

Corporate and Financial restructuring 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 restructuring of the road sector

a. Sector governance

(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 restructuring 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 to extensive and differently defined by each road company.

A Working Group consisting of representatives of the MSTI, road 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 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 an 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 companies 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 companies 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 2017. Along 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 bring about 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 restructuring (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 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 rising of capital, guaranteed in full or in part by the World Bank, will be subject to the implementation of corporate and financial restructuring 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 analyzed

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 companies' 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.

Element of reform	Activity	Time
<i>Sector governance</i>		
<i>(i) Transport Development Strategy of the Republic of Croatia 2017-2030</i>	<i>(i) Transport Development Strategy of the Republic of Croatia 2017-2030 approved by</i>	<i>October 2017</i>

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

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

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