Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: PAD1919

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF (EUR) 22 MILLION
(US$ 23.32 MILLION EQUIVALENT)

TO THE

REPUBLIC OF CROATIA

AND

PROPOSED GUARANTEE

IN THE AMOUNT OF (EUR) 350 MILLION
(US$ 370.7 MILLION EQUIVALENT)

TO THE

REPUBLIC OF CROATIA

FOR A

MODERNIZATION AND RESTRUCTURING OF THE ROAD SECTOR (P155842)

April 7, 2017

Transport & ICT
EUROPE AND CENTRAL ASIA

CURRENCY EQUIVALENTS

(Exchange Rate Effective February 28, 2017)

Currency Unit	=	HRK
EUR1	=	US$1.06
US$1	=	HRK7.02

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ARZ	*Autocesta Rijeka-Zagreb* (Motorway Zagreb-Rijeka)
AZM	*Autocesta Zagreb-Macelj* (Motorway Zagreb-Macelj)
BP	Bank Procedures
CapEx	Capital expenses
CAS	Country Assistance Strategy
CEF	Connecting Europe Facility
CFADS	Cash Flow Available for Debt Service
CPS	Country Partnership Strategy
CQS	Consultant Qualification Selection
DA	Designated Account
DC	Direct Contracting
DO	Development Objective
DS	Debt Service
DSCR	Debt Service Coverage Ratio
EA	Environmental Assessment
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
ESCR Report	Environment & Social Compliance
ECCHR	WB Croatia Office
ECCEU	WB's Central Management Unit for European Union
EDP	Excessive Deficit Procedure
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EIRR	Economic Internal Rate of Return
EMF	Environmental Management Framework
EMP	Environmental Management Plan
ESA	European System of National and Regional Accounts
ESI	European Structural and Investment Funds
EU	European Union
FBS	Fixed Budget Selection
FM	Financial Management
FY	Fiscal Year
FX	Foreign Exchange
GDP	Gross Domestic Product
GENDR	WB's Environment & Natural Resources Global Practice
GGODR	WB's Governance Global Practice
GoC	Government of Croatia
GRS	Grievance Redress Service
GSURR	WB's Urban, Rural & Social Development Global Practice
GTIDR	WB's Transport & ICT Global Practice
GWADR	WB's Water Global Practice
HAC	*Hrvatske autoceste* (Croatian Motorways)
HAC-ONC	*Hrvatske autoceste odrzavanje i naplata cestarine* (Croatian Motorways Maintenance and Tolling)
HC	*Hrvatske ceste* (Croatian Roads)
HNB	*Hrvatska narodna banka* (Croatian National Bank)
HR	Human Resources
HRK	Croatian Kuna
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
ICT	Information and Communication

	Technologies	IFC	International Financial Corporation
IEG	Independent Evaluation Group		
IFI	International Financial Institutions	IMF	International Monetary Fund
IFR	Interim Unaudited Financial Report	IPF	Investment Project Financing
IPO	Initial Public Offering	IRR	Internal Rate of Return
IT	Information Technology	PPL	Public Procurement Law
ITA	Intermodal Transport Agency	PPP	Purchasing Power Parity
ITS	Intelligent Transport Systems	PR	Public Relations
KPIs	Key Performance Indicators	PPS	Purchasing Power Standards
LCS	Least Cost Selection	PSC	Public Service Contract
LLCR	Loan Life Coverage Ratio	PSC	Project Steering Committee
LSP	Letter of Sector Policy	QCBS	Quality and Cost Based Selection
M/E	Monitoring and Evaluation	RAMS	Road Asset Management System
MARS	Modernization and Restructuring of the Road Sector	REOI	Request for Expressions of Interest
		RFP	Request for Proposal
MIGA	Multilateral Investment Guarantee Agency	RSAP	Road Safety Action Plan
		SBD	Sample Bidding Documents
MIP	Macroeconomic Imbalances Procedure	SOE	Statement of Expenditures
MoF	Ministry of Finance	SOEs	State-owned Enterprises
MSTI	Ministry of Sea, Transport and Infrastructure	SORT	Systematic Operations Risk-Rating Tool
MTR	Mid-term Review	SSS	Single Source Selection
NCB	National Competitive Bidding	TA	Technical Assistance
NGOs	Non-government organizations	TDS	Total Debt Service
NPV	Net Present Value	TEN-T	Trans-European Transport Network
OP	(WB's) Operational Policy	TOR	Terms of Reference
OpEx	Operating expenditures	UNDB	United Nations Development Business
PDO	Project Development Objective	VAT	Value Added Tax
PIU	Project Implementation Unit	WB	World Bank
		WBG	World Bank Group
PMS	Pavement Management System	ZUC	*Zupanijske uprave za ceste* (County Roads Authorities)
PPA	Public Procurement Act		

Regional Vice President:	Cyril E. Muller
Country Director:	Arup Banerji
Senior Global Practice Director:	Jose-Luis Irigoyen
Practice Manager:	Juan Gaviria
Practice Manager (Guarantees):	Pankaj Gupta
Task Team Leader (ADM):	Jean-Francois Marteau
Task Team Leader (Guarantees):	Richard MacGeorge

CROATIA
Modernization and Restructuring of the Road Sector

TABLE OF CONTENTS

PAD DATA SHEET

Croatia

Modernization and restructuring of the road sector (P155842)

EUROPE AND CENTRAL ASIA

TRANSPORT AND ICT

Report No.: PAD1919

Basic Information		
Project ID P155842	EA Category B - Partial Assessment	Team Leader(s) Jean-Francois Marteau, Richard Bernard MacGeorge
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]	
	Financial Intermediaries [ ]	
	Series of Projects [ ]	
Project Implementation Start Date 01-Jul-2017	Project Implementation End Date 31-Dec-2021	
Expected Effectiveness Date 01-Jul-2017	Expected Closing Date 31-Dec-2021	

Joint IFC	Joint Level		
No			
Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Juan Gaviria Pankaj Gupta (Guarantee)	Jose Luis Irigoyen	Arup Banerji	Cyril E Muller

Borrower: Ministry of Finance			
Responsible Agency: Ministry of Sea, Transport and Infrastructure (MSTI)			
Contact:	Tomislav Mihotic	Title:	State Secretary
Telephone No.:	38516169111	Email:	josipa.vukasovic@mmpi.hr

Project Financing Data (in USD Million)					
[X]	Loan	[ ]	IDA Grant	[X]	Guarantee
[ ]	Credit	[ ]	Grant	[ ]	Other

Total Project Cost:	1,083.32	Total Bank Financing:	394.02
Financing Gap:	0.00		

Financing Source	Amount (USD Millions)
Borrower	0.00
International Bank for Reconstruction and Development (Loan)	23.32
Private Commercial Sources, IBRD Guaranteed	370.70
Private Commercial Sources, Uncovered (TBD)	424.30
European Bank for Reconstruction and Development	265.00
Total	1,083.32

Expected Disbursements (Loan part - in USD Million)

Fiscal Year	2018	2019	2020	2021	2022
Annual	7.65	7.80	5.45	1.50	0.92
Cumulative	7.65	15.45	20.90	22.40	23.32

Institutional Data

Practice Area (Lead)

Transport & ICT

Contributing Practice Areas

Energy & Extractives

Proposed Development Objective(s)

The objective of the Project is to strengthen the institutional effectiveness, enhance the operational efficiency and increase the debt service capacity of Croatia’s road sector.

Components

Component Name	Cost (USD Millions)
Component A: Institutional strengthening and Sector Reforms	7.09
Component B: Operational Restructuring of Road Sector Companies	16.23
Component C: Support to the Sector debt and financial restructuring	795.00

Systematic Operations Risk- Rating Tool (SORT)

Risk Category	Rating

1. Political and Governance	Substantial
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Substantial
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Substantial
8. Stakeholders	Substantial
9. Other: Financial Markets	Substantial
OVERALL	Substantial

Compliance

Policy		
Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any waivers of Bank policies?	Yes [ ]	No [X]
Have these been approved by Bank management?	Yes [ ]	No [ ]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

Safeguard Policies Triggered 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 Waterways OP/BP 7.50		**X**
Projects in Disputed Areas OP/BP 7.60		**X**

Legal Covenants

Name	**Recurrent**	**Due Date**	**Frequency**

Audit of reimbursement applications	X		Yearly

Description of Covenant

For purposes of Part B.3(ii) of the Project, the Bank shall require that the Borrower carries out a specific audit of the reimbursement applications related to the Retrenchment Payments financed under the Project as part of the regular project audit. Such audit shall include agreed upon procedures to obtain reasonable assurance on the eligibility, existence, correct amounts of paid Retrenchment obligations under the Project.

Name	Recurrent	Due Date	Frequency
Acceptable investment programs for road construction and maintenance	X		Yearly

Description of Covenant

The Public Road Construction and Maintenance Program of the Republic of Croatia as defined in the Roads Act and the annual construction and maintenance plans defined by the RSC are defined and include investment programs acceptable to the Bank.

Name	Recurrent	Due Date	Frequency
Retroactive Financing			

Description of Covenant

No withdrawal shall be made for payments made prior to the date signature of the Loan Agreement, except that withdrawals up to an aggregate amount not to exceed Euro three million (€ 3,000,000) may be made for payments made prior to this date but on or after January 1, 2017, for Eligible Expenditures under Category (1).

Name	Recurrent	Due Date	Frequency
Acceptable governance plans for each road sector company		30-Jun-2017	

Description of Covenant

The Borrower shall cause Each Road Sector Company to approve a governance plan acceptable to the Bank by June 30, 2017 and to ensure its implementation.

Conditions

Source of Fund	Name	Type
IBRD	Subsidiary and Inter-Institutional Agreements	Effectiveness

Description of Condition

The Subsidiary Agreement and Inter-Institutional Agreements have been executed on behalf of the Borrower and each of HC, HAC and ARZ

Source of Fund	Name	Type
IBRD	Project Implementation Manual	Effectiveness

Description of Condition

The Project Implementation Manual shall have been adopted by the Borrower, through MSTI, in a manner satisfactory to the Bank.

Team Composition

Bank Staff

Name	Role	Title	Specialization	Unit
Jean-Francois Marteau	Team Leader (ADM Responsible)	Program Leader		ECCEU
Richard Bernard MacGeorge	Team Leader	Lead Infrastructure Finance Specialist	Guarantees, Finance	GEEFS
Antonia G. Viyachka	Procurement Specialist (ADM Responsible)	Procurement Specialist	Procurement	GGO03
Iwona Warzecha	Financial Management Specialist	Sr Financial Management Specialist	Financial Management	GGO21
Blanka Babic	Team Member	Consultant	Finance, governance	GTI03
Daniel Pulido	Team Member	Senior Infrastructure Specialist	finance, institutions	GTI04
Fiona J Collin	Team Member	Sr Transport. Spec.	Engineering and Road Asset Management	GTI03
Goran Puz	Team Member	Consultant	Roads Standards	GTI03
Ioannis Dimitropoulos	Team Member	Transport Specialist	Engineering and Road Assets Management	GTI03
Jasna Mestnik	Team Member	Finance Officer	Disbursement Officer	WFALN
Jelena Lukic	Safeguards Specialist	Social Development Specialist	Social Development	GSUGL
Luz Meza-Bartrina	Counsel	Senior Counsel		LEGLE
Natasa Vetma	Safeguards Specialist	Senior Environmental Specialist	Environmental specialist	GEN03

Neil Pravin Ashar	Counsel	Senior Counsel		LEGSG
Nina Chee	Safeguards Advisor	Regional Safeguards Adviser		OPSPF
Prajakta Ajit Chitre	Team Member	Infrastructure Finance Specialist	Finance	GEEFS
Sebnem Erol Madan	Team Member	Senior Infrastructure Finance Specialist	Finance	GEEFS
Tamara Mihaljcic	Team Member	Consultant		GTI03
Tendai Madenyika	Team Member	Consultant		GEEFS
Vladimir Skendrovic	Team Member	Consultant		GTI03

Extended Team

Name	**Title**	**Office Phone**	**Location**
Ivana Ivicic	Environment consultant		Zagreb

Locations

Country	**First Administrative Division**	**Location**	**Planned**	**Actual**	**Comments**
Croatia	City of Zagreb	City of Zagreb		X	

I. STRATEGIC CONTEXT

A. Country Context

1. **Croatia is a high income country located at the crossing of several main European transport corridors.** The country's most important industries are tourism and, to a lesser extent, pharmaceutical and metal industries, which rely on good connectivity. The steady increase in industrial production, construction and chemicals sectors boosted Gross Domestic Product (GDP) in the period from 2003 until the global economic crisis of 2008. GDP per inhabitant, measured in Purchasing Power Standards (PPS), rose from 56 to 63 percent of the European Union (EU) average by 2008. Large amounts of relatively cheap capital inflows entered the economy, creating credit, consumption, and real estate booms. During 2001-2008, Croatia also undertook a large road network expansion, with over HRK 57.6 billion (EUR 7.7 billion) of investment in motorways aimed at fully integrating the Croatian territory after independence, spurring industry growth and tourism, and integrating the Croatian network into the broader European network.

2. **Since the global economic crisis, the Croatian economy deteriorated substantially and has only just started to recover.** The cumulative output loss over the 2009-14 period amounted to 13 percent of the 2008 GDP, bringing GDP per capita down to 59 percent of the EU average. The pace of investment in motorways started to decelerate in 2009 due to the crisis, but still continued to be significant. Although Croatia's accession to the EU on July 1, 2013 marked an opportunity to reverse this negative trend, a return to positive economic growth was only realized in 2015 when a 1.6 percent GDP increase was recorded, followed by an estimated 2.9 percent increase in 2016. GDP is expected to grow annually by an average 2.7 percent by 2019. The main growth drivers are expected to be personal consumption given the labor market recovery as well as personal income tax reform, and investments, underpinned by EU funds.

3. **The adverse economic situation led to a substantial increase in poverty, compared to the pre-crisis levels.** The protracted recession affected real per capita income, which in 2014 stood at 8 percent below its pre-crisis level. It is estimated that the poverty rate, measured at $5/day in 2005, reached a peak of 9.8 percent in 2014, from 5.9 percent in 2009. With the growth and labor market recovery, both poverty and unemployment fell to 8.8 percent and 13.8 percent, respectively. While unemployment declined from 16.3 percent a year earlier, it remained higher than the Eurozone average and the third highest in the EU. This fall was triggered in part by migration outflows to Western Europe and adverse demographics.

4. **Since 2008, the public debt almost doubled to 86.7 percent[1] of GDP, of which the road sector debt amounts to 11 percent of GDP**, reflecting mostly the government guarantees given to support the build out of the motorway network. The EU Macroeconomic Imbalances Procedure (MIP) identified the main sources of vulnerabilities to be: declining export performance; vulnerabilities arising from sizeable external liabilities; highly leveraged firms; and quickly expanding general government debt, all of which were exacerbated by low growth and poor

[1] Expected to decrease to 85.4 percent in 2016 and further below 80 percent in 2019. Croatia's Gross External Debt position was Euro 41.7 Billion as of December 2016.

adjustment capacity. The European Commission (EC) opened an Excessive Deficit Procedure (EDP) in January 2014 and recommended corrective measures that have only been partly implemented so far. The EC review of December 2016 strongly recommended the implementation of major reforms in public administration, public financial management, social sectors, and State-owned Enterprises (SOE) governance, most notably in the transport sector.

5. **Debt-financing terms for Croatia remain relatively unfavorable, some 75-100 basis points above its Central European peers, and no access to tenors beyond 10 years in domestic and international bond markets.** Credit agencies took note of Croatia's worsening fiscal position, downgrading the sovereign credit rating to below investment grade in December 2013. As of January 2017, both Standard and Poor's and Fitch had revised Croatia's long-term foreign currency ratings' outlook to stable from negative, although both rating agencies continue to maintain their ratings at 'BB', two notches below investment grade.

6. **As a result of fiscal tightening measures, the fiscal deficit was reduced to 3.3 percent of GDP in 2015 after being on average at 6 percent of GDP in 2016 since the crisis outbreak.** The fiscal deficit is estimated to have decreased below 2 percent of GDP in 2016 and is expected to decline to 1 percent of GDP by 2019. However, in the current growth scenario, the structural deficit is projected to rise, therefore requiring further efforts to solidify public finances under the EU Stability and Growth Pact commitments, and aid in the country's objective to join the European Monetary Union.

7. **The government currently provides substantial support to the road sector.** Every year, the sector receives around 0.9 percent of GDP, in delegated state revenues (mainly through fuel taxes and car registration fees). In addition to these transfers, which mostly cover maintenance costs, the GoC is also supporting SOE investments and, unlike other SOEs, this has been facilitated through state guarantees of loans. These guarantees have exceeded the direct budget transfers every year, reaching five percent of GDP at their peak. The consequent road sector debt is a burden to the state, because the road sector SOEs are unable to refinance their debt without government guarantees. Inadequate corporate governance, and lack of sound investment and financing decisions - together with overstaffing and inefficient maintenance practices - amplify the problem.

8. **The government is exploring a debt optimization strategy for SOEs suffering from weak profitability and high indebtedness, and a plan to accelerate reforms and redirect capital investment funding sources to EU funds where possible.** SOE restructurings are needed in order to: (i) adjust the level of service to correspond to demand and (ii) adjust the companies' cost structure to make them efficient and sustainable. While the recession has led to a defensive fiscal consolidation and restructuring of the corporate sector, resulting in around 120,000 job losses, state companies have not followed the same pace especially in the transport sector. Restructuring of the road sector SOEs would diminish the need for government transfers or guarantees for new investment by generating savings and allowing for reorientation of resources for investment or social expenses.

9. **A Letter of Sector Policy (LSP), prepared by the government and approved on March 16, 2017 proposes a set of reforms to put the sector on a financially sustainable path and reduce the need for state support.** The LSP represents a clear commitment to: (a) optimize the

debt of the road sector; (b) control investments, particularly in state roads, to limit debt and to focus spending on EU funded projects; (c) achieve a sustainable financing model through modernization of the companies,; and (d) restructure the road sector by improving supervision and planning, controlling public investment, and increasing governance and operational efficiency by establishing KPIs, staff rationalization, outsourcing and setting appropriate standards to maintenance works.

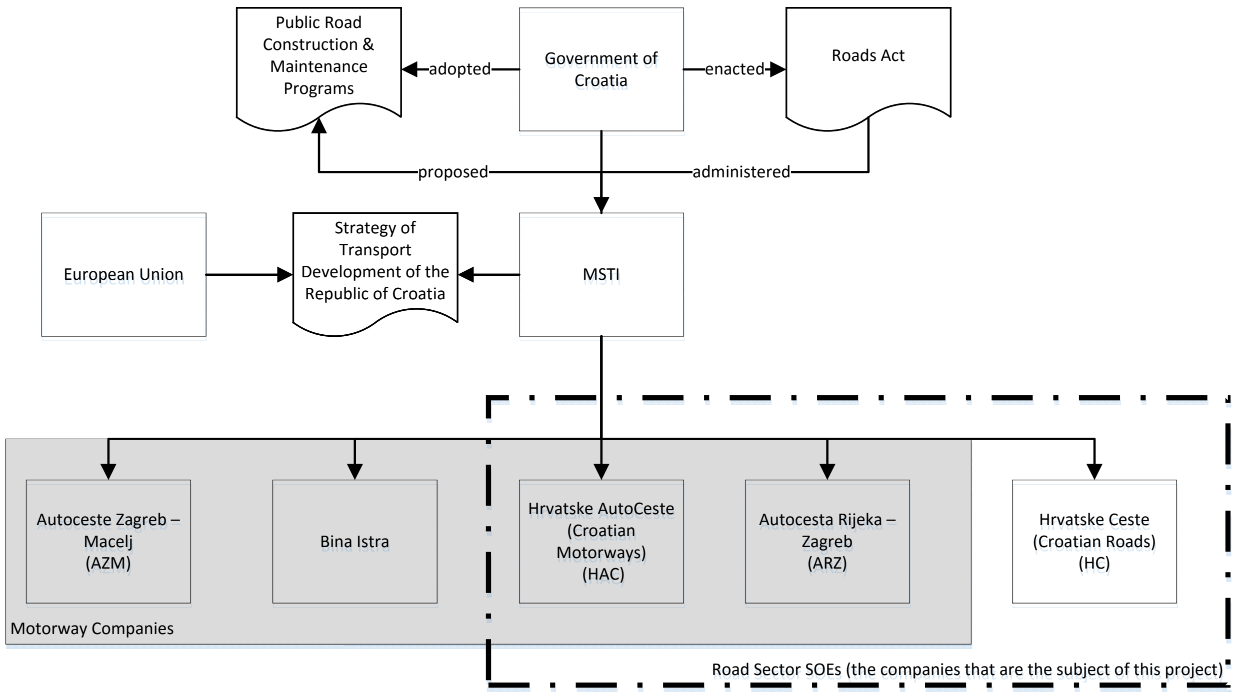
B. Sectoral and Institutional Context

10. **The road network—well developed and carrying more than 75 percent of the transport demand—is possibly the largest infrastructure asset of the country.** Motorway density is high by EU standards (approx. 23 km of network / 1000 km^2 land area) as a result of: (i) the need for visible integration of the Croatian territory after independence; (ii) efforts to spur industrial growth and tourism; and (iii) desire to integrate Croatia into the broader European network (Trans-European Network corridors X and V, which traverse the country). The modal split of inland public transport in 2015 indicates that 72.9 percent of freight and 70.6 percent of passengers were transported by roads. When individual transport is added, more than 90 percent of trips are taken by road. Freight road transport grew by as much as 38 percent during 2001-2014, while passenger road transport declined 12 percent in the same period.[1]

11. **The Ministry of Sea, Transport and Infrastructure (MSTI) formulates road sector policy and regulations and supervises their implementation.** MSTI has arrangements with a number of SOEs that manage the construction, maintenance and operations of various networks. It oversees these SOEs (road sector companies), approves road maintenance and development plans, and takes part in the EU level sector dialogue.

[1] These figures relate to public transport and as a result exclude individual car use. Individual vehicle use increase has much more than offset the decline in public road passenger transport through buses.

Figure 1



12. **The Roads Act (Official Gazette 84/11, 18/13, 22/13, 54/13, 148/13 and 92/14) provides the legal and regulatory framework for the road sector.** This overarching law defines road sector classification, standards, financing, and legal status. The investment and maintenance program for the Croatian road network derives from the following main documents:

a. The *Strategy of Transport Development of the Republic of Croatia of 2014* specifies long-term development priorities. A revised transport sector strategy is under development and will be submitted for public consultation by July 2017. The revised strategy will deviate from the prior focus on infrastructure development, shifting to transport planning and emphasizing multimodality, safe and sustainable transport services, improving regional connections and completing the Croatian part of the Trans-European network of corridors (TEN-T).

b. Medium term objectives are set forth in the four-year *Public Road Construction and Maintenance Programs,* adopted by the Government of Croatia (GoC) based on the MSTI's proposal.

c. *Annual construction and maintenance plans* defined by road operating companies, for construction and maintenance, and approved by the MSTI.

13. **All public roads are classified as a public good under the ownership of the Republic of Croatia but their management and financing differs across network types.** In 2016, the

Croatian road network comprised 26,954 km of classified roads, which included motorways[2] (1,420 km - including planned sections), state roads[3] (7,098 km), county roads (9,499 km) and local roads (8,937 km). Management and financing of Croatian roads are as follows:

a. The motorway network is managed by four entities: publicly-owned Croatian Motorways (HAC) and *Autocesta Rijeka - Zagreb* (ARZ), and concessionaires *Bina-Istra and Autocesta Zagreb Macelj* (AZM). HAC is a limited liability company for the management, construction and maintenance of 926 km of motorways. It was established in 2001 as one of the legal successors to the Croatian Road Authority, which has now ceased to exist. HAC is financed through toll revenue, fuel tax proceeds (0.2 HRK/liter), revenues from roadside services, and shareholding in Bina-Istra and Bina-Fincom. ARZ started operations in 1998 as a shareholding liability company for the construction, and management of 187 km of motorway, mainly along the Rijeka-Zagreb section and operates under a concession agreement with the Republic of Croatia. HAC-ONC (Croatian Motorways Maintenance and Toll Collection), was formed in 2012 on a non-competitive basis to perform routine maintenance and toll collection activities for HAC (beginning operations on April 16 2013). Similarly, the ARZ founded subsidiary, ARZ-ON, was formed to perform regular maintenance and toll collection for ARZ motorway sections. ARZ-ON was merged with HAC-ONC on January 31 2013. The relationships between HAC-ONC and HAC/ARZ are determined by respective four-year contracts expiring in 2018.

b. State roads are managed by Croatian Roads (HC), established in 2001 as a legal successor to the Croatian Road Authority. HC is a limited liability company for managing, constructing and maintaining the state road network. It is mainly financed through proceeds from fuel tax (0.8 HRK/liter) and a few other fees related to vehicle use. Routine maintenance of state roads, as well as a significant portion of county and local roads, is performed by twelve companies of mixed public and private ownership, which were founded on a regional basis following the 1998 reorganization of the road sector. HC and the twelve companies have entered into a “framework agreement”, on the basis of which individual contracts have been enacted for routine maintenance, which expire in 2018.

c. County roads and local roads are public goods owned by the Republic of Croatia and managed by county road authorities (*Zupanijske uprave za ceste* or ZUC). Financing of county and local roads is done partly by HC and through proceeds from vehicle registration.

14. **Between 1997 and 2015 HC, HAC, and ARZ (the Road Sector SOEs) developed their network using some 72 commercial and International Financial Institution (IFI)[4] loans, resulting in a current outstanding amount of EUR 5.2 Billion, all of which are fully guaranteed by the Government.** In 2014, the debts of HAC and ARZ were consolidated into the general government debt in accordance with the European System of National and Regional Accounts (ESA) 2010 requirements.

---

2 By definition, a motorway is road of at least two lanes in each direction designed for traffic with a minimum speed limit of 80 kilometers per hour (km/h), with controlled access and regulated ingress/egress.

3 State roads are important routes for vehicle traffic between various parts of the country, but classification of these roads does not depend on the actual conditions of the road.

4 Mostly EIB and EBRD for loans totaling more than EUR 1 Billion and spanning the whole network. HAC and HC also had USD 78 million in IBRD loans as part of the Rijeka Gateway Project.

15. **The current structure of road sector liabilities and State guarantees create substantial risks for the road sector and the country.** The cost of capital is a relatively less pressing issue than access to longer loan tenor. The Road Sector SOEs have been able to meet their debt service obligations with heavy reliance on GoC guarantees, however the limited financial management resources within the companies are taken up by managing immediate term debt refinancing and rolling over, rather than long term investment planning and asset management. Over the next five years, cash flow generated by these companies covers only 30 percent of the debt service excluding any capital expenditure needed for maintenance of the network.[5] Decisive action is needed for the Road Sector SOEs to become fully independent.

16. **The Croatian road sector does not yet have the systems and institutional capacity to effectively and efficiently manage road assets.** Motorway companies were developed mostly to build the network, and as a result future assets maintenance was not prioritized. Consequently, companies do not adequately collect and manage road condition and traffic data, which is needed to optimize capacity and to develop efficient maintenance strategies. There is no link between the long-term strategy documents and the short and medium term planning of road investments, nor mandatory prioritization criteria for investment selection. Better planning and Public Investment Management (PIM) Systems are needed to ensure the viability of the road sector.

17. **Government control of SOEs is generally limited to accounting reporting regarding the use of subsidies, and there are no corporate or operational performance indicators in place.** Motorway staffing per kilometer for operations is at least 25 percent higher than comparable networks in Europe[6] and the salary of personnel is much higher than the Croatian average for comparable skills, especially for low skilled employees, which form the majority. Salaries are paid primarily using revenues from toll collections and subsidies from the budget are used for investment and refinancing of existing loans. Toll tariffs are not subject to congestion or seasonal adjustments.

18. **In 2012, the government began to explore PPP options to increase efficiency and reduce the debt burden of HAC and ARZ**. A long-term concession to a private sector operator ("monetization") and an Initial Public Offering (IPO) of HAC-ONC were both considered, and in preparation the GoC implemented a minor restructuring of ARZ and HAC over 2013/2014. The changes related mainly to headcount and organizational consolidation, as well as to financial management and funding sources.[7] In the end, as a result of strong public opposition to private sector control of the motorways, the GoC did not pursue these options. The restructuring did not materially improve financial performance, maintenance remained inefficient and there was no significant revenue optimization from tolls and other sources.

19. **Public funding of the state roads company's (HC) capital investment program has**

---

[5] Funding for periodic maintenance on the existing network is far from secure, despite significant fuel tax revenue allocations. In addition to the EUR 200 million needed for operating costs, which are covered by revenue and taxes, a further EUR 100 million would normally be needed annually for periodic maintenance (EUR 72 million for HAC, EUR 20 million for HC, and EUR 8 million for ARZ).

[6] Report funded by EBRD on the restructuring of the motorway sector, Atkins & others, 2016

[7] Mostly decrease of the fuel tax allocation to HAC reflecting less needs for financing construction of new motorway sections

been insufficient. HC, as a non-revenue earning entity, has relied on commercial and IFI loans to meet financing needs, rather than through state support, which has led to a large stock of accumulated debt, estimated at EUR 1.2 billion. Although a significant portion of the fuel tax is allocated to HC, this transfer is insufficient to preserve assets and service debt. Maintenance costs are also high and there is an increasing backlog of periodic maintenance and rehabilitation.

20. **Overall, Road Sector SOEs face operational and financial challenges:** (a) over-investment in the network; (b) weak governance; (c) high operating costs; (d) large debt stock; (e) short tenor of existing loans; (f) currency risk and (g) insufficient credit strength to access the loan market for long tenors on a stand-alone basis. Taking each in turn:

Operational Challenges

a. **Over-investment.** The sector planning has long focused on building the motorway network, but also, to a large extent, includes the development of the national network. Design was done based on very high standards, leading to oversized infrastructure in the case of many assets. As a result, the asset maintenance costs for the infrastructure will become significant as the infrastructure ages. Similarly, the selection of investment outside of motorways was not made on economic grounds, which has led to unsustainable levels of investment.

b. **Companies governance could be improved.** Given the high priority given to network development after independence, the road sector benefited from large funding and autonomy, resulting in impressive construction performance. This implied a focus on construction at the expense of maintenance, and limited attention to costs and staff counts. Staff and service costs are high and overall administrative and company internal control mechanisms were unevenly developed.

c. **Operating performance has been expensive and sustainability of the system is at risk.** Operating expenditures are high, driven by staff cost, and service level normative requirements that favor spending on routine maintenance rather than preventive investment or periodic maintenance. Revenue policy is suboptimal with significant discounts to some categories of drivers and no substantial adjustment to tariff policy since the start of operations; ancillary revenue could also improve. Finally, the operating model has not planned for the likely raise of periodic expenditures given the increase in assets built in the last 20 years. This will worsen the imbalance between asset maintenance costs and revenue, as debt service will remain high.

Financial Challenges

d. **Size and terms of debt stock relative to earnings.** Commercial loans comprise 72 percent of the Road Sector SOEs debt stock, with the balance provided by IFIs. HAC faces the most acute debt sustainability problem, followed by HC and ARZ. Over the next five years, HAC’s cash flows are projected to cover about 30 percent of the debt service, mostly due to the company’s large repayment obligations. In the long-term, over the next 20 years, it is projected that about 77 percent of debt can be carried from sector earnings, again weighed down mostly by the level of HAC's debt. Total road sector debt is above industry averages as measured by the ratio of total debt to the Cash Flow Available for Debt Service (CFADS). This ratio stands at 15.8, 15.0, and 9.7 for HAC, ARZ and HC, respectively. In comparison, European toll road operators and concessionaires have a Debt to CFADS ratio in the range of 3.3-7.3. These can be characterized as short-term and long-term debt challenges.

e. **Mismatch between short tenor of existing loans and the long life of road assets.** All Road Sector SOEs are facing a wall of debt over the next five years. Many loans have a short maturity with an average life of less than 4 years. Around EUR 3.0 billion, or 57 percent of outstanding loans, mature between 2017 and 2019, placing a significant refinancing risk on the Road Sector SOEs and further straining state finances. Continuous short-term borrowing to meet debt service obligation further compounds the problem of high indebtedness by introducing significant refinancing risk. Extending debt tenors to match asset life and thereby diversify repayments and refinancing risk would help reduce the annual debt service burden to a level that can be sustained by the sector.

f. **Currency risk as over 96 percent of approved guarantees are denominated in Euro**. The Croatian National Bank (HNB), because of the overall exposure of Croatia to the Euro, has actively intervened to ensure that the Kuna trades in a narrow band by reference to the Euro, but this is not guaranteed in the long term.

g. **Insufficient credit strength to access the market for long tenors on a stand-alone basis.** Neither the credit strength of the Road Sector Companies, nor Croatia's current credit rating allow for access to the long-term finance needed to make the debt service of the Road Sector SOEs sustainable. While yields in the domestic bond market are low in nominal terms, access has been limited and the longest tenors currently outstanding are inside 10 years.

21. **The government is aware of the road sector problems set out above and is committed to resolving them.** The GoC has demonstrated its commitment by designing and agreeing upon a sector business model improvement plan which lays the path for an overall sector reform that is outlined in a Letter of Sector Policy. Some critical reforms identified in the LSP have already been taken, including on the toll adjustment. This particular action required strong involvement of the Prime Minister, and signals critical intra-governmental alignment and support—including for unpopular measures. The government is now working concurrently on investment, operations and debt optimization measures and has requested World Bank support in this regard. The Government has worked with the Bank to engage a transaction advisor to support the strategy for financial optimization of the companies. For the motorway sector, reforms will be consistent with EU rules on state aid and competition policy. These were modified in July 2016 and now authorize the government intervention and guarantees to public motorway companies if they hold natural monopolies.

C. Higher Level Objectives to which the Project Contributes

22. **The project is consistent with the Country Partnership Strategy (CPS) for FY14-17.** The CPS aims to assist Croatia's convergence with the EU through an engagement that is focused on key reform-based outcomes, supporting the Europe 2020's smart, sustainable and inclusive

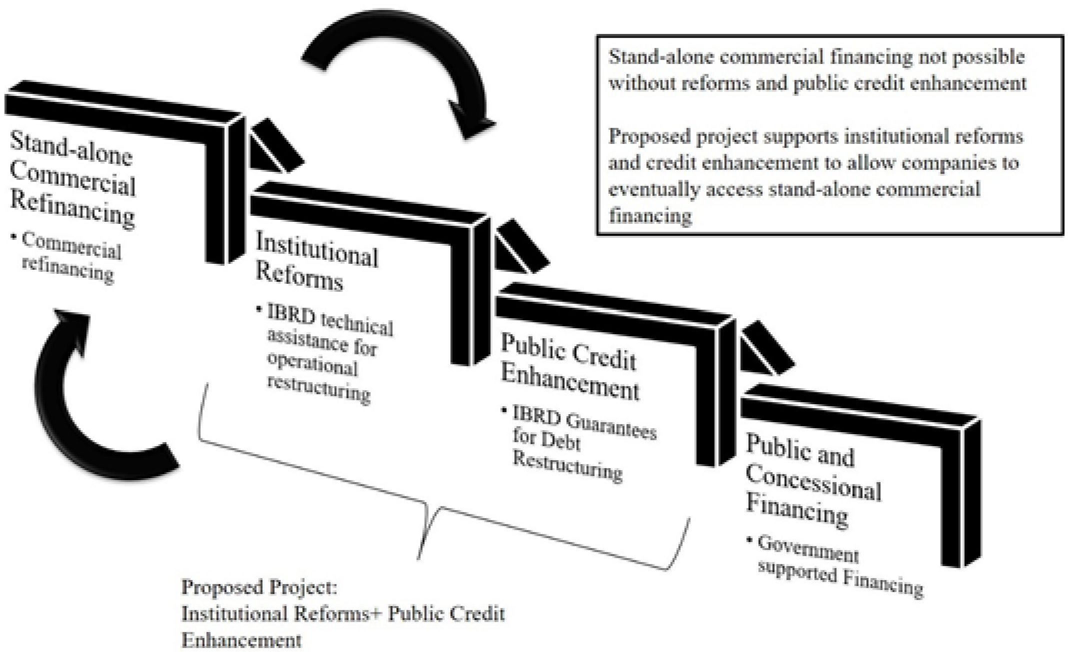
growth' strategy and the government's reform agenda. The project supports all of the CPS pillars. Firstly, it supports the public finance pillar by decreasing the country's macroeconomic instability through rationalization of sector expenditures and an improved public debt profile. Secondly, it supports the competitiveness pillar by promoting restructuring and efficiency of the road sector to enable its faster convergence to operational and financial performance of EU-28 countries. Lastly, the EU membership pillar is supported by strengthening the capacity of public Road Sector SOEs, one of the main recipients of EU funds. The sector will also be under strict review of the EC for competition and sector policy aspects. The Systematic Country Diagnostic underway identifies SOEs performance and state debt as a critical issue for Croatia.

23. **The project supports the government's strategy for the sector, included in the Letter of Sector Policy (LSP)[8].** Designed at the end of 2016 and approved by government decision on March 16, 2017, the LSP (see paragraph 9) reinforces sector-planning functions, supports improvements in operational efficiency and enables financial optimization. The LSP is informed by the National Transport Strategy and the Road Safety Action Plan (prepared by MSTI in alignment with the 2011-2020 National Road Safety Plan), both of which consider actions necessary to continue to unlock EU funding, and achieve compliance with respective EU directives and international best practices. The LSP implementation schedule spans over a four-year period that coincides with the Project implementation period. It includes difficult measures which will change behaviors for ministries and management, for example in corporate governance and in public investment management where the new system should be based on best practices. At micro level, it will cut operating costs by optimizing all business functions, but also modernize operations and pricing of tolls.

24. **The project is consistent with the proposed "Cascade Approach to Infrastructure Financing".** Under the right circumstances, toll road operators can obtain financing from commercial sources on a stand-alone basis. With adequate and secured funding, even non-tolled roads can raise financing in the market. In the case of Croatia, while the Road Sector SOEs have raised commercial debt, this is guaranteed by the Sovereign. The current institutional framework and operating model of the Road Sector SOEs does not allow to access commercial finance on a standalone basis. Comprehensive sector reforms and credit enhancement are needed in order for the companies to improve their financial outlook and to eventually access capital markets independently (see Figure 1 below).

8 The full text of the LSP is in Annex 2

Figure 2: Proposed engagement consistent with the "Cascade Approach"



25. **The project will directly contribute to economic development and improve productive activities in the public road sector** through two pathways. Firstly, in the short term, it will help to ensure that the public companies can mobilize the funding required for periodic maintenance and existing assets renewal (EUR 100 million per year), by reducing the impact of road sector debt servicing by extending tenor and diversifying refinancing risk. Secondly, in the long term, by improving the cost structure of all the companies, it will free approximately EUR 50 million per year to contribute to the asset renewal investment.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

26. The objective of the Project is to strengthen the institutional effectiveness, enhance the operational efficiency and increase the debt service capacity of Croatia's road sector.

B. Project Beneficiaries

27. **The primary project beneficiaries are all road users.** Improvements in road maintenance and road safety resulting from operational reforms will primarily benefit road-users (51 percent of which are women). These improvements include the following: (a) better road quality through a revamped road asset management based on systems for collecting and supervising road asset data; (b) safer transportation following road safety through audits on the

TEN-T network; (c) improved traffic management and tunnel operations through Intelligent Transport Systems (ITS); (d) higher efficiency and quality of road maintenance through rationalization and improvement of operations; and (e) secured preservation of assets over time and increased potential for new investments in the future both resulting from lower debt service burden and higher revenue generation. Intervention will follow modern management practices focused on ensuring service levels, including, for example, quality, safety, riding comfort, travel speed and energy efficiency standards.

28. **The secondary group of beneficiaries is Road Sector SOEs.** HAC, HAC-ONC, HC and ARZ together employ 3,516 workers (out of which 785 are female). Companies will benefit from the proposed debt optimization strategies, allowing more resources to be allocated to operations, maintenance and new investments. The TA funded by the Project will provide for a functional analysis at each company (HC, HAC, ARZ and HAC-ONC), and develop detailed Action Plans that will optimize management and maintenance costs, enhance outsourcing where beneficial, reduce technical units and rationalize administrative activities.

29. **Debt relief and safety improvements will help poverty reduction and the bottom 40 percent**. The impact of the project on the bottom 40 percent of the population and on poverty reduction is linked to the consequences of the debt relief provided by the project and improvements in road safety. Increasing the motorways companies' debt service capacity will directly reduce the state debt, while the strengthening of planning and management functions will help rationalize investment. Failure to do so would increase the country's fiscal deficit and immediate public debt service (see section VI, fiscal aspects) by close to fifteen percent in 2017-2019, and diminish the ability of the state to provide other essential public services to the population. By increasing the cost efficiency of road operations by 20 to 30 percent depending on companies, the GoC could refocus the same fraction of direct transfers (0.9 percent of GDPs) to productive investment in asset preservation and debt service[9].

30. **Gender considerations will inform the labor restructuring process**. Gender disaggregated data will be monitored in the retrenchment plans. It is expected that men will be more affected by staff reductions as they represent the majority of employees in two companies: HAC-ONC (478 women and 2,354 men, working mostly in maintenance and toll collection) and HAC (97 women and 106 men), and occupy the majority of positions in the toll and maintenance functions. ARZ employs 36 workers (14 men and 22 women) and HC has 445 employees (257 are male and 188 female); however, it is not expected that these two companies will undertake significant staff reductions. The Retrenchment Plans will include gender disaggregated information and clear criteria for non-discriminatory process for identifying redundancies and corresponding grievance redress mechanisms, such as access to the Croatian Ombudsperson for Gender Equality in case a worker feels that they are being treated unfairly or discriminated based on gender. The monitoring and evaluation processes associated with the implementation of the Retrenchment Plans will also include gender-specific indicators.

[9] Another potential impact may have been retrenchment. While the sector restructuring will include retrenchment of personnel in the companies, the Collective Bargaining Agreements and the state unemployment benefits system provide adequate protection to reduce the income shock from job losses. Overall, the impact of retrenchments will be more than balanced by the direct positive impact on road users, some of whom are in the bottom 40 percent. See section VI-E for more details

C. PDO Level Results Indicators

31. The indicators listed in Table 1 will measure PDO achievements, as defined below:

a. **Institutional Effectiveness:** Extent to which road sector companies have the legal and regulatory framework, organizational structure, incentives and technical capabilities needed to design, build, operate, maintain and finance the infrastructure under their management in an effective manner.

b. **Operational Efficiency**: Ability to provide quality services in a cost-efficient manner.

c. **Debt Service Capacity**: Ability of road sector companies to cover principal and interest payment on new and existing debt from their own operating surpluses.

d. **Private Capital Mobilization:** Amount of financing from a private entity on commercial terms due to the active and direct involvement the World Bank leading to commitment.

e. **Private Indirect Mobilization**: Amount of financing from private entities provided in connection with a specific activity for which the World Bank is involved.

Table 1 – PDO Indicators

PDO Indicator	Assessed Aspect of PDO
Ability of MSTI to plan road sector investments	Institutional effectiveness
Ability of MSTI to monitor and enforce performance of Road Sector SOEs using Key Performance Indicators (KPIs) and unified acceptable accounting standards and polices under service agreements between Government and reorganized companies	Institutional effectiveness
Operating Expense Ratio (Total Operating Expenses / Total Operating Revenue)	Operating efficiency
Operating Expenditures per kilometer of road network	Operating efficiency
Debt Service Coverage Ratio (DSCR)	Debt service capacity
Loan Life Coverage Ratio (LLCR) 10 Year	Debt service capacity
Debt to CFADS Ratio	Debt service capacity
Private Capital Mobilized	Debt service capacity
Private Financing Indirect Mobilization	Debt service capacity

III. PROJECT DESCRIPTION

Project Scope:

32. **The project aims to improve the institutional effectiveness, operational efficiency and debt service capacity of the Croatian Road Sector to address the current country and sector challenges described above.** At a high-level, these objectives seek to tackle issues identified in section I: Low institutional effectiveness, inadequate investment and operational performance and large size and short tenor of the debt stock carried by the Road Sector Companies, as well as inability to access long-term debt that would coincide with the long life of road assets.

33. **The Project provides a comprehensive solution that covers institutional, operational and financial concerns.** The Project supports governance, planning and monitoring reforms that will make Road Sector SOEs more effective and enable their efficiency. Support targets institutional investment management and company level governance and management arrangements to promote a performance-based culture and ensure that future investments are economically justified. The project will also address operational practices, making operations more effective to maximize revenues and lower operational costs.

34. **The Project will help alleviate the burden of existing debt on Road Sector SOEs through a process of loan optimization**. This involves a strategy of re-profiling certain principal and interest payments so that debt service is within the limits of each company's cash flows and in line with industry averages. These cash flows are also expected to improve because of the expected earnings improvements as a result of reforms supported by the operation.

35. **The Project will also support the implementation of measures contained in the LSP and will benefit from substantial prior IBRD and EBRD engagement in transport sector reform.** Targeted Technical Assistance actions (TAs) and retrenchment funding by European Bank for Reconstruction and Development (EBRD) and IBRD will support the implementation of the policy measures outlined in the LSP. The Project is expected to put Road Sector SOEs in a position to access commercial finance, initially with other forms of credit enhancement, including MIGA and other IFI guarantees, but eventually on their own. The Project can be summarized as follows:

Table 2

	FY 2017	FY 2018-2020
Institutional Strengthening, Sector Reforms and Operational Restructuring	• Launch of LSP and associated reforms • IBRD retrenchment financing and launch of TA in the form of an IPF loan of EUR 22 million. • Adoption of the LSP • Merger of HAC and its operating subsidiary HAC-ONC • Toll tariff adjustment • Investment control in place • Corporate governance of companies reformed • Service agreements between state and companies	• Implementation of the LSP (companies, restructuring, rationalization of planning & programming). • Road asset management modernization and investment planning rationalization • Revised maintenance standards • New tolling policy and modernization of tolling system • Systematic adjustment of motorway maintenance operations • New procurement of state and county roads maintenance • Adjustment of overhead costs for all companies
Debt Optimization	• Involving IBRD directly (Private Capital Mobilized), a debt optimization intervention supported by a EUR 350 million IBRD IPF Guarantee. • Not involving IBRD directly (Private Financing Indirect Mobilization), (i) rescheduling short-maturing loans and (ii) Other short-term financing interventions as needed.	Out of project scope: • Subject to FY17 interventions, further risk mitigation support could be required from MDBs and IFIs, including MIGA. • Further commercial refinancing as needed for the remainder of the debt to improve financial outlook of the Road Sector SOEs.

36. **Financial optimization of the sector to achieve standalone creditworthiness may require additional assistance from IFIs over several years.** The project enables the beginning of this optimization through the actions included in the LSP and, most likely,[10] a first refinancing mobilized by the government with the support of an IPF Guarantee. Potential further support by MDBs or MIGA may be considered if the actions listed in the LSP as described in detail in Annex 2 are achieved. The sector reform is also expected to ease access to domestic funding, from which the government may raise finance for its general funding purposes. The current project is a standalone operation without any commitment to further phases of support.

Financing Instruments:

37. **The project's financing will be implemented through two Investment Project Financing (IPF) instruments:** (i) a Loan of EUR 22 million and (ii) a Guarantee of up to EUR 350 million for the benefit of commercial lenders and/or bond investors.

38. **The two IBRD instruments will focus on where the greatest impact can be obtained**.

[10] The precise strategy will depend on the final recommendations of the GoC's transaction advisor (see section VI.B for more details), discussions with existing creditors, market soundings with new creditors and tailoring of the guarantee instrument to generate the best possible outcome.

The IBRD Loan will strengthen governance and institutional and operational capacity as a requirement for efficiency. The Guarantee will provide credit enhancement that enables access to sustainable commercial debt with tenors to allow the Road Sector SOEs to retire debt from their own resources.

39. **The IBRD Loan will support the implementation of the measures outlined in the LSP over a four-year period.** The loan will fund the contracting of implementation support consultants to update standards, support restructuring measures (including staff rationalization), setting up of control, asset management and IT processes, and reform of procurement strategies for more efficient contracting. The loan will also fund part of the retrenchment program resulting from this modernization alongside an existing EBRD loan as outlined below and in Annex 2. Through the IBRD Loan, appropriate Environmental and Social Safeguards and extensive citizen engagement measures are to be applied in the implementation of the reform.

40. **The Guarantee is intended to be used to refinance loans to be specified, most likely through a long-term sovereign debt issuance (15 years or longer).** Neither the Road Sector Companies nor Croatia can achieve affordable, long tenor commercial debt terms without support. The companies need to extend the final maturity of their loans from up to 7 years to 15 years or longer, which would also improve average maturity. As the companies cannot borrow longer than seven years and Croatia has no track record of borrowing longer than 10 to 12 years on affordable terms, the tenor extensions needed will require credit enhancement from a highly rated entity. It is in this regard that an IPF guarantee is expected to play a key role, as Component C below and Annex 6 describe in detail. The balance of debt is intended to be reprofiled to longer maturities to reflect the government reforms, improvement to CFADS and the average tenor extension resulting from the refinancing.

41. **Progress achieved in sector policy prior to negotiating the Loan part of the Project:** Before negotiating the Loan portion of this financing, GoC committed to a comprehensive reform of the sector built upon policy actions detailed in the LSP. The LSP was signed and confirmed by the GoC at the end of March 2017. Completion of the included Policy Actions at the end of March 2017 were achieved before the submission of the project to IBRD's Board of Directors. These include:

- Increasing toll rates on the HAC network (for harmonization with ARZ) and setting a seasonal tariff increase by 10 percent in the summer period;
- Capping new lending for the national roads set at 1.231 Billion HRK 2017-2020, and limiting borrowing for new motorway investment to EU funds co-financing;
- Approving an Investment plan for the road sector for 2017-2020 with clear prioritization criteria;
- Finalizing Corporate Governance Plans for HC, HAC and ARZ;
- Laying out actions required in road safety through an instruction letter from the Ministry of transport to operators.

42. Likewise, the IBRD would proceed with the proposed guarantee subject to adequate progress in the implementation of actions set out in the LSP, including consideration of:

- Starting implementation of Corporate Governance Plans for HC, HAC and ARZ;

- Confirming that summer tolls are implemented;
- Setting up a planning department in MSTI including coordination of long term planning and medium term investment plans;
- Signing service agreements between the state and the three companies;
- Completing the absorption of HAC-ONC by HAC (legal steps completed) and finalizing a contract between HAC and ARZ on delegation of operational activities;
- Starting the process of voluntary retrenchment in HAC and HAC-ONC including identification of staff;
- Confirming an agreement between ZUC and HC on procurement for maintenance for state and local roads;
- Confirming and implementing short term savings in HAC (identification with ARZ of services to be merged for savings) and HC as identified and implemented to meet LSP 2017 savings targets.

Related IFI Involvement in the Sector:

43. **EBRD is already involved in the sector dialogue and may contribute with investment support for the program agreed with the government as part of the LSP.** EBRD is also supporting the refinancing of HAC through a EUR 250 million loan signed in March 2016. It disbursed EUR 100 million in mid-2016, with a second EUR 100 million tranche to be disbursed in 2017. The loan also contributes to the motorway sector reforms (to fund retrenchments and capex) through a EUR 50 million tranche. The companies themselves may locally mobilize transition funding in parallel with guarantee support from the GoC.

44. **EIB is a major contributor to support investment in the sector**. It is the largest IFI creditor for both ARZ and HC, and contributes to the funding of the national share of financing of all EU funded projects.

45. **After the first refinancing supported by this Project, the government could seek additional support from MDBs for a second refinancing.** If the LSP is satisfactorily implemented the government has indicated that it may request further supporting instruments to finalize the debt restructuring of the sector. These guarantee instruments could be mobilized through IBRD, and potentially MIGA. In terms of lending support, it is not envisaged at this stage to complement the proposed IPF loan with any additional loan financing, as the cost of implementation is covered by the Project and is complemented with the existing EBRD financing, including for goods and limited works to improve motorway operations.

A. COMPONENTS

46. In order to meet the PDO level objectives mentioned above, the Project scope is organized under three components corresponding to objectives. The first two components are supported by the IBRD loan. The third component relates to the sector financial optimization. Annex 2 describes in detail components A and B including the amount for each sub-component, and Annex 6 explains the Rationale for the IPF Guarantee and provides further details on the transaction structuring.

Component A: Institutional strengthening and Sector Reforms (Estimated cost US$7.09 million with contingencies)

47. The objective of this component is to establish an institutional framework for the road sector, including through:

1. Financial Transaction Advisor

Hiring of a financial transaction advisor who shall, inter alia: (a) prepare a debt optimization strategy for the Road Sector Companies; (b) analyze debt facilities for reprofiling and refinancing; (c) propose the type and sequencing of the refinancing instrument; and (d) develop and implement the engagement strategy for communication, negotiation and conclusion of the arrangements with the capital market.

2. Transport Sector Planning and Road Sector Governance and Monitoring

(i) Development of a directorate in the MSTI to coordinate strategic planning and public investment management.
(ii) Development of a sector governance framework including definition of KPIs and monitoring arrangements.
(iii) Establishment of an application for data exchange and reporting between MSTI and the Road Sector Companies.
(iv) Improvement and standardization of accounting practices across the Road Sector Companies.
(v) Improvement of the business environment for the freight transport industry through review of administrative processes applied to the road transport sector.
(vi) Introduction and improvement of citizen engagement through consultation processes.

3. Implementation support

Provision of support to MSTI in managing and coordinating the Project and building its procurement, financial management, safeguards management, monitoring and evaluation capacity, dealing with legal, public relations, communication and human resources matters through the provision of technical advisory services, Training, as well as Project audits

Component B: Operational Restructuring of Road Sector Companies (Estimated cost US$16.23 million with contingencies)

48. The objective of this component is to implement management tools and carry out the revenue enhancement and cost rationalization actions required to improve operational and financial sustainability of the Road Sector Companies, including through:

1. Road classification and standards

Provision of support to MSTI and the Road Sector Companies to: (i) implement a technical classification of the public road network; and (ii) develop consistent sets of maintenance-related regulations and specifications for all classes of roads.

2. Road Asset Management System

(i) Design and implementation of a road asset management system (RAMS) for all Road Sector Companies to comprise a computerized database with inventory, condition and traffic data.
(ii) Development of a multi-year costed road maintenance program by each Road Sector Company.

3. Rationalization of Operations and Business Functions – Motorways

(i) Development of action plans and their implementation to improve technical and business efficiency and effectiveness through optimization of management and roads' operations and maintenance costs, outsourcing enhancement and rationalization of technical units, administrative activities and revenue improvements.
(ii) Provision of staff retrenchment packages to include support for retraining, counselling, advisory services and employment intermediation.

4. Tolling

Carrying out of studies to identify the preferred automated tolling system and new tariff structure, including plans to transition from the current system and pricing regime.

5. Operational and business rationalization of HC

Development of an action plan to support the: (i) restructuring and transition of HC to a regional management system based on six regions; (ii) carrying out of joint procurement at regional level among HC and ZUC; (iii) development of improved maintenance contracting practices; and (iv) assessment and programming of periodic maintenance based on the RAMS.

6. Road Safety

Carrying out of technical studies for purpose of increasing road safety on the motorway system including tunnels and traffic information.

Component C: Debt Optimization – up to EUR 4 billion of the Road Sector SOEs' EUR 5.2 billion of debt may be optimized. IBRD's direct involvement relates to a first refinancing mobilized by the government with the support of an IPF Guarantee[11]

49. **The objective of this component is to mobilize commercial financing for the Road Sector SOEs to refinance their short term and expensive loans (Guaranteed Refinancing Facility).** The mobilized commercial financing is expected to lengthen the tenor and potentially reduce the interest rate on road and motorway companies' debt, thereby matching liabilities more

[11] Please refer to paragraphs 14, 35 and 55; and Annex 6 (Rationale for IPF Guarantee & Transaction Structuring) and Annex 7 for further details.

closely to asset life, reducing annual debt service and increasing the independent sustainability of sector debt.

50. **The Project will provide a Guarantee amounting to EUR 350 million[12], to enable the sovereign to raise long tenor debt for the Road Sector Companies to refinance selected Actionable Loans.** The IPF Guarantee may be used to support a single financing transaction for this purpose either singularly or in parts to support across multiple financings at different points in time. Guarantee coverage of any given financing is expected to be in the range of 20-60 percent of the face value of the principal of that financing, depending on market feedback and final structuring of the instrument. Please also refer to Annex 6 Rationale for IPF Guarantee & Transaction Structuring for further details.

51. **Road Sector SOEs' existing commercial debt that is likely to be refinanced in 2017 phase has remaining tenors of less than three years on average**. World Bank partially guaranteed sovereign financings and new commercial debt is expected to increase tenors to 15-20 years or longer for this refinancing and potentially reduce interest rates. In this Guaranteed Refinancing, there will be no reduction in the amount of government support. The Guaranteed Refinancing will provide some relief from heavy debt service requirements over the next five years, allowing for sufficient time for operational reforms to yield results. It is expected that the refinanced debt would be particularly aimed at putting Road Sector Companies on a sustainable financial footing in the long term.

52. **The operation will set the Road Sector SOEs on the path to long-term financial sustainability**. Achieving the objective of this component is subject to other factors related to LSP implementation such as: consistent financial discipline on the part of all companies; successful implementation of the improvement program for the sector supported by component A and B; and future investments in amounts that are prudent and affordable.

53. **The Guaranteed Refinancing is a key part of facilitating the road sector reform and freeing sovereign resources for productive investments and developments**. As the Road Sector SOEs become gradually creditworthy on a standalone basis, they are expected to be able to finance their activities without the need for state guarantees (at least for motorway companies), thereby allowing a reduction in Debt/GDP, strengthening overall Croatia credit, allowing GoC access to cheaper funding and creating fiscal space for productive investments. Given the overall debt amount a further refinancing may be needed in 2018-2019 to finalize the operation. As stated earlier, it is possible that the government requests additional support from IFIs for refinancing or mobilizes MIGA guarantees.

---

[12] To the extent that the amount of debt required to be refinancing exceeds the Guaranteed Refinancing, further capital raisings with or without enhancement from IFIs is expected to be required.

B. Project Financing

Table 3 - Project Cost and Financing (in Euro VAT inclusive)

Project Components	Project Cost (EUR M)	IBRD Financing/ Guarnatee (EUR M)	Percent IBRD
Component A - Institutional Strengthening and Sector Reforms	***6.08***	***6.08***	***100.00%***
A.1 Strategy for Sector Debt Re-Structuring	2.83	2.83	
A.2 Transport Sector Planning and Road Sector Governance and Monitoring	1.25	1.25	
A.3 Implementation support	2.00	2.00	
Component B - Operational Restructuring of Sector Companies	***13.92***	***13.92***	***100.00%***
B.1 Road classification and standards	0.80	0.80	
B.2 Road Asset Management System (RAMS)	3.25	3.25	
B.3 Rationalize Operations and Business Functions (Motorways)	5.97	5.97	
B.4 Tolling	1.00	1.00	
B.5 Operational and Business Rationalization of HC	0.60	0.60	
B.6 Road Safety	2.30	2.30	
Unallocated	*2.00*	*2.00*	*100.00%*
Sub-Total (Components A and B)	**22.00**	**22.00**	***100.00%***
Component C - Debt Optimization *	***750.00***	***350.00***	***46.70%***
C.1 Debt Optimization Activities (IBRD Guarantee)	750.00	750.00	
IBRD Financed/Guaranteed Subtotal (Components A, B, and C)	**772.00**	**372.00**	***48.20%***
EBRD Support to Project Development Objectives	*250.00*	*0.00*	*0.00%*
Total	**1,022.00**	**372.00**	***36.40%***

**Note: EUR 750 million is expected to be raised with the support of a EUR 350 million IBRD Guarantee subject to final structure of the instrument and market response.*

Financing Terms for the IBRD Loan

54. The Bank will provide the loan to the Recipient at standard terms, with a maturity of ten years, including 4 years of grace. On -lending of the proceeds of the loan to the companies, which will benefit from the activities, is not envisaged. Retrenchment payments can be made using advances from a designated account of the Borrower or through reimbursement by the state after companies pay the retrenched staff.

Financing Terms for the IBRD Guarantee

55. The IBRD Guarantee would be issued for a maximum term equal to the tenor of the guaranteed debt. In accordance with the pricing policy for IBRD Guarantees, there is a Guarantee Fee of 50-100 basis points per annum (depending on the average life of the guaranteed debt and IBRD exposure) calculated over the amount of the Guarantee for the given year and payable from the date and as a condition to effectiveness of the IBRD Guarantee. Annex 7 includes the Term Sheet and summary description of the Terms and Conditions of the IDA Guarantee. The funds raised by the guaranteed instrument(s) would be on-lent by the sovereign to the Road Sector Companies.

C. Series of Project Objective and Phases

56. Not applicable

D. Lessons Learned and Reflected in the Project Design

57. **Importance of managing fiscal impacts and contingent liabilities associated with road investment programs in a sustainable manner.** The situation has carried on since the mid-2000s without adequate government oversight mechanisms, leaving sector investment policies ill-defined. The Companies lack revenue sources, and are burdened with excess staff that make operations inefficient and costly. The project is a comprehensive road sector solution encompassing government's overall investment policy and SOE control role, including a restructuring to set the stage for an efficient system. The operational and institutional issues are being addressed in MARS through various legal, normative, organizational and operational actions identified in the LSP and supported under Components A and B. The LSP also provides important mechanisms to limit the risk by committing the government to directly service the debt for new investment carried out by HC and placing a cap on investment.

58. **Significance of matching the duration of assets and liabilities in the financing of the road sector.** The current structure of road sector liabilities and guarantees is unfavorable because many loans have a short maturity of 5-10 years, with around EUR 3.0 billion of outstanding loans maturing between 2017 and 2019. This represents a significant refinancing risk for the Road Sector Companies. In the case of all companies borrowing commercially at short term and progressively rolling over the debt has led to a situation that is untenable. The assistance provided under MARS will better match liabilities with road asset life and put mechanisms and practices in place to prevent the sector from continuing short term borrowing and entering into unfavorable debt positions.

59. **Successful reforms require ownership and public consultation**. A lack of consultation around the originally proposed IPO process resulted in significant public concern that has delayed the resolution of the debt issues and reinforced opposition to private management of motorway operations. Learning from this, citizen engagement will continue to be important during the project, and the design of the MARS project includes support to assist government to engage with the public on how the debt will be re-structured; the way companies are re-organized; and to explain the social consequences (retrenchment process). The Project will also reinforce dialogue with users on quality of service. In terms of overall reform, the government successfully managed the adoption of the LSP and the announcement of the toll increase. Inside the administration and companies, the preparation of the LSP benefited from the work of eight working groups covering all aspects to ensure that the measures were either initiated by the staff of ministries and companies or designed with their inputs.

60. **Social aspects of companies' reorganizations require careful management.** On the employment side, the project design provides TA to develop the HR strategies and methodologies that will be used to address workforce reduction and redeployment, and to ensure adequate compensation is provided. Citizen engagement will be important to ensure that both the public, and company workers, understand why change is needed, and how that change will be

implemented. Where staff re-organization is identified in the Action Plans developed under Components B.3 (ii) and B.5, support for downsizing and public consultation will be provided under Components A3. MSTI engaged with unions on the subject of the Letter of Sector Policy including labor restructuring. During project implementation, the process of preparation of retrenchment plans will include consultations with workers' representatives (Works' Council and unions) at each company and other stakeholders such as Croatian Employment Service.

61. **Importance of considering alternative designs for complex reform programs and setting the right conditions for maximizing the value of PPP**. From a technical reform design perspective, PPP options were abandoned (as explained earlier) given the social aversion to such solutions in the short term. The revised competition framework for this sector approved by the EC in July 2016 now allows for public motorways to receive state aid with very few conditions, removing one of the main government justifications for privatization. More radical mergers of all motorway and Road Sector Companies would have caused disruptions without guarantees of savings. Radical short term outsourcing of maintenance of motorways was also considered but deemed technically complex (given the legal implications) and socially unacceptable (given the staffing impact). Finally, the preparation of the project has tested the capacity of the government to design and implement the reform program. It was therefore agreed that significant technical assistance was required to implement some of the critical aspects, while the main equipment required as part of the implementation (tolling equipment) would benefit from EBRD funding to ensure that the reform is not compromised by financial or technical shortcomings.

62. **Failed sector improvement attempts such as "monetization" of assets and IPO of operator company will not be pursued**. Perpetuating the debt through continuous refinancing could obviously not be pursued as a sustainable solution; nor was insolvency, as the state is intent on reducing debt. The proposed monetization that failed in early 2015 would not have allowed the government to get the most value from its public assets. The prices offered (below the total value of the debt outstanding) reflected the fact that the companies had not undergone reforms. In addition, in their offers, private bidders requested maximum flexibility to set tolls and adjust them periodically and other costly investor protections. In addition, under this alternative, a significant amount of debt would have had to be assumed directly by the State. Therefore, this measure was not only sub-optimal from an economic point of view but also not politically feasible. Lastly, the monetization only included motorways companies, postponing any modernization efforts in the road company.

63. **Refinancing lending instruments are not sufficient.** From a debt refinancing perspective, a situation without credit enhancement would lead the government to progressively take over most of the debt service for the companies. Use of direct long term refinancing loans were explored and the EBRD has accepted to contribute to the refinancing of HAC for EUR 200 million. While MDB refinancing loans are useful, it is not a sufficient or sustainable solution to address the significant amount of debt present, which requires using commercial lenders directly or employing market instruments.

64. **The Use of several World Bank Group instruments was considered for the guarantee instrument.** The principle of the project design requires that proceeding with the provision of a guarantee instrument, subject to adequate progress on the implementation of the LSP, which in a

lending context would typically be obtained through the use of disbursement linked indicators such as the ones used in Program for Results. However, no guarantee instrument exists as part of Programs for Results. The use of the funds leveraged by the World Bank Guarantee needs to be used for a specific purpose (repayment or refinancing of specific loans contracted by SOEs) and these funds need to be re-paid to the state by these companies. As a result, Policy Based Instruments cannot be used, as funds leveraged cannot be allocated to a specific use under a policy based instrument. Therefore, the most appropriate instrument is considered to be an IPF.

65. **This operation draws upon lessons learned from two recent guaranteed refinancings.** In 2016, the $500 million refinancing of the Kenya Power and Lighting Company's existing commercial debt reached financial close. This project highlighted that while the guaranteed refinancing provided some relief in debt service obligations, the undertaking of reforms to ensure operational efficiency and strong corporate governance was an important element to long term financial sustainability. In the case of the Ghana Policy Based Guarantee for a Sovereign Bond issued in 2015, a key lesson learned was that countries should build sufficient leeway into their financing timeline to ensure they have the flexibility to choose the right time to access the market. Secondly, countries should not limit themselves to a single market segment and instead develop alternatives to access multiple markets, as may be needed. The IBRD guarantee and the timing of its availability would provide Croatia with the flexibility to benefit from both of these lessons. As a result of its inherent flexibility, the guarantee could be adapted in response to market soundings that are being conducted by the Transaction Advisor. It could be segmented and used for accessing the same or different markets and at different times. The guarantee could support commercial financing in the loan and/or bond capital markets, and could be structured in a flexible way to provide principal and/or coupon coverage. The Bank's guarantee would be partial and apply on select debt service payments through a structure to be developed in coordination with the market, the Government and its Transaction Advisor.

66. **This operation draws upon lessons learned from two recent guaranteed refinancings.** In 2016, the $500 million refinancing of a Power Utility's existing commercial debt reached financial close. This project highlighted that while the guaranteed refinancing provided some relief in debt service obligations, the undertaking of reforms to ensure operational efficiency and strong corporate governance was an important element to long term financial sustainability. In the case of a Policy Based Guarantee for a Sovereign Bond issued in 2015, a key lesson learned was that countries should build sufficient leeway into their financing timeline to ensure they have the flexibility to choose the right time to access the market. Secondly, countries should not limit themselves to a single market segment and instead develop alternatives to access multiple markets, as may be needed. The IBRD guarantee and the timing of its availability would provide Croatia with the flexibility to benefit from both of these lessons. As a result of its inherent flexibility, the guarantee could be adapted in response to market soundings that are being conducted by the Transaction Advisor. It could be segmented and used for accessing the same or different markets and at different times. The guarantee could support commercial financing in the loan and/or bond capital markets, and could be structured in a flexible way to provide principal and/or coupon coverage. The Bank's guarantee would be partial and apply on select debt service payments through a structure to be developed in coordination with the market, the Government and its Transaction Advisor.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

67. The overall sector improvement will be supervised by a Project Steering Committee (PSC) chaired by the Minister of MSTI, and specific sub committees will guide and monitor all the technical and financial aspects of the sector restructuring and debt refinancing. The chair of the subcommittee for the financial aspects will lead the guarantee aspects of the project, together with the head of sector in charge of public debt in the Ministry of Finance. The chair of the subcommittee for technical reforms will provide oversight on the implementation of the LSP and advise the minister on its implementation. Committees' propositions that impact the implementation of the LSP are proposed by the chair to the minister for decision, while chairs lead the work of each subcommittees and will interact with the units in charge of implementation on a daily basis.

Implementation of components A and B of the projects (IBRD Loan)

68. **The Borrower will be the Republic of Croatia represented by the Ministry of Finance** (**MoF**), and the **Implementing Agency will be the MSTI.** However, the reform activities will cover not just MSTI, but also HAC, ARZ and HC. Technical support will be provided by several Working Groups established during project preparation, and TA will be provided to support a Project Implementation Unit (PIU) attached to MSTI. MSTI will provide technical support, fiduciary management and public relation inputs for all components, while the companies will carry out the technical oversight of the relevant TA contracts as appropriate and implement the Action Plans that derive from the LSP. The contribution of each company to the various components is listed in Annex 3.

69. Within each of the Companies, a team will be assigned to assist in managing relevant TAs, and to escalate issues to the PSC and PIU, where required. The Company teams will include overall coordinators, and persons responsible for technical investments, retrenchment and human resources aspects, and safeguards. These experts will perform the project-related work together with their regular responsibilities. The PIU will report to the Minister and the PSC, and will be reinforced by technical advisors on a needs basis, including for financial management, procurement, monitoring and evaluation, financed under project TA (except for procurement).

70. Annex 3 sets out a schematic view of the project implementation arrangements for the loan and technical assistance part of the project. Subsidiary and inter institutional agreements will spell out the responsibility of the companies in the implementation of the various projects subcomponents. A project implementation manual will be elaborated by the loan's effectiveness in order to describe the implementation arrangements for the project.

71. Funds related to retrenchment payments to be carried out by HAC will be transferred from the MSTI to HAC on a reimbursable basis subject to submission by HAC to MSTI of an appropriate documentation. Alternatively, HAC can also request advance funds from a designated account to finance eligible retrenchment expenditures.

Implementation arrangements for component C of the project (guarantee instruments).

72. On the basis that the IPF guarantee is applied to support a long tenor debt raising by Croatia, the Borrower and the Implementing Agency will be the MoF which will on-lend funds to refinance debt. The Road Sector Companies will be party to the Project Agreements with IBRD regarding their use of the on-lent funds. Croatia is expected to pass the proceeds of the guaranteed financing to the respective Road Sector Companies through downstream agreements with each road company. It is expected that a Transaction Advisor already selected will undertake, on behalf of MoF, investor pre-sounding to inform on the amount, tenor, terms and type of financing to be undertaken with the support of the IBRD guarantee.

B. Results Monitoring and Evaluation

73. **MSTI will be responsible for monitoring and evaluating results.** Component A-2 will support the definition of a monitoring system which will allow MSTI to monitor most of the quantitative indicators under the project automatically and facilitate transmission of information from the companies to the government. Disclosure of results and actions is also a critical element of the corporate governance plans adopted by the companies, and all company level indicators are part of the companies' KPIs. Table 4 summarizes the indicators and responsibilities for correction.

74. The MSTI will prepare a project report each semester based on the set of indicators below, which will also report on all aspects of implementation. This report will also include the interim financial reporting of the loans.

Table 4 - Intermediate Results Indicators

Indicator Name	Relevance	Data source
Ability of MSTI to plan road sector investments	PDO	MSTI
Ability of MSTI to monitor performance of motorways & Road Sector Companies	PDO	MSTI
Operating Expense Ratio	PDO	MSTI model, co's
Operating Expenditures per kilometer	PDO	MSTI model, co's
Debt Service Coverage Ratio (DSCR)	PDO	MSTI model, co's
Loan Life Coverage Ratio (LLCR) 10 Year	PDO	MSTI model, co's
Debt to CFADS Ratio	PDO	MSTI model, co's
Status of implementation of new financing strategy	A.1	MSTI
Operational status of Planning Department established in MSTI	A.2	MSTI
Implementation status of service agreements (MSTI & Road Sector Companies)	A.3	MSTI
Weighted Average toll revenue per Vehicle-Km travelled	B.4	MSTI, co's
Status of implementation of new toll revenue enhancement measures	B.4	MSTI
Percent Reduction in Operating Cost of Motorways rel. to baseline	B.3	MSTI model, co's
Reduction in Operating Cost for State Roads rel. to baseline	B.5	MSTI model, HC
Staff per Kilometer of road under operation (motorways)	B.3	MSTI, co's
Implementation status of end-performance road maintenance standards	B.1	MSTI
Implementation status of Road Asset Management System (RAMS) development & incorporation in planning	B.2	MSTI
Percent of HC network where county agencies (ZUC) participate in joint procurement committee	B.5	MSTI, HC
Percentage of TEN-T road network for which road safety audit or inspection as per EU Directive 2008/96 has been carried out	B.6	MSTI, co's
Citizen engagement - Percentage of satisfied road users	B	Companies
Gender balance - Number of staff retrenched in the motorway operator (gender disaggregated)	B	Companies
Private Direct Mobilization (Debt Refinanced with IBRD Guarantee)	C	MSTI
Private Indirect Mobilization (Debt Reprofiled)	C	MSTI
Weighted Average Maturity of Road Sector Agencies Debt	C	MSTI model

C. Sustainability

76. The sustainability of the road sector assets is enhanced by the implementation of a comprehensive road asset management system. It will allow the companies to have an evidence based short and medium term planning. The resizing of maintenance operations will also incorporate improvement and compliance with EU safety directives. The review of maintenance standards prior to implementation will ensure that the substantial cost savings expected are not made at the expense of the quality of maintenance and safety.

77. Environmental sustainability derives from the sustainability of the asset management system. Environmental compliance of the operations will also be tested in the first year of the project (see safeguards section in section VI). As the tolling policy will be modified, it will also be used to ensure that the pricing is commensurate to the environmental impact, especially for the heavy trucks.

78. The debt sustainability of the sector is one of the main purposes of the project. It is discussed in section VI.A. the overall improvement of the system efficiency through the LSP implementation is a main driver of this increased sustainability.

V. KEY RISKS

A. Overall Risk Rating and Explanation of Key Risks

79. There are two main drivers of project risks: (a) the project design as a combination of a guarantee and investment project financing instruments, that covers four implementing agencies, and has major fiscal implications; (b) the ambition to re-shape the culture of key stakeholders, from entities that were primarily focused on building infrastructure to companies that manage, operate and maintain existing assets to defined services and standards. The overall project risks are assessed as substantial. The main risks are presented as follows:

Table 5 - Systematic Operations Risk-Rating Tool (SORT)

Risk Category	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project	Substantial
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environmental and Social	Substantial
8. Stakeholders	Substantial
9. Others: Financial Markets	Substantial
Overall	***Substantial***

Table 6 – Risks Rated as Substantial and the Mitigation Measures

Key Risks	Mitigation Measures
Political and Governance	Following several years of political uncertainty, a coalition government is in place and the current context is stable. However, given that supporting sector reforms require coordination among various levels of government and the SOEs, there is a risk in sustaining strong ownership with a coalition government. The risk is partially mitigated in that the sector policy is tied to orientations agreed with the EC and has been discussed and endorsed by all political parties over a three-year period when perceptions of political uncertainty were elevated. In terms of governance, the very high visibility of the sector reform, as well as the proposed disclosure of sector monitoring and companies' performance (KPIs agreed upon under the project) will be critical elements to limit the risks.
Macroeconomic	Following a prolonged recession and unstable macroeconomic situation, Croatia has started economic recovery with all major macroeconomic indicators showing signs of improvement. Long-term forecasts remain difficult, amid still very high levels of fiscal deficit and public debt, which call for further fiscal consolidation at the expense of financing implementation of restructuring programs, or may lead the government to abandon measures for improved road revenue collection. Delays in implementation of structural reforms, which would slow down economic growth and expand the fiscal deficit, may impact the sovereign credit rating. A potential rating downgrade would increase the cost and availability of borrowing, affect the proposed debt optimization and make the overall implementation of the project more expensive. Though the overall macroeconomic risk is difficult to mitigate, Croatia is also under close supervision of the EC which may propose corrective actions shall the macroeconomic situation worsen.
Financial Markets risk	Appetite of loan and bond capital markets can vary depending on external events as well as evolution of interest rates. The policy of the European Central Bank as well as other external events may impact the pricing and terms of Croatian debt raising indirectly. If market conditions at time of debt raising are not favorable, the government may authorize the companies to enter into short or medium term bridge financing rather than long term refinancing with the use of partially guaranteed instruments. Subject to further market sounding, a partially guaranteed instrument should in principle allow companies to obtain attractive, long tenor financing in good conditions. However, after the reprofiled amount and terms are known, the amount of refinancing required to solve the remaining debt challenge or a shortfall of MDB appetite to provide support could leave part of the challenge unresolved.
Sector strategies and policies	Success of actions to be implemented for improving management and performance of the Road Sector Companies, or sector and corporate policies, are contingent on the government's capacity to manage the road sector and coordinate decisions across several ministries and enforce the implementation of the LSP. Hence, slow implementation of improvement programs may send a negative signal to private financiers and limit their interest in debt optimizing for the further phases. Likewise, failure to meet project targets related to implementation of improvement programs, may as a consequence delay provision of the Bank guarantee instrument and delay other parts of financial restructuring. Project design, by which financing is contingent upon adequate implementation of improvement measures, mitigates the risk, and both the LSP and the sector

	strategy have been consulted widely in the government. The conditions for the issuance of the guarantee instrument already include revenue and cost measures and significant governance and transparency commitments. During placement, the government will indicate to its lenders and investors its commitment to the sector reform program under the LSP. Failure to honor these commitments would jeopardize the trust of the market in the government.
Technical design of project	The project would represent the largest ever World Bank intervention in Croatia. Failing to implement it on time and with desired outcomes may reflect negatively on Croatia's macroeconomic position and represent a reputational risk for the Bank. This is particularly important in relation to the private sector interest to participate in debt optimizing, the extent of which is unpredictable and goes beyond the area of control of the Bank. Initial market sounding raised significant interest of potential financiers, while the project designs a flow of funds raised in the market for debt repayment. The main mitigation to the reputational risk lies in the public disclosure of government commitments under the LSP (evidenced by ample press coverage even at draft stage), political consensus on the need for external support, and need to comply with commitments vis a vis the market.
Environmental and Social	The attempted concession of HAC/ARZ faced a very strong civil opposition, putting the government under close public watch for any decision involving the sector. In addition, project support to retrenchment process may be perceived negatively and implemented with delays, and risks triggering unions. To mitigate this risk, the team has verified compliance of the measures taken by the companies with the law and collective bargaining agreements. The most significant retrenchments are likely to be in HAC-ONC. As part of its loan, EBRD has already allocated a grant for technical studies to support restructuring, which included the preparation of a labor restructuring plan to comply with EBRD's policies in relation to social safeguards. In addition, to meet the World Bank requirements on retrenchment, companies prepared satisfactory retrenchment framework applicable to all companies. The principles laid out in the framework will govern the retrenchment process financed by the World Bank. Appropriate grievance and redress mechanisms were also incorporated into the project.
Stakeholders	The main risk is linked to the multiplicity of stakeholders and to the resistance to change possible in the companies. Mitigation requires constant engagement by management with the companies' staff and constant coordination between stakeholders through the project coordination.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

For confidentiality purposes many elements in the economic and financial analysis could not be disclosed as they may impact the debt optimization process

Current Position of Companies

80. Operating Efficiency: The strained operating performance of the companies has resulted in an inability to service debt obligations without strong GoC support while adequately maintaining assets. This situation has resulted in the Road Sector SOEs financing liabilities with additional liabilities through continuous short term refinancing and without resolving underlying operating issues or short debt maturities. The table below shows that for all three Road Sector Companies, the operating margin is insufficient to cover both capex and debt service obligations (Current portion of long term debt plus financial expenses):

Table 7: companies operational and financial indicators (in HRK million)

HRK Millions	2013	2014	2015
HAC Operating Margin	716	820	924
HAC CapEx	1,817	645	366
HAC Debt Service Obligations	4,961	3,280	3,957
HAC Total Debt	22,231	23,728	23,367
ARZ Operating Margin	256	255	212
ARZ CapEx	23	8	4
ARZ Debt Service Obligations	1,723	650	708
ARZ Total Debt	7,321	7,212	7,461
HC Operating Margin	1,943	2,043	1,463
HC CapEx	1,542	1,087	n/a
HC Debt Service Obligations	883	1,172	1,550
HC Total Debt	8,839	9,774	10,154

81. Debt Sustainability: Out of the three Road Sector Companies, HAC has the highest debt burden with HRK 22.6 billion of debt (59% of the total sector debt), followed by HC at HRK 9.3 billion (24% of total debt), and ARZ with HRK 6.4 billion (17% of total debt). The majority of the debt is short term in nature with a weighted average loan life of 3.5 years. Not only is this significantly shorter than the life of the road assets, but it also puts significant pressure on the companies to service all of the debt in the next three years while exploring short term refinancing options.

Impact of the Project

82. The proposed operation is expected to improve the cash flows available to service debt obligations. It will also reduce the current portion of long term debt due in any given year. This will allow the companies to service their debt without increasing pressure on GoC support.

83. The sector reforms detailed in the Letter of Sector Policy target operational improvements that would improve both operating margins and cash balances in the near term. Toll revenues across HAC and ARZ are expected to improve from HRK 2.4 billion in 2017 to HRK 2.7 billion in 2021 (an increase of 14.5 percent), while operating efficiency improvements related to staffing reductions and other factors are expected to reduce operating costs from HRK 830 million in 2017 to HRK 646 million in 2021, a reduction of more than 20%. Further reduction can be assumed from complementary measures.

84. However, operational reforms alone will not be sufficient to put the Road Sector Companies on the path to independent financial sustainability, given that 55% of the total debt stock matures in the next three years. The World Bank partially guaranteed debt optimization aims to extend the maturity of the existing loan portfolio from up to 7 years to 15-20 years. This exercise is expected to "smoothen" debt service payments. This would improve the ability of the companies to meet debt service obligations without the constant need for short term refinancing which require significant management attention. Annex 5 provides additional details on the improvement in operating and financial ratios.

Economic assumptions

85. Inflation projections[13] assume a 2.0 percent rate from 2020 onwards (baseline case) and multiplication factors of 1.1/0.9 for the optimistic and pessimistic cases, respectively. Exchange rates as of January 2, 2017 (7.55 HRK/EUR; 1.05 USD/EUR) have been used for the baseline scenario. For the pessimistic and optimistic scenarios, the high and low values from ECB reference exchange rate data (yearly averages) between 2006 and 2016 have been used, respectively; and also to identify the lowest and the highest exchange rate (average of observations throughout the year) in the period from 2006 to 2016 (for HRK/EUR the range is 7.22 to 7.63; for USD/EUR the range is 1.05/1.47).

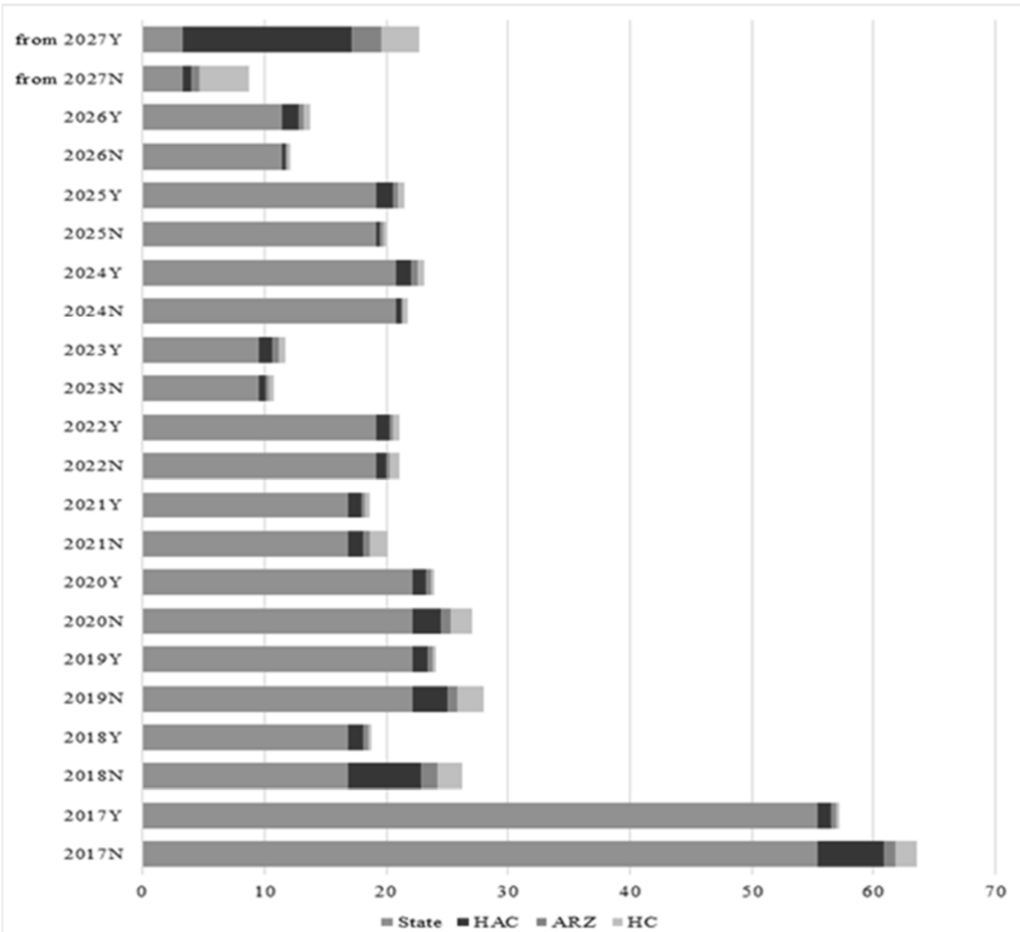
86. GDP and tourism growth rates, both being drivers of traffic demand, are in accordance with World Bank projections from June 2016 in the baseline case (2.4 percent from 2018 onwards); pessimistic growth rates are derived from World Bank projections of March 2016 (2.0 percent from 2018 onwards) and optimistic ones from extrapolation of Croatian Ministry of Finance estimates (3.2 percent from 2017 onwards).

13 IMF's World Economic Outlook Database (April 2016)

Impact on Debt and comparison with State debt service

87. **The current level of road sector debt and their statistical treatment.** As from 31 December 2010, the official sector classification of institutional units in the Republic of Croatia is based on ESA 2010 methodology. Under it, the central government debt and deficit comprises ARZ, HAC and HC (from 2008).

Figure 3: Total State Debt Service, in billion HRK



Total state debt service, in billion HRK

Note: State debt service relates to central government debt only excluding other general government sectors and public enterprises. "N" after years denotes scenario without the project, whereas "Y" denotes the scenario with the project.

88. In the period 2010-2016, the general government debt increased from 58.3 percent of GDP to 83.7 percent increase of debt since 2010 has been affected by the accumulation of budget deficits and factors that are mainly related to the realization of potential risks related to companies in state ownership. In addition, the level of general government debt was significantly influenced by the reclassification of several highly indebted companies in state ownership to the general government sector. The biggest impact on the general government debt so far was marked by the inclusion of the three following subjects: HAC, ARZ and HC.

89. The biggest short term impact of the debt optimization side of the project relates to the short term strong decrease of the consolidated debt service of the state in the coming four years, as illustrated by Figure 2 above.

B. Technical

Sector Reforms and Improvements

90. Sector improvements will encompass all State road and motorway companies, and will introduce reforms aimed at (a) Providing tools and systems for improved governance and monitoring by MSTI of the Road Sector SOEs operations; (b) providing mandatory criteria for investment planning and prioritization of capital investments against clear economic and social assessment criteria; (c) promoting operational improvements and efficient provision of maintenance through a functional analysis of the requirements of the core business functions and preparing Action Plans to deliver those improvements; (d) improving transparency and competition in procurement of maintenance for State Roads; (e) providing improved systems for road and motorway asset management and addressing the backlog of periodic maintenance through improved asset management planning; and (f) optimizing revenue sources, rationalizing operational and administrative functions and right-sizing staffing to ensure that sufficient budget is available to provide road maintenance to a consistent service levels and performance standards.

91. The LSP[14] presents the main directions for road sector reform in the three key areas of (a) sector governance, (b) investment planning, financing and implementation, and (c) companies' governance and operations.

92. In **sector governance**, a national transport strategy is in the process of official adoption. A technical classification is being officially published, with unified criteria for applying uniform maintenance standards in accordance with the traffic level and functional importance of any given road. Maintenance regulations and end-performance specifications will be developed for all technical categories of roads. Restructured companies are to contribute to optimized management of the road sector: the new planning and strategy department in MSTI will coordinate the investment plans of Road Sector Companies; and HAC is to become the integrated provider of operation and maintenance services for the entire state-managed motorway network, through absorption of the operator HAC-ONC and the merger of operational activities with ARZ. The operation and maintenance organization of the new HAC is to be optimized through examination of alternative outsourcing scenarios and streamlined regional organization, creating economies of scale.

---

[14] The full text of the LSP is at the beginning of Annex 2.

93. In **investment planning, financing and implementation**, capital investment plans for 2017-2020, and henceforth on an annual rolling basis, shall ensure sustainable financing of periodic maintenance and limited funding of new construction projects in accordance with prioritization criteria and EU funding availability, given the advanced level of network development. Road Asset Management Systems for motorways and state roads will provide the tool for optimized investment programming of periodic maintenance. The fuel tax will remain the main source of financing for the state roads and partly for HAC. For HAC and ARZ, the main revenue source of toll revenues will be enhanced through both an upward adjustment of fares and the gradual introduction of an automated system, maintaining the existing distance-based principle while at the same time optimizing costs and allowing improved reflection of external costs (congestion, emissions) in the pricing. Finally, pending road safety enhancements - such as in safety barriers, tunnel safety, axle-load control, blackspot improvements and road safety audits/inspections - are expected to contribute to improvement in Croatia's road safety statistics, which remain poor compared to most EU countries.

94. In **companies' governance and operations**, corporate governance plans have been adopted, which introduce performance management contracts and increased transparency and accountability provisions. Human resources management will be a crucial part of reforms, both for assistance to the management and HR department during the labor optimization process and retraining for modernizing the existing HR policies. Finally, the management of HC and in particular its maintenance activities will be reorganized, introducing operational improvements aiming at optimizing maintenance costs, improving contractual practices and increasing competition in the market. The new end-performance standards as well as the introduction of joint procurement with county road authorities (ZUC) are expected to strengthen HC's capacity while increasing transparency.

Financial and Debt Optimization

95. The appraisal of the Guarantee required a comprehensive assessment of the financial situation and prospects of Road Sector SOEs, including detailed financial projections under various scenarios of traffic demand, maintenance costs and financing costs and the Bank suggested early in 2016 to the government to recruit a financial transaction advisor to support this work.

96. **The Government is working with a Transaction Advisor to confirm and further develop a financing strategy and this strategy is constantly updated** with full consultation of the Bank team. The development of an optimal financial strategy for the road sector has two main components. The first is to optimize CFADS, which the LSP addresses. The second addresses debt optimization, for which two approaches, conducted sequentially or in parallel, are recommended. The first tackles the more expensive and shorter-term loans that could be refinanced with longer-term facilities. The second is for the GoC and Road Sector SOEs to negotiate a reprofiling of loans that are cost-effective but maturing in the short term. In addition, the actions related to public investment management in the LSP will allow GoC to control the level of additional debts, and in the case of HC, the state itself would take or directly service any new lending for new construction to avoid further accumulation of liabilities at the Company level.

97. **The appraisal of the Guarantee required a comprehensive assessment of the financial situation and prospects of the Road Sector SOEs**, including detailed financial projections under

various scenarios of traffic demand, maintenance costs and financing costs. An assessment of the many loans into which the Road Sector Companies have entered was also required, to understand creditor rights and the limitations to organizational change that may need to be renegotiated. These findings are not included in this Project Appraisal Document for reasons of commercial confidentiality.

98. **The Bank team developed a comprehensive financial model for each of the companies to analyze their financial outlooks**. The models consider earnings and projects the cash flows associated with each individual loan held by the companies. The model projections were able to demonstrate the scale of the problem for the government and the companies while dividing the challenges into individual elements. The model was then adapted to project the pool of cash available for debt service in each year and to calculate how much of that pool was available for commercial debt after making allowance for debt coverage factors and IFI debt. This exercise identified that some EUR 4.0 billion of debt in aggregate could be sustained by the companies from sector earnings over twenty years (compared to the EUR 5.2 billion of debt stock). On this basis, almost all debt requires optimizing in some manner. The financial model was also used to calculate the optimal debt profile within the twenty-year time horizon. This provided insights into the extent to which the debt stock would need re-profiling.

99. **Consideration of guarantees also required an assessment of the financing options available to the Road Sector SOEs in the commercial market**. The assessment to date confirmed the urgent need and the benefits of optimizing a substantial portion of road sector debt. It also provided a clear indication of the annual investment that Road Sector SOEs can afford in the medium term and of the negative financial impact that excess investment, lower than expected demand growth and any delay in tariff adjustments by the motorway companies could be expected to have for each company and for the sector. A summary of the conclusions is included in the Appraisal Summary and in Annex 5.

100. **A method has been devised for optimizing debt**. The Transaction Advisor has analyzed all the loans (commercial and IFI) on the balance sheets of HAC, HC and ARZ, based on the type of creditor, remaining loan life, amount outstanding and financing terms. Each loan was then categorized for optimization in the form of prepayment, reprofiling or no action.

101. **For commercial debt, the recommended approach depends on the remaining term and size of each facility.** No action is recommended for loans having a remaining average life of less than one year, as these are likely to have matured by the time the financial strategy is in effect. Loans with less than EUR 20 million outstanding have also been disregarded because these have little impact on the strategy. Action is focused on loans with an average maturity of more than a year and with more than EUR 20 million. These are referred to as Actionable Loans.

C. Financial Management (FM)

102. **The fiduciary financial management assessment** of the Project including the IPF IPF Loan (IBRD Loan) and the Bank Guarantee seeks to obtain reasonable assurance the proceeds of the IBRD Loan and the proceeds of the Bank-guaranteed debt are used only for the purposes for which the financing is granted, with due attention to considerations of economy and efficiency.

The assessment concludes that financial management arrangements including existing country and entities' systems in place, together with proposed measures are sufficient to support the operation, and the fiduciary financial management risk is moderate.

103. **FM implementation arrangements for the IBRD Loan** will use existing financial management systems and accounting staffing in MSTI, Road Sector Companies and State Treasury for the project fiduciary purposes. *FM issues and action plan.* One identified weakness relates to the lack of experience in managing World Bank financed projects. Thus in order to strengthen project implementation capacities and to supplement existing accounting staff, MSTI should assign a staff (via internal recruitment, from Road Sector Companies or external) to perform project financial management functions related specifically to the IBRD Loan.

104. **Flow of funds.** At the request of the MSTI the MoF will create an analytical account in the State Treasury which will be used as a Designated Account (DA) in line with the existing treasury procedures. The loan funds will flow from the Bank through the Croatian National Bank to the DA and via Treasury system and MSTI to contractors on the basis of approved invoices, or to HAC to finance eligible retrenchment payments.

105. **Financial Accountability and Reporting.** The MSTI will prepare semester un-audited interim financial reports (IFRs) related to the use of Loan proceeds that will be submitted to the Bank within 45 days of the end of each calendar semester, from the first disbursement and throughout the project life. The project financial statements, including Statement of Expenditures (SOE) and Designated Account (DA) Statements will be audited by independent auditors acceptable to the Bank and on terms of reference acceptable to the Bank. The annual audited project financial statements and the audit report will be provided to the Bank within six months of the end of each fiscal year.

106. **FM arrangements for the Bank-guaranteed debt. Flow of fund and reporting**. The proceeds of the Bank-guaranteed debt (that is, the Sovereign Financing) to be issued by the Republic of Croatia will be transferred to HAC, ARZ and HC, which will use those proceeds to repay or pre-pay the selected loans. The proceeds from the issuance of the Bank-guaranteed debt will flow to the bank account of the Republic of Croatia held in the Croatian National Bank. The MoF/MSTI will prepare and submit to the Bank a letter/ report confirming receipt and use of the proceeds for each of the Bank-guaranteed debt which will be also subject to an audit.

107. **Performance Monitoring** of the participating companies is vital to the project and sustainability of the road sector. Thus during the project life, the Bank will also require annual audit of financial statements of each company and each group to be submitted by HC, HAC, and ARZ (if applicable following the sector restructuring). The respective requirements are linked to both guarantee and loan parts of the Project for which the Road Sector Companies are beneficiaries.

108. **Entity level FM issues and action plan.** One of the identified weaknesses relates to broader financial management capacity at each road company level including application of various accounting standards and policies by the Road Sector Companies. As required in the Road Act HC, HAC are using specific accounting regulations (some revenues and expenditures are charged through capital and public good road infrastructure assets resulting in reporting "zero" financial results of the companies) departing from International Financial Reporting Standards (IFRS), which are obligatory for Entities of the Public Interest in Croatia. ARZ, a 100 percent State owned company, is applying IFRS following the business model of the private sector

concessionaire (thus not showing infrastructure as tangible assets on its balance sheet but as concession rights), and obtained modified (qualified) audit opinions of its annual financial statements. As a result, financial statements are not reflecting financial results of the companies and cannot be used as a clear key financial performance indicators for comparisons with peer foreign companies. The key financial documents including audit reports, business plans and financial plans (prepared in line with Road Act with the main focus on financing of the investment and maintenance plans) are publicly available on the companies' websites. Companies are also preparing a number of monitoring and financial reports to various entities but there is a need to select and focus on financial KPIs which are relevant and for which management and MSTI will be held accountable. The IBRD Loan addresses the above issues through sub-component A2: Transport Sector Planning and Road Sector Governance, including improvement and of accounting regulations, policies and practices across the sector companies; development a Sector Governance Framework including definition for KPIs and monitoring arrangements; and establishment of an application for data exchange and reporting between the Ministry and the Road Sector Companies.

109. During the project implementation the Bank will monitor actions taken by Government and companies to resolve financial reporting issues in order to ensure application of adequate accounting standards and policies consistent for all Road Sector Companies reflecting real operational and business model and to provide faithful representation of the financial position and performance information in the financial statements which should be also used for decision making and exercising corporate governance mandate by MSTI or the Ministry of State Assets.

D. Procurement

110. A **Capacity Risk Assessment** of the implementing agency for carrying out and managing procurement was finalized during project appraisal. Based on the findings of the assessment, the risk for procurement after mitigation is determined as **moderate.** A summary of the risk assessment, including the risks and the proposed mitigating measures, as well as the specific procurement arrangement for the project will be provided in Annex 3.

111. **Applicable Guidelines.** The project will finance mainly consulting services contracts and few goods contracts. Since the Project Concept Note of the project was approved prior to July 1, 2016, all goods and consulting services required for the activities of the project and included for financing from the Loan proceeds shall be procured in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" dated January 2011, Revised July 2014 and "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" also dated January 2011, Revised July 2014; and the provisions stipulated in the Loan Agreement. A summary of the various items under the different expenditure categories are summarized further in Annex 3. According to the World Bank current policies and procedures, the project is automatically redirected to the Systemic Tracking of Exchanges in Procurement (STEP) platform of the World Bank and all procurement related actions have to be conducted through STEP.

112. **General Procurement Notice (GPN)** for the project will be published after project

negotiations in United Nations Development Business (UNDB), the World Bank's external website, in *Narodne novine* (Official Gazette) and on the implementing agency's website.

113. **Advance Contracting and Retroactive Financing.** In order to accelerate project implementation, the Bank and the Implementing Agency agreed in advance on the selection process and contract signing of one large consulting assignment and of several contracts. For the contract for a Financial Advisor under reference number A1 - a QCBS – MARS, a selection process was carried out during project preparation. The selection procedure applied was QCBS and on November 30, 2016 the Bank issued a no-objection to the draft negotiated contract with the winning consultant for the amount not to exceed EUR 2,822.325,00 exclusive of local indirect taxes. It was noted in the no-objection that the referenced contract is eligible for financing from the Loan proceeds for the proposed Modernization and Restructuring of the Road Sector Project when it is approved and becomes effective.

114. **Procurement Plan:** A summary procurement plan, covering the first 18 months or project implementation was agreed at project negotiations. The summary procurement plan, including as a minimum (i) a brief description of the goods, works, non-consulting services and consulting services required for the project; (ii) the proposed method of procurement; (iii) the Bank's review requirements; (iv) timeline, contract commencement and completion. After loan negotiations, the agreed summary procurement plan will be published on the Bank's external website, as well as all its subsequent updates once the Bank issued no-objection to them.

115. **Anti-corruption measures.** The MSTI and the Road Sector Companies, through the PIU, will implement the Project in accordance with the World Bank's Anti-Corruption Guidelines (ACGs) including not engaging services of firms and individuals debarred by the Bank. The list of such debarred firms and individuals is located at http://www.worldbank.org/html/opr/procure/debarr.html In addition, the agreements relating to the guarantee will appropriately reflect the Anti-Corruption Guidelines for World Bank Guarantee and Carbon Finance Transactions, requiring the relevant parties not to engage in corrupt, fraudulent, obstructive, coercive or collusive practices with respect to their respective participation in the Project or to engage entities debarred by the Bank as per the above.

E. Social (including Safeguards)

116. The project will not finance physical investments and civil works, therefore OP 4.12 on Involuntary Resettlement is not triggered. An overall Environmental and Social Compliance Report (See Section F) will review the overall sector practices in related areas as part of the capacity monitoring of the sector.

117. The most significant social risk related to the loan activities and to the sector restructuring in general is associated with the labor restructuring in the four roads companies (ARZ, HAC, HC and HAC-ONC). OP 4.01 applies to the social risks and impacts of the Project associated with retrenchment. As of November 2016, the four companies together employed about 3516 people, out of which HAC - ONC employed 2,832 workers, HC had 445 workers, HAC had 203, and ARZ had 36 employees. The number of workers affected by labor restructuring will be known upon

establishing the new operating model of the four roads companies. It is estimated that there is substantial likelihood that toll and maintenance staff will be mostly affected by the workforce reduction due to automatization and review of operational standards for these business functions.

118. The retrenchment process is governed by a robust set of national labor regulations and Collective Agreements, which result from comprehensive and periodic negotiations with the unions. The companies expressed their preference to conduct the workforce reduction on a voluntary basis through early retirement packages or incentive severance compensation. Applicable collective agreements for HAC, HC, ARZ and HAC - ONC, provide for design of such incentive severance program. This process shall be conducted in collaboration with the respective Works Council at each company. The companies and councils would jointly determine the conditions for the implementation of the incentives programs. The EBRD loan already includes a provision for separations in HAC and HAC-ONC. World Bank and EBRD safeguards policies related to retrenchment are consistent. If there is a need to conduct involuntary redundancies, this process will be carried out in compliance with collective agreements, national labor regulations and good international practice. The IBRD loan will finance severance payments only in respect of HAC.

119. The companies prepared a retrenchment framework, applicable to all respective companies, based on the aforementioned national regulations and collective agreements, as well as good international practices, aimed at ensuring a transparent and fair process. The framework was prepared in accordance with World Bank policies on retrenchment. The Framework lays out applicable national legal framework, the workforce profile, available methods of retrenchment, selection criteria options, formulas for the calculation of the severance payment and the grievance mechanism available to the workers affected by labor restructuring. The draft retrenchment framework was discussed with the roads sector restructuring working group on human resource modernization during project preparation. The MSTI also engaged with unions on the subject of the Letter of Sector Policy including labor restructuring in February 2017.

120. Once the impacts of labor restructuring at the level of each road sector company are known (HAC including HAC-ONC, HC, ARZ), each company will prepare a retrenchment plan, which will be reviewed and approved by the Bank, as an instrument to manage, implement and monitor retrenchment. The plans will be based on the principles and procedures laid out in the retrenchment framework. Each company has legal and human resources department, with prior experience in labor restructuring. During the process of retrenchment plans preparation, companies will carry out consultations with workers' representatives and other stakeholders such as Croatian Employment Service. It is estimated that the timeline for retrenchment plans preparation and carrying out consultations with key stakeholders is three months. The IBRD loan financing for retrenchment is limited to HAC (including HAC-ONC) as it is estimated that the number of staff to be retrenched in HC and ARZ should be very limited.

121. During retrenchment plan preparation, companies will consult with worker representatives (Works' Council) on the program of voluntary separations, on the eligibility criteria for voluntary separation, and if applicable, on the collective dismissals process including the selecting criteria. These consultations are legally required by the applicable labor law and collective agreements. Under the Labor Law (2014), consultation with the company's Works Council is required throughout the process of retrenchment. Information submitted to the Works Council in writing

must include the reasons for projected redundancies, the total number of employees within the company, the total number and categories of employees most likely to be made redundant, the selection criteria for choosing redundant workers, the amounts and formulae for calculating severance and other payments, and the measures taken to mitigate the effects of redundancy. Consultations with the Works Council should also look to explore and explain all options and proposals that could avoid the need for dismissals. Collective agreements require the explicit approval and cooperation of the Works Council in order to decide what criteria (and under what weightings) workers may be scored under a process of collective redundancy. As per the Labor Law, Article 127, paragraph 5, an employer must notify the public institution responsible, regarding consultations held with workers' councils and notify the Croatian Employment Service (HZZ) of its retrenchment decisions and enable the service 30 days to review its plans. During this time, HZZ has the power to postpone the process for up to 30 days more in order to mitigate the negative circumstances of the retrenchment or explore such avenues further. In addition, the companies will make further efforts to ensure that the unions and affected employees receive timely and clear information about the retrenchment process, preparation of retrenchment plans and corresponding alternatives throughout the process. All consultations with Works Council and unions will be documented.

122. **Gender**: The Retrenchment Framework is gender informed and gender desegregated data will be monitored in the retrenchment plans. It is expected that men will be more affected by staff reductions as they represent the majority of employees in three companies: HAC - ONC (478 women and 2,354 men), HAC (97 women and 106 men), HC (188 women and 257 men) and ARZ (22 women and 14 men), and occupy majority of positions in the toll and maintenance functions. The Retrenchment Plans will include gender disaggregated information and clear criteria for non-discriminatory process for identifying redundancies and corresponding grievance redress mechanisms, such as access to the Croatian Ombudsperson for Gender Equality in case a worker feels that they are being treated unfairly or discriminated against based on gender. The monitoring and evaluation processes associated with the implementation of the Retrenchment Plans will also include gender-specific indicators. As part of the monitoring of the project impact, the companies have agreed to an indicator tracking the proportion of men and women in the overall staffing with a view to increase the proportion of women in the companies.

123. **Citizen Engagement:** In terms of citizen engagement, there is an active program of engagement with citizens/road users and grievance redress at the level of the motorway operator through their website. Email and phone of the information centers are also available to local and international road users. More than 16,000 requests have been received in 2016 and all responded to. Citizen engagement will be monitored through a specific indicator part of the project report, reviewing the companies' response rate to customers' requests. Tracking of customers' satisfaction through an annual customers' satisfaction surveys carried out by the motorway operator. The process of consultations and engagement with workers related to labor restructuring is described above.

124. Roads Sector Companies which will carry out labor restructuring will establish grievance mechanisms at the company level. These specially appointed committees will serve to resolve complaints by employees in relation to the application of selection criteria for involuntary redundancies. In addition, to the company level grievance mechanism, the Labor Law provides the core elements for the protection of workers' rights and prescribes the procedure for submitting and

resolving complaints. To ensure that the issues raised are appropriately addressed and closed-out, the results of the company level grievance mechanism (i.e. the number and type of comments/grievances received and timely resolution of complaints) will be reported on in the retrenchment plans implementation reports.

F. Environment (including Safeguards)

125. **Environmental Assessment OP/BP 4.01 is triggered**, as the umbrella Safeguards policy, under the project as Clients are performing various planning and roads maintenance operations of different size and scope that are impacting environment and might have adverse environmental impact. These planning and maintenance activities are not components of the Project. However, as the project is looking to reinforce the sector planning functions, support improvement in operations efficiency and financially optimize the road sector, looking into environmental and social management systems (ESMS) and performance represents a good practice. The Project also supports severance pays, which falls under the overall umbrella safeguards policy, and which justify the Category B rating.

126. In order to address the related environmental and social issues, the Companies (HAC, HAC ONC, ARZ and HC) will prepare an Environmental and Social Compliance Report (ESCR) to assess companies' ESMSs and performance, one year after Project effectiveness under terms of reference satisfactory to the Bank, and on the basis of said ESCR, the Road Sector Companies will: (i) prepare and disclose an action plan that, *inter alia*, identifies actions, agreed with the Bank, as may be necessary for the environmentally and socially sustainable management of the Borrower's road sector; and (ii) adopt such action plan not later than three months after the completion of the ESCR. The latter is an outcome of the initial environmental and social analysis performed during project preparation phase, which concluded that majority of companies had good systems in place, but would benefit from additional soft measures such as (a) capacity building to strengthen environmental and social performance and integration to business processes; as well as (b) building a platform for comprehensive voluntary ESMS, where needed.

127. The report will be structured around four major themes : (a) organization and operability of the established environmental management systems of the Implementing Companies for overall environmental protection; (b) environmental performance and assurance of environmental regulations compliance for planning and construction activities; (c) compliance with environmental regulation and standards of (road) infrastructure maintenance and other regular operational activities; and (d) practices in land acquisition and involuntary resettlement for companies' activities and its compliance with national and EU legislation. Based on the conclusions of the report, areas for improvement and related measures for each of the companies will be identified and an Action Plan for their implementation will be agreed with the companies. The agreed plan will be a subject to supervision and reporting.

128. ToR for the ESCR were completed, in English and Croatian language, before the project appraisal and were disclosed on companies' web pages on March 13, 2017. A call for public commenting was issued. Received comments will be addressed in the finalized ToR for the Report if relevant. The draft ESCR together with the Action plan will be disclosed, again on the website of the companies, in English and Croatian language, together with call for comments remaining

accessible to the public for at least two weeks. Upon disclosure, the companies will organize a consultation meeting for the interested public. The approach to the consultation process will be proactive aiming at involvement of broad scope of stakeholders: environmental and nature protection NGOs, citizens' groups and more. Invitations will be sent for identified interested or potentially affected groups. The ESCR will be considered final with the incorporated expressed public concerns and attached minutes of the meetings of the consultations.

129. The project will also support variety of other maintenance and operations programs through technical assistance. The Borrower/ companies and Bank staff will ensure that the relevant environmental and social concerns if any are addressed in line with national standards and Safeguard policies provisions are applied as usual for TA operations, i.e. through incorporating safeguards related considerations as appropriate in the TORs of the respective studies.

G. Other Safeguards Policies Triggered *(if required)*

130. None

H. World Bank Grievance Redress

131. Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

Annex 1: Results Framework and Monitoring

CROATIA: Modernization and Restructuring of the Road Sector

Project Development Objectives

PDO Statement

The Project Development Objective (PDO) is to strengthen the institutional effectiveness, enhance the operational efficiency and increase the debt service capacity of Croatia's road sector.

For the purpose of measuring progress towards achieving the PDO, the following definitions are adopted:

- **Institutional Effectiveness**: Extent to which Road Sector SOEs have the legal and regulatory framework, organizational structure, incentives and technical capabilities needed to design, build, operate, maintain and finance the infrastructure under their management in an effective manner;
- **Operational Efficiency:** Ability to provide quality services in a cost-efficient manner;
- **Debt Service Capacity**: Ability of road sector agencies to cover principal and interest payment on new and existing debt from their own operating surpluses.

These results are at	Project Level

Project Development Objective Indicators

Indicator Name	Baseline End-CY 2016	Target Values				
		End-CY 2017	End-CY 2018	End-CY 2019	End-CY 2020	End Target End CY 2021
Institutional Effectiveness:						
Ability of MSTI to plan road sector investments	Inexistent sector-wide planning coordination	Creation of planning department under MSTI; transport			Availability of inputs for rolling investment plan, in particular RAMS	Motorway and road networks managed under rolling investment plans

		strategy approved				
Ability of MSTI to monitor and enforce performance of motorway and Road Sector Companies using Key Performance Indicators (KPIs) and standardized accounting measures under service agreements between Government and reorganized companies	Inadequate performance-monitoring system	Adoption of corporate governance plans	Completed new institutional setup of sector companies Service performance agreements in place			Integrated monitoring system in place
Operating Efficiency:						
Operating Expense Ratio (Total Operating Expenses / Total Operating Revenue)	HAC: 0.38 ARZ: 0.32 HC: 0.28					HAC+ARZ: <0.27 HC: <0.27
Operating Expenditures per kilometer of road network	HAC: 0.69 ARZ: 1.04 HC: 0.08					HAC+ARZ: <0.60 HC: <0.07
Debt Service Capacity:						
Annual Debt Service Coverage Ratio (DSCR)	HAC: 0.27x ARZ: 0.47x HC: 0.57x	1.0x	1.0x	1.0x	1.0x	HAC: 1.0x ARZ: 1.0x HC: 1.0x
Loan Life Coverage Ratio (LLCR) 10 Years	HAC: 0.7x ARZ: 0.7x HC: 1.0x	1.0x	1.0x	1.0x	1.0x	HAC: 1.0x ARZ: 1.0x HC: 1.0x
Debt to CFADS Ratio	HAC: 15.8x ARZ: 15.0x HC:9.7x			12.5x 12.5x 9.0x		HAC: 10.0x ARZ: 10.0x HC:7.3x
Intermediate Results Indicators- Track progress towards achieving outcomes						
		Target Values				

Indicator Name	Baseline End-CY 2016	End-CY 2017	End-CY 2018	End-CY 2019	End-CY 2020	End Target End CY 2021
Component A – Institutional strengthening and Sector Reforms: The objective of this component is to establish an institutional framework for the road sector built upon: strong planning and oversight by the MSTI; clear division of responsibilities based on performance-based service agreements between the planning and oversight functions (MSTI) and the road asset management functions (Road Sector Companies); and a coordinated financing plan.						
Status of implementation of new financing strategy for HAC, ARZ and HC under government coordination [A.1]	Contract with advisor signed	Financing strategy approved; execution of first debt optimization transaction	Additional debt optimization transaction is executed			Debt optimization transactions contemplated in the Financing Strategy are executed
Operational status of Planning Department established within MSTI [A.2]	Inexistent planning and coordination functions within MSTI	Department created	Department produces first sector plan			Department is fully operational
Status of implementation of improved and harmonized accounting standards [A.2]	Non-harmonized accounting standards	TA completed	Improved accounting standards applied (implementation from Jan 1, 2019 if not feasible earlier)			
Component B –Operational Restructuring of Road Sector SOEs: The objective of this component is to implement the management tools and carry out the revenue enhancement and cost rationalization actions required to increase income while reducing operating expenditures without sacrificing quality.						
Revenue Optimization						
Weighted Average toll revenue per Vehicle-Km travelled [B.4]	HAC: 0.59 ARZ: 0.63					HAC: >0.67 ARZ: >0.67
Status of implementation of new tolling revenue enhancement measures [B.4]	Existing mixed toll system	New tolling strategy defined	Bidding documents for automated toll system	New tolling systems contracts awarded		New automated tolling system completely implemented
Operating Expense Optimization						
Percent Reduction in	HAC+ARZ: 830 mn	7 percent	15 percent			30 percent

Operating Cost of Motorways relative to baseline: HAC and ARZ [B.3]	HRK annual					
Reduction in Operating Cost for State Roads relative to baseline: HC [B.5]	HC: 543 mn HRK annual					515 mn HRK
Staff per Kilometer of road under operation (motorways) [B.3]	HAC: 2.7 ARZ: 3.3					HAC + ARZ: < 2.2
Management Tools						
Status of implementation of end-performance road maintenance standards [B.1]	Standards without end-performance requirements	Award consultancy	Update of regulations (pravilnici); end-performance standards in place			Service standards incorporated in rolling plan
Status of implementation of Road Asset Management System (RAMS) [B.2]	Road Sector SOEs do not have integrated RAMS	RAMS TA contract awarded	RAMS implementation contract awarded		RAMS operational	RAMS inputs incorporated in rolling investment plan
Percent of HC network where county agencies (ZUC) participate in joint procurement committee	0 percent			50 percent		100 percent
Percentage of TEN-T road network for which road safety audit or inspection as per EU Directive 2008/96 has been carried out [B.6]	0 percent		10 percent			100 percent
Citizen engagement: Maintain full responsiveness rate to comments and grievances from citizens	100 percent	100 percent	100 percent	100 percent	100 percent	100 percent

Gender balancing: Ratio of women employed in the motorway sector after retrenchment	0.19		>0.20			>0.25

Indicator Description

Indicators will be reported to the Bank as part of Project Reports to be produced with the frequency stated in the legal agreements.

Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)	Frequency of Calculations	Data Source / Methodology	Responsibility for Data Collection
Ability of MSTI to plan road sector investments	Availability of planning organization elements	Semi-annual	MSTI	MSTI
Ability of MSTI to monitor and enforce performance of motorway and Road Sector Companies using Key Performance Indicators (KPIs) and standardized accounting measures under service agreements between Government and reorganized companies	Availability of KPI monitoring system that allows tracking of performance measures and standardized accounting standards to verify compliance with targets established in service agreements.	Semi-annual	MSTI	MSTI
Operating Expense Ratio	Calculated as ratio of operating expenditures (routine maintenance, tolling, administration – direct costs plus subcontracts) over operating revenue (toll and ancillary revenue for HAC/ARZ; and fuel tax plus ancillary revenue for HC)	Semi-annual	Calculated from the sector model to be maintained by the MSTI	Road Sector Companies
Operating Expenditures per kilometer	Calculated as ratio of operating expenditures (as defined above) over length of network in km	Semi-annual	Calculated from the sector model to be maintained by the MSTI	Road Sector Companies
Debt Service Coverage Ratio	This indicator measures the capacity of the sector	Semi-annual	Calculated from the	Road Sector Companies

(DSCR)	(road sector agencies-HAC, ARZ and HC) to meet its debt service obligations out of the cash flows generated by the sector. If the indicator is less than 1x [less than 100 percent if percentage representation is chosen], this means that the sector is unable to cover its debt service obligations out of its own cash flows. The indicator captures both the revenue and the debt service sides of the financial viability equation. The Indicator is defined as Cash Flow Available for Debt Service (CFADS) over Debt Service (DS) for the preceding 12 months. For the purpose of this indicator: -CFADS is defined as total revenue net of opex and capex in the period -DS is defined as interest plus principal payable in the period		sector model to be maintained by the MSTI	
Loan Life Coverage Ratio –LLCR (HAC/ARZ and HC)	Ratio of Present Value of Cash Flow Available for Debt Service (CFADS) over 10 years to Total Outstanding Debt in year of calculation. This indicator will be calculated over a 10-year period using forward looking projections. This measure is used to estimate the ability of the borrower to repay the outstanding loans over the medium term.	Semi-annual	Calculated from the sector model to be maintained by the MSTI	Road Sector Companies
Debt to CFADS Ratio	The measure indicates the capacity of Road Sector SOEs to meet their financial obligations	Semi-annual	Calculated from the sector model to be	Road Sector Companies

	from their own revenue. Where the ratio is falling, it indicates that the company's capacity to meet its financial obligations from its own CFADS is strengthening. The indicator is calculated as follows: Debt Outstanding for Period/CFADS		maintained by the MSTI	

Intermediate Results Indicators- Track progress towards achieving outcomes

Status of implementation of new financing strategy for HAC, ARZ and HC under government coordination	Availability of financing strategy elements	Semi-annual	MSTI	MSTI
Operational status of Planning Department established within MSTI	Availability of policy elements	Semi-annual	MSTI	MSTI
Status of Implementation of harmonized accounting standards	Availability of policy elements	Semi-annual	MSTI	MSTI
Weighted Average toll revenue per Vehicle-Km travelled	Average toll rate (including VAT) per vehicle-kilometer for all vehicle categories, weighted by the percentage share of each category in the total vehicle-km	Semi-annual	MSTI	Motorway companies
Status of implementation of new tolling revenue enhancement measures	Availability of policy elements	Semi-annual	MSTI	MSTI
Percent Reduction in Operating Cost of Motorways relative to baseline: HAC and ARZ	Operating cost defined as including total amount of HAC-ONC contract plus HAC and ARZ staff and overhead costs	Semi-annual	Calculated from the sector model to be maintained by the MSTI	Motorway companies

Reduction in Operating Cost for State Roads relative to baseline: HC	Operating cost defined as including total amount of routine maintenance contracts plus HC staff and overhead costs	Semi-annual	Calculated from the sector model to be maintained by the MSTI	HC
Staff per Kilometer of road under operation (motorways)	Total staff (operator and road manager) per km	Semi-annual	MSTI	Motorway companies
Status of implementation of end-performance road maintenance standards	Availability of policy elements	Semi-annual	MSTI	MSTI
Status of implementation of Road Asset Management System (RAMS)	Availability of system for development and incorporation in planning	Semi-annual	MSTI	MSTI
Percent of HC network where county agencies (ZUC) participate in joint procurement committee	Total road length in respective HC business units over total HC length	Semi-annual	MSTI	HC
Percentage of TEN-T road network for which road safety audit or inspection as per EU Directive 2008/96 has been carried out	Total road length with documented completed audit or inspection	Semi-annual	MSTI	Road Sector Companies
Citizen engagement: Responsiveness rate to comments and grievances from citizens	Percentage of citizen inquiries (comments and grievances) that Road Sector Companies address. This indicator will be measured using the internal reporting of the Road Sector Companies regarding citizen engagement measures.	Semi-annual	Road Sector Companies	Road Sector Companies
Gender balance: Ratio of women employed in the motorway sector after retrenchment	Percentage of women in the motorway sector relative to total after retrenchment	Semi-annual	Road Sector Companies	Road Sector Companies

Annex 2: Letter of Sector Policy and Detailed Project Description
CROATIA: Modernization and Restructuring of the Road Sector

1. This Annex comprises the full text of the letter of sector policy LSP, which describes the actions adopted by the government on the sector restructuring and improvement and its detailed timetable. A second part of this Annex describes the activities funded by the project, their cost and details their timetable for implementation and their link to the implementation of the LSP.

Letter of sector policy adopted by Government Decision on Mars 16, 2017

Corporate and Financial improvement of the road sector

The Croatian Government (the Government) is committed to optimizing the debt held by public companies in the road sector, and wants to achieve a sustainable financing model through corporate and financial restructuring within the road sector.

The Government is also committed to reforming the road sector, to enhancing its supervision and planning of the sector, to increasing operational efficiency of all companies, and improving sector finances.

The Government has requested support from the International Bank for Reconstruction and Development (IBRD) for the Modernization and Restructuring of the Road Sector Project. Over the past year, excellent cooperation has been achieved with IBRD and other International Financial Institutions (IFIs) in defining the elements of the road sector restructuring. The Government also consulted the European Commission over this important issue (DG Competition).

Corporate and financial restructuring of the road sector presents the main areas where restructuring is planned. It also presents plans and activities to be implemented by the Government and public companies within the sector.

Context

In the years since Croatia's independence and especially after 1997, the publicly-managed network of motorways and state-roads was constructed by three companies, namely HC (Croatian Roads Company), HAC (Croatian Motorways Company) and ARZ (Rijeka-Zagreb Motorway Company) – the latter also being the Concessionaire. Financing was provided mainly through commercial loans and IFI loans, all fully covered by Government guarantees. In 2014, debts of the two companies, Croatian Motorways Company and ARZ were consolidated into the general government debt in accordance with the requirements of the European System of National and Regional Accounts (ESA 2010). By the end of 2015, according to ESA 2010 methodology, liabilities of these three public companies amounted to 40,5 billion Kuna, or 12,1% of GDP, and could not be covered only by revenue generated directly by the companies alone. By the end of September 2016, according to the ESA methodology, the combined outstanding debt of these three public companies amounted to 39,6 billion Kuna. The current structure of liabilities is an additional risk factor (maturities of around seven years, variable interest rates and currency risk due to Euro denomination of loans).

The Government aims to (i) improve the debt financing structures for HC, HAC and ARZ, to optimize the share of existing debt that the sector can service from its own sources; (ii) progressively reduce the annual debt service to limit the sector's impact on public finances and (iii) limit the extent of the State guarantees to be issued for any future or existing public company debt in the road sector.

Croatia's motorway network is at a high level of development, without the need for significant short term investments. The national road network is also comprehensive and in good condition according to national and EU standards. As a result, capital investment at the national roads level will focus on the Peljesac Bridge Project and several bypass roads at critical areas of the network, using significant European Funds earmarked for these activities.

Operations and maintenance activities needed to provide the required level of service and retain the company's asset value are sustainable and are implemented in line with the national and EU legislation. The operations (including toll collection) and routine maintenance of the State-managed motorway network are performed by Croatian Motorways - Maintenance and Tolling (HAC-ONC), whose shareholders are HAC and ARZ. A closed-toll collection system is currently in use on most motorway sections, with toll rates proportional to the actual distance travelled. HAC is also partly financed by a share of the fuel tax allocation to the road sector, the remaining share of which is the main source of income for HC. Routine maintenance on roads in Croatia is performed by a consortium of maintenance contractors on the basis of annual contracts under a framework agreement. Some of these contractors are partly-owned by county and regional authorities. The overall road system operating costs are excessive, especially for routine maintenance activities, while the long-term activities of periodic maintenance and road network rehabilitation are not efficiently implemented.

To ensure that the road sector adequately contributes to the overall economy and at the same time remains financially sustainable, operational improvements are needed in the following key areas:

(a) Sector governance
(b) Planning, financing and implementation of investments in the road sector
(c) Management of public companies and their operations

Main elements of corporate and financial improvement of the road sector

a. <u>Sector governance</u>

(i) Transport Development Strategy of the Republic of Croatia 2017-2030r
The National Transport Development Strategy for the period 2017 – 2030 (Strategy) outlines the vision, main objectives, long term investment plans, and operating principles for the road sector as well as for all other modes of transport. The Strategy's main guidelines have been agreed upon with the European Commission and the reviewed text of the Strategy will be approved by the Government by October 2017. It will be adopted after the implementation of a Strategic Environmental Impact Assessment and a public consultations phase, planned for June-July 2017. The Strategy will acknowledge principles for corporate and financial improvement of the road sector. It is also a precondition set by the European Commission for accessing funds earmarked for the sector, as part of the Operational Program Competitiveness and Cohesion 2014-2020.
(ii) Standardization of road classification and maintenance / management criteria, to ensure proper and cost-effective maintenance of the assets

Uniform classification and maintenance standards are necessary. A given road with a certain traffic volume and functional significance will have an equal level of maintenance for a sound cost, regardless of who manages the road. Routine maintenance standards have so far been too extensive and differently defined by each road company.

A Working Group consisting of representatives of the MSTI, Road Sector Companies and county road authorities proposed common technical classification criteria. The purpose was to identify distinct functional categories, irrespective of the current administrative (geographical) limits, to allow uniform implementation of construction and maintenance standards. The Decision to initiate procedures for technical classification of roads will be made by the end of March 2017.These Standards for technical classification of roads will become the basis for preparation of Regulations and Bylaws to be completed by October 2017 while the Standards themselves shall be completed by October 2018. They will define routine and periodic maintenance of all public roads, regardless of the maintenance contracting methods. The Standards will define the desired level of maintenance to be achieved, compatible to the EU network. They will improve the quality, rationalize unit prices and promote better market competitiveness.

(iii) Enhancing the role of the Ministry of Sea, Transport and Infrastructure (MSTI) as the body responsible for the planning and control of the public Road Sector Companies operation within the sector

The public roads network has been developed on the basis of mid-term road construction planning documents (Program of Construction and Maintenance of Public Roads adopted by the Croatian Government for a four-year term). Sustainability and future road network development are the key requirements of the long-term, strategic transport sector development. To meet these requirements, the Ministry of Sea, Transport and Infrastructure (MSTI) will propose long-term strategic transport sector development goals to the Government, plan in accordance with these goals to ensure the coherence of the public companies' investment plans.

The Ministry will establish a Department to define long-term strategic goals, plan in line with these goals and ensure that mid-term plans of other public companies are harmonized with the Agency's operations. The Department will also coordinate investment plans, enhance investment management control by implementing strong public investment management principles and shall control project management performance through its users. The Ministry (MMPI) will bring a Decision on the establishment of the Department, which will commence its operations by June 2017.

The efficiency of the State as the owner and the purchaser of services from the Road Sector SOEs can be upgraded by introducing a monitoring system and benchmarks for the operational and financial performance of companies. The financial management and accounting tools used by the Road Sector SOEs therefore have to be improved. This implies strengthening the ownership role of the MSTI, defining Key Performance Indicators (KPIs) to determine the level of performance, and establishment of an operations monitoring system by the MSTI. Elements mentioned above will be stated in performance contracts to be signed by the Ministry (MSTI) and HAC/HC by the end of September 2017. Implementation of these Contract will allow publically available, transparent reporting.

(iv) Restructuring of the companies within the motorway sector.

Following the analysis of options for restructuring of public companies in the road sector given in the EBRD-funded Study, the Government confirms its intention to merge HAC with HAC-ONC and transfer the operational activities of ARZ to HAC by delegating responsibilities. The restructuring of motorway companies will be conducted according to market rules, EU and national legislation, and consultations with the European Commission, according to need. This is expected to optimize business processes, provide economies of scale and reduce overall expenses. Legal steps for completion of the HAC / HAC-ONC merger and ARZ rationalization will be finalized by the end of July 2017Along with this merger, laws and subsequent texts will define full monopoly of the new public companies in the area covered by their respective network. Each entity will be prohibited from operating in another market outside Croatia or any other market open to competition, or subject to a separation of accounts for such respective activities, in order to exclude possible cross-subsidies. Such laws will also be subject to amendments in relation to, inter alia, accounting principles in order to ensure that assets accounting are adapted to their operations. The enactment of these legal steps will be finalized at the latest by September 2017.

A detailed Study will establish an optimal Action Plan for upgrading the operational and institutional rationalisation of the new public company for operation and maintenance of motorways. This rationalisation will be based on a functional analysis of core operations, improved maintenance works, with an increased emphasis on preventive maintenance and adoption and implementation of end-performance standards and specifications as given in item "(ii)" above. Results of this will be visible through optimized management costs, enhanced outsourcing of maintenance activities, less differently structured regular maintenance Technical Units and improved administration (including unified procurement and IT). These improvements will lower road maintenance operating costs for a given level of service by at least 7 % by end 2017, 15 % by the end of 2018, and 30 % by end 2020 as well as significant further reduction of staffing needs. The restructuring process also includes manpower retrenchment. Initially, voluntary retrenchments will be offered, with an expected reduction of up to 120 employees. Subsequently, further manpower retrenchments and retraining will be necessary, following a comprehensive review of the companies' functional needs. This confirms the Decision to pursue voluntary retrenchments, to be completed by the December 2017. Further downsizing as a result of optimized business processes will be done in line with the Study Guidelines for corporate and financial optimization (funded by the EBRD). This process will start in 2018 and needs to be completed by the end of 2020.

(v) The HAC, ARZ and HC debt reduction Strategy.

A transaction advisor has been appointed by MSTI to: (i) reaffirm and upgrade the strategic financing guidelines developed by the Government in 2016; (ii) define debt-financing guidelines in line with the Strategy; (iii) recommend the Strategy and financing structure for Government approval and (iv) assist in implementation of the debt reduction process of public companies in the road sector.

The debt financing Strategy, among other, may involve: (i) refinancing of existing loans in the proportions and terms to be recommended by the transaction advisor; (ii) provide additional net cash flows for sector financing and company operations, based on the proposed sector financing measures, and (iii) apply the risk mitigation instruments such as guarantees provided by the World Bank, as requested by the Government in the letter to IBRD, dated April 23, 2015. The aim of this

Strategy is to rationalize the amount of debt guaranteed for by the State, along with the option of simultaneous long-term financing of the road sector.

The first raising of capital is expected during the second half of 2017. Such raising of capital, guaranteed in full or in part by the World Bank, will be subject to the implementation of corporate and financial optimization of the road sector.

b. Planning, financing and implementation of investments in the road sector

(vi) Road Asset Management System (RAMS) to ensure accuracy of investment planning
A RAMS covering motorways, state and county roads will be developed through a contract to be awarded by March 2018. After data collection on the inventory and condition of inventory, the system will become operational by March 2020. The RAMS will use all available asset management systems from public companies within the road sector and HC. This RAMS will ensure availability of current data on the condition of the network and will serve as a data base for continuous updating of motorway and state road periodic maintenance estimates. The RAMS will also be available for county-managed roads, namely for data-entry on road inventory and road condition, and to generate their own future maintenance programs. It will allow rehabilitation and periodic maintenance to be programmed, based on actual road conditions and not based on predefined periodic norms.

(vii) Approved road sector investment plan for 2017-2020
The MSTI plans to present the Public Roads Construction and Maintenance Program 2017-2020 to the Government for approval by the end of March 2017. It will focus on: (i) funding of periodic maintenance from each company's own resources without loans; (ii) limit new construction in the motorway sector to projects already in progress and EU-funded investments; (iii) limit the HC new construction projects to the ones already started and to EU-funded projects, complemented by projects that meet the agreed criteria and are within budget.
HC capital expenditures, excluding periodic maintenance, EU-funded projects and projects already in progress, will be funded through loans taken by HC preferably from the most cost-effective sources available. Such loans will be serviced from the State Budget. The limit for such loans for 2017-2020 is set at 1.232 billion Kuna for HC.

Except the Construction and Maintenance of Public Roads Program for 2017-2020, the public companies will prepare an annual framework investment plan, in cooperation with the MSTI and Ministry of Finances, using all sound economic and social value criteria for assessing and prioritizing all proposed new investments. The Plan will be prepared in accordance with a multi-criteria framework to be developed by May 2017. Future investment Plans will also include costs of periodic, investment maintenance and rehabilitation based on the Road Asset Management System (as in "(vi)" above), once available, by March 2020.

(viii) Revenue and tolling
HC and HAC currently benefit from an allocation of the fuel tax. HC uses its share of the tax to cover maintenance costs and to finance some investments, while HAC uses its share of the tax solely for investments. The Government confirms that these resources will remain, given the needs of the two companies, at the level defined by the Act of Roads. Seasonal toll rate increase by 10%

is planned between 1st July and 30th September on HAC and ARZ motorways, starting 2017 onwards. Toll rates for categories II, III and IV will be harmonized by 2020. Further changes, such as reduction in electronic toll (ENC) discounts shall be gradually implemented, starting June 2018, to be in line with EU norms. Additional revenues for the road sector will also be analysed.
A future (fully automated electronic tolling system consistent with the Study – EBRD) will be defined by December 2017. Bidding documents will be prepared by July 2018, with the purpose of implementing the system by 2020-2021 or earlier, depending on the selected technology. This (fully automated electronic) tolling system will maintain the basic principles of distance-based charging, which are generally present in the current system, but will reduce toll staffing, limit congestion, especially during the summer peak period, and upgrade environmental protection measures, especially vehicle related emissions. Toll rates will be reviewed at least once a year.

Investments in the current toll system, given that it will be upgraded in the short to medium term, shall be limited to those required for maintaining its current functionality and encouraging the use of electronic tolling.

(ix) Road safety
Implementation of road and traffic safety-related initiatives on Croatia's TEN-T road network, in accordance with EU Directives is an integral part of the Sector Plan, which already benefit from European Funding. In addition, by mid-March 2017, the MSTI will adopt an Action Plan aimed at supporting the goals of Croatia's 2011-2020 national Road Safety Plan. The Action Plan includes various measures for motorways and state roads such as upgrading of safety barriers, road safety improvements on the Zagreb-Karlovac motorway, axle-load control, and reduction of the number of accident blackspots. Joint network activities will include road safety audits and inspections, improvements in tunnel safety, and expansion of nationwide traffic management information systems. Audits and inspections shall be completed on at least 10% of motorways and 10% of state roads by July 2018, with the aim of covering the complete TEN-T network by the end of 2020.

c. Governance and operations of public companies

(x) Corporate governance principles
Good corporate governance depends primarily on balanced implementation of internal and external mechanisms. These ensure a balance between owner, supervisory board and public company management. The results are efficient management and control mechanism, alleviation of possible conflict situations that could arise between management structures.

Corporate Governance Plans based on OECD principles will be adopted by all Road Sector SOEs' management boards during March 2017. The Plans will comply with the existing Decision on the Code of Corporate Governance of Companies in which the Republic of Croatia has shares (OG 112/10). Corporate Governance Plans will include the use of performance management contracts for management structures, as well as increased transparency through frequent disclosure of decisions, financial data and performance. Implementation of these measures will be reviewed annually.

Corporate Governance Plans applicable to management structures and supervisory boards will also include defining and implementing the following elements: structure, management and supervision of operations, transparency and disclosure of information, audit and internal control, compensation for supervisory board members, risk management, and corporate social responsibility.

(xi) Human Resources management tools

The management of Human Resources (HR) is a crucial element of the road sector's management. Modern HR and labour management systems shall be adopted, which include compensation policies, work control, work planning and estimating systems.

When it comes to restructuring the road sector, any required manpower downsizing shall be managed in an effective and socially acceptable manner.

(xii) More efficient Maintenance Operations

One of the results of restructuring of motorway companies under item (iv), is a more efficient and cost effective maintenance of the motorway network. The rest of the network, as well as road maintenance and traffic management operations on all public roads will be reorganized to optimize operating costs and staffing needs. This confirms the fact that the next round of maintenance contracts, to start in April 2018, will be organized at the level of regional centres. Further operational improvements will be determined by March 2018, taking into account the experience from the Istria pilot performance-based contract, maintenance standards and specifications stated in Article (ii).

HC and the CRM/ZUC (County Road Management) will continue working to develop a technical roads classification system and consistent nationwide maintenance standards (as stated in "(ii)" above). Agreement on the conditions of joint procurement of maintenance works will be finalized by October 2017. The joint procurement Agreement will define the basic principles and conditions of joint procurement procedures for maintenance works to ensure that HC and CRM/(ZUC) remain responsible for their respective maintenance contracts. This will be performed at the regional centre level under an independent joint procurement committee, consisting of HC and CRM/ZUC members. This process will start in the second half of 2017, while the HC and CRM/ZUC maintenance service contracts, which expire before April 2018, (or from the contract expiration date for the CRM's whose contracts expire before 2018) will be implemented in April 2018. The remaining CRM's (whose contracts expire after 2018) will harmonize their contract duration periods with the duration of the joint procurement contract signed between HC and a part of CRM's with the maintenance service providers. Thus the next round of procurement would be for maintenance service contracts, with participation of HC and all CRM's. This will increase market competition and opportunities for local contractors. The new contracting procedure will come into force in July 2018.

Specific and detailed planned activities

In order to achieve the above objectives, the following activities have been identified and will be implemented as specified in the table below.

Table 1

Element of reform	**Activity**	**date**
Sector governance		
(i) Transport Development Strategy of the Republic of Croatia 2017-2030	*(i) Transport Development Strategy of the Republic of Croatia 2017-2030 approved by the Croatian Government*	*October2017*
(ii) Common system for classification of roads and maintenance standards/ public roads management standards to ensure appropriate and cost effective maintenance of assets;	*Classification approved*	*March 2017*
	Classification of roads and maintenance Standards	*October 2018*
(iii) Strengthening of the MSTI in its role as sector planner and responsible for the ownership and control functions of the public companies in the sector;	*Approval of the MSTI for organization of Department*	*March 2017*
	Start of Department work	*June 2017*
(iv) Reorganization of public companies in the motorway sector;	*Completion of legal steps for ARZ restructuring and HAC-HAC-ONC Merger*	*July 2017*
	Implementation of first wave of voluntary manpower retrenchment – stage 1	*December 2017*
	Implementation of stage 2 of corporate restructuring – manpower retrenchment and cut in maintenance costs	*End 2020*
(v) HAC, ARZ and HC debt financing Strategy	*Strategy developed and recommended by MSTI's transaction advisor.* *Implementation of Strategy is expected to be carried out in several stages, starting in September 2017*	*May 2017*

Table 2

Element of reform	**Activity**	**Time**
Planning, financing and implementation of investments in the road sector		
(vi) Develop a road asset management system (RAMS) to ensure exactness in investment planning	*Contract award*	*March 2018*
	RAMS operational	*March 2020*
(vii) Approved road sector investment plan for 2017-2020	*Rolling investment plan and financing strategy for investments, to include RAMS-derived costs*	*March 2020*
(viii) Revenue and tolling	*Implementation of seasonal toll increase by 10%*	*July 2017*
	Selection of preferred fully automated electronic tolling system (and definition of transition process from current system, including revised toll rates for the transitional period - seasonal & congestion charging) - concluded	*December 2017*
	Prepared bidding documents for public procurement of fully automated electronic toll system	*July 2018*
(ix) Road safety	*Ministry to present safety action plan*	*March 2017*
	Prepared bidding documents for axle load monitoring *Completion of audits or inspections on at least 10% of motorways and 10% of state roads*	*July 2018*

Table 3

Element of the reform	**Activity**	**Time**
Governance and operations of public companies		
(x) Company governance principles	*Adoption of corporate governance plan for public companies*	*March 2017*
(xii) More efficient maintenance system;	*Agreement between HC and CRM/ZUC on joint procurement*	*October 2017*
	Modified bidding documents for 1-year routine maintenance contracts (per Business Unit) - joint procurement with ZUC	*October 2017*
	Procurement of maintenance contracts following the new contracting approach	*July 2018*

Project description (components funded by the IBRD loan)

A. Project Components

1. Component C of the project (Debt optimization) does not benefit directly from support from the IBRD loan. It is described in Annex 6. The objective of that component is to increase the tenor on road company debt, thereby reducing the annual debt service obligations and putting road companies on a sustainable debt path.

Component A: Institutional strengthening and Sector Reforms (EUR 6.08 million[15])

2. This component will finance consultancy services, institutional strengthening and capacity development to support debt re-structuring and sector reforms, and comprises the following sub-components.

Sub-component A.1: Financial Transaction Advisor (EUR 2.83 million)

2. Financing will provide for the engagement of a Financial Transaction Advisor, to support the government in improving the existing debt of the companies. The financial transaction advisor will assist the government to (a) prepare a debt optimization strategy for HAC, ARZ and HC; (b) undertake analysis of debt facilities for reprofiling and refinancing, (c) propose the type and sequencing of the refinancing instrument; (d) develop and implement the engagement strategy for communication, negotiation and conclusion of the arrangements with the capital market; and (e) conclude arrangements with lenders. This activity is underway as of January 2017 and will be subject to retroactive financing.

[15] All figures below are in Euros and excluding contingencies and unallocated funds

Sub-component A.2: Strengthening of the Ministry of Sea, Transport and Infrastructure (MSTI) in Sector Planning and Oversight of Public Road Enterprises and Road Sector Governance and Monitoring (EUR 1.25 million)

3. The Loan financing will support the development of a department, under the Ministry of Sea, Transport and Infrastructure, which will coordinate strategic planning and public investment program management in the transport sector. It will seek to optimize vertical and horizontal functions, generate economies of scale, reduce duplication, and improve cooperation by consolidating resources that are currently spread across transport companies and agencies. it will progressively contribute to the goal of improved road sector governance and MSTI oversight of State-owned enterprises (SOEs) in the road sector, through an effective linkage between sector strategy and investment plans elaborated at subsector level. For that part of the subcomponent the project will support:

(i) technical assistance in the creation of the Directorate by means of necessary equipment for the commencement of the department's operation (EUR 0.2m). Running costs will be supported by the government.

3. This sub-component will also develop a system for improved governance and financial management of the road sector, by establishing overall sector goals, roles and responsibilities of the Ministry and road SOEs, and parameters of their interactions. The governance framework is aimed at improving the efficiency of the MSTI as the owner and purchaser of services from the road sector SOEs, and improve SOE management through establishment of monitoring systems and benchmarks for companies' operational and financial performance. Accounting practices across the companies will be improved and standardized, particularly in relation to methodologies for registration and depreciation of assets. Comprehensive long-term financial planning strategies will be introduced; companies will develop project management and financial systems that allow to plan works, record costs, issue invoices, and fully understand and manage revenue and expenses.

5. The project will provide support for several technical assistance activities, including (a) consultancy development of a sector governance framework reinforcing MSTI's ownership role, including a.o. definition of key performance indicators (KPIs) for measuring company performance and monitoring arrangements incl. service agreements between MSTI and SOEs (EUR 0.3m); (b) consultancy [and possible hardware provision] for the establishment of an IT application to facilitate data exchange and reporting between MSTI and SOEs (EUR 0.3m); (c) consultancy to review accounting methodologies and improve accounting tools used by the SOEs and to ensure consistency of accounting across the SOEs (EUR 0.1m); (d) consultancy on the business environment for the freight road transport industry (EUR 0.2m) (e) consultancy to introduce/improve citizen engagement (EUR 0.15m).

Sub-component A3: Implementation Support (EUR 2 million).

6. Under this sub-component, financing will be provided for technical assistance to support implementation of the Project at MSTI, in relation to technical, financial, communications, HR and legal matters, as well as a project audit. The activities are expected to contribute to (i) coordination of project activities; (ii) institutional strengthening and capacity building; (iii) refinement, implementation and possible updating of the road sector strategy and associated investment plans.

Financing will provide support for consultancies on (a) technical coordination (EUR 0.6m); (b) financial coordination (EUR 0.2m); (c); (d) communications (EUR 0.2m); (e) human resources issues (EUR 0.3m); (f) project audits (EUR 0.5m); (g) legal matters (EUR 0.2m).

Component B: Operational Restructuring of Road Sector SOEs (total EUR 13.92 million)

7. This component will finance operational restructuring of motorway companies and Croatian Roads (HC), including human-resource impacts. On motorways, it will build on reforms introduced by the Government and complement activities carried out through an EBRD loan to Croatian Motorways (HAC) for operational restructuring of the entire state-managed motorway subsector, with distinct activities on maintenance and tolling. On both motorways and HC, it will enhance the technical framework for maintenance through support revisions to the road classification and maintenance standards, as well as a comprehensive Road Asset Management System (RAMS). Finally, road safety priorities within the MSTI, as identified in the Ministry's Road Safety Action Plan for 2017-2020, will be supported by a dedicated sub-component.

Sub-component B1: Road classification and standards (approximately EUR 0.8 million)

8. Technical assistance finance under this sub-component will assist MSTI and the Road Sector Companies (motorways and HC) to (i) implement a technical classification of the public road network on the basis of functional criteria and (ii) develop consistent sets of maintenance-related regulations and specifications for all road classes, for the purpose of achieving efficient and effective road maintenance. The regulations and specifications will be defined in accordance with end-performance levels of service, for use in future maintenance contracts. They will follow the principle of "fair standards" (neither under- nor over-dimensioned) and covering the full range of road maintenance activities including traffic/incident management and tunnel safety, with appropriate references to input-based standards and technical specifications. Routine/preventive and periodic maintenance will be covered. Financing will provide support for a consultancy to support MSTI and companies in the above activities.

Sub-component B2: Road Asset Management System (EUR 3.25 million)

8. Financing under this sub-component will provide technical assistance to implement road asset management systems (RAMS) for all Road Sector Companies. The RAMS will comprise a computerized database for planning, scheduling and costing of road interventions, and this will form the basis for development of multi-year costed maintenance programs by each Company. The RAMS will cover pavement (PMS) and structure management systems (including bridges and tunnels) and the scope will include all stage-managed motorways and HC, with expandability for ZUC. Existing partial RAMS elements will be duly considered for inclusion. RAMS include simple mapping for each managing entity (company).

9. Technical assistance is phased in two consultancies: (a) to develop RAMS strategy and prepare scope (ToR) for 2nd phase (EUR 0.18m); (b) RAMS implementation including any data collection, deterioration modelling, costed 4-year rolling plan, technical support as well as guidelines and training for future RAMS management and usage for budgeting purposes (consultancy for EUR 2.0 m and equipment for EUR 1.07m).

Sub-component B3: Rationalize Operations and Business Functions – Motorways. (EUR 5.97 *million)*

10. Financing under this sub-component will be used to support operational and business rationalization of the motorway companies in conjunction with the EBRD-financed operational restructuring operation. It will be aimed at achieving improvements in the technical and business efficiency and effectiveness of the motorway companies. Detailed Action Plans will be developed, based on the Restructuring Action Plan / Labor Restructuring Plan developed for MSTI through the EBRD financing for HAC-ONC and HAC. The main objectives, as identified in this plan, include optimizing management and maintenance costs, enhancing outsourcing where beneficial, reducing technical units and rationalizing administrative activities. It is anticipated that this process will result in labor restructuring, and retrenchment packages will be part-financed by EBRD. The IBRD loan financing is limited to HAC as it is assumed that the number of potential retrenchment in ARZ and HC will be very limited. Such packages will include support services for retraining and enhancing opportunities for finding alternative employment, including counselling and advisory support and employment intermediation. The activity would also encompass development and management of citizen engagement mechanisms and ensure social and environmental responsibility.

11. Financing will support consultancy services (EUR 1.2m) to review possibilities for increased overall outsourcing of routine maintenance functions (now largely performed by HAC-ONC), by examining the whole spectrum (from no outsourcing to full outsourcing); analyze the effect of this spectrum of options on the organization of motorway companies (HR/staffing, spatial organization, administrative & IT services, plant and equipment, record systems, management systems etc.); examine options to improve HR systems, compensation policies, systems for job-control, planning and estimating works; consider supervision and monitoring and develop operational standards to manage the road manager vs. operator interface. Finally, the consultancy will obtain agreement on preferred approach and resulting spatial, plant and staff organization, and develop detailed Action Plans for the preferred solutions. Throughout this process, the parallel support by legal, HR, financial, accounting and other consultancies of sub-components A2 and A3 will be important. Downstream work for support to MSTI and companies during the implementation will be necessary, covering quality, IT, plant and equipment management, procurement and other issues. IBRD contribution to the initial voluntary retrenchment and further to complement the main EBRD loan is estimated at EUR 4.77 million.

Sub-component B4: Tolling (EUR 1 million)

12. Financing under this sub-component will be used to identify, detail and implement an improved road charging system ensuring full automation. The scope of the technical assistance will include analytics to identify the preferred new automated road charging system and tariff structure, including plans to transition from the current tolling system and pricing regime through immediate and medium-term adjustments - including a consideration of legal and institutional issues as well as HR impacts, the latter to be refined using the “EBRD Plans” (ref. sub-component B3) as a basis. Other relevant subcomponents (A2, A3) are also expected to provide horizontal support.

13. Financing will support a staged consultancy (EUR 1m) that will (i) review options, technologies and systems, legislation, enforcement issues, costs/benefits, EU compliance and ITS, cross-border and inter-operability issues, toll rates (differentiation, classification, environmental / emissions component, phasing etc.), (ii) dimension HR impacts, (iii) recommend option, (iv)

develop preferred option including transition plan and bidding documents, (v) perform downstream work in the implementation phase.

14. Moreover, financing will also be provided for retrenchment packages, to be covered by EBRD Finally, the EBRD loan will also finance the implementation equipment in two phases (interim and final).

Sub-component B5: Operational and business rationalization of HC (EUR 0.6 million)

15. This sub-component will assist to reform state-road maintenance practices by financing technical assistance to develop an Action Plan that will support (a) the decentralization of HC into six regional business units; (b) joint procurement at regional level among HC and ZUC; and (c) development of improved maintenance contracting practices using revised maintenance service-level standards, and assessment and programming of periodic maintenance needs based on the Road Asset Management System (RAMS). Parallel activities from sub-components A2, A3, B1 and B2 will support the process.

16. Financing will support consultancy services (EUR 0.6m) for operational and business rationalization of HC. An organization review of HC and its functions will be carried out, including monitoring of outsourced maintenance and procurement. The action aims at optimizing business processes, cost control and IT support and strengthening HR capacities, including enhancement of job descriptions. Alternative options for improvement of processes, policies, practices will be examined. An Action Plan for HC will be developed. Downstream work will also be performed in the implementation phase.

Sub-component B6: Road safety measures (EUR 2.3 million)

17. The objective of this component is to contribute to the achievement of Croatia's road safety goals by supporting the MSTI's Road Safety Action Plan (RSAP) for 2017-2020 - in alignment with the country's broader 2011-2020 National Road Safety Plan. Specific activities within the MSTI's 2017-2020 investment plan are part of the RSAP. Financing will support consultancy services for design of improvements on the HAC motorway network, namely: (a) safety barrier improvements (EUR 1.4m); (b) harmonization of remaining tunnel safety improvements in accordance with the EU Directive 2004/54 (EUR 0.6m); and (c) nationwide Intelligent Transport Systems for traffic information improvements (EUR 0.3m).

Detailed Project Costs under the Loan Financing

18. Table 4 below provides details about project costs and financing

Table 4 - Detailed Project Cost and Financing (in Euro VAT inclusive)[16]

		Component Description	Type	By Who (I,E,C)	Unit Cost €m	Total by Sub-Comp €m	Total By Comp €m (1)	IBRD €m
Component A - Institutional Strengthening and Sector Reforms							6.08	6.08
A.1	**Strategy for Sector Debt Re-Structuring**					2.830		2.83
	a	Financial Transaction advisor	C	I	2.830			2.83
A.2	**Transport Sector Planning and Road Sector Governance and Monitoring**					1.250		1.25
	a	Procurement of IT equipment	G	I	0.200			0.20
	b	Sector Governance Framework including planning department	C	I	0.300			0.30
	c	IT Application for Reporting	C	I	0.300			0.30
	d	Accounting standards	C	I	0.100			0.10
	e	Business environment for freight road transport industry	C	I	0.200			0.20
	f	Citizen Engagement Tools	C	I	0.150			0.15
A.3	**Implementation support**					2.000		2.00
	a	Technical coordinator	C	I	0.600			0.60
	b	Financial coordinator	C	I	0.200			0.20
	c	Communications consultancy	C	I	0.200			0.20
	d	HR consultancy	C	I	0.300			0.30
	e	Project audit	C	I	0.500			0.50
	f	Legal Support	C	I	0.200			0.20
Component B - Operational Restructuring of Sector Companies							13.92	13.92
B.1	**Road classification and standards**					0.800		0.80
	a	Detailed Maintenance Performance Standards	C	I	0.800			0.80
B.2	**Road Asset Management System (RAMS)**					3.250		3.25
	a	RAMS scoping consultancy	C	I	0.180			0.18
	b	RAMS implementation support	C	I	2.000			2.00
	c	Equipment for RAMS implementation	G	I	1.070			1.07
B.3	**Rationalize Operations and Business Functions (Motorways)**					5.970		5.97
	a	Rationalize Operations and Business Functions (Motorways)	C	I	1.200			1.20
	b	Retrenchments		I	4.770			4.77
B.4	**Tolling**					1.000		1.00
	a	Tolling Strategy	C	I	1.000			1.00
	b	Tolling Equipment	G	E				
	c	Tolling Transition - Retrenchment		E				
B.5	**Operational and Business Rationalization of HC**					0.600		0.60
	a	Rationalize operations and business functions (HC)	C	I	0.600			0.60
B.6	**Road Safety**					2.300		2.30
	a	Safety Barriers	C	I	1.400			1.40
	b	Safety In Ten-T Tunnels	C	I	0.600			0.60
	c	ITS for Traffic Management and Road-User Information	C	I	0.300			0.30
		Unallocated					2.00	2.00
		Sub-Total					22.00	22.00
Component C - Debt Optimization							350.00	350.00
C.1	**Debt Optimization Activities (IBRD Guarantee)**		GU	I		350.000		
		Total IBRD Commitment					372.00	372.00

[16] Only includes details of IBRD Financed Components

Table 5 – Timetable for Implementation and links to the LSP implementation

	Project Implementation Arrangements By Component Activity	Letter of Sector Policy date	Supplemental Letter target dates and other key dates
Component A - Institutional Strengthening and Sector Reforms			
	Approval of the National Transport Strategy	October 2017	
A.1	**Strategy for Sector Debt Re-Structuring**		
a	Financial Transaction advisor	Strategy developed May 2017	[signed January 2017]
	- Expected start of strategy implementation	September 2017	
A.2	**Transport Sector Planning and Road Sector Governance and Monitoring**		
	- Approval for creation of Department	March 2017	
	- Commence operations	June 2017	
	- Plan of sector investment priorities for 2017-2020 presented to GoC	end March 2017	
	- Multicriteria framework for prioritization developed	May 2017	
a	Procurement of IT equipment		Award procurement September 2017
b	Sector Governance Framework including planning department	CorpGov plans adopted March 2017	
	- Service agreements between State and road companies	September 2017	
c	IT Application for Reporting		In place Dec 2018
d	Accounting standards		In place Dec 2017
e	Business environment for freight road transport industry		To be defined
f	Citizen Engagement Tools		To be defined
A.3	**Implementation support**		
a	Technical coordinator		Commence by June 2017
b	Financial coordinator		Commence by June 2017
c	Communications consultancy		Commence May or June 2017
d	HR consultancy		Commence June 2017
e	Project audit		Commence March 2018
f	Legal Support		Commence June or July 2017
Component B - Operational Restructuring of Sector Companies			
B.1	**Road classification and standards**		
	Approved updated Road classification	March 2017	
a	Detailed Maintenance Performance Standards		
	- Award TA		Oct/Nov 2017
	- Complete Ph 1 (Regulation update)	October 2017	
	- Complete Ph 2 (Detailed Standards)	October 2018	
B.2	**Road Asset Management System (RAMS)**		
c	Road Asset Management System (RAMS)		
	- TA for scoping		Conclude within 2017
	- Implementation	Contract award by March 2018	
	- RAMS operational	March 2020	
	- First costed 4 year rolling maintenance plans for HC and Motorways	March 2020	
B.3	**Rationalize Operations and Business Functions (Motorways)**		
	- Legal steps completed for the merger of HAC, HAC-ONC and ARZ	July 2017	
	- Enactment of additional legal steps for motorway monopoly status	September 2017	
a	Rationalize Operations and Business Functions (Motorways)		Award contract by Jul 2017
	1st stage improvements	Decrease of opex by 7% - End 2017	
	2nd stage improvements	Decrease of opex by 15% - End 2018	
	3rd stage improvements	Decrease of opex by 30% - End 2020	
b	Retrenchments		
	Staged implementation	120 people by December 2017	
B.4	**Tolling**		
	HAC toll increase		March 2017
	Seasonal toll increase implementation	July 2017	
	Electronic toll discount reductions	June 2018	
	Harmonization of HAC-ARZ on categories II, III, IV	2020	
a	Tolling Strategy		ToR & RFP by April 2017
	- Selection of type of automated toll system	December 2017	
	- Bidding Documents for automated system	July 2018	
b	Tolling Equipment	System implementation by 2021	
c	Tolling Transition - Retrenchment		To be determined
B.5	**Operational and Business Rationalization of HC**		
	- Agreement on the joint procurement of HC-ZUC maintenance	October 2017	>= 50% of HC net covered in 2019
	- New contracting procedure	July 2018	
a	Rationalize operations and business functions (HC)		
	- Determine further operational improvements	March 2018	Rationalized ops launched Mar 2019
B.6	**Road Safety**		
	Officially adopt MSTI's RS Action plan	March 2017	
	EU Directive 2008/96 - Audits and inspections on TEN-T	10% of network aud/insp by July 2018	Complete by Dec 2020
	Axle weight monitoring on state roads	Bidding docs by July 2018	
a	Safety Barriers		Award contract by January 2018
	Design of blackspot treatment on State roads		To be determined
b	Safety In Ten-T Tunnels		Award contract by January 2018
c	ITS for Traffic Management and Road-User Information		To be determined
	- Crocodile II implementation		Award contract by January 2018
	Zagreb-Karlovac design of improvements		To be determined

Annex 3: Implementation Arrangements
CROATIA: Modernization and Restructuring of the Road Sector

Project Institutional and Implementation Arrangements

1. The overall sector reform will be supervised by a Project Steering Committee (PSC) chaired by the Minister of MSTI, and existing sub committees will guide and monitor all the technical and financial aspects of the sector reform and debt refinancing. This committee is established by ministerial decision. The chair of the subcommittee for the financial aspects will lead the guarantee aspects of the project, together with the director in charge of public debt in the Ministry of Finance. The chair of the subcommittee for technical reforms will provide oversight on the implementation of the LSP and advise the minister on its implementation. Committees' propositions that impact the implementation of the LSP are proposed by the chair to the minister for decision, while chairs lead the work of each sub-committees and will interact with the units in charge of implementation on a daily basis.

2. A PIU, established within MSTI, will be maintained at all times during the implementation of the Project, with composition, mandate and resources satisfactory to the Bank, for the purpose of ensuring prompt and efficient overall coordination, implementation and communication of Project activities, including being responsible for: (i) technical investments, retrenchment and human resources aspects; (ii) financial management and procurement; (iii) ensuring compliance with environmental and social safeguards and maintaining coordination with environmental working group (comprised from Implementing Companies' environmental staff); (iv) preparing and circulating periodic progress reports; and (v) monitoring and evaluation of Project activities. The PIU shall report to the Minister of MSTI and the PSC.

3. Within each of the motorway and roads Companies, a team will be assigned to assist in managing relevant TA, and to escalate issues to the PSC and PIU, where required. The Company teams will include overall coordinators, and persons responsible for technical investments, retrenchment and human resources aspects, and environmental and social safeguards. These experts will perform the project-related work together with their regular responsibilities.

4. To facilitate the carrying out of Component B.3(ii) of the Project, the MSTI will make part of the proceeds of the Loan available to HAC under a subsidiary agreement under terms and conditions approved by the Bank, which shall include a provision that the funds would be allocated free of charge and without reimbursement ("Subsidiary Agreement").] This component would involve an actual transfer of funds to HAC for retrenchment payments. For the rest of Component B, companies will provide technical oversight with funding and fiduciary responsibility staying with MSTI. The involvement of the companies in the various subcomponents is listed as followed: B.2: HAC and HC; B.3 and B.4 : HAC and ARZ;B.5: HC; B.6: HAC.

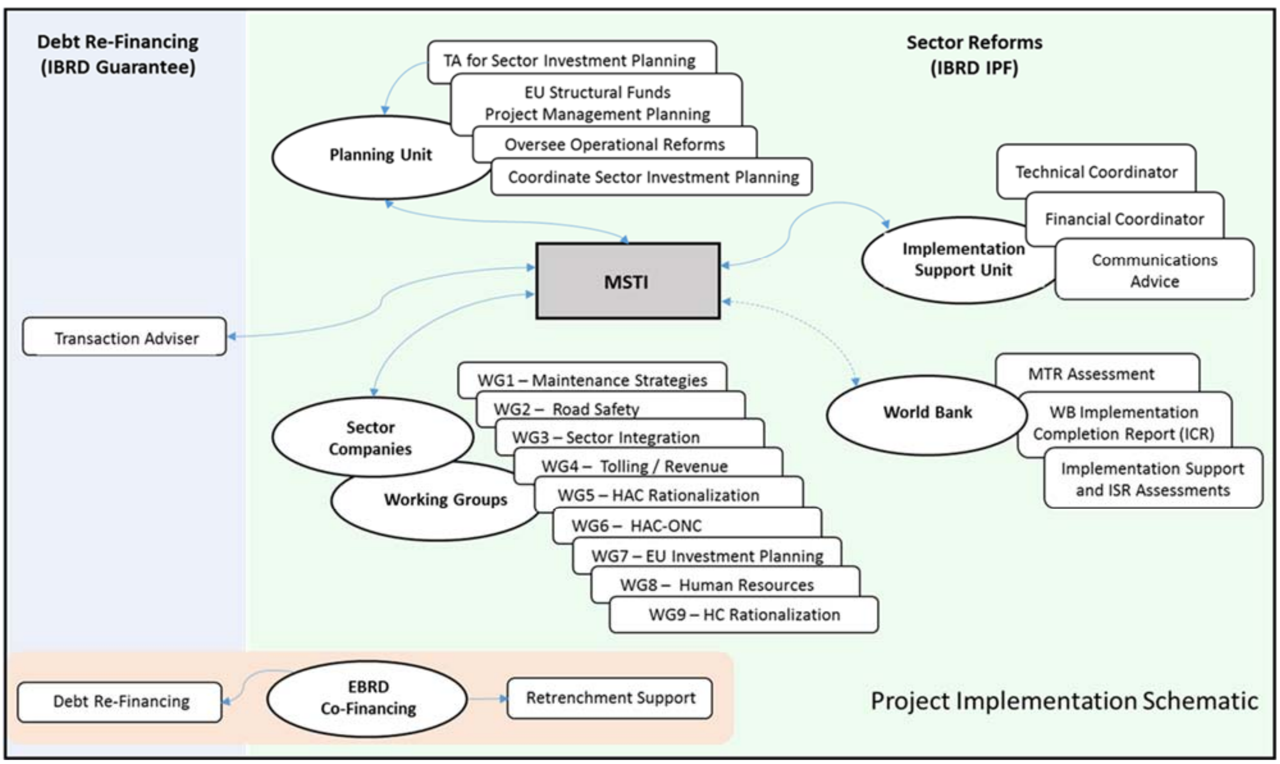
5. MSTI shall carry out the Project in accordance with a **Project Implementation Manual** in form and substance satisfactory to the Bank, providing details of arrangements and procedures for the implementation of the Project, including: (a) capacity building activities for sustained achievement of the Project's objective; (b) disbursement and financial management; (c) institutional administration, coordination and day-to-day execution of Project activities; (d) monitoring, evaluation, reporting (including mechanisms and formats for the preparation of

Annual Work Plans and Budgets, information, and communication; (e) procurement; and (f) such other administrative, financial, technical and organizational arrangements and procedures as shall be required for the Project; provided, however, that in case of any conflict between the provisions of the Project Implementation Manual and those of this Agreement, this Agreement shall prevail.

6. The MSTI and the Road Sector SOEs will prepare and furnish to the Bank for review and approval, not later than one month in each Fiscal Year during the implementation of the Project, a proposed annual work plan and budget covering all activities proposed to be carried out under the Project in the forthcoming Fiscal Year. Each such proposed annual work plan and budget shall specify among the activities, any training activities that may be required under the Project, including: (a) the type of training; (b) the purpose of the training; (c) the personnel to be trained; (d) the institution or individual who will conduct the training; (e) the location and duration of the training; (f) the cost of the training; and (g) the expected outcome and impact of the training.

7. Table 1 below, shows a schematic view of the project implementation arrangements.

Table 1 - Project Implementation Schematic



Financial Management, Disbursements and Procurement

Financial Management

8. Overall the project financial management risk before mitigation measures is assessed to be moderate and the residual risk remains moderate.

9. **Bank Guarantee(s) FM implementation arrangements. Flow of funds, reporting, and disbursement.** The proceeds of the Bank-guaranteed debt (e.g. Sovereign Financing(s)) to be issued by the Republic of Croatia will be on-lent on the same terms or provided as other contributions to the Road Sector Companies: HAC, ARZ and HC, which will use those proceeds to repay or pre-pay selected short term and most expensive loans. The administration and accounting of the debt will be the responsibility of the Ministry of Finance (MoF). The proceeds from the issuance of the Bank-guaranteed debt will flow to the bank account of the Republic of Croatia held in Croatian National Bank. The MoF/MSTI will prepare and submit to the Bank a letter/ report confirming receipt and use of the proceeds for each of the Bank-guaranteed debt (Sovereign Bonds or commercial loans) showing transfers to Road Sector Companies (in form of on-lending, or other contributions) and repayments or pre-payments of the identified loans. The report on use of the Bank-guaranteed debt will also be included in the annual project report and subject to annual audit. The disbursement from the guarantee will only occur in the event that the debt is not repaid by the Ministry of Finance. The Bank would make a payment to the beneficiary institution. Subsequently Republic of Croatia will be obliged to repay in accordance with the terms of the Indemnity Agreement (see Annex 7 for more details on the contractual modalities).

10. The **FM arrangements related to the TA Bank Loan** include as following:

i. ***Use of country systems.*** The project will use existing financial management systems in the MSTI, Road Sector Companies and the State Treasury for the project fiduciary purposes. The strengths that provide a basis of reliance on the project financial management arrangements include: (i) use of existing accounting staff in MSTI, (ii) existing accounting and state treasury systems and internal procedures which can be utilized for the project financial management. The identified weakness relates to the lack of experience in managing World Bank financed projects which will be mitigated by assigning a staff dedicated to project financial management including reporting, financial monitoring, loan disbursement and communication with the Bank in English.

ii. ***Budgeting and Counterpart Funding Arrangements.*** The Project will finance items included in the procurement plan or related to severance payments. The MSTI will request and include sufficient budget allocation to finance project activities in line with the existing budgetary procedures and the Law on Budget. As the Loan will finance up to 100 percent of the defined project expenditures including taxes no counterpart funding is envisaged at this stage.

iii. ***Accounting and Maintenance of Accounting Records.*** The accounting books and records of the MSTI are maintained on modified accrual basis of accounting with disclosure of commitments and in accordance with the National Accounting Standards. The MSTI will record transactions in its own accounting system (KONTO) which is able to generate trial balance for the whole Ministry but also for the Project, list of expenditures, liabilities by project, source of funding, cost account. The MSTI has written procedures including Accounting Policy and Chart of Accounts, Instruction related to flow of documents. Accounting policies to be applied to the project include the following major assumptions: (i) Cash or modified accrual accounting to report project expenditures; (ii) Reporting done in HRK/EUR for expenditures including all project funds i.e. the WB loan and other co-financing, if any; and HRK/EUR for Designated Account Statement.

iv. ***Internal Controls and Internal Audit.*** The MSTI and the MOF have adequate internal controls for the project, including regular reconciliation of bank accounts within the Treasury System, adequate segregation of duties, proper accounting policies and procedures. The project will finance predefined activities included in the procurement plan or agreed retrenchment payments. Therefore, only payments for contracts included in the procurement plan will be eligible. Treasury is supported by the IT SAP system which requires registration of contract and orders and subsequent invoices before making payments and also checking budget allocation for given activity. There are no current issues with regard to the timeliness of payments processed via Treasury System. Each incoming invoice is entered into SAP contract monitoring system which after matching with order sends it automatically to the procuring department for verification of conformity with the contract specification, amount and confirmation in terms of quality, quantity, and timeliness of deliverables. Thereafter invoices are verified by accounting department with regard to supplier data, mathematical accuracy and recorded by as liability on appropriate cost account and submitted for payment authorization by the Head of the Directorate and Chief Accountant. Approved payment order is submitted to the MOF via Treasury System and after execution of the payment the MSTI obtains confirmation of payments. Contract monitoring is effectively performed by procuring units supported by use of SAP module. Internal audit department in MSTI can provide additional assurance, however due to the relatively low value of the Bank financed project in the overall budget of the MSTI and due to the fact that the internal audit programs do not specifically cover upcoming World Bank financed project the Bank is not able to solely rely on internal audit for its fiduciary purposes.

v. ***Periodic Financial Reporting.*** MSTI shall prepare and furnish to the Bank not later than forty five days after the end of each calendar semester, interim unaudited financial reports (IFRs) for the project covering the semester, in form and substance satisfactory to the Bank. The IFRs will be prepared based on the accounting records kept in KONTO system used by the MSTI.

vi. ***External Audit.*** MSTI will be responsible for the timely preparation of the annual project financial statements for the independent external audit. Project financial statements (including SOE and DA activities) will be audited by an independent auditor acceptable to the Bank. Supreme Audit Office is an audit institution acceptable to the Bank in Croatia, however due to rotation of the entities subject to audit (MSTI might not be audited every year in the future), and the deadlines for submission of the audit report extending beyond June 30 it might be more practical to engage private sector auditors for project audit. Each audit of the Financial Statements shall cover the period of one (1) fiscal year of the Borrower, commencing with the fiscal year in which the first withdrawal was made under the Loan. The terms of reference for the audit have been agreed with the Bank, and will be attached to the Minutes of Negotiation. In addition, the auditors are expected to deliver management recommendations letters in relation to the project. Each management recommendations letter will identify internal control deficiencies and accounting issues, if any. The audit reports, audited financial statements and management recommendations letter will be delivered to the Bank within six months of the end of each fiscal year. The audited Project Financial Statements will be published on the MSTI website within two months after the Bank has sent an official audit acknowledgement letter.

vii. **Performance monitoring** of the Road Sector Companies is vital to the project and sustainability of the road sector. Thus the Bank will also require annual audit of each separate entity: HAC group, HC, and ARZ to be submitted on annual basis together with management letters. The separate entity and consolidated financial statements audit report of Road Sector Companies shall be submitted to the Bank within 6 months after the end of the fiscal year. The Audited Financial Statements of the project and the Road Sector Companies will be made publicly available in a timely fashion on the Road Sector Companies' website and by the Bank.

Table 2 - Financial Reporting and Audit Requirements

FM covenants	Responsible	Deadline
Submission of annual audited project financial statements together with the Management Recommendations Letter. The scope of financial audits will include reviews of claims made for reimbursement of retroactive eligible expenditures during the period covered by the audit and will cover a report confirming receipt and use of the proceeds for each of the Bank-guaranteed debt (e.g. Sovereign Financing) showing transfers to Road Sector Companies (in form of on-lending, or other contributions) and repayments or pre-payments of the identified loans.	MSTI	Covenant: Within 6 months after the end of each financial year and also at the closing of the project. First report due June 30, 2018.
Submission of the semi-annual Interim Unaudited Financial Reports (IFRs).	MSTI	Covenant: 45 days after the end of the reporting semester
Submission of entity audit reports of financial statements of Road Sector Companies (HC, HAC, HAC-ONC, ARZ) and consolidated audit report of financial statements of HAC together with English translation and Management Recommendations Letter.	HC, HAC, HAC-ONC, ARZ	Covenant: Within 6 months after the end of each financial year. First report due June 30, 2017.
Submission of a letter/ report confirming receipt and use of the proceeds for each of the Bank-guaranteed debt (e.g. Sovereign Financing) showing transfers to Road Sector Companies (in form of on-lending, or other contributions) and repayments or pre-payments of the identified loans.	MOF/ MST	Covenant; [60 days] After issuing of each Bank Guarantee.

11. **Entity level FM issues and action plan.** Improvement and standardization of accounting regulations, policies and practices across the sector companies, development a Sector Governance Framework including definition for KPIs and monitoring arrangements, and establishment of an application for data exchange and reporting between the Ministry and the Road Sector Companies are included activities under Project sub-component A2 (Strengthening of the MSTI in Sector Planning and Oversight of Public Road Enterprises and Road Sector Governance and Monitoring). The terms of Project Agreements with road companies as part of the guarantee should also include requirements regarding the use of guaranteed debt extended to Road Sector Companies, periodic progress reporting, loan repayment, auditing requirements.

12. **Accounting regulations and practices of roads entities in Croatia.** Road Sector

Companies including HC, HAC, HAC-ONC, ARZ are using various accounting regulations and accounting policies thus the information included in the audited financial statements of the companies cannot be easily compared without adjustments and used for decision making, monitoring, and measurement of financial position and performance. As all these companies are under common control of the state and there are no imminent plans for privatization the government should review and unify accounting regulations and policies which would reflect the real operational and economic model of the restructured road entities with application of suitable accounting standards such as International Financial Accounting Reporting Standards (IFRS) applicable for commercial entities and/or International Public Sector Accounting Standards (IPSAS) applicable for public sector entities. The Ministry of Finance which is in charge of setting of accounting standards in Croatia should be actively involved in this process. The change of the accounting standards and policies should be synchronized with enhancement of other financial management and operational aspects and normally should be implemented from the beginning of the accounting year.

13. In particular HC and HAC as limited liability companies are applying provisions of the Accounting Act and the International Financial Reporting Standards (IFRS) endorsed by the EU with exceptions of specific accounting provisions *"lex specialis"* included in the Roads Act. The Roads Act requires specified road companies HC and HAC to apply so called "capital approach" for certain revenues (incl. vehicle registration fee, fuel tax proceeds, interest and foreign exchange income, profit realized by companies) and expenses (incl. interest and foreign exchange losses, regular and periodic road maintenance, depreciation not covered with other income of the companies, other difference between revenues and expenses realized by the companies) which instead of being recognized through income statement are charged directly to public capital which in general represent "public good" i.e. roads infrastructure in the legal ownership of the Republic of Croatia. In practice HC and HAC are reporting zero profit and do not show all operating revenues and expenses in their income statement. Such zero balancing approach and limited autonomy and accountability with regard to the financial performance suggest that HC and HAC are not profit oriented entities. HC with over 97 percent income from fuel tax which must be spent for road construction and maintenance included in the annual plans approved by the Government, can be considered as a service-oriented entity which provide public services to achieve agreed outcomes and is totally dependent on government funding. HAC with the fuel tax revenues which constituted approximately 50 percent of total revenues in 2013 and 24 percent since 2014 falls closer to the commercial public sector entity which should be more self-sustainable however still with support of the defined revenue from fuel tax.

14. The information from financial statements of Road Sector Companies cannot be used without major adjustments for calculation of ratios or indicators commonly used in financial analysis, setting KPIs, and comparison of their financial performance amongst them and also with peer companies abroad.

15. As a result, financial information included in income statements of HC and HAC do not faithfully represent all revenues and expenses related to construction and management of roads and motorways as a whole. However, it is possible after adjustments and extracting relevant information from existing accounting records to combine both revenues and expenses related to operation of entities and public capital to present financial position and performance in clear and

transparent way and in line with acceptable accounting standards.

16. HAC-ONC is applying Accounting Act and the IFRS. HAC-ONC 2015 audit report includes unmodified (clean) opinion on financial statements.

17. ARZ is 100 percent state owned joint stock company which applies provisions of the Accounting Act and IFRS including IFRIC 12 solution used by private sector concessionaires/operators in PPP arrangements. ARZ 2015 audit report includes qualified audit opinion on financial statements due to lack of provision for planned maintenance required in order to return motorways in defined conditions to the grantor (Republic of Croatia) after expiration of the concession. ARZ took commercial loans to finance construction of motorway infrastructure legally owned by the Republic of Croatia and recorded initial cost of constructions as intangible assets in form of concession rights. ARZ is not showing motorways in its balance sheet as tangible assets which are also not depreciated using economic and technical useful life which is normally estimated at 40-50 years. Instead ARZ is depreciating its concession rights for a shorter period only until the end of the concession which de facto means that construction costs are depreciated during 25 years on average. As toll revenues are not sufficient to cover the construction costs (including also debt service) and maintenance of motorways, the concession rights have been significantly impaired (decreased) as the current value of expected future cash flows is lower that net book value of the concession rights. This resulted in reporting huge loss which exceeded share capital and currently ARZ is showing negative equity which for a commercial company would normally raise going concern issue and would require additional contributions from owners. In addition, the road infrastructure (being in public good domain) constructed and financed by ARZ is not shown as tangible assets on ARZ balance sheet, is not included in the fixed assets register, its current monetary value is not estimated, while motorways exist and are in operation and used by motor vehicles users. On the other hand, debt incurred by ARZ to finance the road infrastructure was stranded from the tangible assets or sufficient cash inflows resulting with assets and liabilities mismatch. However, this issue is not a mere accounting problem, but rather a fact of inaccurate long term traffic projections and cost revenue calculation at the stage of investment planning, which need now resolution in a form of the road sector restructuring.

Disbursements

18. ***Flow of funds & Disbursements.*** At the request of the MSTI, the MoF will create an analytical account in the State Treasury for receipt of the loan proceeds which will be used as a Designated Account (DA) in line with the existing treasury procedures. The loan funds will flow from the Bank through a Single Treasury Account with the Croatian National bank to the DA and via Treasury system and MSTI to contractors on the basis of approved invoices. Retrenchment payments to employees will be made by HAC using existing HR payroll procedures from own sources and then reimbursed or using advances on the designated account. Withdrawal applications for the replenishments of the DA will be sent to the Bank via Client Connection system directly by MSTI based on need for loan funds. MSTI will prepare the applications for withdrawals and documentation of use related to the loan fund using the Client Connection system (the Bank's system for electronic disbursement).

19. ***Disbursement*** from the Loan Account will follow the traditional method, either through reimbursement, direct payment to suppliers, and advances to the designated account. The expenses

will be documented with the use of Statement of Expenditures SOEs. Withdrawal applications for the replenishments of the DA will be sent to the Bank directly by MSTI based on need for loan funds. Supporting documents for SOEs, including completion reports and certificates, will be retained by MSTI and made available to the Bank during project supervision. The reimbursement of expenditures from the DA may be made on the basis of certified SOEs. The ceiling and authorized allocation for the IBRD DA will be defined in the project Disbursement Letter. The DA will be denominated in the currency of the loan as selected by the Borrower (EUR).

20. ***Retroactive Financing.*** The project will finance retroactively expenditures already paid by the MSTI which will include agreed and selected contracts which are within the scope of the project, procured in line with the Bank Procurement Guidelines, or which procurement process have been assessed as consistent with the Guidelines. The retroactive payments may be made up to an aggregate amount not to exceed (i) EUR three million for Eligible Expenditures made prior to the Loan Agreement signing date but on or after January 1, 2017.

21. ***Retrenchment payments*** can include one-off voluntary severance payments, involuntary severance and notice payments, and related payments of taxes and other social contributions as included in the retrenchment plan acceptable to the Bank. The Loan will fund only retrenchment in HAC. Once the retrenchment plan is done and acceptable to the Bank, HAC would proceed with payment and funds from the loan would be used to reimburse HAC for the corresponding expense. Retrenchment payments will be subject to a specific audit as part of the overall annual project audit.

Table 3 - Withdrawal of the Proceeds of the Loans and estimated disbursements

Category	**Amount of the Loan Allocated (expressed in Euro)**	**Percentage of Expenditures to be financed (inclusive of Taxes)**
(1) Goods, non-consulting services, and consultants' services and training for the Project	15,230,000	100%
(2) Retrenchment Payments under Part B.3 of the Project	4,770,000	100%
(3) Unallocated	2,000,000	100%
TOTAL AMOUNT	**22,000,000**	**100%**

Project Components			Estimated Total	IBRD Financing	Yr 1-FY18 (To 30 Jun '18)	Yr 2-FY19 (To 30 Jun '19)	Yr 3-FY20 (To 30 Jun '20)	Yr 4-FY21 (To 30 Jun '21)	Yr 5-FY21 (To 31 Dec '21)	Total
			€ m	€ m	€ m	€ m	€ m	€ m	€ m	€ m
1	**Component A - Institutional Strengthening and Sector Reforms**									
	A.1	Strategy for Sector Debt Re-Structuring	2.83	2.83	1.42	1.42				2.83
	A.2	Transport Sector Planning and Road Sector Governance and Monitoring	1.25	1.25	0.63	0.63				1.25
	A.3	Implementation support	2.00	2.00	0.50	0.50	0.40	0.40	0.20	2.00
		Sub-Total	***6.08***	***6.08***						
2	**Component B - Operational Restructuring of Sector Companies**									
	B.1	Road classification and standards	0.80	0.80	0.40	0.40				0.80
	B.2	Road Asset Management System (RAMS)	3.25	3.25	1.08	1.08	1.08			3.25
	B.3	Rationalize Operations and Business Functions (Motorways)	5.97	5.97	1.99	1.99	1.99			5.97
	B.4	Tolling	1.00	1.00	0.33	0.33	0.33			1.00
	B.5	Operational and Business Rationalization of HC	0.60	0.60	0.20	0.20	0.20			0.60
	B.6	Road Safety	2.30	2.30	0.58	0.58	0.58	0.39	0.18	2.30
		Sub-Total	***13.92***	***13.92***						
		Unallocated	2.00	*2.00*	0.50	0.50	0.50	0.34	0.16	2.00
	Total Financing Required (incl VAT)		**22.00**	**22.00**	**7.62**	**7.62**	**5.08**	**1.13**	**0.54**	**22.00**

Procurement

22. A **Capacity Risk Assessment** of the implementing agency for carrying out and managing procurement was initiated during project Preparation and was finalized during project Appraisal. Based on the assessment, the Bank determined that the risk for procurement, after mitigation, is **moderate.** The procurement thresholds and the ceiling for shortlists, comprising only national consultants are set in accordance with the maximum ECA regional thresholds effective January 2, 2014, and revised on February 10, 2015.

23. The project will be implemented by the MSTI. A Project Implementation Unit (PIU) will be established within the Ministry, which will be responsible for the overall coordination, management and fiduciary functions (including procurement and financial management) with reference to the project. Eight Working Groups (WG), established by the MSTI during the project preparation stage to assist with identifying the project reform elements, will support and cooperate with the PIU on various project activities such as preparation of Terms of References (TORs), participation in evaluation and contract negotiations and contract management. In addition, teams will be assigned within each of the motorway and roads Companies, to assist in managing the relevant TA and to cooperate with the PIU as required. It is envisaged that the project will finance mainly consulting services contracts of various nature, scope and value, and only very few goods and non-consulting services contracts. The day-to-day procurement work under the project will be carried out by two procurement specialists. One HAC expert, familiar with the World Bank's procurement procedures assisted with various procurement assignments related to project preparation. He has experience as a Procurement Adviser in a number of World Bank financed projects. A formal decision on his assignment to work as a Procurement Adviser to the project is still pending and is expected to be issued by project Effectiveness. Ideally, the current Procurement Adviser will be supported by one more Procurement Specialist, hired as a consultant to the PIU on an as-needed-basis. **A summary of the risks for procurement identified during the capacity assessment and the mitigation measures are outlined in the table below**:

Table 4 - Summary of Risk Assessment

No.	***Description of Risk***	***Rating of Risk***	***Mitigation Measures***	***Rating of Residual Risk***	***Timeline for completion***	***By whom***
1.	Significant frontloading of selection procedures during the first six months of the project.	**S**	The initial summary procurement plan for the first 18 months of project implementation shall be agreed during negotiations, and will be updated during project implementation annually or on an as-needed-basis. An additional Procurement Specialist to be hired on an as-needed-basis, as well as a monitoring of the procurement processes and contract management on a regular basis.	***M***	***At Project Negotiations and during Project Implementation***	***MSTI and Word Bank***
2.	One HAC staff assigned to work on procurement under the project, but no formal decision on this assignment.	**S**	A formal Decision to be issued on the organization of the procurement function in the PIU.	***M***	***By Project Effectiveness***	***MSTI***
3.	The procurement and review thresholds for the project will be in accordance with the most recent ECA Region Reference Thresholds for Procurement methods effective January 2, 2014 and revised February 10, 2015.	**S**	Procurement under the project will be carried out in accordance with the relevant most resent Procurement and Consultant Guidelines of January 2011, Revised July 2014 and standard bidding and proposal documents of the World Bank posted on its external website at: http://www.worldbank.org/en/projects-operations/products-and-services/brief/procurement-policies-and-guidance Bank will conduct regular post reviews and provide procurement support to the PIU in the form of tailor made presentations and training sessions. The particular prior and post review arrangements will be specified in the	***M***	***Thresholds to be agreed at Project Negotiations and updated as relevant during Project Implementation***	***MSTI and World Bank***

			procurement plan agreed with the Bank			
4.	According to the World Bank current policies and procedures, the project is automatically redirected to Systemic Tracking of Exchanges in Procurement (STEP) platform of the Bank and all procurement related action have to be conducted through STEP. The Project shall use the Systemic Tracking of Exchanges in Procurement (STEP). STEP is a brand new platform and MSTI staff does not have experience with STEP	**S**	Procurement and project management staff to be trained in use of STEP. Information on STEP is available on the World Bank's website at: https://step.worldbank.org/	***M***	***After Negotiations and during Project Implementation***	***MSTI and World Bank***

24. **Advance Contracting and Retroactive Financing.** A retroactive financing in the amount of EUR 3 000 000 is foreseen in the loan agreement, needed inter alia for the contract for Financial Advisor under reference number A1 - a QCBS – MARS. The selection process for this activity was carried out during project preparation. The selection procedure applied was QCBS and on November 30, 2016 the Bank issued a no-objection to the draft negotiated contract with the winning consultant for the amount not to exceed EUR 2.822.325,00 exclusive of local indirect taxes. It was noted in the no-objection that the referenced contract is eligible for financing from the Loan proceeds for the proposed Modernization and Restructuring of the Road Sector Project when it is approved and becomes effective.

25. **Applicable Guidelines.** The project will finance mainly consulting services contracts and a few goods contracts. Since the Project Concept Note of the project was approved prior to July 1, 2016, all goods and consulting services required for the activities of the project and included for financing from the Loan proceeds shall be procured in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" dated January 2011, Revised July 2014 and "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" also dated January 2011, Revised July 2014; and the provisions stipulated in the Loan Agreement. A summary of the various items under the different expenditure categories are summarized further in Annex 4.

26. **General Procurement Notice (GPN)** for the project will be published after project negotiations in United Nations Development Business (UNDB), the World Bank's external website, in *Narodne novine* (Official Gazette) and on the implementing agency's website.

27. **Procurement Plan:** A summary procurement plan, covering the first 18 months or project implementation was agreed at project negotiations. The summary procurement plan, including as

a minimum (i) a brief description of the goods, works, non-consulting services and consulting services required for the project; (ii) the proposed method of procurement; (iii) the Bank's review requirements; (iv) timeline, contract commencement and completion. After loan negotiations, the agreed summary procurement plan will be published on the Bank's external website, as well as all its subsequent updates once the Bank issued no-objection to them.

28. **Review Arrangements.** The procurement plan indicates the specific review arrangement for each contract. Contracts not subject to Bank's prior review, will be post reviewed by the Bank's procurement specialist assigned to the project. Post review of contracts shall be carried out once a year. At a minimum 1 out of 10 contracts will be randomly selected for post review. The specific procurement and review thresholds, applicable for the project are defined in the tables below:

29. **Prior Review Threshold**: Procurement Decisions subject to Prior Review by the Bank as stated in Appendix 1 to the Guidelines for Procurement*:*

Table 5

	Procurement Method	**Method Threshold EUR**	**Prior Review Threshold EUR**
1.	ICB (Goods)	*> 2 000 000*	*First and all > 3 000 000*
2.	NCB (Goods)	*< 2 000 000*	*First contract*
3.	Shopping (Goods)	*< 100 000*	*First contract*
4.	Direct Contracting	*Any amount*	*All > 80 000. Borrower would still need to meet the requirements for DC as outlined in par 3.7 of the Procurement Guidelines*

30. Selection decisions subject to Prior Review by Bank as stated in Appendix 1 to the Guidelines Selection and Employment of Consultants:

Table 6

	Selection Method	**Method Threshold EUR**	**Prior Review Threshold EUR**
1.	Competitive Methods (Firms)	Any amount except for CQS < 300 000	First contract, all > 1 000 000 and all TORs
2.	Single Source Selection (Firms)	Any amount	All TORs and contracts above US$ 10,000. Borrower should still meet the requirements for SSS as outlined in Consultant Guidelines (par. 3.8 – 3.11)
3.	Individual	Any threshold	All TORs, Procurement and Legal consultants, and specific contracts that need to be subject to prior review will be identified in the

			procurement plan on an as-needed basis.

31. Short list of consultants for services, estimated to cost less than EUR500,000 equivalent per contract, may comprise entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines.

32. **Anti-corruption measures.** The implementing Agency through its PIU will follow the World Bank's anti-corruption measures and will not engage services of firms and individuals debarred by the Bank. firms and individuals is located at http://www.worldbank.org/html/opr/procure/debarr.html

Environmental and Social (including safeguards)

33. Implementation of the environmental compliance assessment is the responsibility of the Implementing Companies - ARZ, HAC, HAC-ONC and HC. The common Environmental and Social Compliance Report (ESCR), with the purpose to assess companies' environmental performance and management systems, will be prepared looking into organization and operability of established ESMS; environmental performance and compliance in planning and construction activities; environmental compliance of (road) infrastructure maintenance and other regular operational activities; and practices in land acquisition and involuntary resettlement.

34. A working group composed of the representatives of the respective companies – Implementing Companies (ARZ, HAC, HAC-ONC and HC) has been set for this purpose. The working group, with the support of the WB environmental Safeguards Team, prepared the ToR for the ESCR, in English and Croatian language, before the Project Appraisal. It was disclosed at web pages of Implementing Companies, together with the call for comments, for a two-week period. Full ESCR will be prepared by the Working Group based on the final ToR in the first year of project implantation. The report will be subject to WB Environmental Specialists' approval. The overviews, analyses, assessments and recommendation will be presented separately for each company. Based on the conclusions of the report, areas for improvement and related recommended measures for each of the companies will be identified and Action Plan for their implementation agreed with the Implementing Companies not later than three months after the report has been finalized.

35. Capacity of the Implementing Companies can be assessed as mostly adequate for preparing the ESCR: each Agency has at least one person or entire department designated for environmental protection. During the past decade, HAC, ARZ and HC have conducted extensive national and EU investment programs, which indicates there is, in general, extensive knowledge in project management which includes experience in environmental management and compliance monitoring. Responsibility for environmental issues in HAC is divided between the Sector for Design which ensures environmental compliance related to physical investments and development projects, and HAC ONC which implements regular operation environmental protection measures and monitoring. Similarly, ARZ has a designated person in charge of environmental protection issues and compliance while HAC ONC takes care of maintenance, compliance and monitoring of

the regular operation of the motorway. On the other hand, HC does not perform any regular monitoring although the environmental measures are integrated into the operation standards. Within the company, Sector for Development sets a separate Department for environmental protection in preparation of project documentation (studies and assessments). HC includes environmental protection goals amongst its proclaimed organizational values.

36. HAC, HAC ONC and ARZ hold a valid certification for its management systems against ISO 9001, 140001 and OHSAS 180001 norm requirements. Roads Sector Companies have implemented successfully WB safeguards policies under part of the Category A Rijeka Gateway Project. Preliminary environmental and social management system analysis indicated two recommending measures, to be confirmed and further elaborated through ESCR, both addressing the capacity: (i) capacity building towards strengthening of environmental performance and compliance, and (ii) building a platform that would enable the Companies (currently lacking the environmental management system - EMS) to integrate ESMS into its existing management and operations.

37. Implementation of labor restructuring and preparation of retrenchment plans is the responsibility of each company (ARZ, HAC, HAC-ONC, HC). The retrenchment plans will be prepared during project implementation following the principles laid out in the Retrenchment Framework, which is applicable to all four companies. The Retrenchment Framework was prepared prior to appraisal and approved by the World Bank.

38. Capacity of the Implementing Companies can be assessed as adequate for preparing retrenchment plans. Responsibility for carrying out labor optimization is divided between human resources, legal and finance departments. Management of the companies will in accordance with the Labor Law and internal regulations make decisions on redundant employees. A special Committee will be appointed to decide on complaints of employees related to the scoring process on the selection criteria. Among other issues, the Retrenchment Plans will include agreed selection criteria and severance payment amounts for various categories of affected workers. These are to be agreed with Works Councils. Draft Retrenchment Plans will be subject to review and clearance by the World Bank, even if the World Bank financing will be allocated only to HAC retrenchment.

Monitoring and Evaluation

39. **MSTI will be responsible for monitoring and evaluating results.** Monitoring and evaluation will be the responsibility of the PIU together with the overall project reporting. Reporting on the overall project progress will be done on a six-monthly basis. Table 4 in Section IV-B summarizes the indicators and responsibilities for collection, and indicators will be collected on a six-monthly basis as well.

40. **The project in general aims at supporting M&E in the MSTI and companies.** One specific activity in component A-2 supports the definition of a monitoring and exchange of information system which will allow MSTI to monitor most of the quantitative indicators under the project automatically and facilitate transmission of information from the companies to the government. Disclosure of results and actions is also a critical element of the corporate governance plans adopted by the companies as part of the LSP, and all company level indicators are part of the companies' KPIs. The government has also decided to undertake a close monitoring of the

overall implementation of the LSP and of its actions. M&E capacity of the MSTI is not developed so the project will be an opportunity to increase it.

41. Update of the monitoring and evaluation system and potentially of project indicators may be carried out during the mid-term review of the project. Several external factors and project activities (such as the tolling system and all the TA to improve maintenance) may impact the project indicators and the target values. These will be revised at the time if need be.

Role of Partners

42. The project design benefits from parallel financing from EBRD. EBRD lending in the amount of EUR 250 million, to support the refinancing of HAC and motorway sector reforms, was provided to the government through a loan signed in March 2016. Under the design of the MARS project, EUR 50 million of this financing will be used by government as a contribution towards (a) retrenchment packages, based on the outcomes of the Action Plans being financed under the MARS reforms, and (b) installation of a new tolling system which will arise out of the strategies and recommendations arising from TA under the MARS project. EBRD also envisages to contribute to the HC investment plan and the refinancing of its debt, which will be confirmed at the time of the second phase.

43. EIB is a major contributor to the sector and is associated to the sector reform mostly as the main co-financier of EU funded projects, for which it provides a line of credit managed and reimbursed directly by the state, and therefore contributes to secure the investment plan agreed as part of the LSP.

Annex 4: Implementation Support Plan

Strategy and Approach for Implementation Support

Loan and reform part

1. Implementation support missions, including field visits will be carried out regularly, and will focus on: (a) institutional strengthening and capacity building; (b) technical aspects; (c) environmental and social safeguards monitoring and (d) fiduciary. Most of the fiduciary and environmental supervision will be carried out continuously from Zagreb and two technical team members will also be based in Croatia for the daily follow up of technical assistance.

a) **Institutional strengthening - capacity building**. Institutional strengthening and capacity building will receive substantial focus during the project implementation and related implementation support. This will include a regular dialogue on the progress of sector and road company governance, implementation of new institutional arrangements (sector planning, motorway merger, HC decentralization) and improved legal framework for road network management and maintenance, as well as improved framework for road sector investment planning.

b) **Technical aspects.** Major technical consultancies to support the restructuring of the motorway and state road management, as well as tolling, maintenance standards, road asset management system and safety improvements, will be regularly supervised through close cooperation and review from the procurement stage through their completion including any downstream work.

c) **Environment and social safeguards.** Support will be provided in safeguards matters and particular focus will be given to ensuring that labor restructuring activities are performed in accordance with the relevant provisions, and that the Environmental Compliance Report results are owned and recommendation implemented as agreed.

d) **Fiduciary**: As part of its project implementation support and supervision missions, the Bank will conduct risk-based financial management implementation support and supervisions at appropriate intervals. During the Project implementation, the Bank will supervise the Project's financial management arrangements in the following ways: (a) review the Project's semiannual IFRs and the Project's annual audited financial statements (including SAI audit reports is available), auditor's management letters and remedial actions recommended in the auditor's management letters; (b) review the Road Sector Companies' annual audited financial statements and auditor's management letters to monitor financial performance and quality of financial reporting; (c) provide implementation support related to activities enhancing financial management capacity in the Road Sector Companies including proper application of acceptable accounting standards (eg. IFRS) and harmonized accounting policy for Road Sector Companies as a part of PDO monitoring; and (b) during the Bank's on-site missions, review the following key areas (i) project accounting and internal control systems; (ii) budgeting and financial planning arrangements; (iii) disbursement arrangements and financial flows, including counterpart funds, as applicable; and (iv) any incidences of corrupt practices involving project resources. As required, a Bank-accredited Financial Management Specialist will participate in the implementation support and supervision process. Procurement will continuously be supervised from Zagreb.

Guarantee part of the project

2. The first year of implementation de facto includes the finalization of the guarantee and will require a team with a lead/senior infrastructure finance specialist, one or two junior staff to support, and senior legal counsel. Once the guarantee is in place the requirements will diminish with most of the work consisting of checking the progress in reform and the companies' financial situation and long term capacity to repay the debt refinanced by the guaranteed financial instrument.

Implementation Support Plan

3. The implementation support missions will involve engineering, procurement and safeguards specialists and at least once annually also financial management. Particular focus will be put on supervising the implementation of the road safety measures. Capacity regarding environmental and social safeguards will be continuously monitored by the World Bank environmental and social specialists who will participate regularly in implementation support missions and provide input directly to the client as required.

4. The Mid-term review of the project, expected to take place in the first quarter of calendar year 2019, will include assessment of progress in institutional and technical matters as well as road safety.

Table 1 - Main focus in terms of support to implementation during project

Time	***Focus***	***Skills Needed***
First twelve months	*Procurement of major consultancies* *Capacity review* *Institutional framework* *Investment planning* *Definition of sector strategy* *Financial strategy* *Set up for the guarantee instrument* *Social safeguards*	*Road engineering and maintenance* *Tolling* *Systems engineering / ICT* *Road safety* *Financial planning / guarantees* *Investment planning* *Corporate / SOE governance* *Financial management* *Procurement* *Safeguards* *Project management*
12-48 months	*Implementation of designs* *Implementation of sector strategy* *Loan reprofiling and refinancing*	*Road engineering and maintenance* *Systems engineering / ICT* *Road safety* *Financial planning / guarantees* *Financial management*

	Road safety *Social safeguards*	*Procurement* *Safeguards* *Project management*

Table 2 - Skills Mix Required

Skills Needed	***Number of Staff Weeks***	***Number of Trips***	***Comments***
Task team leader(s)	10 / year	4 / year	
Senior Lawyer	4/year	1/year	
Financial/Guarantee specialists	6 / year	3/ year	
Road engineers	8 / year	N/A	Zagreb based
Tolling specialists	8 / year	3 / year	
Transport economist	3 / year	2 / year	
Corporate governance specialist	4 / year	2 / year	
Social safeguards specialists	3 / year	2 / year	
Environmental specialists	2 / year	1 / year	
FM specialists	2 / year	2 / year	
Procurement specialists	4 / year	N/A	

Table 3 - Partners

Name	***Institution/Country***	***Role***
	EBRD	*IFI providing parallel financing to the loan component on motorways*
	EU DG Regio	*Authorizes co-financing of transport investment projects*

Annex 5: Financial and Economic Analysis

For confidentiality purposes many elements in the economic and financial analysis could not be disclosed as they may impact the debt optimization process

1. The financial impact of the World Bank operation to support the financial and operational health of the two motorway companies (HAC, ARZ) and the public roads company (HC) is assessed under two criteria: revenue risk and debt sustainability. Information regarding the impact of the project and company projections has been excluded from this annex due to market sensitivity.

Current Financial and Operational Position of Road Sector Companies

2. In assessing the financial health of the Road Sector SOEs, revenue stability includes the adequacy of tolls to cover expenses. Inflation linked tolls or tolls that follow pricing mechanisms allow for adjustments that keep up with rising operating costs, which would strengthen the financial position of the companies. Revenue risk in the case of the Croatian roads sector is primarily related to the ability of HAC and ARZ to implement toll increases to adjust for inflation annually or as needed or scheduled with limited political involvement. This risk is less so in the case of HC which relies on dedicated fuel tax revenues. Tolls are currently regulated by MSTI and are not inflation linked nor do they follow a pricing formula or mechanism. This affects the ability of the companies to manage their cash flows as they have no control over revenue adjustment mechanisms to keep up with operating costs that have inflation linked components.

3. Debt sustainability measures the ability of the companies to manage and service their individual debt portfolios given their revenue base and CFADS. These are measured using the following metrics:

4. Total Debt Outstanding as a proportion of Cashflows Available for Debt Service (Debt/CFADS) – this measures the financial sustainability of the capital structure of the companies in relation to CFADS. Any improvements in this ratio would indicate retiring of debt outstanding and/or improvements in overall cashflows of the companies resulting from both toll adjustments and operational improvements. HAC currently has Debt/CFADS of 15.8 x, ARZ is at 15.0x, and HC at 9.7x. The industry average for Debt/CFADS for European Toll Road operators ranges from 3.3-7.3x.

5. Debt Service Coverage Ratio (DSCR) – this measures the ability of the companies to meet principal and interest payment obligations. Improvements in this ratio would be a result of improvements in CFADS as well as optimizing of debt, particularly in the form of increasing tenors since the three companies have large short and medium terms loans maturing in the next 4 years as well as bullet payments due in 2017. Current DSCR levels for each of the companies are 0.27x for HAC, 0.47x for ARZ and 0.57 for HC.

6. Loan Life Coverage Ratio (LLCR) – compares the net present value of CFADS vs outstanding debt over a 10, 15, and 19 years forward looking period. This measure is used to estimate the ability of the borrower to repay the outstanding loans in the specified time period,

which is an important measure of independent debt sustainability. The table below shows current LLCR levels for each of the three companies which confirms that the short and medium term debt coverage of the motorway companies is currently low:

Table 1

LLCR	10 Year	15 Year	19 Year	Target
HAC	0.7x	0.9x	1.2x	1.0x
ARZ	0.7x	1.0x	1.2x	1.0x
HC	1.0x	1.4x	1.8x	1.0x

7. The analysis above indicates the current position of the companies is unsustainable from a financial and operational perspective without continuing and significant support by the GoC. Current portions of long term debt (Debt Service) are significantly higher than each of the companies can afford to pay. While the projections indicate that total debt outstanding decreases over time as loans are due, in reality given the low DSCR ratio, debt is likely rolled over and this results in increasing debt obligations or direct service of debt by the GoC. While HC seems to be in a better position than the motorway companies, in terms of total debt outstanding, the public road company still faces considerable challenges to service ongoing debt obligations unaided.

8. Furthermore, the majority of the debt held by the companies is amortizing, but given the short maturities of many loans, the companies are exposed to considerable refinancing risk. HAC currently has a loan portfolio with an average life of 3.1 years, ARZ of 4.7 years and HC of 3.9 years.

Outcome of Proposed Restructuring Measures

Toll rates for HAC and ARZ

9. Toll revenues and CFADS were estimated using the current value of toll revenue levels for the baseline (without project) and pessimistic scenarios, whereas increased toll rates – as per the expected Government's decisions for early 2017 – have been used in the baseline (with project) and optimistic scenarios.

10. For HAC, assumptions are summarized as follows:

- Increase in the effective toll rates by 1.08675 compared to the end-2016 level (compounding a 5 percent nominal rate increase and a 10 percent summer surcharge, assumed to affect the 35 percent of annual traffic representing the 3 summer months of July-September).
- Tolls are to be inflated annually.
- The average discount rate – estimated at 12.9 percent as a weighted average for all users – is assumed to be decreasing by 0.5 percent annually up to 2021 and remains constant (10.4 percent) afterwards throughout the forecast period.

11. For ARZ, the increase in the effective rates is 1.035, since no nominal toll rate increase is to be applied. All other changes are assumed to be as in HAC.

Operating and capital expenses

12. Maintenance of motorways costs are reduced by 15 percent in 2019 and 2020 and by 30 percent from 2021 onwards due to efficiency improvements in maintenance, tolling, and operator's administrative costs.

13. For HC, the optimistic and the baseline (with project) scenario includes the effects of operational expense improvements. During 2018-2020, a 7 percent annual reduction is factored in the model, resulting in a cumulative reduction of about 20 percent during the period.

14. Periodic Maintenance levels across all three companies are assumed to grow according the following assumptions:

- HAC: Current levels of periodic maintenance follow company projections which assume that current expenses of HRK 176 million per year will grow by a compounded annual growth rate of 0.3% per year.
- ARZ: Current levels of periodic maintenance follow company projections which assume that current expenses of HRK 44 million per year will grow by a compounded annual growth rate of 3.2% per year until 2031.
- HC: Current levels of periodic maintenance follow company projections which assume that current expenses of HRK 560 million will decrease by a compounded annual growth rate of 1.2% per year until 2020 and remain flat thereafter.

New expansion capex that is currently planned by the companies has also been assumed in the financial analysis. It is also assumed that a part of the capex will be funded with EU funds:

- HAC: new expansion capex of HRK 2.1 billion is expected between 2017 and 2024. Of this HRK 172 million is expected to be financed with EU funds.
- ARZ: new expansion capex of HRK 1.5 billion is expected between 2017 and 2031. Of this HRK 834 million is expected to be financed with EU funds.
- HC: expansion capex for public roads is expected to grow at a compounded annual growth rate of 26.4% per year until 2020 and remain flat until 2035. During 2017 to 2020, new expansion capex are expected to be funded by EU funds amounting to HRK 2,306 million, state budget and subsidies of HRK 531.4 million, and loans that have already been contracted amounting to HRK 293.1 million. Any other expansion capex will be funded or debt serviced by the GoC until 2021 based on the LSP.

Economic Assumptions

15. Inflation projections assume a 2.0 percent rate from 2020 onwards (baseline case) and multiplication factors of 1.1/0.9 for the optimistic and pessimistic cases, respectively.

16. Exchange rates as of January 2, 2017 (7.46 HRK/EUR increasing to 7.58 in 2018; 1.05 USD/EUR, increasing to 1.30 by 2027) have been used for the baseline scenario. For the pessimistic and optimistic scenarios, the high and low values from ECB reference exchange rate data (yearly averages) between 2006 and 2016 have been used, respectively; and also to identify the lowest and the highest exchange rate (average of observations throughout the year) in the period from 2006 to 2016 (for HRK/EUR the range is 7.22 to 7.63; for USD/EUR the range is 1.05/1.47).

GDP and tourism growth rates, both being drivers of traffic demand, are in accordance with World Bank projections from June 2016 in the baseline case (2.6 percent from 2018 onwards).

Annex 6: Rationale for the IPF Guarantee & Transaction Structuring

1. The proposed IPF Guarantee follows a request from the Government of Croatia to the World Bank's International Bank for Reconstruction and Development (IBRD) for support in the form of a project-based guarantee in the context of the Modernization and Restructuring of the Croatian Road sector ("MARS"). The proposed guarantee is expected to be made under Investment Project Finance policy OP 10.0 in support of financing extended to Croatia by commercial entities and aimed at enhancing the effectiveness of the public sector by permitting the Road Sector Companies to alleviate their debt load.

2. It is planned that the MoF would engage in one or more sovereign Guaranteed Financings amounting to up to an aggregate of EUR 1.0 billion[17], the proceeds of which are expected to be provided on substantially the same terms to HAC, ARZ and HC. The companies would in turn apply those proceeds to pre-pay loans that have been identified for refinancing. IBRD would enter into direct Project Agreements with each of the Road Sector SOEs regarding their implementation of the Project component supported by this Guarantee.

3. The Government has requested a guarantee of up to an aggregate of EUR 350 million (approximately US$ 370 million) for the project. The Government could request further IFI support in FY18 to support future interventions required to fully optimize the road sector debt, however any such request is not the subject of this operation.

4. The IPF Guarantee would complement the IBRD and EBRD loans of EUR 22 million (IBRD) and 250 million (EBRD). It would facilitate Croatia's borrowing up to EUR 1.0 billion in one or several transactions via the Guaranteed Refinancing. Government would undertake to provide the proceeds to the Road Sector Companies on terms acceptable to the IBRD, most likely as downstream loans. The Guaranteed Refinancing would help the Government of Croatia raise long tenor financing of 15 – 20 years or longer to match the needs of the Road Sector SOEs for long tenor financing. This approach is also supportive of IBRD overall objectives of leveraging its balance sheet and multiplying development resources and impact.

5. While Croatia in the past and through the sovereign has already successfully accessed the international capital markets on its own, it has been restricted in terms of tenor to a maximum of 15 years, and more recently only 10 years. The longest remaining maturity outstanding Croatia bond is 7 years in USD and 8 years in EUR. Furthermore, given its rating of BB, increasing market volatility for emerging market issuers trying to access international capital markets could impact Croatia as well in the event of a market downturn.

6. The proposed IPF Guarantee would act as a catalyst by providing Croatia with the appropriate support to ensure it has access to foreign capital inflows at a sustainable cost and more importantly, with extended tenors as needed for the Project. The Road Sector SOE debt anticipated for refinancing is short-term government guaranteed debt (less than 3 years). Given the size of the required refinancing and the need for long tenors, the Government seeks to raise financing from international loan and/or bond markets. The Guaranteed Refinancing is planned to be sought in

[17] commercial financing raised with the support of the IPF guarantee will depend on whether bank or loan markets are accessed and what percent guarantee support is required by the market. If bond markets are accessed, guarantee may be sized to reach targeted rating level (such as BBB- or BBB) for optimal placement

addition to government planned sovereign borrowing from capital markets for general budget needs. The type and amount of financing to be raised with the support of the guarantee has been determined together with the Government of Croatia and its Transaction Advisor based on a detailed analysis of the Road Sector Companies and their existing debt liabilities in light of the Sector Policy commitments for the road sector from the Government.

Access benefits of IPF Guarantee

7. **Croatia is rated BB/Ba2/BB by S&P/Moody's/Fitch.** It has 10 bonds outstanding, with a notional of US$9.0 billion and EUR 4.5 billion. The longest tenor of bonds it has raised was 15 years in 2002 and 2012 before it was downgraded to below investment grade by rating agencies. Its last issuance was EUR 1.25 billion 10 year bonds in March 2017.

8. **The IPF Guarantee would allow Croatia to achieve long tenor and acceptable pricing in order to achieve the objectives set out for the Project.** There are a number of financing alternatives that could benefit from the IPF Guarantee such as a Eurobond or commercial loan. The choice between different financing alternatives would be determined on the basis of investor pre-soundings to be conducted by the Transaction Advisor, the advantages and disadvantages of each depending on the market conditions at the time of the placement versus parameters such as volume, maturity, spread savings and World Bank guarantee utilized/leveraged.

9. **A financing supported by IPF Guarantee could be rated or deemed to be Investment Grade.** It is expected that, if rated (for example as part of bond market access), the guarantee could result in a rating upgrade of 2-3 notches depending on the final guarantee structure and coverage. This would enable Croatia to raise financing rated (or deemed to be rated) BBB-/BBB instead of BB, enabling investment by funds that are only allowed to buy investment grade securities.

10. **Optimal Financing Amount.** Financing amount to be raised with the support of the IPF Guarantee would be determined together with the Government of Croatia and its Transaction Advisor based on the refinancing needs of Road Sector Companies under the MARS project and in line with the financial optimization proposal being prepared by its Transaction Advisor with due consideration given to capital market dynamics. The guarantee will be provided to the extent necessary to mobilize commercial financing.

11. **Positive signaling, bridging the knowledge gap.** IPF Guarantee would demonstrate international support for Croatia's MARS program. The Government's reform agenda for the road sector, evidenced by the Sector Policy Letter, would form one of the bases on which government would engage with the market for the partially guaranteed financing. Evidence also suggests that such financings are successful in bringing new investors by offering an improved risk profile and better messaging while ensuring continuity of access to international markets and maintaining market discipline.

Catalyst for road company debt reprofiling and reduction in sovereign obligations

13. The improvements in the financial profiles of the Road Sector Companies as a result of the undertakings outlined in the Sector Policy Letter, operational measures and the debt re-profiling via the partially guaranteed sovereign financing are expected to incentivize lenders to participate in the other phase of MARS carried out in parallel, which likely involves negotiating a reprofiling

of their loans. If sovereign obligations can be reduced at the conclusion of the multiple phase operation, capacity to facilitate productive investment or development in other critical areas for the country could increase.

No negative impact on Croatia public debt ratios

14. **The guarantee is not expected to impact Debt/GDP ratios as it will be supporting refinancing of pre-existing government guaranteed debt of the Road Sector Companies.** All road company debt is guaranteed by the Government of Croatia and is consolidated in the government's balance sheet. Partially guaranteed debt proceeds will be used to refinance some of this existing debt and therefore should not lead to an increase in Debt/GDP. However, given some of the debt refinanced could be in Kuna, a potential change in the local vs FX mix of borrowings could result. However, the increase in the tenor of the debt a result of the guarantee and the subsequent refinancing of shorter term government guaranteed debt should result in a marginally improved the overall debt profile for Croatia.

15. Following the optimization of the remaining Loans and on the basis that the Road Sector SOEs eventually become standalone financially sustainable entities, the road company debt that is currently consolidated in the government balance sheet could be considered for de-consolidation at that time, resulting in a reduction in Debt/GDP.

Transaction Structuring

16. **The IPF Guarantee structure is flexible.** It could support commercial financing in the loan and/or bond capital markets and could be structured in a flexible way to provide principal and/or coupon coverage. The Bank's guarantee would be partial and apply on select debt service payments through a structure to be developed in coordination with the market and the Government. Possible guarantee structures could include rolling coverage of scheduled principal and coupon payments for an amortizing loan or bond or a bullet bond, or a percentage of all debt service payments throughout the life of the loan/bond or back-ended coverage where debt service payments only at the end of the loan/bond tenor would be covered. The final structure will be set based on the optimal application of the IPF Guarantee.

17. **Mechanics of the IPF Guarantee.** Croatia as the issuer of the Sovereign Financing would have the primary obligation to ensure timely repayment to the investors. If the Road Sector Companies fail to make payments to the MOF under the on-lending facilities, the Croatia MoF would still be bound to make payments under the Sovereign Financing(s). If Croatia failed to make a guaranteed debt service payment, the holders of the financing could call on the Bank's guarantee for repayment of the amount of such payment. Following payment by the Bank under its guarantee, under its Indemnity Agreement with the Croatia, the Bank would have sole discretion to decide whether to demand immediate repayment from Croatia or to extend terms for repayment over time. The guarantee would not be reinstated for any amounts paid under the guarantee; however, any uncalled amounts of the guarantee would remain in place according to the original structure. IBRD would also enter into direct Project Agreements with each of the Road Sector Companies regarding their implementation of the Project component supported by this Guarantee. Please refer to the draft term sheet in the Annex hereto for further detail on terms and conditions of the proposed guarantee.

Figure 1 – Guaranteed Note Structure

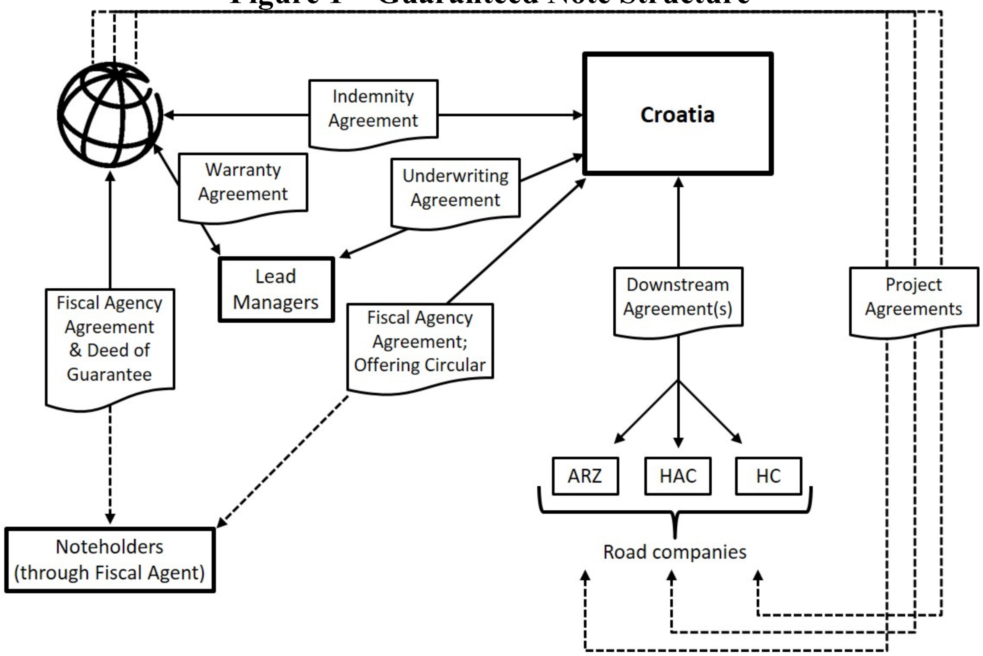
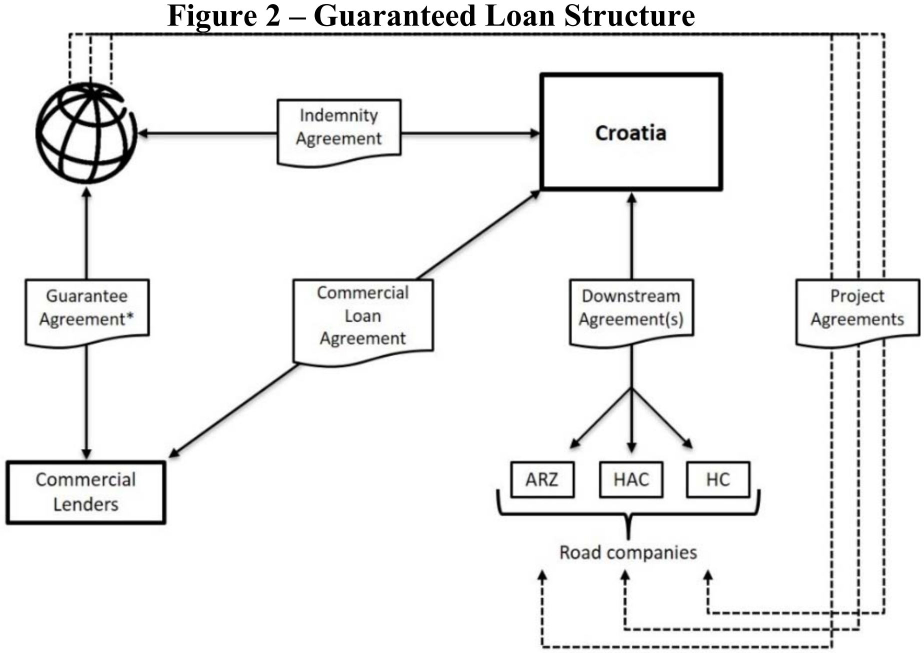


Figure 2 – Guaranteed Loan Structure



* Guarantee Agreement can be embedded in Commercial Loan Agreement

18. **At this stage, different financing alternatives supported by the IPF Guarantee are possible**. Several options could be contemplated for a partially guaranteed financing for the government. Based on the Bank team's informal market soundings, Croatia could utilize the guarantee in support of, for example, a public bond or loan, or one or more of each. The Bank

would work with Croatia and its Transaction Advisor to determine which segment of the market provides the best value for the guarantee and meets the needs of the government. The choice between different financing alternatives would be determined on the basis of investor pre-soundings and the market conditions at the time of the placement in light of Croatia's funding parameters such as volume, maturity, spread savings and World Bank guarantee utilized/leveraged. It is important to establish with the Government of Croatia and its Transaction Advisor which markets best serve to meet Croatia's objectives as part of finalizing guarantee and financing terms closer to the time of issuance.

Annex 7 Summary of Terms and Conditions of the Proposed IBRD Guarantee(s)

This term sheet contains a general summary of the main terms and conditions of an IBRD Guarantee for a commercial financing to be contracted by the Republic of Croatia. These terms would be subject to further development, based on Croatia's choice of underlying financing and other circumstances/events or findings until the signature of the Guarantee Agreement and related legal documents. *This term sheet does not constitute an offer from IBRD to provide a Guarantee. The provision of the Guarantee is subject,* inter alia, *to IBRD review and acceptance of the underlying financing structure and transaction documentation.*[18]	
A. IBRD-Guaranteed Notes (Proposed Structure (1)) | or IBRD-Guaranteed Loan (Proposed Structure (2)) (the Financing)	
Borrower:	Republic of Croatia acting through its Ministry of Finance for and on behalf of the Road Sector Companies ("GoC"). Road Sector Companies: Croatian Motorways (HAC), Motorway Zagreb-Rijeka (ARZ) and Croatian Roads (HC).
Currency:	USD, EUR or Kuna indexed to EUR.
Principal Amount:	To be determined following investor/lender soundings; expected to be up to the equivalent of EUR 1,000 million through one or more sequenced transactions.
Term:	Up to 20 years per transaction.
Repayment of the Financing:	Bullet, Annual, Semi-annual or Quarterly, as to be determined.
Note or /Loan Interest Rate:	In the case of Notes, a Coupon acceptable to GoC and IBRD. In the case of Loans, a spread above the base interest rate appropriate to the selected Currency and Loan interest period and being acceptable to GoC and IBRD.
Use of Proceeds:	The Borrower shall pass through Downstream Agreements, on terms to be agreed, proceeds of the Financing to the Road Sector Companies to refinance the loans specified in Attachment 1.
Drawdown:	Single or multiple drawdown
IBRD Guarantee	
Guarantor:	International Bank for Reconstruction and Development (IBRD)
Guarantee Support:	Following the occurrence of a Guaranteed Event, IBRD would guarantee the payment of principal and interest amounts or selected, pre-agreed debt service payments up to the Maximum Guaranteed Amount all being subject to claims made by the [Fiscal] Agent on behalf of the Note or Loan holders (as the case may be).

[18] Progress adequate to IBRD in the implementation of the actions in the Letter of Sector Policy adopted by the Government of Croatia on March 16, 2017 would be required before IBRD would proceed with the provision of the Guarantee(s).

Guaranteed Events:	Failure by the Borrower to make certain payments of [principalor principal and interest (as to be determined) on][repay at scheduled maturity the principal amount of] the IBRD-guaranteed Loan or Notes, as the case may be.
Guarantee Period:	To be defined.
Guarantee Face Value:	Up to EUR 350 mln across all financings.
Maximum Guaranteed Amount:	The Maximum Guaranteed Principal up to the Guarantee Face Value plus Maximum Guaranteed Interest as below. For the avoidance of doubt, IBRD's exposure under the Guarantee may never exceed the Guarantee Face Value] [For each financing, a partial amount of financing, expected to be between 20% to 60% of the face value of that financing, up to a maximum aggregate amount of up to EUR 350 million across all financings]
Maximum Guaranteed Principal:	If applicable, for each financing, a partial amount of financing, expected to be between 20% to 60% of the face value of that financing, up to a maximum aggregate amount of up to EUR 350 million across all financings.
Maximum Guaranteed Interest:	If applicable, in the event IBRD would cover selected, pre-agreed principal repayments, IBRD may also cover scheduled interest/coupon due and payable on the disbursed and outstanding guaranteed principal amount pursuant to the IBRD-Guaranteed Loan or notes, as the case may be. For the avoidance of doubt, IBRD does not cover penalty interest, default interest or charges of similar nature.
Subrogation:	If and to the extent IBRD makes any payment under the Guarantee, IBRD will be subrogated immediately to the extent of such unreimbursed payment to the lenders'/holders' rights.
Right to Purchase:	If IBRD guarantees payment of interest, then upon payment default by the Borrower, IBRD would have rights relating to the purchase of all rights, title and interests of the Beneficiaries in the Financing.
Front-end Fee:	25 bps of the Maximum Guaranteed Amount payable by the Borrower.
Standby Fee:	25 bps per annum, charged on the undisbursed amount of the Maximum Guaranteed Amount from the earlier of i) 60 days after signature of the guarantee agreements and ii) the effective date of the guarantee. The Standby Fee also applies if IBRD limits coverage of the Guarantee pursuant to any limitation event. Payment of the Standby Fee is the obligation of the Borrower and must be paid in advance on regular payment dates.
Guarantee Fee (recurrent)[19]:	50-100[20] basis points per annum. The Guarantee Fee is assessed on IBRD's periodic committed and outstanding financial exposure under the Guarantee

[19] Can also be paid upfront, which is more likely in a bond guarantee.
[20] The guarantee fee level is determined by the average life of the guarantee: 50bps up to 8 years, 60bps from 8 to 10 years, 70bps from 10 to 12 years, 80bps from 12 to 15 years, 90bps from 15 to 18 years and 100bps from 18 to 20 years.

	(i.e. the present value of the Maximum Guaranteed Amount). Payment of this fee is the obligation the Borrower and must be paid either in advance semi-annually or in a one-time lump sum. Where the Guarantee Fee is payable in installments, the Guarantee will terminate in the event of nonpayment of any installment of the relevant Guarantee Fee.
No Additional Amounts	The Guarantee is limited to certain outstanding scheduled payments of principal or principal and interest (as to be determined) and would not cover any additional amounts payable by Croatia with respect to such amounts.
Termination events	The Guarantee may be terminated, *inter alia,* (i) if an installment of the Guarantee Fee or Standby Fee is not paid when due; (ii) if an amendment, waiver, modification or other change is made or given relating to certain provisions of the finance documentation, IBRD's rights or obligations, or the Guarantee without IBRD's prior written consent, including but not limited to any material amendment or modification to a finance document or any amendment or waiver that materially and adversely affects the rights and obligations of IBRD; (iii) following full payment of all guaranteed amounts or (iv) after the final date for payment under the Guarantee.
Exclusions	IBRD is not liable for losses directly resulting from noncompliance with, or the invalidity, illegality or unenforceability of any transaction document under laws in effect on, or events occurring before, the date of the Fiscal Agency Agreement (in a guaranteed Notes structure) or IBRD-Guaranteed Loan Agreement (in a guaranteed Loan structure).
Governing law:	English law or New York Law.
B. Indemnity Agreement	
Parties:	IBRD and Croatia (the "Member Country")
Indemnity:	The Member Country will reimburse and indemnify IBRD on demand, or as IBRD may otherwise direct, for all payments under the Guarantee and all losses, damages, costs, and expenses incurred by IBRD relating to or arising from the Guarantee.
Covenants:	Usual and customary covenants included in agreements between member countries and IBRD , as well as undertakings to pay the fees and expenses of IBRD's external counsels, auditors and other advisors, as well as IBRD's roadshow expenses, in connection with a guaranteed Notes offering. Use of Proceeds: The Borrower covenants to apply the Use of Proceeds through Downstream Agreements to the Road Sector Companies in a form and substance acceptable to IBRD in accordance with the Sector Policy letter and shall cause the Road Sector Companies to apply this financing and in the amounts specified in Attachment 1.
Remedies:	If the Member Country breaches any of its obligations under the Indemnity Agreement, IBRD may suspend or cancel, in whole or in part, the rights of

	the Member Country to make withdrawals under any other loan or credit agreement with IBRD, or any IBRD loan to a third party guaranteed by the Member Country, and may declare the outstanding principal and interest of any such loan or credit to be due and payable immediately. A breach by the Member Country under the Indemnity Agreement will not, however, discharge any guarantee obligations of IBRD under the Guarantee.
Governing Law:	The Indemnity Agreement will follow the usual legal regime and include dispute settlement provisions customary for agreements between member countries and IBRD.
C. Project Agreements	
Parties:	IBRD and each Road Company
Content:	Agreement between IBRD and each Road Company with respect to implementation of the operation setting out the requirements on institutional arrangements, use of proceeds, etc.
D. Downstream Agreement(s)	
Parties:	Croatia and each[21] Road Company.
Content:	Set(s) out modalities for routing of funds raised in the guaranteed financing to each of the Road Sector Companies and any other necessary arrangements, use of proceeds, etc.
	Further detail to be provided in Attachment 2
E. Additional Terms and Documentation required for Proposed Structure (1) (IBRD-Guaranteed Notes)	
Fiscal Agent:	To be identified (the Fiscal Agent).
Lead Managers:	Commercial and/or investment banks to be identified (the Lead Managers).
Distribution:	To be determined.
Listing:	To be determined.
Form and Settlement:	To be determined.
Roadshows:	Representatives of IBRD, including its legal counsel, would attend all roadshows or investor presentations relating to the Financing.
Conditions Precedent:	Usual and customary conditions for financing of this type including but not limited to the following: a. Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Croatia relating to the Indemnity Agreement);

[21] Alternatively, a single Downstream Agreement among Croatia and all three Road Sector Companies may be considered.

	b. Payment in full of the Guarantee Fee, the upfront fees, the relevant installment of the Standby Fee, and expenses and costs of IBRD external counsel and other expenses; c. Conclusion of an Indemnity Agreement between IBRD and Croatia, the Fiscal Agency Agreement among the Fiscal Agent, Croatia and IBRD (expected to include the Guarantee), a Purchase Agreement among the Lead Managers and Croatia, a Warranty Agreement among the Lead Managers and IBRD, the Project Agreements between IBRD and the Road Sector Companies, the Downstream Agreement(s) in form(s) acceptable to IBRD, and any other applicable documentation, including preparation of an Offering Memorandum whose presentation of the Guarantee is acceptable to IBRD; and d. Satisfaction of any other conditions precedent under the financing documents.
IBRD-Guaranteed Fiscal Agency Agreement[22]:	
Guaranteed Fiscal Agency Agreement:	Agreement among the Borrower as Issuer, Fiscal Agent and IBRD as Guarantor setting out terms and conditions of the Notes, mechanism for payment on the Notes, and containing the terms and conditions of the Guarantee.
Agency mechanics:	The Fiscal Agent may make a demand on IBRD for payment under the Guarantee if, at a number of Business Days to be determined prior to the scheduled payment date of a guaranteed payment on the Notes, the Issuer has not transferred amounts sufficient to make such payment to the appropriate account of the Fiscal Agent. After receiving a duly completed Demand Notice, IBRD will make payment to the Fiscal Agent on behalf of the Note holders on or before the relevant due date for making the scheduled payment on the Notes.
Choice of law:	New York or England
Warranty Agreement:	
Warranty Agreement	IBRD would enter into a Warranty Agreement with the Lead Managers in order to make and receive certain representations and warranties about the information each set of parties provides to the other in that type of transaction, as well as to receive certain representations, warranties, and undertakings from the Lead Managers, including but not limited to a representation and warranty that the Lead Managers have not engaged in any Sanctionable Practice in connection with the transaction, and an undertaking by the Lead Managers not to engage in any Repackaging Arrangements (as described below) and to inform purchasers of the Notes of IBRD's repackaging restrictions.
Offering Document:	
Offering Document	Document describing the offering of the Notes and providing market-standard information for investors regarding the Notes, Croatia, IBRD and the Guarantee.

[22] Depending on type of issuance, Fiscal Agency Agreement may be replaced by a Trust Indenture or Trust Deed

Purchase Agreement:	
Purchase Agreement	The Issuer would enter into a Purchase Agreement with the Lead Managers relating to the offer, initial purchase and distribution of the Notes.
Deed of Guarantee (if applicable):	
Deed of Guarantee	Depending on the legal regime and nature of the issuance, IBRD may enter into a Deed of Guarantee setting out the terms of the Guarantee for the benefit of the Note holders.
F. Additional Terms and Documentation required for Proposed Structure (2) (IBRD-Guaranteed Loan)	
IBRD-Guaranteed Loan Agreement:	Agreement among the Borrower, the Agent/Lenders (and, if the Guarantee provisions are included in this agreement, IBRD as Guarantor) setting out terms and conditions of the Loan and mechanism for payment on the Loan . The Guarantee provisions could be contained in the IBRD Guaranteed Loan Agreement or separately in an IBRD Guarantee Agreement between IBRD and the Agent on behalf of the Lenders.
Conditions Precedent to IBRD Guarantee:	Usual and customary conditions for financing of this type including but not limited to the following: a. Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Croatia relating to the Indemnity Agreement); b. Payment of the Guarantee Fee (either in full or the first installment), the Front-End Fee and the relevant installment of the Standby Fee; c. Conclusion of an Indemnity Agreement between IBRD and Croatia, the Project Agreements between IBRD and the Road Sector Companies, the Downstream Agreement(s) in form(s) acceptable to IBRD, and any other applicable documentation, all acceptable to IBRD; and d. Satisfaction of any other conditions precedent under the financing documents.
Exclusions, Withholding, Limitation/ Suspension & Additional Termination Events:	Standard exclusion, withholding, limitation/suspension and termination events for IBRD guarantee transactions of this nature.
Assignment/Transfer	Except as IBRD may otherwise agree, any assignment of the IBRD Guaranteed Loan may be made only to an assignee established as a bank or financial institution duly licensed to carry out banking or financial business in its country of domicile. Such assignee may be a partly or wholly government-owned institution, but cannot be an export credit agency, multilateral institution or state entity. Such assignee must not have been declared ineligible to be awarded an IBRD- or IDA-financed contract in accordance with the World Bank Sanctions Procedures and must not be sanctioned pursuant to a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations.

	The assigning Lender shall provide advance notice of potential assignments to IBRD.
Repackaging Arrangements:	The Guarantee beneficiaries will severally undertake for the benefit of IBRD that, provided the IBRD Guarantee remains in effect, they will not enter into or permit any of their affiliates to enter into any arrangement pursuant to which any security or other similar obligation is created or issued, the economic effect of which is the separation of rights of payment from IBRD under the IBRD Guarantee and of rights of payments from Croatia under the financing, which is referred to as "Repackaging Arrangements".
Choice of Law:	New York or England

Attachment 1 – Use of Proceeds

	Croatian Motorways (HAC) EUR Equivalent	**Motorway Zagreb-Rijeka (ARZ) EUR Equivalent**	**Croatian Roads (HC) EUR Equivalent**
Loan Reference 1	TBD	TBD	TBD
Loan Reference 2	‘’	‘’	‘’
Etc	‘’	‘’	‘’
Total	**TBD**	**TBD**	**TBD**

Attachment 2 – Downstream Agreements

To be determined following further discussions with Road Sector Companies and the Transaction Advisor for Croatia.