PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA21849

Project Name	Sustainable Croatian Railway in Europe (P147499)
Region	EUROPE AND CENTRAL ASIA
Country	Croatia
Sector(s)	Railways (80%), Public administration- Transportation (15%), Information technology (5%)
Theme(s)	Regional integration (35%), Other public sector governance (25%), Debt management and fiscal sustainability (20%), Other social deve lopment (10%), Trade facilitation and market access (10%)
Lending Instrument	Investment Project Financing
Project ID	P147499
Borrower(s)	HZ Infrastructure, HZ Cargo, HZ Passenger Transport
Implementing Agency	Ministry of Maritime Affairs, Transport and Infrastructure
Environmental Category	B-Partial Assessment
Date PID Prepared/Updated	10-Mar-2015
Date PID Approved/Disclosed	10-Mar-2015
Estimated Date of Appraisal Completion	13-Mar-2015
Estimated Date of Board Approval	30-Apr-2015
Appraisal Review Decision (from Decision Note)	

I. Project 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 Communautaires 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. To achieve this goal, it will be critical to improve connectivity, affordability and service quality, particularly to the centers where jobs, markets, and social facilities are located.

The global economic crisis, with the loss of credit rating, exposed Croatia's macroeconomic vulnerabilities. The stimulus for a significant share of Croatia's pre-crisis growth has been withdrawn resulting in six consecutive years in recession through 2014. A mild recovery, estimated at 0.2 percent GDP increase, is now forecast for 2015, spurred by EU-funded investments. Prior to the crisis, large, relatively cheap capital inflows circulated into the economy, creating credit, consumption, and real estate booms that subsequently reversed. Such capital inflows are not expected to return, due to Croatia's weak growth outlook and the more competitive, risk averse post-crisis international environment. Unemployment rose to 17 percent in 2013, much higher than the Eurozone average (12 percent). Public debt has doubled since 2008 and remains on an upward trajectory, and the private sector has continued deleveraging. Credit agencies took note, reducing Croatia's sovereign debt to speculative status in 2013. In January 2014, the European Commission (EC) opened an Excessive Deficit Procedure (EDP) for Croatia and recommended corrective measures by 2016. Notwithstanding a modest reduction in the national poverty in the 2010-2012 period (from 21.3 percent to 20.5 percent), both the consumption of the average population and of the bottom 40 percent contracted in the 2008-2012 period (by 4.6 percent and 3.5percent respectively).

Sectoral and institutional Context

Government investments in the transport sector over the past fifteen years have mostly targeted the development of the motorway network, which is now almost completed. There have been notable changes in nearly all transport modes. Significant investments were launched in the main passenger and commercial ports (including with the World Bank support in Rijeka and Ploce), the biggest international airport in Zagreb was concessioned out to a private consortium and the national air carrier completed a restructuring program approved by the EC.

The Government is currently formulating strategic documents for the whole transport sector as part of the overall EU 2014-2020 programming perspective. An interim transport strategy was adopted in October 2014, while the full transport strategy based on a comprehensive traffic model needs to be completed by the end of 2016. The finalization of this strategy, consistent with EU objectives is a condition for disbursement of EU funds in the sector. The emphasis of the interim strategy is on safe and sustainable transport, and on the completion of the Croatian part of the Trans European network of corridors (TEN-T). The national program for the Croatian railway sector expired in 2012. The general EU 2020 objectives and the interim strategy all give a very strong orientation in favor of railway compared to other modes.

Despite some decline in traffic, railway still represents a significant share of traffic and has a strong potential.. Since 2007, traffic has gone down continuously but Croatia's railway share of both cargo and passenger traffic remains above EU average. Arresting the decline in market share for passenger transport and tapping into the solid transit freight flow potential is essential. Railway freight transport in Croatia is predominantly transit: the country benefits from its strategic location at the junction of two main European transport corridors, Corridor X and Corridor Vb. More than EUR 600 million has been invested in Adriatic seaports over the past decade, in an attempt to develop ports as entry points for international goods to markets inland. However their potential has not been fully utilized, because of poor connectivity with other transport modes, especially poor port-railway connections and weak railway link to neighboring countries. On the passenger side, suburban services around the main centers still have a lot of untapped potential while improvement in transport services and a more commercial approach could realistically reverse the traffic trend.

In parallel with the sector dialogue with the World Bank through the Croatia Railway Policy Note, the Government has implemented a major railway sector reform in 2012, compliant with the EU

Directives. Initial reform steps were taken already in the mid-2000s, with the formation of Croatian Railway as a holding company with four lines of business. This complex process required the establishment of an effective regulatory framework to regulate access for new operators and to ensure competition. Two regulatory bodies overseeing traffic safety and standards and the fair access to the market, were later established in line with EU regulations. In June 2012 the Ministry of Maritime Affairs, Transport and Infrastructure (MMATI) then adopted a five year restructuring plan for Croatian Railway Holding. The Croatian Railway Holding split into three independent entities - HZ Infrastructure (HZI), HZ Cargo (HZC) and HZ Passenger Transport (HZP), limited liability companies owned by the Republic of Croatia, and the holding company was dissolved.

The Croatian railway sector still faces numerous operational, institutional and organizational issues (these are benchmarked and analyzed in great depth in the Croatia Railway Policy Note) due to the low staffing in MMATI, the infrastructure condition, and low productivity of assets and labor by European standards, while the weak financial situation of the companies is not allowing them to develop. The railway sector is a major user of budget support and has been heavily reliant on it in the last decade. Budget support amounted to 0.6 to 1.2 percent of GDP annually. Overall the strategy, which underlies the government support to the sector, is geared towards the provision of operating subsidies, both for infrastructure and passenger services. Very few direct investments were recently provided to the sector apart from the state guarantees given in 2013 and 2014 for commercial loans to finance investments as a transitory solution (in infrastructure), rolling stock purchase (HZ Passengers) and short term liabilities (HZC).

The European Structural and Investment (ESI) funds will boost the sector in the medium term, but the system needs to improve to survive: It is forecasted that close to EUR 1.1 billion of ESI funds would be allocated to the Croatian railway sector between 2014 and 2020, essentially to upgrade and develop the international corridors in the TEN-T network. The financial needs to fully upgrade the corridors would probably require at least two EU funds programming periods (e.g. until 2027). Short term impact on the network condition is limited, while HZI needs to proceed with urgent rehabilitation and operators need investment to have the functioning network to survive.

Looking forward, the Government of Croatia and the sector face two apparently contradictory obligations:

- Respect the government commitments vis-a-vis the EU: it needs to contribute to sustainable growth, supporting safe, inclusive and sustainable transport systems. This requires implementing EU funded programs to develop infrastructure along European Corridors, and to sustain or develop cleaner transport services. The bankruptcy of historic railway operators would seriously compromise these commitments and objectives, but EU directives on railway strictly limit the support that can be provided as part of the state aid. The condition of the system is such that both HZC and HZP need such aid to survive, and
- Given Croatia’s current fiscal constraints, there is a strong incentive toward limiting or decreasing subsidies to railway which still are among the largest expenditures of the Government. This means that subsidies are likely to diminish, in a context where the current level of spending has not managed to put the sector on a sustainable path. Productivity gains by European standard seem achievable and the state should increase cost cutting incentives to get to these levels.

Following the reform of 2012, focus of the Government is now on implementing restructuring of the companies and rationalizing public support. The institutional reforms are mostly complete. In the recent years, the companies’ managements have mostly focused on implementation of the separation and solving immediate financial difficulties or bankruptcy (HZC, and subsidiaries of HZI and HZP) with much less emphasis on reorganization of services and operations, commercial policy or medium term planning. Experience in Europe also shows that operational restructuring takes a lot of time. This has now started, HZP and HZC are currently finalizing their reform plans for submission to the European Commission, while a new business plan of HZI is taking into account a smaller level of investment financing available from the EU and domestic sources. Each company's restructuring plan now span until 2018-2019, which is consistent with the duration of reform of railway companies in other countries. The companies have also continued to focus on labor and staffing. Under the leadership of the Ministry of Finance subsidies are evaluated under a spending review which will set targets for 2015-2017.

In this context, the World Bank can play a critical role to help the Government reach its objectives while complementing the actions and financing of European Institutions. The Croatian railway sector needs public funding to survive including its public transport operators, but the state aid needed will be useful only if it is linked to modifications of the companies' operations, and to investment in the network. The World Bank is well equipped to support the companies' restructuring over the course of an investment project and can tailor financing to the short to medium term rehabilitation needs, while EU funds focus on the country's corridors development. The World Bank's involvement in parallel to the support provided by EU institutions to manage their large development projects will improve the overall system's efficiency and can also help rationalize future investment.

II. Proposed Development Objectives

The Project Development Objective (PDO) is to improve the operational efficiency and the financial sustainability of the public railway sector in Croatia.

III. Project Description

Component Name

Project Coordination and Sector Policy Support

Comments (optional)

The objective of this component is to assist the MMATI to enhance its institutional capacity as coordinator of the railway sector to improve governance and overall management of the sector. It comprises the following sub-components:

- Asset Management. Support to MMATI and the companies in finalizing asset management separation between all companies and clarifying the legal status of the main assets.
- Assistance to MMATI in project coordination and sector policy/sector reform monitoring and definition of railway services obligations with HZP (Public Service Obligation) and HZI, and the preparation of the railway sector development and infrastructure maintenance plan once the national transport strategy is completed in 2016.

Component Name

Support to HZ Passenger Transport Restructuring

Comments (optional)

The objective of this component is to support HZP in improving its operations efficiency and financial situation in order to deliver better services in a financially sustainable way, including: :

- Retrenchment. Retroactive financing of eligible severance payments and financing of the

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implementation of HZP's retrenchment plan for 2015-2018. Retraining and support in searches for redeployment, including counseling and advisory support and employment intermediation.
• Contribution to Restructuring Plan Implementation. This comprises 3 main categories of investment: (a) Rehabilitation of rolling stock to improve efficiency of the fleet; (b) IT modernization and integration; (c) Studies and recommendations to adapt business processes to reorganized operations and improve energy efficiency.

Component Name

Support to HZ Cargo Restructuring

Comments (optional)

The objective of the component is to support HZC in increasing its operations efficiency and financial situation in order to deliver better services in a financially sustainable way, including:

Retrenchment. Retroactive financing of eligible severance payments and financing of the implementation of HZC's retrenchment plan for 2015-2017. Retraining and support in searches for redeployment, including counseling and advisory support and employment intermediation.
Contribution to Restructuring Plan including; (a) Periodic maintenance of rolling stock to improve efficiency of the fleet; (b) IT modernization and integration.

Component Name

Support to HZ Infrastructure Restructuring and Enabling Investment to Increase the System Efficiency

Comments (optional)

The objective of this component is: (i) to support HZI in improving its operational efficiency and financial sustainability through restructuring, and (ii) to restore the physical infrastructure's condition and safety. It includes the following subcomponents:

• Retrenchment. This subcomponent consists of financing: (i) retroactively eligible severance payments and (ii) financing implementation of HZI's retrenchment plan for 2015-2019. Retraining and support in searches for redeployment.

• Railway Safety Crossings program and other safety investment, including first tranche of the HZI 10 year plan for the installation of railway safety crossings and various works on slope stabilization and structures rehabilitation.

• Other Railway Emergency Investment. Including rehabilitation works

IV. Financing *(in USD Million)*

Total Project Cost:	200.80	Total Bank Financing:	183.40
Financing Gap:	0.00		

For Loans/Credits/Others	**Amount**
Borrower	17.40
International Bank for Reconstruction and Development	183.40
Total	200.80

V. Implementation

Institutional and Implementation Arrangements

The project will be implemented by HZI, HZP, HZC, and coordinated by MMATI. The project would comprise three loans to each of the borrowing companies with a state guarantee.

Implementation arrangements for the project would be based on project implementation units (PIUs) in each borrowing company. HZI, HZP and HZC have confirmed teams of qualified staff who will be involved in the Project, including overall coordinators, and persons responsible for technical investment (one per each main area in the case of HZP and HZC, and the director in charge of investment planning in the case of HZI), retrenchment and human resources aspects, safeguards, procurement and financial management. These experts are current staff of the companies and would perform the project-related work together with their regular responsibilities. A specific team will be set up in MMATI with the support of the Ministry of Finance (MOF) to oversee the project coordination and the sector reform.

The overall Project coordination team will be led by MMATI and comprise individuals appointed in MMATI, MOF, Ministry of Regional Development and EU Funds (MRDEUF) and the project coordinators in each borrowing company. A high level steering committee, including the Ministers of Transport, Finance and the heads of management boards of each company, would review the project performance, sector reform communication and progress in sector reform at least once a year.

The project will use existing financial management systems, as HZI, HZP, and HZC are revenue earning entities with acceptable financial management arrangements in place for project fiduciary purposes. For each company, the implementation of the retrenchment process will follow Croatian Law, the Collective Agreements with the Unions and the Retrenchment Plans for future process agreed upon during the project preparation. These plans build upon, and enhance, the process conducted by the Companies since 2012 to date.

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01	✕	
Natural Habitats OP/BP 4.04		✕
Forests OP/BP 4.36		✕
Pest Management OP 4.09		✕
Physical Cultural Resources OP/BP 4.11		✕
Indigenous Peoples OP/BP 4.10		✕
Involuntary Resettlement OP/BP 4.12	✕	
Safety of Dams OP/BP 4.37		✕
Projects on International Waterways OP/BP 7.50		✕
Projects in Disputed Areas OP/BP 7.60		✕

Comments (optional)

VII. Contact point

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