

CASE STUDY

Innovative Investment Project Financing Supports Energy Stabilization Fund in Uruguay

OVERVIEW

Fondo de Estabilización Energética (FEE) is a mechanism established by the Government of Uruguay to reduce the impact of drought on Government and electricity utility finances. IBRD Investment Project Financing with an innovative structure boosts FEE's liquidity with a view to easing cash crunch and improving service delivery.



Background

Uruguay's electricity matrix is dominated by hydropower. During periods of drought, when rainfall is insufficient, the state-owned electricity company, *Administración Nacional de Usinas y Trasmisiones Eléctricas* (UTE), needs to switch to more expensive energy sources that increase the cost of electricity generation significantly. Higher electricity generation costs for UTE also impact the Government of Uruguay (GoU)'s fiscal position. Uruguay's fiscal deficit increased from 0.9 percent of GDP in 2011 to 2.8 percent in 2012 partly due to a severe drought and high oil prices¹.

The GoU has established a comprehensive risk management strategy to mitigate the effects of drought on its balance sheet, which includes: 1) adopting policies to diversify the energy matrix, and

2) putting in place a financial risk management strategy. The financial risk management strategy includes 1) reserve funds to offset the impact of medium-to-high frequency and low-to-moderate impact weather shocks; 2) an energy stabilization fund, *Fondo de Estabilización Energética* (FEE), to mitigate the impact of less frequent medium-intensity weather shocks; and 3) insurance-linked capital markets transactions to transfer the risk of low probability but high impact events (see case study *Mitigating the Impact of Drought on Energy Production in Uruguay*).

Financing Objective

FEE serves as an important tool to insulate GoU and UTE's budget against volatile electricity generation costs. It does so by accumulating funds when weather conditions are favorable and electricity generation

¹ 63 % increase in implicit cost of electricity provision

costs are low, and transferring funds to UTE to finance necessary expenditures and limit borrowing when weather conditions are adverse. There are well-defined rules in place for contributions to FEE and use of funds. GoU needed to ensure that FEE had access to sufficient liquidity at all times.

IBRD Financial Solution

The most appropriate solution was a contingent financing facility that would be triggered whenever FEE's funds fell below a specified level as a result of adverse weather conditions. This would reduce the probability of GoU having to transfer resources to UTE and the amount of transfers needed by UTE to meet unexpected weather-related costs.

The Development Policy Loan (DPL) with a Deferred Drawdown Option (DPL DDO) and the Catastrophe Deferred Drawdown Option (CAT DDO) are types of Development Policy Financing offered by the Bank. However, the Bank does not have a contingent financing option for Investment Project Financing (IPF). At the request of the project team the Executive Board of the World Bank approved a waiver to modify IBRD loan terms and allow the team to offer a hybrid IPF with a contingent financing component to meet GoU needs.

On December 2, 2014, the Bank's Executive Board approved a US\$200 million loan for the National

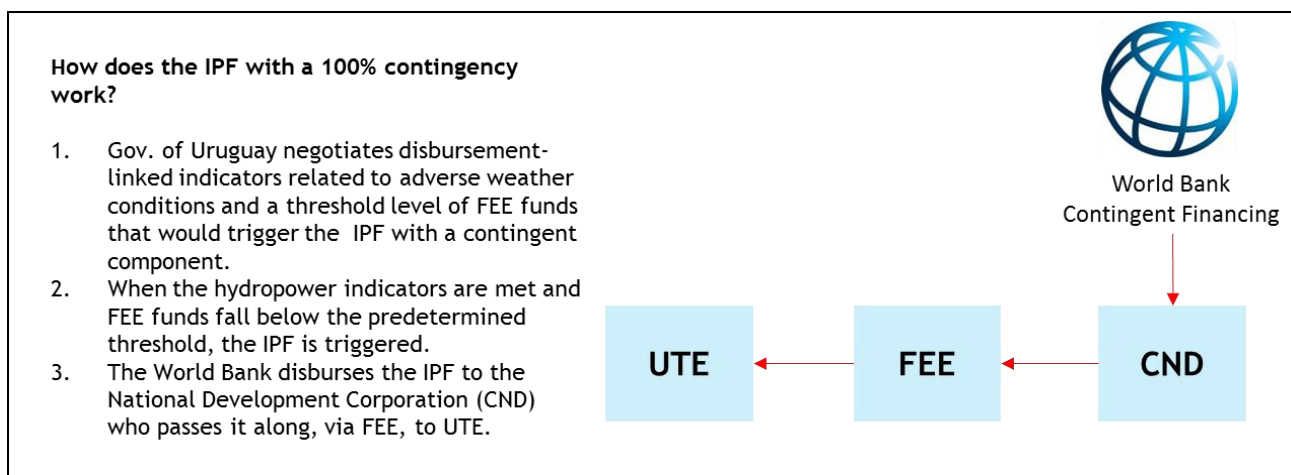
Development Corporation (CND) of Uruguay with a sovereign guarantee from the Oriental Republic of Uruguay. A commitment fee of 50 basis points (same as the DPL DDO but higher than the standard IBRD loan) was charged for the contingency option.

The contingent financing will be triggered according to rules stipulated in Decree 422/11, which ensures that funds can be transferred to UTE only in adverse weather conditions, and when FEE's funds fall below a minimum level set at \$50 million. CND is responsible for monitoring the conditions for disbursements and disbursing to FEE as part of the on-lending operation. The project was declared effective on April 21, 2015 and has a life of three years.

Outcome

The hybrid structure of the IPF is an innovative approach to support a stabilization fund. In the event of a drought, the World Bank will disburse funds to FEE via CND, subject to specific conditions. This will not only strengthen FEE's ability to mitigate the impact of higher electricity generation costs on the balance sheets of both UTE and the GoU, but also help reduce the volatility of electricity tariff.

The IPF with a contingent component complements the World Bank's other financing instruments and may be replicated in other countries.



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