



European Bank
for Reconstruction and Development

Fidanka Bacheva-McGrath
CEE Bankwatch Network

7 November 2011

Dear Ms Bacheva-McGrath,

Thank you for your letter received on 04 November in relation to the transition impact of the Ombla and Boskov Most Hydro Power projects.

Transition impact targets the development of functioning markets through the support of policies and market-oriented institutions that exhibit a particular set of skills and behaviours. Impact has to be systemic, meaning that it should reach beyond the project company. This may be achieved through demonstration effects, skills dispersion, or through changes to the regulatory framework leveraged by policy dialogue directly associated with the project. An energy efficient and low carbon economy is regarded as an intrinsic element of well functioning and sustainable markets. The transition to a low carbon economy requires sound institutional, legal and regulatory frameworks to stimulate investment, create the right incentives and overcome market failures.

When considering investments that respond to climate change, there is often a lack of market related impact and some larger scale projects can only be capable of being delivered by incumbent companies. However, these effects can be offset by the demonstration effect of new technologies and techniques to the wider industry. Such an effect is reinforced when the project employs best international practices and uses innovative solutions which can lead to positive impacts not only in the target country but across the region. Support for hydro power projects can result in a range of positive impacts. It not only provides additional renewable generation for the country, but due to its technical characteristics it can provide peaking power to address volatile demand and also reserve capacity that can be used to cover more intermittent wind power generation.

The Ombla Hydro Power Project will be the first engagement by the Bank with HEP since 1995 and the first project with the company since the new Management Board was formed in 2009 following the dismissal of the former Management Board on corruption allegations. Since then, the company has been working to improve its corporate governance and internal practices. However, there are still significant gaps that need to be addressed including procurement and environmental procedures. Because of the EBRD's investment in this project, HEP has agreed to follow EBRD's Procurement Policies for Public Sector Operations for this project, thus ensuring

improvements of its internal policies and practices. This is reinforced by the company's commitment to covenant the adoption and implementation of an Environmental and Social Action Plan developed by international consultants which addresses the characteristics of the unconventional nature of the project. The EBRD is also requiring the completion of an additional biodiversity study and a biodiversity management plan prior to disbursement of the EBRD loan that could affect the proposed Natura 2000 areas. Through these actions, the Bank is engaging with the client to go beyond its national environmental requirements and towards international best practice, and thus setting a new standard in the country. This will be an important benchmark in Croatia, which is currently developing the institutional capability to oversee and enforce such practices.

The transition impact potential of the project also comes from the demonstration effect of introducing a new unconventional hydro generation plant in Croatia. The project could potentially attract the development of similar plants in countries with karst aquifer areas, as well as other hydro plants. The project will also benefit the local wholesale energy market as a considerable proportion of the output of the plant will be openly traded. In addition, it will increase the supply of potable water for the city of Dubrovnik. As with any new approach or technology, there are potential risks with this new technical approach to building a hydro power plant, but these have been taken into account when assessing the impact of the project.

Regarding the further development of renewable energy in Croatia, the EBRD is actively developing a diverse pipeline of renewable energy projects, which are all at various stages of approval. In addition, we believe hydro plants such as Ombla will allow for the further development of solar and wind, of which there is great potential in Croatia, as such hydro plants results in increased stability and flexibility of the power network.

In terms of technical assistance, the EBRD has provided, and continues to provide substantial technical assistance support to the Croatian authorities in relation to the wider development of renewable energy. The Bank provided support in 2010 for a study of wind power integration, which examined the capacity of the Croatian power system to accept (interruptible) wind power, and what investments would be needed in the transmission grid or other parts of the power system in order to increase the capacity of wind power that the system can safely handle. The Bank is also currently responding to a further substantial request for support from the Ministry of Economy, and is providing technical assistance in a number of areas, though especially concentrated on harmonisation with the EU's 2009 Renewable Energy Directive.

The financing of the Ombla project is envisioned to be in the form of an A/B corporate loan totalling EUR 123.2 mln (EUR 80 mln A loan / EUR 43.2 mln B loan). The Bank can finance 35% of an enterprise's long term capital under an EBRD A loan (though can also arrange any further debt required under an EBRD B loan). In cases where there is a greenfield project financed through a special purpose vehicle, this requirement equates to 35% of the project's funding requirement. However, the loan in question is to the holding company (whose balance sheet is much larger than just the Ombla project), and thus can exceed the 35% A loan threshold.

The Boskov Most hydro power project benefits from many of the same transition impact characteristics but it is also associated with effective policy dialogue with the authorities in the country, which has recently helped to achieve good progress in the liberalisation process of the power market under the country's new 2011 Energy Law. The success of the project is linked to significant increases in liberalisation for consumers and wholesale electricity market reform. The aim is to ensure that an environment is created that promotes new entrants to the energy market. Furthermore, as with all investments undertaken by the Bank, it should be seen as part of the wider support that is being given to the energy sector in FYR Macedonia. For instance, the Bank operates a number of financing facilities, such as the West Balkans Sustainable Energy Direct Financing (WeBSEDF), that are successfully targeting smaller independent renewable energy investments in the region.

The Bank appreciates your detailed comments on country level transition indicators and we look forward to continuing our dialogue on the topic when your representatives visit the Office of the Chief Economist in the coming weeks.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'BRK-2', written in a cursive style.

Biljana Radonjic Ker-Lindsay
Head, Civil Society Engagement Unit
European Bank for Reconstruction and Development