil prices during the recent commodity price boom further increased the costs of thermal energy. Also, the cost of imported electricity in dry years was exceptionally high in recent years. Given the investments in renewable energy, the volatility in the cost of electricity production is expected to decline markedly. The difference in cost between a rainy and a dry year would drop from 75 US$ per MW/h in 2011 to an estimated 25 US$ per MW/h in 2017. Thus, the structural vulnerabilities of Uruguay's electricity system associated with the hydro dependence will start declining when significant wind farm capacity will be installed. In addition, the regasification plant under construction will also contribute to reduce the electricity cost by lowering the costs of the thermal energy.

The GoU has implemented tariff smoothing policies in order to avoid large price volatility and the adverse impact on households and firms. Electricity tariffs are set incorporating average medium-term electricity generation costs. Tariff readjustments take into account the evolution of costs in relation with expected inflation, the price of Brent, the expected exchange rate vis-à-vis the USD, and UTE operating costs. Tariffs are proposed by UTE, the Energy and Water Services Regulation Unit (Unidad Reguladora de Servicios de Energía y Agua - URSEA) analyses the proposal and transmits its assessment to the executive branch that determines the tariffs.

Given the tariff smoothing policies, deviations from average cost are absorbed through transfers from the Ministry of Economy and Finance. The government does not want to allow pass-through of short run upstream production cost fluctuations to electricity tariffs. Consequently, the cost of fluctuations is reflected in UTE’s overall deficit and surplus position. Such deficits and surpluses are then balanced via transfers from the Ministry of Economy and Finance.

On the structural front, the GoU’s investments and private investments in the energy sector aim at increasing the contribution of other renewable sources, improving efficiency and moving to cheaper alternative sources. By 2016, authorities expect to have a more balanced electricity matrix, with a lower weight of hydropower and less expensive, more efficient thermal generation plants, and non-conventional renewable sources (wind and biomass). However, some implementation challenges—such as attaining the planned integration rate of intermittent sources of energy in the transmission grid or slow investment executions—could delay the transition toward the new energy matrix.

Meanwhile, as the electricity matrix is being diversified, the GoU has put in place a sector specific risk mitigation strategy by using risk retention and risk transfer instruments as part of its electricity sector risk management strategy covering drought shocks that affects electricity generation costs. Figure 4 shows the different layers of this strategy. As part of its risk retention mechanisms, UTE maintains around US$80 million in cash to face weather shocks that have short duration, are frequent but of limited impacts. Beyond cash reserves, in 2010 the GoU has established the Energy
Stabilization Fund (Fondo de Estabilizacion de Energia - FEE) designed to attenuate part of the effect of the less frequent weather shocks of medium intensity. Favorable weather conditions in 2013-14 facilitated the building up of a sizeable amount of funds at the FEE (around US$350 mi). Finally, following the combination of severe drought and high oil prices that resulted in substantial increase in electricity generation costs in 2012, as part of its risk transfer strategy, UTE has purchased a weather-oil price insurance that protects its financial position in the case of low probability but of extreme and high cost droughts.

The FEE is not only a risk management tool but also a fiscal stabilization instrument. The FEE contributes to reducing the volatility of tariff rates and of government borrowing needs generated by weather-related additional costs. It does so by accumulating funds in periods of favorable weather conditions when electricity generation costs are low and not spending them, and by using these funds to avoid reducing other expenditures and/or borrowing by the full impact of the shock when the weather cycle is adverse. In this manner, the FEE also contributes to stabilize electricity tariffs in the face of climatic events, enabling a more predictable tariff environment for households and firms.

The FEE was established in 2010 as a sole-purpose fund “to reduce the negative impact of hydropower deficits on the financial situation of UTE and on the consolidated public sector accounts”. Law 18.719 of December 2010 creating the FEE within the National Development Corporation (Corporación Nacional para el Desarrollo - CND). Decree 442 of December 2011 defined that CND, in its capacity as Trustor of the FEE, needs to enter into a management trust fund contract with the National Financing Corporation of Investment Funds (Corporación Nacional Financiera de Fondos de Inversión- CONAFIN AFI S.A) to act as trustee, with UTE being the beneficiary. The trust fund contract has not been celebrated yet, and in the meantime the FEE funds and operations are recorded in a separate account of the CND.

The FEE has well defined and transparent rules of contributions and use of funds and a ceiling for the accumulated funds that ensures its stabilization role. It is tailored to the specific characteristics of the relation between weather conditions and UTE’s balances. Decree 442 establishes objective criteria based on hydrological conditions in which UTE needs to allocate funds to FEE and in which the FEE needs to transfer accumulated funds to UTE. This decree also establishes a minimum level of contributions (fixed part) to reduce the probability that the FEE’s funds are exhausted and a ceiling for the accumulated funds to avoid an excessive accumulation of funds. The ceiling was set at the equivalent of US$500 million. Once accumulated funds in the FEE reach this ceiling, rules of contribution no longer apply. The ceiling is used to calculate the minimum contributions from UTE. Finally, the size of the FEE is bounded between 0 and the ceiling of US$500 million, which means that when funds are completely exhausted, the FEE cannot fulfill its function while the ceiling level is indicative of the GoU’s targeted risk level coverage with this risk retention instrument. Finally, Decree 442 mandates that the FEE’s assets are managed by the Central Bank in an account separate from the country’s international reserves, but following similar guidelines. In summary, clear definition of roles between stakeholders, well defined rules for contributions and uses, and conservative and transparent investment policies indicate that the FEE is a sound stabilization instrument that is tailored for the mitigation of risks faced by UTE.

Still there is room for further improvements for the FEE related to its institutional framework, its integration with the overall fiscal framework and with risk management strategy. According to the Decree 442/011, a trust fund agreement is expected to define institutional arrangements governing
the FEE and the roles and responsibilities of the stakeholders. In this regard, with Bank’s support, the GoU is setting up this agreement based on international best practices. Second, the FEE was designed to respond to UTE’s financial flows, and the rules and recording of contributions and uses could be better articulated with the public sector accounts. Finally, as the parameters that define contributions and uses were defined in 2010, a recalibration using more up to date parameters reflecting the evolving structure of the energy matrix, could enhance its efficiency.

II. Proposed Development Objectives
The Program Development Objectives of this proposed operation are to enhance the Government of Uruguay’s efforts to mitigate the effect of adverse weather conditions on its fiscal accounts and enhance the efficiency of the Government’s risk management framework used to mitigate these risks.

III. Project Description
Component Name
Leveraging the FEE ability to cushion weather climatic shocks
Comments (optional)

IV. Financing (in USD Million)

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For Loans/Credits/Others

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V. Implementation
The proposed operation will be implemented over a three-year period; overall coordination and implementation will be the responsibility of the National Development Corporation (CND) and the Ministry of Economy and Finance. The proposed operation will rely on implementation arrangements between CND and its 100 percent controlled company CONAFIN AFI S.A.

The proposed Project will be implemented by CND and the subsidiary agreement by CONAFIN AFI S.A., a subsidiary Company of CND, which is the Trustee of the Energy Stabilization Fund (FEE). The CND will be responsible for most fiduciary, management, and monitoring and evaluation tasks. The CND will be responsible for monitoring the conditions for disbursements and of requesting the disbursement of the contingent financing if the disbursement conditions are met and will be responsible for disbursing to the Energy Stabilization Fund, as part of the on-lending operation. The Trustor will monitor compliance with the rules of disbursement and will be responsible for certifying that the conditions are met and for informing the World Bank once the conditions for disbursement have been met. The CND will also monitor compliance with Bank safeguard and compiling information from. The Trust Fund will be funded with internal government resources provided by Rentas Generales, funds contributed by UTE, and external financing.
VI. Safeguard Policies (including public consultation)

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Comments (optional)

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