

CASE STUDY

Financial, Economic and Legal Analysis of Options for Restructuring a State Enterprise from an ECA Region Country

BACKGROUND

One of the most vulnerable countries to climate change in the ECA region benefits from several loans from an International Financial Institution (“The Bank”). The aim of the loans is to improve the availability, reliability and quality of municipal services in the country, considering projected future climate changes risks. Household water services are fundamental for ensuring the health and wellbeing of all segments of country’s population.

The State Enterprise (“The Company”) responsible for the delivery of basic municipal services such as water supply and wastewater services is one of the biggest clients of the Bank. The Company was established 18 years ago, as the result of split-up of a State Concern. Currently, the Company owns all the regional and local companies providing municipal services: 25 Water and Wastewater Companies, 64 Housing and Public Utilities Companies, 1 Energy Network Company, 4 Construction and Education Companies and 28 Rural Water Suppliers.

OBJECTIVES

The Bank aims to engage a Consultant (the “Consultant”) to perform the two main tasks:

1. To perform specific agreed-upon procedures on Revenues, Costs, Payables and Receivables of the Company and its subsidiaries, further consolidation as a single economic entity, sectoral breakdown (e.g. water and wastewater, solid waste management, etc.) of above-mentioned elements of financial statements and assessment of creditworthiness of the Company on a consolidated basis.
2. To facilitate the Bank’s assessment of the operational performance of the State Enterprise and its subsidiaries and assess institutional bottlenecks (e.g. main operational departments, as well as support units) to develop a detailed improvement roadmap for institutional restructuring and propose alternative options, including but not limited to implementation steps and timings, necessary legislative changes if any, and responsible parties.

SCOPE OF WORK

The scope of work has three stages:

- Stage 1 – Agreed upon procedures report
- Stage 2 – Preliminary analysis
- Stage 3 – In-depth study of restructuring options and report preparation

Stage 1 – Agreed upon procedures report

The Consultant shall subcontract an International Audit Firm, which meets the Bank requirements, with a local presence. The Audit Firm shall undertake this engagement in accordance with International Standard on Related Services (‘ISRS’) 4400 Engagements to perform Agreed-upon Procedures regarding Financial Information as promulgated by the IFAC.

Based on the results of this engagement, the International Audit Firm will provide draft Independent Report of Factual Findings. The report should include consolidated Statement of Comprehensive Income, consolidated Statement of Financial Position and consolidated Statement of Cash Flows of the State Enterprise and its subsidiaries for the last three years, in accordance with IFRS. The consolidated financial statements and accounts shall be presented in local currency and USD and be complemented with detailed notes with sectorial breakdown, addressing the following issues:

- a) **Breakdown of revenues:** operational and non-operational revenue, subsidies received, subsidies given to subsidiaries, description and specification of any system of privileges).
- b) **Billings versus receipts:** summary of billings versus receipts with receipts broken down into cash and non-cash transactions; summary of movements of accounts receivable (if any); listing at least the ten largest debtors; assessment of the likelihood that the receivables are collectible and provisions for bad debt in accordance to IFRS.
- c) **Specification of costs:** breakdown of operating costs and comparison to international benchmarks; specification of electricity consumption and of average electricity prices and fuel prices if relevant; specification of any non-operational expenses, extraordinary expenses, including tax and late payment penalties;
- d) **Payables and other liabilities:** specification of the total amount of payables and other liabilities; listing at least the five largest creditors;
- e) **Reconciliation of profit and Bank account movements.**

Stage 2 – Preliminary analysis

The Consultant should conduct an analysis of the current activities of the Company and the existing best practices in the field of Water Supply and Sanitation reforming, define the key parameters of business activities and agree on the options for restructuring, including holding cash flows management, client databases and optimisation approach.

1. Analysis of the activities of the Company and its subsidiaries, including:

- 1.1. Analysis of the existing legal structure
- 1.2. Analysis of legislation governing the activities of the Company (including tariff regulation)
- 1.3. Defining the goals and objectives of reforming based on information provided by the Company's management and Government bodies
- 1.4. Analysis of the Company's behaviour dealing with subsidiaries, management fees charged and mechanism for determining management fees.
- 1.5. A brief analysis of the key financial and economic performance indicators (key items of income and expenditure, key balance sheet items and investment program), including:
 - analysis of consolidated financial statements for the last 3 years;
 - analysis of the structure and income behaviour of the Company in physical and monetary terms over the past two years by sectors;
 - analysis of the cost structure and behaviour of the Company in physical and monetary terms over the past two years by sectors;
 - analysis of the current tariff structure and identification of the cost recovery level tariff within all regions of operations, including critical assessment of currently applied

- methodology for water tariff calculation and approval procedures, and the role of institutions involved in the process of water tariff setting;
 - analysis of contractual and actual terms of settlements between the Company and debtors and creditors and their changes during the last two years;
 - analysis of fixed assets of the Company, their degree of depreciation, implemented and planned investments for maintenance and modernization of fixed assets;
 - analysis of the financing of Company's activities at the expense of the state budget and borrowed funds;
 - analysis of the subsidy mechanism applicable to its activities.
- 1.6. Analysis of the key elements of the existing taxation regime (VAT, income tax and property tax)
 - 1.7. Assessment of the Company's management capability to carry out investments planned through their entire life cycle, from the assessment of their feasibility, to construction and commissioning, to operations of the various infrastructure assets and facilities. The assessment should also consider the Company's capacities to integrate climate change risk assessment into investment planning and implementation.

The analysis specified in subparagraphs 1.1 to 1.7 will be made based on information provided by the Company, Government bodies, and the Bank.

2. Analysis and definition of the main possible options for restructuring the activities of the Company, considering:
 - 2.1. Options for reforming the enterprise proposed by the Government and the Company;
 - 2.2. Experience in the restructuring of similar water supply and sanitation enterprises in the leading European countries (e.g., Great Britain, France, Germany), as well as some countries in Central Asia and CIS;
 - 2.3. Existing, under revision and development of national legislation;
 - 2.4. Specific features of the sector and key business parameters.

Based on the results of this work, the Consultant will arrange a meeting with the main stakeholders and Management of the Company and the most acceptable options for restructuring will be discussed and approved and will be the subject of further analysis.

Stage 3 – In-depth study of restructuring options and report preparation

The Consultant will perform a comparative analysis of restructuring options selected in Stage 2 with the current situation and provide a report where the analysis results will be presented, according to the following:

1. Financial and economic forecast of the main indicators of the Company after restructuring, considering the options agreed at Stage 2. Within the framework of this work, the following will be carried out:
 - Analysis of the effect of each agreed restructuring options on the operational and financial activities of the restructured Company if applicable sector wise;
 - Analysis of the effect on investment policy and sources of financing.

2. Comparative analysis of the relationship between the Government and the Company, among others, considering the budget process related to financing from the budget capital investments, subsidies, capital repairs, incentives, payments, the system of mutual settlements.
3. Comparative analysis of the taxation regime (VAT, income tax, including depreciation, as well as property tax) and financing of the enterprise's activities (borrowed funds, investments), as well as investment before and after restructuring from the point of view of the Company and of the state budgets.
4. Legal analysis of the procedure to restructure the Company, considering:
 - The possible transfer of Company's managed assets to the municipalities;
 - Relationships with the current creditors and donors of Company;
 - Legal succession of civil obligations and contracts;
 - Issues of corporate governance (including cost control);
 - Issues of taxation (VAT, income tax, including issues of depreciation, and property tax).
5. Legal analysis of the procedure for establishing a private operator and transfer of movable and immovable property:
 - Analysis of the existing procedure for the transfer of state property;
 - Identification of gaps in legislation (if any), that impede the effective implementation of the proposed scheme and development of acceptable solutions for their elimination (e.g. the adoption of regulations at the level of the Government or the conclusion of civil law contracts).
6. Analysis of management practices that would support the implementation of the restructuring options:
 - Review and identify development needs related to Company's current corporate status, management structure, internal and external reporting lines, decision making bodies, and staff employed.
 - Recommend an efficient organisational structure including an organisation chart with job-description and staff qualifications attached to each position or group of positions, which clearly divides tasks and responsibilities between staff and departments.
 - Propose transparent decision-making procedures, bodies, specifying compositions and powers, including a system of delegation of responsibilities and effective internal and external control mechanisms.
 - Propose suitable governance structure, including decision making processes, public consultations, relationships with the municipalities.
 - Describe the required changes to management practice that would support the implementation of the restructuring options;
 - Identify benefits and shortcomings of the management practices of restructuring options and make recommendations.

The result of this stage will be the preparation of a draft financial, economic and legal conclusion in the form of a report. As annexes to the report, a list of documents, sources or references to them should be provided, explaining or confirming the conclusions drawn. Also, a meeting should be held

with the main stakeholders, Management of the Company and the Government, where the draft report will be presented.

DELIVERABLES

The key deliverables and target dates for the assignment are as follows:

Deliverable/Activity	Target date
Draft Independent Report of Factual Findings	Within 60 working days from the beginning of the assignment
Final Independent Report of Factual Findings	Within 10 working days after the submission of draft
Meeting as the result of Stage - 2 with the main stakeholders and Management of the Company	Within 30 working days from the submission of draft Independent Report of Factual Findings
Proposal of the most appropriate options for institutional restructuring	Within 5 working days after the meeting as the result of Stage - 2
Draft financial, economic and legal conclusions	Within 30 working days after the end of the second stage and agreeing on the options for restructuring
Meeting with the main stakeholders, Management of the Company and the Government to discuss draft report	Within 10 working days after the submission of draft
Final Report	Within 5 working days after the agreement with the relevant parties

CONSULTANT'S PROFILE

The following experts are expected to be mobilised for the delivery of the Assignment:

- Project Manager/ Utility expert
- International Utilities sector expert
- International Public Finance Expert
- International Public Administration Expert
- Local institutional/legal Expert
- Local Public Administration Expert
- Local Public Finance Expert
- Local finance expert
- Local economist
- Local Environmental and social expert