

**PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

Report No.: PIDA17

Project Name	Russia Energy Efficiency Financing Project (P122492)
Region	EUROPE AND CENTRAL ASIA
Country	Russian Federation
Sector(s)	Energy efficiency in power sector (100%)
Lending Instrument	Financial Intermediary Loan
Project ID	P122492
Borrower(s)	Gazprombank
Implementing Agency	Gazprombank and Ministry of Energy, Russian Energy Agency
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared	27-Sep-2011
Estimated Date of Appraisal Completion	28-Sep-2011
Estimated Date of Board Approval	12-Jan-2012
Decision	

I. Project Context

Country Context

Russia's economy consistently grew at about 7 percent annually from 1998 to 2008, yet the economy remained vulnerable to both external and fiscal risks. Overall macroeconomic stability during that decade was strengthened by healthy fiscal surpluses against pressures for larger spending and lower tax rates; monetary policy that helped reduce high inflation; and the creation of an oil reserve fund. Oil and gas fiscal revenues increased from 6 percent of gross domestic product (GDP) in 2001 to more than 10 percent in 2008, thereby allowing additional spending room, but also led to increased dependence on a highly volatile source of income. Just prior to the crisis, Russia's decade-long economic expansion accelerated above the long-term trend, with clear signs of overheating, raising macro-vulnerabilities.

The Russian economy was hit hard by the global crisis in September 2008, but both the pre-crisis macroeconomic fundamentals and the Government's policy response have been strong. Hit by shocks to commodities prices and capital outflows, the economy's real GDP dropped by 7.9 percent in 2009. Unemployment and poverty rose, and the ruble fell. The fiscal surplus turned into a deficit due to crisis-related expenditures and reduced revenues. The banking sector, which had relied heavily on non-deposit financing, faced severe liquidity constraints. A deposit run at the end of 2008 exacerbated the liquidity crunch, and threatened financial stability. Large fiscal reserves before the crisis (about 16 percent of GDP at the end of 2008) allowed the government to introduce an anti-crisis package of measures to support the financial sector and real economy and cushion the impact on the population. As a result, the country succeeded to avoid a currency crisis or major bank failures and promptly restored confidence in the banking system.

Russia's economy needs modernization and diversification to reduce its dependence on external factors. The Government's effective anti-crisis policy response and increased prices for commodities enabled Russia to restore economic growth. The GDP grew by 4 percent in 2010 and is expected to grow at about the same rate in 2011-2012. However, The Russian economy needs modernization and diversification. It is over-reliant on the energy extraction industries and the export revenues that they generate, and there has long been under-investment in alternative means of generating growth. This leaves the economy and the government finances exposed to the inherent volatility in prices for natural resources. At the same time, technological and innovation advancement in the real sector lags behind, which badly reflects on the competitiveness of the Russian economy. The government has realized this issue and has been vigorously pursuing a modernization agenda. Energy efficiency (EE) has been recognized as one of the key elements of modernization and diversification.

II. Sectoral and Institutional Context

Energy Efficiency

Energy efficiency represents a huge untapped energy resource to Russia. Little attention was paid to EE in Russia during decades of energy intensive industrial development, especially during the Soviet era. With abundant energy resources and low consumer prices, Russia became one of the largest but least efficient energy consumers in the world. According to recent IBRD/IFC estimates, Russia can cut its energy consumption by about 45% or some 300 mtoe, an amount which exceeds the annual energy consumption of France. This would translate into a CO2 emissions reduction of about 800 million tons per year. The largest technical EE potential can be found in residential and public buildings (53.4 mtoe and 15.2 mtoe correspondingly), electricity generation (44.4 mtoe), industry (41.5 mtoe), transport (38.8 mtoe), and heat supply systems (31.2 mtoe). However, if Russia's EE potential and related economic and environmental benefits are to be realized, the country will need to mobilize about US\$300 billion for EE investments.

The Russian authorities have recognized the importance of EE for sustained economic growth. The Russian President, Dmitry Medvedev, signed in 2008 a decree calling for an action plan to cut the energy intensity of Russia's economy by 40 percent by 2020. It was followed by the preparation of a Law 261-FZ #On Energy Efficiency Improvement and Energy Saving# that was passed by the Duma in November 2009. This framework Law has been complemented by about thirty by-laws adopted by the government in order to implement it. Furthermore, the government adopted an Action Plan on EE and Energy Saving in December 2009, and a State Program #Energy Savings and Increase in Energy Efficiency through 2020#, approved by the Government in December 2010. The Government expects to reduce the country's energy intensity by 40 percent by 2020, through a combination of an active EE investment program, as well as through continued structural adjustments and energy tariff reforms. In addition, in December 2009, the government established the Russian Energy Agency (REA), which is responsible for coordinating and implementing the government's EE agenda.

The EE legal and institutional developments are being complemented by economic incentives, namely energy price adjustments. Specifically, gas tariff increases in recent years have been in the range of 20-30 percent per year depending on the customer group and are expected to keep growing in next years. The current level of gas tariffs for both households and industry is about US\$110/1000m3. Electricity tariffs grew by more than 10 percent on average in recent years, with the average electricity tariff rates of about US\$0.10/kWh in 2011 and further adjustment to full cost recovery levels are anticipated. In addition, the government is now developing a set of fiscal incentives to promote investments in EE. Further, the recent EE legislation requires universal metering, which will allow for consumption-based billing for space heating which will provide further incentives for more rationale energy use.

However, implementation of Russia's EE agenda, especially at this initial stage, is likely to face significant challenges and barriers. As evidenced by the experience in other countries, the development and implementation of an EE legal and regulatory framework and effective mechanisms to deliver financing and implement measures require concerted and persistent efforts. It usually takes years before complex and multifaceted EE related issues are addressed to enable commercial financing of EE and behavioral change, which are key success factors in realizing a country's EE potential.

Investments in EE in Russia are facing challenges that are common to many other middle income countries. There are three related issues:

- # Institutions and policy: lack of knowledge in industry on energy management systems and skills to prepare bankable EE investment projects; underdeveloped legal and institutional framework for energy performance contracts; restrictive administrative procedures in the public sector (procurement, budgeting); lack of incentives in the public sector to save energy; unclear/incomplete guidelines and methodologies (EE regional and municipal action plans, energy audits, measurement and verification protocol).
- # Banking financing: high perceived risk; lack of quality market data; lack of EE financing products (project identification, appraisal, monitoring); high transaction costs.
- # Market development: still limited awareness of both public and private energy consumers, as well as banks, about financial gains stemming from EE investments; uneven quality of energy auditors and a barely existent ESCO market.

Learning from international experience could help Russia in implementing its EE agenda. At present, there is a number of TA and financing projects initiated in the past years by various donor organizations in support of the Russia's EE policy. The most sizable assistance is provided under Global Environment Facility (GEF) supported projects that are implemented by EBRD, IFC, UNDP and UNIDO. Those projects aim to address issues faced by industry, public sector, and residential housing; they cover such topics such as introduction of energy management systems, energy performance contracting, EE labeling, technical and financial assistance to banks. The multilateral donor community meets on a regular basis to coordinate their respective programs. In addition, several countries have been providing bilateral assistance on EE related topics to Russia.

IBRD is well placed to support Russia in realizing the EE potential. IBRD jointly with IFC prepared in 2008 a report on Russia's EE potential that helped raise the issue to the highest political levels. Subsequently, IBRD jointly with IFC assisted a number of regions in the North-West region of Russia to develop their respective EE programs and conducted a regional conference on EE related matters. These activities together with a continued dialogue with various stakeholders in Russia at both federal and regional levels have made IBRD well placed to assist the Government with implementation of its EE program.

Securing commercial financing is a key factor in realizing the country's EE potential. The importance of commercial financing in achieving nation-wide energy savings targets was highlighted by the State Program #Energy Savings and Increase in Energy Efficiency through 2020#. It calls for investing about US\$300 billion into EE projects through 2020, out of which 93 percent should come from off-budget sources, that is mostly from banks. Despite government and donors efforts to boost banking financing for EE projects, the banking sector in Russia is still only marginally participates in financing EE investments.

The Russia Energy Efficiency Financing Project. In consultation with government stakeholders and in coordination with main donors that have ongoing EE related programs in Russia, IBRD, in conjunction with Russian partners, developed a project that includes a financial intermediary loan to systemic banks and significant technical assistance to banks, project owners and service providers to address selected issues facing banking financing of EE projects. The project will build on and continue activities implemented under the IFC Russia Sustainable Energy Finance Program, which will be completed by the middle of 2012, and complement ongoing IFC EE activities, including Russia Resource Efficiency and Residential Energy Efficiency Programs. The project will focus on the sectors that possess significant savings potential and appear ready for commercial investments, namely industry (e.g., metals, chemicals, oil and gas, agro-processing), municipal utilities and public buildings.

The Russian Banking Sector

Fragmentation and concentration simultaneously characterize Russia's banking system; at the same time the system is dominated by a few large state-owned banks. In Russia, 1012 banks were active as of end 2010. The system is concentrated with the top five banks representing approximately 48 percent of total banking assets, and the top 20 banks accounting for about 69 percent of total assets, as of end 2010. Furthermore, as of end 2010, state-controlled banks represented approximately 46 percent of total assets and about 60 percent of total deposits

III. Project Development Objectives

The Project Development Objective is to improve the efficiency of energy use in Russia by scaling-up commercial lending by banks for EE investments in the industrial and public sectors. The global environmental objective is to reduce emission of greenhouse gases (GHGs) by scaling-up EE investments. The PDO will be achieved through a combination of financial and technical assistance (TA), supported by a US\$500 million IBRD loan and a US\$22.73 million GEF grant, to concerned Russian entities, including Gazprombank (GPB) and the Russian Energy Agency (REA).

The project will provide assistance to three key groups of stakeholders. International experience shows that the success in enabling investments in EE depends on participation of and interactions between three groups, namely banks, project owners, and service and equipment providers. The project will directly target selected representatives from all the three groups. Several Russian banks will receive training and some technical assistance to develop their EE lending business, so that they could enter the market of financing EE projects. GPB, the third largest bank in Russia, will receive an IBRD loan that will co-finance its EE credit line. A visible presence of GPB in the market of EE financing, demonstration of a viable EE lending business, and dissemination of its experiences, will further support EE lending uptake by other banks.

Furthermore, the project will help several regions improve their EE plans and develop bankable EE subprojects. In five regions, namely Kaluga, Novosibirsk, Samara, Yaroslavl and Yekaterinburg, GEF will support REA's TA efforts to regional and municipal authorities in improving their EE programs and to several project owners in the regions in preparing bankable projects. This should boost the demand for EE service and equipment providers, while demonstrating viable procurement, contracting and financing models. Dissemination of the results and lessons learned across the country will spur other regions, municipalities and energy consumers on to follow the example. This in turn could help address a critical issue facing commercial financing of EE projects, namely shortage of EE investment projects that are acceptable to commercial banks.

IV. Project Description

Component Name

- Component 1. Energy Efficiency Investments in Industry
- Component 2. Energy Efficiency Investments in the Public Sector
- Component 3: Market Development
- Project Management

V. Financing (in USD Million)

For Loans/Credits/Others	Amount
BORROWER/RECIPIENT	517.00
International Bank for Reconstruction and Development	500.00
Global Environment Facility (GEF)	22.73
Local Govts. (Prov., District, City) of Borrowing Country	45.00
Local Sources of Borrowing Country	47.00
Sub-borrower(s)	140.00
Total	1271.73

VI. Implementation

VII. Safeguard Policies (including public consultation)

Safeguard Policies Triggerred by the Project	Yes	No
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 Waters OP/BP 7.50		X
Projects in Disputed Areas OP/BP 7.60		X

VIII. Contact point

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