PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: PIDC2744

Project Name	Sustainable Croatian Railways in Europe (P147499)
Region	EUROPE AND CENTRAL ASIA
Country	Croatia
Sector(s)	Railways (80%), Public administration- Transportation (20%)
Theme(s)	Debt management and fiscal sustainability (20%), Other public sector governance (25%), Regional integration (35%), Other social deve lopment (10%), Trade facilitation and market access (10%)
Lending Instrument	Investment Project Financing
Project ID	P147499
Borrower(s)	Republic of Croatia
Implementing Agency	Ministry of Maritime Affairs, Transport and Infrastructure
Environmental Category	A-Full Assessment
Date PID Prepared/ Updated	22-Jan-2014
Date PID Approved/ Disclosed	22-Jan-2014
Estimated Date of Appraisal Completion	15-Oct-2014
Estimated Date of Board Approval	15-Dec-2014
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

Croatia became the 28th European Union (EU) member state in July 2013 after six years of demanding negotiations. The EU accession presents a unique opportunity to address the country’s needs by providing an incentive to adopt reforms, harmonize legislation with the EU Acquis Communautaire and access EU Structural and Cohesion funds amounting to more than 3 percent of GDP per year. The Government’s 2013 Economic Program commits to Europe 2020 “smart, sustainable and inclusive” growth strategy and emphasizes reforms which promote macroeconomic stability and competitiveness as the basis for accelerated recovery.

As a number of Europe and Central Asia (ECA) countries, Croatia has been strongly impacted by the 2009 global crisis and the country is in a recession for the fifth consecutive year. Since the crisis outbreak, the GDP decreased by more than 10 percent. In the first three quarters of 2013, GDP cumulatively fell by 0.7 percent due to subdued demand, adverse labor market conditions and burdening private sector debt. Poor FDI inflows in 2012 (EUR 1,050 million) continued throughout the first nine months of 2013 (EUR 407 million), reflecting a delay in preparation of selected strategic investment and privatization projects. The prolonged crisis led to a defensive restructuring of the corporate sector, further deteriorating labor market conditions. Unemployment rate continued to grow, with official unemployment rate reaching 21.1 percent in November 2013. Recession also raised poverty (between 2008 and 2010, national poverty indicators increased from 13.3 to 15.3 percent) and changed the profile of the poor to include more economically active, better educated and younger people than before the crisis.

Budget deficit was reduced from 7.8 percent of GDP in 2011 to 5 percent in 2012. The deficit is likely to reach 5.5 percent of GDP for 2013. The Government expects the fiscal deficit to remain at 5.4 percent of GDP in 2014, which will trigger the EU's Excessive Deficit Procedure. In December 2013, the Government has adopted a Plan for Implementation of Long-Term Fiscal Consolidation Reform Measures for 2014-2016. Public debt with continued rising from 51.9 percent of GDP in 2011 to 60.6 percent in September 2013.

The projected GDP growth of 0.8 percent in 2014 will be mostly driven by weakened domestic and external demand, while facing numerous risks since exports, credit and employment growth depend on robust growth in the Euro area, sustained improvement in long-term credits to the corporate sector, and recovery of consumer and investor confidence. Medium-term growth is to be supported by reinvigorated private sector investment and privatization, support to infrastructure development and higher FDIs. Careful management of the main budget spenders and of the main potential beneficiaries of EU Funds is therefore critical in this fiscally constrained environment.

Sectoral and Institutional Context

Government actions in terms of investment over the past decade have mostly targeted the development of the motorway network, which is now almost completed. Significant investments were launched in main passenger and commercial ports (in Rijeka and Ploce), while the biggest international airport in Zagreb has recently been concessioned out to a private operator.

The Government is currently formulating strategic documents for the whole transport sector as a part of the overall process of preparation for the EU 2014-2020 programming perspective. An interim transport strategy will be designed by the end of 2014, while the full transport strategy needs to be completed by 2016 and be aligned with EU objectives (i.e., emphasis will be on safe and sustainable transport, as well as completion of the TEN-T network of main EU corridors). Most of the current actions are however guided by the general EU 2020 objectives, and by the sector restructuring program of 2012 (see below).

Prior to its accession to the EU, Croatia launched a major railway sector reform in compliance with EU Directives, which require to break historical public monopolies by separating infrastructure management from operations, as well as by separating core business activities (freight and passenger services for example). Similar reforms, implemented following various levels of separation in all EU countries since the early 1990s, aim to encourage efficiency and free market operations over time, while focusing state subsidies on infrastructure investments and the provision of public service contracts for passenger services. This is a complex process as it requires the establishment of an effective regulatory framework to regulate access to new operators and the ensuing competition. The EU has also defined rail as one of the key recipients of EU Cohesion funds given that this mode is deemed safer and more energy efficient than roads, which are the dominant mode in the sector. It is forecasted that the EU funds would allocate close to EUR 2 billion to the Croatian railway sector between 2014 and 2020. In Eastern, Central and Southern EU Member States, where it used to be the dominant mode, it is considered critical to preserve the key corridors.

The 2012 rail sector restructuring. In Croatia, initial reform steps had been taken in mid-2000s, with the formation of Croatian Railways (HZ) as a holding company with four lines of business. Two regulatory bodies, respectively overseeing traffic safety and standards, and the fair access to the market, were later established in line with EU regulations. To accelerate the reform agenda prior to EU accession, the Ministry of Maritime Affairs, Transport and Infrastructure (MMATI) adopted a five year restructuring plan for Croatian Railways in June 2012. Croatian Railways are now split into three independent companies - HZ Infrastructure (HZI), HZ Cargo and HZ Passenger Transport (HZP). For each company, the reform program provides an assessment of the current situation and defines strategic goals, investment programs, financing needs, and annual targets on assets and staff reduction.

The sector still faces numerous institutional and organizational issues and challenges which may not be entirely addressed by the restructuring plan. First, traffic is decreasing since the start of the crisis for both passengers and freight. Private sector may gain new markets when it accesses the cargo market, but international experience shows this will first occur in niches. Hence this may be insufficient to reverse the trend unless there are some substantial improvements in quality of infrastructure and services.

Second, the railway sector has been heavily relaying on budget support which in the last decade amounted to 0.6 to 1.2% of GNP annually. Although the EU support to the sector will likely be sustained, direct state financial support is bound to be constrained in the coming years.

Operational performance remains an issue. Labor productivity at sector level has been constantly falling since 2008. The sector wage bill remains very high. In 2011, the Croatian Railways system used more than 75 % of its operating revenues to cover labor costs, while most European railways operate with a wage bill of around 40 %. The Restructuring Plan prepared by HZ Holding in 2012 proposed significant staff retrenchment over 5 years, but bolder actions are needed to bring companies on a profitable path. The overall financial performance of the Croatian Railways system is still weak and there is a substantial need for cost-cutting and business rationalization in order to deliver results within the planned timeframe of next 3-4 years. While the Government considered debts relief for companies, their sustainability is not secured.

Relationship to CAS

The project is consistent with, and included in, 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; and priority will be placed on the Europe 2020 ‘smart, sustainable and inclusive growth’ strategy and the Government’s reform agenda. In particular, the project will support the CPS pillar of competitiveness, by promoting restructuring of public enterprises to enable their faster convergence to operational and financial performance of EU28 countries. In addition, the pillar related to EU memberships is also supported through involvement in a sector which will be one of the main absorbers of EU funds. The EU objective of regional inclusion will be tackled by helping integration of the Croatian railway system into the EU TEN-T network.

The project is also consistent with the World Bank strategic goal of boosting shared prosperity, as it will target the lower income populations, who are the primary users of railway passenger services in Croatia. Low income population will also benefit at several degrees from the overall railway program of the government through skilled and unskilled labor required for the 2 billion Euro infrastructure investment program. Indirect benefits from more rationale public resources allocations would allow to shift resources from operational subsidies allocated to suboptimal rail services, towards long term hardware investments promoting the country's economic diversification and innovation, whilst allowing the state to carry out some of its core social responsibilities, such as in health and education.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The higher level objective of the project is to support the overall sustainability of Croatia's railway sector and the efficiency of its key corridors. A longer term reform program for the Croatian railway sector will be reflected in the sector strategy under preparation.

In this context, the proposed project will support fundamental yet shorter term needs of the sector. The Project Development Objective (PDO) of the Sustainable Croatian Railways in Europe Project is to improve operational efficiency and accountability of the public rail sector, and improve connection of the Rijeka port to the rail portion of the Trans-European Network.

Key Results (From PCN)

Key results would include, among others: (i) contracts signed between the state and HZI-HZP which integrate sound cost and revenue data, (ii) long term strategies and business plans for HZI and HZP in place, (iii) sustainable middle term investment program for the rail sector with clear source of funding, and (iv) reduction of times and costs of 10-20 percent deriving from the rehabilitation of the connection of the port of Rijeka to the rail network and the rehabilitation of key infrastructure (improvement of lines serving key passenger markets and environmental liabilities – depending on funding and readiness availability).

Several indirect results could be monitored during project implementation, such as the evolution of logistics chains efficiency or logistics costs in Croatia. However, these would be influenced by many factors that are beyond the scope of the project, including the overall sector strategy, the emergence of alternative cargo service providers, etc.

III. Preliminary Description

Concept Description

The project would comprise three components, as follows:

Component 1: Support to sector governance

MMATI's (Ministry of Maritime Affairs, Transport and Infrastructure) role is currently assumed with limited resources and requires further support in several key areas. The Bank assistance may be provided to define public service obligations with HZI and HZP and the set-up of a reliable data collection system that would allow the MMATI to adequately manage funding of passenger services and infrastructure maintenance. In addition, support will be required to: (i) assess and help define the optimal network needed to carry out the core rail operations and (ii) to evaluate logistics performance and competitiveness of the main corridors. Lastly, as the MMATI also holds an important shareholder role in various companies, the proposed project could support the state as policy maker, purchaser of service and shareholder.

Component 2: Support to companies' restructuring

Support to retrenchment in HZI and HZP. The project will contribute to financing of labor restructuring because these financing needs are not yet covered by the Government and other International Finance Institutions (IFIs).

Support to the restructuring plans of HZI and HZP. The project will finance soft investments in both companies in order to modernize operations and facilitate the implementation of the restructuring plan. This will include financial and asset management systems, reorganization, and improvement of operations. The project will support preparation of a business plan for HZP that will integrate activities that the company is currently undertaking (such as preparation of a new ticketing system) and changes that are planned for the medium term (fleet modernization, revised Passenger Service Contracts, etc.). HZI management capacity for large scale projects may need to be strengthened in light of the ambitious investment plans ahead. Moreover, additional private sector participation in the sector can still be sought, for example by implementing leasing arrangements for new trains/ rolling stock, asset management, performance based contracting for infrastructure maintenance and Public Private Partnership arrangement for station management, but these and the support that the project may give will be discussed further during preparation which is ongoing.

Component 3: Enabling investment to increase the system efficiency

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Infrastructure development. HZI network operations still suffer from past underinvestment and use of obsolete technologies, and are one of the key deterrents to the use of train for passenger services, including in densely populated areas. Competitiveness of cargo transport would benefit from improved corridor connectivity and integration into the wider European network, to allow larger and continuous trade flows. Many of the related investments cannot be funded by EU funds, while potential gains in efficiency and competitiveness could be significant in the short-term. In this respect, rehabilitation of the rail line segments from Rijeka to Skrljevo and the passenger side of Rijeka railway station (corridor Vb) will be assessed and considered for financing, but only if the level of readiness is sufficient.

Periodic maintenance and rehabilitation. The project could help finance some backlog clearance of rehabilitation in segments that have exceeded their design life if linked with clear efficiency objectives, for example, to decrease both maintenance and passenger train operating costs. Track rehabilitation for lines servicing densely populated areas and linkages to major socio-economic centers will be considered. The project could either contribute to the overall rehabilitation program through supply of inputs (ballast, sleepers, rails) or fund specific rehabilitation contracts. This would depend on the assessment of the procurement implications of the various options and of their cost effectiveness. The principle behind this proposal would be to secure rehabilitation funding which has been lacking for many years.

Access to the Rijeka Port. The Port of Rijeka Authority (PRA) is funding the design and environmental studies for: a) the intermodal terminal linking the envisaged Zagreb Container Terminal (ZCT) and the main freight station in Rijeka, and b) the reorganization of the Rijeka freight station itself as part of the Rijeka Gateway II Project. Initial estimates show that the total investment cost in ZCT rail access is around EUR 40 million, of which around EUR 30 million is to be covered by the HZI (marshaling yard) and the rest funded by PRA or the future concessionaire (intermodal yard). The proposed project would finance the HZI component.

Safety and Environmental Liability. In principle, HZI plans to fund its main rail-road crossing automation with other sources, but the system still has environmental liabilities that pose risk to safety and the environment, especially in the Botovo facility (tank and freight wagon washing station) near one of the Drava River tributaries. Clean-up of this facility may be envisaged under the project.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
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	

V. Financing (in USD Million)

Total Project Cost:	100.00	Total Bank Financing:	75.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	25.00
International Bank for Reconstruction and Development	75.00
Total	100.00

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