

January 13, 2011

**EBRD response to Comments from  
Germany on CTF Private Sector Proposal  
“Kazakhstan District Heating Modernisation Framework”**

Financial Volume:                    up to 39 Mio. USD CTF Loan  
   + 2.4 Mio. USD Grant for advisory services  
   + 286,000 USD Grant for Implementation & Supervision budget  
   + 314,000 USD for Knowledge Management Component

Purpose of the program:                    The Kazakhstan District Heating Modernization Framework aims at providing loans to heat suppliers in Kazakhstan co-financed by Clean Technology Fund concessional loan funds for energy efficiency investments. The project will be part of an IFC/ EBRD joint initiative to develop sustainable energy financing facilities under the CTF Investment Plan for Kazakhstan. The proposed Framework aims to make a significant transformational impact in three critical areas in addressing climate change challenges in Kazakhstan by (i) enhancing energy security by improving energy efficiency in District Heating through reducing heat losses by at least 10% over the medium term; (ii) supporting a clean energy transition by reducing reliance on fossil fuels in the generation of heat through increased efficiency of DH systems and by focusing on meeting energy needs in an environmentally sustainable manner, thereby reducing GHG emissions; and (iii) increasing/ supporting existing private sector involvement in the delivery of the heat supply.

### **Summary**

We welcome this proposal. It is well reasoned, well written and thought through. The program concept appropriately aims at enhancing energy security, supporting a clean energy transition and increasing private sector involvement and we therefore recommend the approval of the proposal in consideration of the aspects mentioned below.

With respect to the financing terms: The terms for the clients of the facility are favorable and

in view of the current state of district heating in Kazakhstan, the TA component is important and necessary. CTF financial leverage for the program is expected as 1: 4 (CTF: EBRD) and 1:5 (CTF: EBRD and Project sponsors). Tenor of the loan which is up to 20 years is very favorable, and a long grace period seems useful in giving the sector more sustainability.

[EBRD COMMENT: Specific loan terms are expected to be less generous, and will reflect the specific situation of the client and the client's customers for heat. The level of concessionality will be determined based on specific EBRD-CTF guidelines developed with EBRD economists which aim to minimize subsidy and market distortion.]

With respect to the sectoral issues: to date very few long term projects took place in the communal utilities sector in Kazakhstan. The centralized heat supply in Kazakhstan has depreciated by 80%. It should be noted that some of the sector background figures which are used in the report seem outdated, being from 2007. It would make sense to collect newer data and incorporate it into the proposal.

[EBRD Comment: Collecting new data is foreseen as part of the technical assistance component. This data will be shared.]

A long term success of the programme very much depends on the implementation of the envisaged sub-project category "(v) introduction of meters and improved control equipment allowing for institutional improvements and regulatory reforms". Behavioural change of consumers need the incentives of consumption based tariffs.

As to the criteria: reducing heat losses by at least 10 per cent does not seem very ambitious – especially when keeping in mind the very generous financing terms. 10 percent does seem an acceptable level of ambition if only technical losses are addressed. If other losses are included, a higher level of ambition should be sought. We would appreciate clarification of what is envisaged.

[EBRD Comment: Minimum savings requirements will be at least 15%. In order to be able to reflect local specific circumstances (and the in some cases probably less generous financing terms), we would like to keep the requirements flexible. Nevertheless, we will clearly strive to achieve the highest possible level of heat loss reduction in each case, in close co-operation with the client.]

## **Comment on the Financing Terms**

Criteria of selecting four clients of the facility, i.e. district heat providers were not specified in the proposal. It is stated broadly that they could be “private or municipal operators with the institutional capacity and commitment to successfully undertake projects”. Due to the issues related to transparency and risks associated with corruption it is important that the criteria for selecting end borrowers be elaborated and the selection itself should take place in a competitive, transparent and open manner with the active MDB involvement.

[EBRD comment: EBRD has a long history of operating in challenging institutional environments. All projects will be subject to proper internal due diligence and close supervision. The selection of clients will be undertaken by the EBRD's Municipal and Environmental Infrastructure Team in co-operate with the Kazakh government. EBRD will however have the final decision based on its assessment of the ability of working with the potential client.]

## Comments on the Project Proposal

The proposal touches upon the sensitive issue of tariff increases. The idea that the consumers of heat should pay based on the actual consumption and not on the norms which were developed during Soviet times, is appropriate and timely. At the same time the risks related to tariffs increase should not be overlooked. It is very appropriate if increase in the tariffs is accompanied with raising the awareness of the consumers about using meters and controlling heat use. A long term change in customer behavior can only be achieved through the introduction of metering and consumption based tariffs. Further, only consumption based tariffs will create the necessary market framework for energy efficiency technologies and services. Therefore all the measures listed in the proposal should be introduced prudently and carefully in order to avoid bad publicity and resilience from the side of population who are the consumers of heat. As an illustrative example, on January 12, 2011, the Head of AREM has stated that tariffs for heat will increase in 2011 by 10- 11% for the end user, and this is being done without introducing metering based on the norms. This will inevitably lead to dissatisfaction of the users and to the increasing indebtedness for heating from the side of low-income users. The focus of tariff adjustments from our point of view should rather be the introduction of metering and consumption based tariffs rather than on a general tariff increase. On a medium term basis, a revised, consumption based tariff should be accompanied by the promotion and introduction of financing options for energy efficiency measures on end-user level.

[EBRD comment: we fully agree that behavioural change is going to be the critical element. The focus is very clearly on achieving this. Nevertheless, tariff increases will be required to ensure the long-term viability of the heat businesses. It will be necessary to demonstrate to heat customers that the increases bring real benefits to them by improving their situation, e.g. by allowing them better control. The ultimate aim has to be to restrict through increased energy efficiency customer **bill** increases even when **unit** cost increases.]

EBRD is planning to pursue financing for residential end-user energy efficiency improvements. At present the legal framework in Kazakhstan is not developed for such facilities, but it forms part of EBRD's work plan to support the government in making the required changes.]

In addition, it must be noted that there are several governmental bodies in the Republic of Kazakhstan which have to do with regulation and modernization of district heating system, for instance Agency for Construction, Housing and Utilities of the Republic of Kazakhstan. This agency has among its primary tasks, the Development of public regulation policy on water supply and drain, power supply (power network facilities 0, 4 kWt), heat supply (except for

heat stations and boiler rooms with the capacity of 100 Gcal/hour and over). There is also a center for modernization and development under the auspices of this Agency. The mechanism of interaction with governmental bodies, besides Agency of the Republic of Kazakhstan for Competition Protection - Antimonopoly Agency (AREM) which could be potentially lengthy and tedious, has not been mentioned in the proposal in detail although it is likely that it is envisaged under the current Heating Modernization Framework. A keen interest of the governmental bodies to take active part in Kazakhstan District Heating Modernization Framework, should be expected.

[EBRD comment: EBRD has a long history of working with the Government of Kazakhstan in improving legal and regulatory frameworks. EBRD local staff has built up close working relationships with the relevant ministries and agencies, and Kazakhstan is a priority country for EBRD. We intend to pursue similar close dialogue in the framework of this facility, and have already begun tentative discussions with the authorities on this.]

### **CTF Investment criteria**

#### **1. „Potential for GHG Emissions Savings”**

##### 1) CO<sub>2</sub> Emission–Reduction / Programme–Duration:

It is estimated that the Project’s direct emission savings would reach approximately 0,5 million t CO<sub>2</sub>e by the end of the five year period 2011 to 2015.

##### 2) Technology Development / Abatement Potential:

The programme aims at diffusion of clean technologies into the market. The expected effects would therefore be learning by doing and possibly adapting the technologies to the specific country environment.

#### **2. „Cost-Effectiveness“**

##### 1) CTF cost effectiveness for the Program:

0.12t CO<sub>2</sub>e/ 1 USD invested from TF at the end of the five-year period 2011 to 2015.

#### **3 “ Demonstration potential at scale”**

##### a. Elements that will support replication and development of renewable energy sector:

##### b. Potential impact on private public sector relations:

CTF resources are expected to provide the necessary impetus and also allow for the necessary coordination of other initiatives and efforts in the market. The project aims at mobilizing private sector funds for DH sector. It should also be mentioned that Kazakh authorities have declared that they are willing to support development of Public Private Partnerships in order to develop further communal utilities sector, hence the current Framework would be one of the actual initiatives to implement the promulgated state policy.

##### c. Appraisal of chart on expected emission reduction:

A chart has not been provided in the proposal.

#### **4 „Development Impact“**

a. Impacts on energy intensity of the gross national product

Has not been quantified within the proposal. However, since the Framework aims to modernise and hence to make DH sector in Kazakhstan much more efficient the positive impact upon GDP should be expected in the medium or long term.

b. MDG-Relevance:

MDGs help to ensure environmental sustainability (MDG 7) will be addressed.

c. Side effects for the environment and eco system:

The Project is expected to result in a series of environmental and economic benefits, e.g. the Program helps to reduce emissions of GHG and other pollutants.

## **5 „Implementation Potential“**

Providers of DH should be very interested in receiving long term favourable financing. At the same time it should not be underestimated that normally energy efficiency investments, even though financially viable, could encounter problems during implementation.

[EBRD comment: EBRD has a long history of successful investments and in-depth expertise in DH refurbishment throughout its region. We believe that this experience will help us to ensure that the investments to be undertaken under this programme in Kazakhstan will be successful.]

## **6 Mitigation of Market Distortions and Risks**

One of the strongest risks as pointed out in the proposal could be substituting of concessional finance for the much needed tariff reforms, as well as subsidy dependence and distortion to the heat supply market. In this context the Technical Assistance needs to be structured in such a way as to help mitigate these risks.

[EBRD comment: We fully agree.]