

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC10441

Project Name	Uruguay Climate Events' Impact Mitigating Investment Project Financing (P149069)
Region	LATIN AMERICA AND CARIBBEAN
Country	Uruguay
Sector(s)	Public administration- Energy and mining (50%), General public administration sector (30%), Hydropower (20%)
Theme(s)	Other economic management (70%), Other public sector governance (30%)
Lending Instrument	Investment Project Financing
Project ID	P149069
Borrower(s)	National Development Corporation of the Oriental Republic of Uruguay
Implementing Agency	National DEvelopment Corporation
Environmental Category	C-Not Required
Date PID Prepared/ Updated	11-Sep-2014
Date PID Approved/ Disclosed	11-Sep-2014
Estimated Date of Appraisal Completion	20-Oct-2014
Estimated Date of Board Approval	02-Dec-2014
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

The proposed operation designed as an Investment Project Financing (IPF) with 100 percent contingency supports the authorities' efforts to reduce the vulnerability of fiscal accounts to droughts. This operation supports Uruguay's risk management strategies and is consistent with the World Bank Country Partnership Strategy for the period 2010-2015. It builds and complements World Bank operations focusing on a particular type of risk management policies that are associated with climate shocks and that could affect negatively public sector accounts and individual consumers and firms.

Uruguay is a small and high income country . With a population of 3.4 million inhabitants, a GDP of US\$55.7 billion and a GNI per capita of US\$15,180 in 2013, Uruguay is one of the most developed economies in Latin America . Uruguay is an open economy, with a trade to GDP ratio

close to 55 percent. Its main exports are agricultural products (soya, meat, cereals, etc.) but recently pulp exports have also become important. Its main trade partners are its Mercosur neighbors Brazil and Argentina, and China which has been increasing its importance as an export destination. Exports to China, US, EU27 and the rest of the world are mostly primary goods, while exports to Mercosur and Latin America consist mainly of manufactured goods. Tourism services exports are also important (mostly to Argentina), but export of other services, including software and logistic services have grown markedly.

Uruguay's recent economic growth performance has been strong and the country just became a high-income economy in 2013. Uruguay's economy has expanded at an annual average of 5.6 percent since 2006, when the economy has fully recovered from the 2002 financial crisis, and GDP growth volatility has declined. Growth was supported by a favorable external environment characterized by strong external demand, high commodity prices, and high global liquidity. Rapid economic growth has been accompanied by significant job creation, and unemployment has declined to historically low levels.

The country has reduced significantly inequality, poverty rates and boosted shared prosperity. Inequality declined markedly, with the Gini coefficient dropping to 0.384 by 2013 from 0.455 in 2006. The strong economic growth and inclusive social policies led to a reduction in the moderate poverty rate from 32.5 percent in 2006 to 11.5 percent in 2013 while extreme poverty declined from 2.6 percent to 0.5 percent. Growth has been also accompanied by marked progress in shared prosperity as the income for the bottom 40 percent of income distribution grew by 6.8 percent between 2004 and 2012, 2.2 percentage points (or 30 percent) higher than the mean income growth for Uruguay.

Good governance and political stability have been decisive in supporting the country's good economic performance. Uruguay has garnered an enviable record of political stability and good governance. Uruguay has been routinely listed among the region's top performers in governance indicators. Currently, the country ranks fourth in Latin America and the Caribbean in the Country Policy and Institutional Assessment (CPIA), in the Democracy Index of the Economist Intelligence Unit rank, and in the corruption perception index of International Transparency.

Prudent economic policies have played a key role in maintaining strong growth and macroeconomic stability, and helped the country to attenuate the effects of the global economic crisis. Macroeconomic management combines fiscal discipline, an inflation targeting monetary regime and a flexible exchange rate regime. Uruguay's fiscal policy has been sound, contributing to reducing fiscal vulnerabilities, and allowing for a significant reduction in debt. Gross public sector debt declined below 60 percent of GDP by the end of 2013 down from 75 percent of GDP in 2006, while net public sector debt declined to 23.3 percent of GDP from 46.8 percent of GDP in 2006, as international reserves increased markedly. In addition, proactive debt management has allowed a strong improvement in the debt profile. More than 80 percent of the debt is at fixed rate and average debt maturity reached 12 years. The central bank has consistently adopted a monetary policy to ensure stable inflation, albeit remaining in high single digits. Exchange rate policies were broadly flexible with punctual interventions aimed at reducing short-term volatility.

Notwithstanding the progress described above, as a small open economy the country faces challenges related to its exposure to external conditions and severe climate events. Due to its size and increasing degree of openness and global integration, Uruguay is highly sensitive to the global

economic conditions and international commodity prices for its exports and imports. In particular Uruguay is exposed to developments in its main trading and economic partners, Brazil and Argentina. In addition, a sharper than expected deceleration in growth in China could have a negative impact on commodity prices, including on those that Uruguay exports (in particular soybeans, but also beef, wood etc.). No less important, given the importance of agricultural exports and the strong reliance on natural sources in its energy matrix, the country is exposed to climate shocks.

In particular, because the high reliance on hydropower for its electricity supply, severe droughts have affected the country's growth performance and its macro-fiscal stability. Some extreme scenarios (low probabilities of 3-4 percent) of drought combined with high oil prices could have had significant external current account and fiscal impacts. A severe drought has a first order impact of up to 1 percent of GDP, or approximately \$500 million, as the country needed to use more on thermal electricity generation which would require the increase in oil imports. As tariffs are set based on an average hydrological year (i.e. hydropower generation costs in normal years), deviations from this historical average require the use of more expensive energy sources (mainly thermal), which result in increased electricity generation costs and losses for the state-owned electricity company (Electricity Transmission and Electric Power Plants Administration - Administración de Usinas y Trasmisiones Eléctricas, UTE). For example, due to the combination of increased oil needs and higher oil prices, the cost of meeting energy demand stood at US\$1,405 billion in 2012, well above the budgeted US\$973million (based on the historical average of hydropower generation), which caused a marked deterioration in UTE's financial performance.

These shocks have had substantial impacts on public sector balances. Fiscal deficit has widened markedly in 2012 to 2.8 percent of GDP up from 0.9 in 2011, on account of temporary factors, led by a drought-induced deterioration in the financial balance of UTE). On the contrary, lower cost of producing electricity due to increased hydropower energy resulted in improvement in the UTE's balances which contributed markedly to the improvement in the consolidated public sector deficit to 2.4 percent of GDP in 2013.

In the last years, the Government has been adopting policies to diversify the electricity matrix and attenuate the fiscal impacts of these shocks which are expected to improve the resilience to them. On the structural front, the Government electricity strategy aims at increasing the contribution of other renewable sources, improve efficiency and reduce the costs of 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. Meanwhile, when the electricity matrix is evolving towards a more diversified, sustainable and efficient generation, authorities have adopted mechanisms to attenuate the financial impacts of droughts that will continue to affect fiscal balances at least in the short run, including the purchase of a climate insurance and the establishment of an energy stabilization fund.

The proposed operation supports the authorities' efforts to reduce the vulnerability of fiscal accounts to droughts. Created by the Government in 2010, the Energy Stabilization Fund (FEE) is designed to accumulate resources in good hydrological years creating room for buffers to be spent in drought periods, to sustain economic growth without imposing excessive fiscal costs. The contingent nature of this operation is expected to enhance the functioning of the FEE as it will leverage the resources accumulated in the Fund obviating the need to keep a substantial amount of funds and reducing the fiscal and opportunity costs associated with the Fund.

Sectoral and Institutional Context

Mitigating fiscal and climate risks associated to the generation of electricity

Beyond prudent macro-fiscal policies, Uruguay has been adopting a comprehensive risk management strategy to enhance its resilience to external shocks. In recent years the government has significantly reduced vulnerabilities related to the composition of its public debt. The government has mitigated debt roll over risks extending debt average maturity to 12 years and ensuring a more uniform debt repayment schedule (a more uniformly distributed repayment schedule). The government has also adopted a precautionary policy in terms of liquidity. The government has also reduced the exchange rate and interest rate risks. Through liability management and issuing local currency debt the government has increased the local currency government debt to 55 percent. The government has reduced interest rate risks by increasing the share of fixed rate debt.

Furthermore, Uruguay pioneered the use of contingent financing as a way to meet financial obligations in periods of uncertain or adverse conditions in international capital markets. To further reduce roll-over risk the government has also implemented a policy of pre-financing debt service ensuring the liquidity necessary to meet repayment obligations for the following twelve months, as well as potential deviations in the fiscal accounts due to extraordinary circumstances. As of June 2014 the government has 5.7 percent of GDP in liquid assets. The government also has contingent credit lines with the international financial institutions of close to 3.5 percent of GDP, including 2 DPL-DDOs of US\$260 million each with the World Bank. These policies have increased the fiscal room to respond to external shocks.

The government has also adopted measures to reduce vulnerabilities of the power generation and meet a growing demand for electricity. Uruguay electricity sector is highly dependent on hydropower. In the last 8 years hydropower represented between 43 to 81 percent of the electricity mix, depending on water availability. Supply has historically been complemented by thermal electricity and imports as needed. Non-conventional renewable sources (biomass and wind) have been improving their participation. The country has no proven reserves of oil, natural gas, or coal and has reached its hydroelectric potential which represent close to 75 percent of the electricity mix, and the country has reached its hydroelectric potential from large power-plants. The hydrology of the river basins that connect to the hydroelectric system is highly variable and impacts directly the cost of producing electricity.

The cost of electricity production varies significantly with the rainfall. The cost of producing electricity has increased on average by approximately 75US\$/MWh between a rainy and dry year due to the change in the electricity mix. The cost of imported electricity in dry years has been very high in recent years (with imports from Argentina reaching an average price of 425US\$/MWh in 2009 for example). In addition the cost of producing electricity through thermal generation has also increased as Brent prices have increased markedly during the latest commodity price boom. In 2012, a very dry year, the cost of generating energy + imports was 68 percent higher than in 2011.

Electricity tariffs are calculated, assuming an average hydrological year, to cover the medium-term supply costs (investment, operation and maintenance) and ensure a return between 6 to 10 percent on assets. 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 US\$, and salary increases.

Tariffs are proposed by UTE, the regulator (the Energy and Water Services Regulation Unit, URSEA) analyzes the proposal and shares its assessment with the executive branch who determines the final tariffs. Transfers from FEE to UTE have a stabilization purposes and provide a temporary mechanism to attenuate short run fluctuations in tariffs faced by households and firms.

Measures to address these vulnerabilities

Uruguay has a national long term energy policy and on the supply side diversification of the matrix is the main objective. The country has already made large investments in wind and in a regasification plant, while also supporting the implementation of energy efficiency programs. In an effort to meet rising domestic demand, mitigate the climate risks and reduce reliance on oil imports, the government has developed and pursued major investment plans, with private sector investing significantly, especially in the wind energy. Wind energy is expected to rise to near 5600 GWh by 2018 from around 600 GWh in 2013. The government has also pursued the installation of power plants based on biomass (mainly forest and paper pulp plants residue). By 2018 biomass will be providing around 1700 GWh. In addition, a regasification plant is under construction to reduce the cost of the thermal energy. The large-scale installation of wind turbine plants requires back-up for the hours with no wind, with the most efficient backup generation being the thermal (combined-cycle plants). Thus, in the next years, the electricity production mix will change substantially, with 93 percent coming from renewable sources and 7 percent from Liquefied Natural Gas (LNG). Consequently the average cost of producing electricity production is estimated to decline markedly (an estimated 58 percent to 46USD/Mw/h) by 2016, according to estimates from MIEM. Furthermore, the volatility in the cost of electricity production is expected to decline markedly, with the difference in cost between a rainy and a dry year dropping from 75USD per Mw/h to an estimated 25USD per Mw/h. Thus, the vulnerabilities of Uruguay's electricity system will decline significantly starting by 2015. However, while declining it is clear that at least in the short run, the risks will be still considerable and will not completely disappear even with a strongly diversified energy matrix.

Uruguay has been pro-active and innovative in managing the risk of hydropower deficit. Following additional costs of about \$400 million in both 2008 and 2009, due to a combination of drought and high oil prices the government decided to create an Energy Stabilization Fund (FEE) in 2010 (Law No. 18.719, article 773 of December 27, 2010) with an initial endowment of US\$150 million contributed by UTE. The FEE is the anchor element in UTE's strategy to manage risk and reduce the negative impact of hydropower deficits on its financial situation and on public finances. The strategy currently combines budgetary reallocations, the FEE, access to credit, and insurance. The weather and oil price insurance intermediated by the World Bank Treasury was added in 2013 to transfer some low-probability high-impact risks related to drought and high oil prices to the private market. This insurance offers up to US\$450 million in coverage against the combined risk of drought and high oil price to the UTE. By providing contingent financing to the FEE, this Operation would complement the mix of financial instruments extending the insurance coverage to moderate-probability with less severe impacts risks.

Relationship to CAS

As it supports Uruguay's risk management strategies, this proposed operation is consistent with the World Bank Country Partnership Strategy for the period 2010-15 . The CPS is focused on the following four pillars: (i) Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration; (ii) Competitiveness & Infrastructure; (iii) Agriculture, Climate Change, and

Environment; and (iv) Increasing Social Inclusion & Equity. This operation materializes the Bank support to risk mitigating policies under the first, second, and third pillar.

The World Bank has supported the government of Uruguay in its risk mitigating strategy through operations under the first pillar (DPLs-DDO). The proposed operation which has a 100 percent contingent component would complement the US\$520 million in contingent financing that the two DP-DDOs operations provide (P123242 and P131440). These operations were a response to the Government's request of significant levels of contingent financing from the Bank to support its precautionary financing strategy in the context of increasing current global economic uncertainties. The Government's strategy aims at mitigating risks resulting from deteriorating conditions in international debt markets, which for a small economy like Uruguay could have serious consequences. According to the Government, Uruguay lost access to international capital markets for about one year following the onset of the 2008 global financial crisis. The authorities stated that they would only request disbursement under the DPL-DDOs if international financial conditions were to deteriorate significantly.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The development objective of the proposed operations is to assist the government of the Oriental Republic of Uruguay in its efforts to shield public accounts from the effect of hydropower deficits that affect electricity generation costs by leveraging the Energy Stabilization Fund (FEE) resources dedicated to electricity tariffs stabilization. The PDO would be achieved by providing contingent financing to this Fund to enhance the government's ability to attenuate the volatility of electricity tariffs and cushion the negative effects of rainfall shortages on the financial balances of the state owned electricity company, UTE. The operation will help the government to further cushion volatility of electricity tariffs and the financial flows of UTE enabling a more predictable decision making environment for households, firms, and UTE.

Key Results (From PCN)

This operation will have three key results. A key result of the operation is that of reducing the government and/or UTE's need to finance unexpected borrowing requirements in uncertain market conditions. A second key result is enhancing the risk mitigating capability of the FEE. The third key result is that it will increase the contribution of the FEE to the reduction of short-term volatility of electricity tariffs.

Results Indicators

Indicator 1: Government loans and/or transfers to UTE as a share of the cost of meeting electricity demand when there is a hydro deficit.

Indicator 2: The difference between the cost of supplying the demand (Costo de Abastecimiento de la Demanda, CAD) and tariffs (in percentage)

Indicator 3: The share of FEE in the cost of supplying the electricity demand in case of drought.

III. Preliminary Description

Concept Description

The Energy Stabilization Fund (FEE)

The Energy Stabilization Fund (FEE) was created in 2010 (Law No. 18.719, article 773 of December 27, 2010) as a mechanism to help stabilize electricity tariffs in the face of climatic changes which affect significantly the cost of generating the electricity required to satisfy the projected demand reducing the negative impact of hydropower deficits on the financial situation of the (UTE) and on public finances. It is a sole-purpose fund, established within the National Development Commission (CND) which acts as the trustee. The Law 18.719 stipulates that the fund has an upper limit of 4 billion unidades indexadas, inflation-indexed monetary units which currently is the equivalent of US\$496 million. In 2011, the FEE received an initial contribution amounting US \$150 million from UTE.

The FEE's operating regulations are stipulated by the Decree 442/011. If the quarterly hydropower generated is below an inferior limit of 0.9 of a simulated long term historical average UTE can request the use of funds from FEE (Article 4 of the Decree 442/011) to compensate the difference between the 90 percent of the estimated hydropower generation and the real hydropower generation. That difference is valued at the variable cost of the thermal plants per MWh and that of the effective unitary import cost (Article 5 of the Decree 442/011). When applicable, the quarterly calculations of transfers from the FEE to UTE are made public on the website of the Electricity Market Administration (Administración de Mercado Eléctrico - ADME).

According to the Decree 442/011 the FEE can be funded with internal government resources provided by Rentas Generales, funds contributed by UTE, and external financing. However, it is expected that the Fund should function and be sustainable with the foreseen transfers made by UTE and their extractions whenever there is less hydropower than expected. According to Article 3 of Decree 442/011 UTE transfers to FEE should be made annually and the size of the transfers are associated to the generated hydropower. For example, whenever the actual generated hydropower is above 0.65 the expected one the transfer is 6.5 percent of the maximum level of the FEE. When it is between 0.65 and 1 the transfers are 8.5 percent of the maximum level of the FEE.

To enhance the FEE's governance and institutional framework, the government is setting up a management trust. A management trust as oppose to a financial trust means that the Trustee will not be able to contract commercial loans or issue securities. Once a management trust agreement is created the funds will be transferred at the request of the management trustee Conafin Afisa, and the Executive power decrees will not be necessary. The trust fund is expected to be established in November 2014 before negotiations of this operation will take place.

Description

The proposed operation is designed as an Investment Project Financing (IPF) with 100 percent contingency that would provide funding to the National Development Corporation. CND will on-lend in a symmetric operation to the Energy Stabilization Fund through its CONAFIN AFI S.A. trustee. The funds will be disbursed if disbursement-linked indicators are met and after a threshold level of the Energy Stabilization Funds (FEE) has been used. The operation has a 100 percent contingent component which means that the entire loan amount will be disbursed to CND if the adverse event materializes.

The proposed disbursement-linked indicator (DLI) is the same than the established by the Decree 442/011 which conditions transfers from the FEE to UTE: the difference between expected generated hydropower GHE_Q , which is the historical average, and the Lower Hydropower Limit

(LIH_Q) defined as 90 percent of the GHE. When the disbursement linked indicator is met and the level of FEE funds fall below a certain threshold (to be defined with the government) and the GOU requires it, the proposed operation would disburse to the FEE. The IPF will use the data reported to and published by the Administracion de Mercado Electrico (ADME) to monitor the DLI.

The Financial Management (FM) implementation arrangements will be the same operating at the company level at National Development Corporation (CND) and its 100 percent controlled company Corporación Nacional Financiera Administradora de Fondos de Inversión S.A. (CONAFIN AFI S.A.), since the project comprises an operation with a contingent payment upon meeting the disbursement –linked indicators.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01		x	
Natural Habitats OP/BP 4.04		x	
Forests OP/BP 4.36		x	
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11		x	
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12		x	
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

V. Financing (in USD Million)

Total Project Cost:	150.00	Total Bank Financing:	150.00
Financing Gap:	0.00		
Financing Source			Amount
Borrower			0.00
International Bank for Reconstruction and Development			150.00
Total			150.00

VI. Contact point

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