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Report No. P 119

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS
OF THE
PRESIDENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED LOAN
TO THE
CORPORACION DE FOMENTO DE LA PRODUCCION (FOMENTO)
AND
EMPRESA NACIONAL DE ELECTRICIDAD, S.A. (ENDESA)
FOR A POWER PROJECT
IN
CHILE

October 26, 1956

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS OF THE PRESIDENT TO THE
EXECUTIVE DIRECTORS ON A PROPOSED LOAN TO CORPORACION
DE FOMENTO DE LA PRODUCCION AND EMPRESA NACIONAL
DE ELECTRICIDAD, S.A. IN THE REPUBLIC OF CHILE

1. I submit herewith the following report and recommendations on a proposed loan in an amount equivalent to \$15 million to Corporacion de Fomento de la Produccion (Fomento) and Empresa Nacional de Electricidad, S.A. (Endesa) to finance the foreign exchange cost of expanding Endesa's power facilities.

PART I - HISTORICAL

2. On March 25, 1948, the Bank made a loan of \$13.5 million to Fomento and Endesa as co-borrowers for a program of power development to be executed by Endesa. A very small part of the loan was for mechanical irrigation. The loan has been entirely disbursed and the projects completed except for a few minor items of mechanical irrigation. Repayment of the loan began on July 1, 1953, and is scheduled to be completed by July 1, 1968. Principal repayments to date total \$2,447,000.

3. In March 1951, the President of Chile requested a joint Bank-FAO mission to survey Chile's agricultural and transport needs and to determine priorities. The report of the joint mission, which visited Chile from May to September 1951, was officially presented to the Government of Chile in December 1952, at which time I pointed out that, unless effective action were taken to arrest inflation, efforts to modernize and improve agricultural production would not be successful.

4. In November 1954, the Government sent the Bank its program for development of agriculture and transport, based on the recommendations of the joint mission. Included in this program were many projects in other fields such as fuel and power development.

5. In March and April 1955, a Bank mission visited Chile to study the economic and financial bases of the program, particularly the measures to control inflation and restore incentives to increase production, but found them inadequate for lending operations.

6. Late in 1955, the Chilean Government undertook a vigorous program of economic reform. Following the visit of a Bank mission in April-May 1956 to observe the results being obtained, I informed the President of Chile that the progress which had been made created a basis for renewed lending operations. A copy of my letter was circulated on July 6, 1956, (R-979, Annex C).

7. In July-August 1956, a Bank technical mission visited Chile to appraise three projects which were agreed by the Chilean Government and the Bank to be of top economic priority. They were the Endesa power project, presented herewith, and two coal mining projects on which we are still working.

8. Negotiations for the proposed loan began in Washington on October 17, 1956, with Messrs. Jorge Schneider, Joaquin Figueroa and William J. Siemon representing the Government and the Borrowers.

9. If the proposed loan is made, it would increase the total amount of Bank loans to Chile to US\$52.3 million. The Bank has already made the following loans to Chile:

<u>Year</u>	<u>Serial No.</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount</u>	<u>Principal outstanding as of Oct. 15, 1956</u>
1948	5 CH	Fomento & Endesa	Power development	\$13,500,000	\$11,053,000
1948	6 CH	Fomento	Agricultural development	2,500,000	none
1951	49 CH	Fomento	Exploration for underground water	1,300,000 ^{1/}	522,456
1953	83 CH	Fomento & Papeles y Cartones	Paper & pulp mill	20,000,000	8,593,938 ^{2/}

^{1/} Of which \$445,544 cancelled.

^{2/} Amount disbursed to October 15, 1956.

10. Two other loans totaling about \$10 million for the coal mining projects referred to in paragraph 7 above are under active consideration by the Bank.

PART II - DESCRIPTION OF THE PROPOSED LOAN

Borrowers

11. The loan would be made to Corporacion de Fomento de la Produccion and to Empresa Nacional de Electricidad, S.A., as co-borrowers. Fomento, a government corporation established in 1939 to carry out the Government's development policies, would be a party to the loan primarily because of the requirements of Chilean guarantee legislation. Endesa was formed as a joint-stock company in 1944 to plan electric power development in Chile and to provide facilities for meeting power requirements which cannot be provided by other companies; most of its stock is owned by Fomento.

Guarantor

12. The Guarantor would be the Republic of Chile.

Amount

13. The loan would be in an amount in various currencies equivalent to \$15 million.

Purpose

14. The proceeds of the loan would be used to finance most of the foreign exchange costs of (a) installing an additional 49,000 kw of generating capacity in the Abanico hydroelectric plant (present capacity 86,000 kw); (b) constructing a hydroelectric plant with a generating capacity of 48,900 kw on the Huanehue River near Lake Pullinque; (c) constructing the La Isla hydroelectric power plant with a generating capacity of 68,000 kw; and (d) erecting transmission lines and constructing new or enlarging existing substations. The project should be completed in about 4 years and would serve the industrial regions of Santiago, Valparaiso and Concepcion and important agricultural regions.

15. The total cost of the project is estimated to be about the equivalent of US\$54.5 million.

Amortization

16. The loan would be for a period of 20 years. It would be amortized by semiannual payments beginning October 15, 1960 and ending October 15, 1976, as set forth in Schedule 1 of the proposed Loan Agreement.

Interest, Commission and Commitment Charges

17. The loan would bear interest at 5% per annum. This includes the statutory commission of 1%. The commitment charge would be 3/4 of 1% per annum and would accrue from the effective date of the Loan Agreement or 60 days after the date of the Loan Agreement, whichever is earlier.

Legal Instruments and Legal Authority

18. Drafts of Loan and Guarantee Agreements are attached (Nos. 1 and 2). The Loan Agreement is substantially similar to the earlier Agreement between Fomento and Endesa and the Bank and to other agreements entered into by the Bank for similar projects. The Guarantee Agreement is substantially similar to previous Guarantee Agreements between the Republic of Chile and the Bank and to other guarantee agreements for similar projects. The guarantee of the Republic of Chile would be given pursuant to Law 9298 of January 1949.

19. Also attached is a draft letter containing representations (No. 3) to be made by Fomento and Endesa concerning the carrying out of a proposed power development program, the employment of contractors and of additional engineers and technicians to the extent necessary to keep the program on schedule, the power rates to be charged by Endesa, and the conversion to share capital of advances made by Fomento to Endesa.

20. The report of the Committee provided for in Article III, Section 4 (iii), of the Articles of Agreement, is also attached (No. 4).

PART III - APPRAISAL OF THE PROPOSED LOAN

21. A detailed appraisal of the project (T.O. 122-A) was distributed on October 25, 1956, under report R-1010.

Justification of the Project

22. Electricity consumption in Chile has increased steadily during the past decade. Sales of the public service companies rose from 728 million kwh in 1946 to 1,823 million kwh in 1955, an increase of 150%. In recent years, it has been necessary to ration power in the region containing the greatest concentration of industrial, commercial and agricultural activity, in which lie the cities of Santiago and Valparaiso. Endesa estimates conservatively that the consumption of energy will increase in the next 10 years at an average annual rate of 9.0%.

23. The project is part of the program of expansion of Endesa's power facilities which, with those to be provided by private companies, should meet the expected demand through 1965. The more important parts of Endesa's system will be interconnected. The program will more than double Endesa's generating capacity and will enable Chile to continue to develop and expand its industrial and agricultural production.

24. Chile has limited known reserves of coal and oil and is therefore interested in the continued development of its hydroelectric power resources.

Method of Procurement

25. It is the policy of Endesa to let contracts on the basis of international bidding so far as practicable, consistent with standardization and technical requirements. Orders for certain major items of equipment have already been placed in Europe after international competitive bidding.

Economic Situation

26. A Report on Recent Financial Developments and Economic Prospects in Chile (W.H. 48-b) is attached (No. 5). This Report points out that at the end of 1955 the Chilean Government embarked upon a series of economic measures designed to check the inflation that had been accelerating in recent years. Earlier stabilization attempts had not succeeded due to the absence of any sustained support by Congress, business or labor groups. Now, however, after a price rise of 93% in the 13 months from December 1954 to January 1956, these groups were sufficiently impressed with the danger of a runaway inflation to give the President the support needed.

27. Action was taken more or less simultaneously on four fronts:

(a) Congress repealed outright the legal provision requiring the automatic annual increase of wages to the full extent of price rises, and allowed an increase in 1956 of only one-half the increase in prices noted above. The automatic linkage between wages and prices was abolished for 1957 and thereafter.

(b) In the banking sector, severe restrictions on rediscounts, combined with the avoidance of large Government borrowings from the Central Bank, sharply reduced the liquidity of the entire banking system.

(c) A sweeping exchange reform eliminated the maze of multiple rates, abolished direct import licensing and established a single floating rate for commercial transactions. A free brokers market was legalized for remittances and capital transfers.

(d) In the fiscal sector a new tax law was enacted and other steps taken to reduce budgetary deficits that had become the major source of inflationary pressure.

28. Record copper prices in 1956 and the largest production since the War provided the additional foreign exchange needed to liquidate most of the commercial arrears, finance current imports (which were restrained by the more realistic exchange rates), and allow a modest increase in exchange reserves. No use has been made of the standby credit of \$75 million which was arranged with the International Monetary Fund, New York commercial banks and the U.S. Treasury when the exchange reform was inaugurated.

29. Although prices will for some time continue to rise as subsidies and price controls are eliminated, the inflation spirit has apparently been broken. In the first 7 months of 1956, prices rose only 17% as compared with 40% in the same period in 1955. The free peso rate has appreciated from 840 pesos per dollar to approximately 500 pesos per dollar. Sizeable inflow of foreign private capital has already begun. The major copper and nitrate companies are undertaking large investment programs designed, within 5 years, to reduce costs and to increase the volume of production about 25%.

30. The year 1956 is a transitional period and some difficult steps must still be taken before stabilization can be assured. Among these, action to bring government finances into balance will be of great importance. Stabilization itself will reduce the need for massive wage increases which have been a prime cause of budget deficits in recent years. Exchange subsidies on some basic commodities are gradually being reduced and should be completely eliminated by the end of 1956. Steps are being taken to eliminate the burden of public services on the budget by providing more remunerative rates for transportation and power; railroad rates were increased 135% in the last 12 months. Finally, over the longer period, structural and administrative changes in the tax system are indicated.

31. In the three years since the Bank's last loan to Chile, amortization of long-term debt has slightly exceeded new long-term borrowing. The decrease in long-term debt has apparently been more than offset by an increase in external medium-term debt and the short-term funding of certain arrears. While service on the total external debt in 1956 comes to about 12% of net exports, more than half consists of payment of arrears (which are scheduled to be repaid by the end of 1957) and service on medium-term debts, nearly all of which fall due by 1960 when amortization on the proposed loan would begin. Service on the proposed loan, together with other long-term loans totaling \$25 million which Chile hopes soon to receive, would add \$4 million annually to total service in 1960, bringing total payments on long-term external debt to about 5% of estimated net exports. On present prospects this service level should be within Chile's repayment capacity provided she exercises reasonable restraint in incurring new medium-term credits.

Prospects of Fulfillment of Obligations

32. Endesa has competent and experienced management and its organization seems well adapted to the operations of the company. Moreover, it has undertaken to obtain the assistance of qualified engineers, technicians and contractors outside its own organization should lack of qualified personnel prevent it from maintaining construction schedules.

33. The total cost of the project would be the equivalent of about \$54.5 million, of which the local currency cost would be the equivalent of about \$37.5 million. Endesa should be able to finance the local currency cost from its own resources, from advances from Fomento, and from funds it will receive under the Chilean Copper Law. The foreign exchange cost, amounting to the equivalent of approximately \$17 million, would be financed by the proposed loan and by medium-term suppliers' credits in the amount of about \$2 million.

34. In each of the past ten years, Endesa has shown a profit after all financial charges. Under legislation now before the Chilean Congress, Endesa would be permitted to charge rates sufficient to realize an annual return of 8-12% on its investment, based on the replacement value of its assets, which would be adjusted annually.

35. Endesa and Fomento should be able to provide the local currency equivalent of the service of the proposed loan. The amounts of foreign exchange required for debt service should be within Chile's capacity to provide in addition to its other obligations.

PART IV - COMPLIANCE WITH ARTICLES OF AGREEMENT

36. I am satisfied that the proposed loan would comply with the requirements of the Articles of Agreement of the Bank.

PART V - RECOMMENDATIONS

37. I recommend that the Bank at this time make a loan in various currencies equivalent to US\$15 million to Corporacion de Fomento de la Produccion and Empresa Nacional de Electricidad, S.A., with the guarantee of the Republic of Chile, on such terms as are specified in the attached draft Loan and Guarantee Agreements, and that the Executive Directors adopt a resolution to that effect in the form attached (No. 6).

Eugene R. Black

October 26, 1956