

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

Approved by the Board of Directors on 18 November 2020¹

MONTENEGRO

**LOCAL ROADS RECONSTRUCTION LOAN
INCREASE**

[Redacted in line with the EBRD's Access to Information Policy]

[Information considered confidential has been removed from this document in accordance with the EBRD's Access to Information Policy (AIP). Such removed information is considered confidential because it falls under one of the provisions of Section III, paragraph 2 of the AIP]

¹ As per section 1.4.8 of EBRD's Directive on Access to Information (2019), the Bank shall disclose Board reports for State Sector Projects within 30 calendar days of approval of the relevant Project by the Board of Directors. Confidential information has been removed from the Board report.

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ABBREVIATIONS / CURRENCY CONVERSIONS

CRBC	China Road and Bridge Corporation
DPS	Democratic Party of Socialists
E&S	Environmental and Social
EBRD	European Bank for Reconstruction and Development
EHS	Environmental Health and Safety
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EIRR	Economic Internal Rate of Return
ESAP	Environmental and Social Action Plan
ESD	Environment and Social Department
ESDD	Environmental and Social Due Diligence
EU	European Union
GoM	Government of Montenegro
IFI	International Financial Institution
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
MoF	Ministry of Finance
MoTMA	Ministry of Transport and Maritime Affairs
NPV	Net Present Value
RFI	Rapid Financing Instrument
PBMC	Performance Based Management Contract
PEPs	Politically Exposed Persons
PIA	Project Implementation Adviser
PIU	Project Implementation Unit
PPAD	Procurement, Policy & Advisory Department
RAMS	Road Asset Management System
SEA	Strategic Environmental Assessment
TA	Transport Administration in Montenegro
TC	Technical Cooperation

CURRENCY EQUIVALENTS

Currency Units are EUR.

PRESIDENT'S RECOMMENDATION

This recommendation and the attached report concerning an operation in favour of Montenegro (the “Borrower”), are submitted for consideration by the Board of Directors.

The Project consists of a loan of up to EUR 26 million to Montenegro to finance works under the Local Roads Reconstruction Project (the “Original Project”). These funds are needed to complete the construction and upgrade of the Lubnice – Jezerine road, (the “Project”), which is a priority transport infrastructure project in Montenegro. Completion of the road will support Montenegro’s economic development and promote connectivity and integration of its regions.

The expected transition impact of the Project will build on, and enhance, the transition impact of the Original Project through the *Integrated* and *Resilient* transition qualities by supporting the preparation of a road asset management system to help optimise road planning and resource allocation in the road sector.

TC support for the preparation of the road asset management system will be funded by the EBRD Special Shareholders Fund.

I am satisfied that the operation is consistent with the Bank’s Country Strategy for Montenegro, the Transport Sector Strategy and with the Agreement Establishing the Bank.

I recommend that the Board approve the proposed loan substantially on the terms of the attached report.

Jürgen Rigterink
Acting President

BOARD DECISION SHEET

MONTENEGRO: Local Roads Reconstruction Project Loan Increase - DTM 51798	
Transaction / Board Decision	Board approval ² is sought for a sovereign loan of up to EUR 26 million under the Local Roads Reconstruction Project (“Original Project”), in favour of Montenegro (the “Borrower”) to finance the completion of the reconstruction of the Lubnice - Jezerine road (the “Project”).
Client	The Client is the Transport Administration (“TA”), a government agency in charge of the national road infrastructure in Montenegro.
Main Elements of the Proposal	<p><u>Transition Impact:</u> The Original Project’s Transition Impact remains applicable. The additional financing will enhance transition impact as follows:</p> <ul style="list-style-type: none"> – <i>Primary Quality – Integrated</i> <p>The Project supports Montenegro’s economic development and its cross-border integration by improving connectivity between its main cities and between Montenegro and neighbouring Serbia and Kosovo. The Project will improve Montenegro’s road infrastructure and services and stimulate economic development in the north eastern part of the country, and shorten the road between the capital of Podgorica and Berane, facilitating the flow of goods and people and reducing transportation costs.</p> <ul style="list-style-type: none"> – <i>Secondary Quality – Resilient</i> <p>The Project will support the preparation of a roads asset management system (“RAMS”), aimed at an optimal sourcing and allocation of resources for the management, operation, preservation and enhancement of Montenegro’s road infrastructure. The RAMS will provide for a more objective and rational approach to road planning and resource allocation.</p> <p><u>Additionality:</u> The EBRD loan offers a tenor that is above the market average, ensures that the Implementing Agency complies with the Bank’s environmental and social policies and Procurement Policies and Rules and closes the financing structure of the project.</p> <p><u>Sound Banking:</u> The transaction is a sovereign loan.</p>
Key Risks	<p><u>Implementation risk:</u> A key risk is TA’s capacity to implement the Project within time and budget. This risk is mitigated by the employment of independent supervision consultants under the Original Project. TA approached the Bank for additional funds when the total amount needed for the Project’s completion was confirmed.</p> <p><u>COVID-19 Risk:</u> Another key risk concerns any macro-economic developments that could affect the capacity of Montenegro to service its debt, particularly in light of COVID-19. Fighting the impact of COVID-19 will lead to a temporary spike in public debt and a sharp deepening of the budget deficit in 2020. According to the IMF, which in October 2020 revised Montenegro GDP from minus 9% to minus 12%, the deficit might be above 10% of GDP. Taking this into account, as well as the EBRD’s GDP forecast (-9% as projected in September 2020), the Montenegrin public debt might exceed 90% of GDP by end-2020. If the pandemic subsides in the near future, GDP is expected to partially rebound in 2021 (by 5.0%), reducing the budget deficit and public debt from 2021.</p> <p><u>Political Risk:</u> Opposition parties won the recent parliamentary elections that took place in August 2020 and a new government is expected to be formed by mid-November 2020. It is expected that the new government will continue to support the Project given its importance for the economic development of relatively poor regions in northern Montenegro.</p>
Strategic Fit Summary	The Project is fully consistent with the Transport Sector Strategy, and the Bank’s Country Strategy for Montenegro which lists supporting connectivity and regional integration by expanding cross-border transport and energy links. The Bank will support key projects in road infrastructure, especially those that serve to improve the country’s connectivity with the rest of the region.

² Article 27 of the AEB provides the basis for this decision.

ADDITIONAL SUMMARY TERMS FACTSHEET

EBRD Transaction	<p>EUR 26 million sovereign loan for the Local Roads Reconstruction Project to finance additional project costs as result of the difference between initial construction estimates and actual costs based on (i) detailed design; (ii) higher prices following procurement as well as additional construction works in the tunnel.</p> <p>The Original Project comprised two loans: one loan in the amount of EUR 5 million signed in 2013 and another loan in the amount of EUR 20 million signed in 2015.</p>
Existing Exposure	<p>The Bank's total cumulative sovereign exposure to Montenegro as of 20 September 2020 was EUR 97 million, out of which EUR 48.9 million was in the road sector. Total operating assets in Montenegro were EUR 260 million, of which EUR 25.9 million was in the road sector.</p> <p>The Bank's private sector portfolio ratio for Montenegro, based on the definition set out in the Agreement Establishing the Bank (article 11.3 (ii)) using the private share of a 5-year rolling cumulative investments, was 31% at the end of September 2020. EPG closed the Original Project for TI monitoring with a final rating of Moderate Good / Negligible (PTI 60).</p>
Maturity / Repayment	15 years [REDACTED].
AMI eligible financing	None.
Use of Proceeds	The proceeds of the Bank's loan will be used to complete the construction works of the Lubnice – Jezerine road and will finance the difference between the initially estimated cost and actual out-turn construction costs based on the detailed design, the outcome of the tender process and additional costs related to tunnel construction.
Investment Plan	[REDACTED]
Financing Plan	[REDACTED]
Key Parties Involved	<p>Government of Montenegro – the Borrower;</p> <p>Ministry of Finance (the “MoF”);</p> <p>Transport Administration (the “TA”) – the Client.</p>
Conditions to disbursement	[REDACTED] Semi-annual sign-offs from ESD based on satisfactory Environment & Social performance updates.
Key Covenants	[REDACTED]
Security / Guarantees	Sovereign loan.
Other material agreements	None.
Associated Donor Funded TC and co-investment grants/concessional finance	<p>A. Technical Cooperation (TC)</p> <p>Preparation of a RAMS:</p> <ol style="list-style-type: none"> 1. This TC will help TA achieve optimal sourcing and allocation of resources for the management, operation, preservation and enhancement of the road infrastructure. The RAMS is expected to provide a more objective and rational approach to road planning and resource allocation. 2. [REDACTED] <p>The TC is post investment.</p> <p><u>Reimbursement:</u></p> <p>The above assignment will be a non-reimbursable transactional TC required to assist the Client in performance improvement.</p> <p><u>Cost sharing:</u></p>

	<p><i>Parallel client contributions:</i></p> <p>The Borrower is expected to contribute EUR 1.39 million to the financing of the additional works. In addition, the Borrower will make a further parallel contribution in the form of payment of any VAT, (currently, at 21 per cent), associated with the works and post-signing TC assignments.</p> <p><i>In-kind contribution:</i></p> <p>Additionally, the Client will also provide in-kind support in the form of office space, communication connections, etc., for the consultants to work, expected to amount to 3 per cent of the total TC budget.</p>
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[REDACTED]

INVESTMENT PROPOSAL SUMMARY

1. STRATEGIC FIT AND KEY ISSUES

1.1 STRATEGIC CONTEXT

The EBRD has been active in financing Montenegro's road sector since 2013 to promote regional integration and economic development. In line with Montenegro's regional road network development strategy, the Ministry of Transport and Maritime Affairs ("MoTMA") and TA (former Transport Directorate, the Government's road construction and maintenance implementation agency) identified upgrading the Lubnice – Jezerine section of the Berane – Kolasin local road to regional road status. Improvement of this road is needed to provide better access to Montenegro's relatively underdeveloped northeast region. Moreover, the new road will promote the regeneration of the region by boosting tourism and agriculture. Using its own funds, the Government of Montenegro reconstructed 10.3 km of the eastern road section between Berane and Lubnice and 11.7 km of the western section of the road between Jezerine and Kolasin, with a remaining 13.9 km road section between Lubnice and Jezerine to be financed by the Bank. Given Montenegro's fiscal constraints, EBRD agreed to provide EUR 25 million through two loans, in the amount of EUR 5 million and EUR 20 million, which were signed on 28 June 2013 and 11 December 2015, respectively. Together these two loans comprise the Original Project.

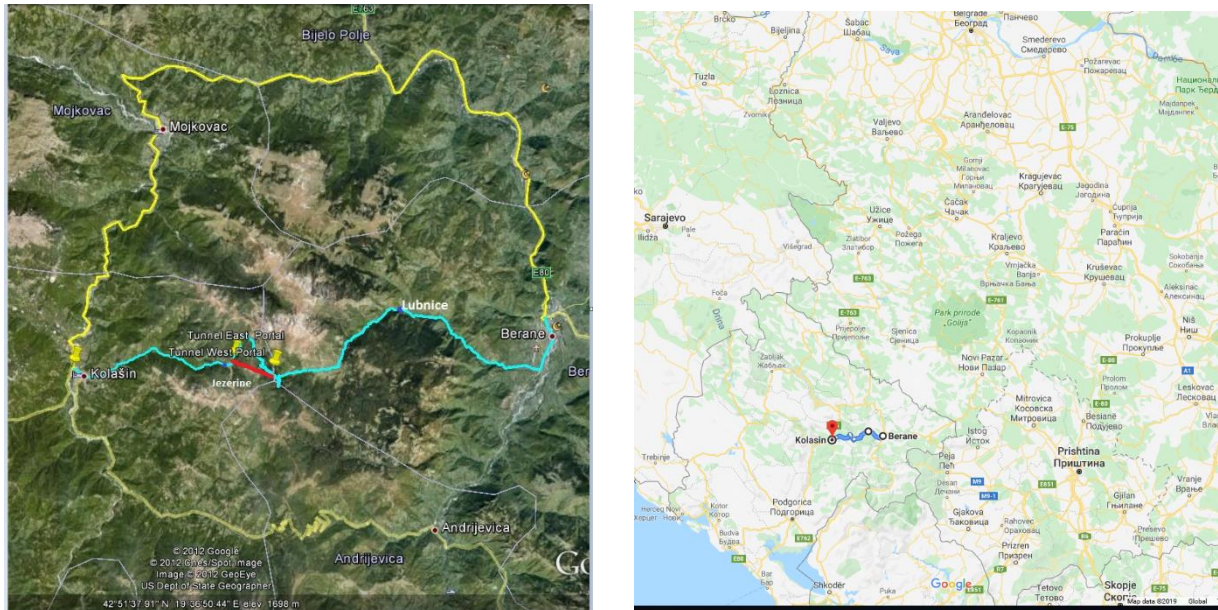
The Berane – Kolasin road which the Project is part of, once completed, will link the north-eastern regional centre, Berane, to the national M-9 road at Kolasin, reducing the distance to the capital of Podgorica by 39 km. The road is on the main route from central Serbia and Kosovo to Podgorica and the Montenegrin coast. The existing road is 3 m to 4.5 m wide and in poor condition. A macadam section, that passes above the tunnel that will be built and goes above 1,600 metres of altitude, is closed during the winter.

The scope of the road reconstruction project includes:

- i) Reconstruction and widening of the 8.3 km long section from Lubnice to Jelovica to give a carriageway width of 6.0 m (up from existing 4.5 m to 4.9 m) road. The reconstruction includes construction of small bridges, drainage structures and retaining walls.
- ii) Construction of new road sections of 5.6 km between Jelovica and Jezerine, including road sections from both sides of the mountain and new 2.8 km long road tunnel, containing lighting, ventilation, fire protection and emergency communications, passing through the Bjelasica Mountain. This reconstruction involves removal of the existing asphalt pavement and construction of new granular and asphalt pavement layers.

Figure 1 below shows the location of the road.

Figure 1: Map of Berane – Lubnice – Jelovica – Jezerine – Kolasin road location



Source: Google maps

1.2 RECENT DEVELOPMENTS

Prepared in 2012 and verified by the Bank's consultants, the construction costs of the Original Project was estimated at EUR 25 million. The preparation of the detailed design took longer than foreseen as TA terminated the contract with the first designer due to unsatisfactory design preparation, necessitating the selection of a new design consultant. The detailed design, which was completed in 2017, estimated the Project's costs at EUR 42.6 million. As the initial two loans of EUR 25 million were sufficient to finance the works during the initial three years, TA elected to start construction and to approach the Bank for additional funds at a later stage, when cost estimates could be more precise. Following confirmation of the financing amount needed to complete the Project, the Government of Montenegro asked the Bank to consider providing additional financing of EUR 26 million which was included in its 2020 budget. This amount covers the higher tender price as well as increased costs as explained below in Section 1.2.2.

1.2.1 Current Status

All contracts have been tendered. Following the completion of the tender process in 2017, the works costs increased to EUR 36.1 million, a EUR 11.1 million increase from the original estimates. The main contract was awarded to Euro-Asfalt d.o.o of Bosnia and Herzegovina in 2017 for EUR 34.8 million. The works supervision contract was signed with IRD of Italy in 2017 for EUR 1.3 million.

To date, EUR 24.69 million has been disbursed. The remaining amount of EUR 0.31 million is expected to be fully disbursed by end-October 2020. As of 15 September 2020, 85% of the road has been built and is ready for asphaltting. The remaining 15% of the road will be built once the tunnel is finished (2,300 m or 82% of the tunnel has been drilled). The remaining tunnelling

works include drilling of 490 m, construction of protection walls and installation of tunnel equipment.

1.2.2 Increased Construction Costs

The key reasons behind the higher construction costs are:

- i) Higher construction cost estimates, particularly for the tunnel, which was extended by 300 metres compared to the original plan.
- ii) The unit prices were adjusted in line with the price increases for concrete, asphalt, iron, fuel and salaries, resulting in EUR 5.5 million of additional costs.
- iii) Additional works in the tunnel due to unexpected and technically more demanding composition of the rocks leading to slower drilling and higher costs.
- iv) Higher supervision costs because of the additional works and construction time extension.

[REDACTED] The Project is scheduled to be completed by December 2021.

1.3 IMPACT OF COVID-19

GDP growth in Montenegro slowed to 3.5% in 2019 from 5.1% in 2018. Growth was based on large investments, high level of private consumption and a robust tourism sector, while the main drags were the twin deficit (current account and budget deficit) and the high level of public debt (up to 81% of GDP as of end-2019, including sovereign guarantees). The deceleration in 2019 was primarily due to the completion of large investment projects and the fall in industrial production. Tourism, however, continued to perform well and the 2019 season was Montenegro's strongest on record.

The COVID-19 pandemic will have a dramatic impact on the country's tourism sector that accounts for up to 25% of its GDP and creates potential vulnerabilities for both public and external finances. The Government has gradually reopened the economy and borders to foreign tourists, but tourism income is expected to be 20-30% of the last year figures. The economy will substantially contract in 2020 (baseline scenarios: IMF: -12.0% as of October 2020 down from -9%; EBRD: -9.0%; WB: -12.4% as of October 2020). This is currently reflected in additional government borrowings of EUR 350-400 million that further deepen public debt constraints.

As for the Project, the construction works slowed down between March 2020 and June 2020 as the number of workers at the construction site was reduced to 90. As workers from Bosnia and Herzegovina were recently allowed to re-enter Montenegro in June 2020, works have resumed. The local sub-contractor has worked without interruption.

1.4 TRANSITION IMPACT

1.4.1 Original Project Transition Impact

The Bank has a long-standing relationship with TA. The positive experience gained in similar projects in Montenegro has been the basis of incremental transition impact ("TI") achieved by the Bank's follow-on projects in the road sector.

The Original Project's transition impact included: (i) framework for markets, through urgent modifications of maintenance contracts with improved performance indicators, tendering of routine maintenance to the private sector, and development of a nationwide maintenance strategy (including periodic maintenance); (ii) skills transfer related to capacity building of the road directorate (including database building); and (iii) setting standards for corporate governance and business conduct, including adoption of secondary legislation on road safety in line with EU directives, completion of a road safety audit (first time in the country), adoption of the road safety strategy for the country and associated capacity building, and some steps towards the introduction of ISO 39001 (first time in the region).

More than five years after signing, TI achievements are as follows: (i) the first tender for maintenance was organised and Crna Gora Put was selected as the provider of the services, (ii) the Performance-Based Maintenance Contract ("PBM") Strategy prepared and adopted by the Ministry of Transport in June 2015, (iii) the template for PBM was adopted by the Ministry of Transport in June 2015, (iv) the training for database management, inspection and verification was carried out in February and April 2015, (v) the Road Safety Strategy and Action Plan were adopted by the Ministry of Transport and (vi) the action plan for obtaining ISO 39001 certification was adopted by the Ministry of Transport.

The outstanding TI is related to the secondary legislation on road safety in line with EU Directives 2004/54/EC and 2008/96/EC has not yet been adopted as the new Law on Roads, which was a precondition for such by-laws, was only approved in August 2020, after several years of delays. Although the road safety inspection programme should have been already launched, TA does not have funds for this exercise.

The original rating of the Original Project was 75, but given the significant delays associated with launching of the road safety inspection programme and adoption of the secondary legislation to comply with respective EU directives, plus the fact that the physical implementation was severely delayed, EPG closed the Original Project for TI monitoring with a final rating of Moderate Good / Negligible (PTI 60).

1.4.2 The Project's Additional Transition Impact

The Project's transition qualities include Integrated, deriving from improved mobility and significant decrease of travel times, and Resilient, stemming from the preparation of a RAMS within the TA.

The table overleaf sets out the TI Objectives and details of the Project.

Table 2: Transition Impact objectives and details

Obj. No.	Objective	Details
Primary TI Quality: Integrated		
1.1	The project delivers material quality improvements of the current infrastructure between or within regions that are currently inadequately integrated.	The Project supports the reconstruction and upgrade of a road that links Berane and Kolasin and Podgorica - the capital city of Montenegro. The Project will boost the economic development of north-eastern part of the country, especially in tourism and agriculture. It will also contribute to regional integration by improving connectivity with central Serbia and Kosovo. The Project will materially improve mobility and traffic safety, which was verified on the back of transport data.
Secondary TI Quality: Resilient		
2.1	First in the sector - The project and associated TC support will help building necessary institutional capacity and procedures for sustainable and efficient infrastructure asset management as one of the first three times in the sector.	<p>The Project will support preparation and adoption of the Roads Asset Management System (“RAMS”). RAMS’s objective is to enable an optimal sourcing and allocation of resources for the management, operation, preservation and enhancement of the road infrastructure. It should provide a more objective and rational approach to road planning and resource allocation.</p> <p>To secure an arm-lengths distance principle and predictability and sustainability of road funding in Montenegro, the Bank will work with the consultant once selected in order to amend the ToR with an aim to include recommendations on the potential institutional transformation of Transport Administration into an independent road management company with sufficient accountability.</p>

1.5 ADDITIONALITY

IDENTIFIED TRIGGERS	Description
A subsequent/consecutive transaction with the same client/group with the same use of proceeds or in the same country (repeat transaction).	The Bank first supported TA in 2004. The original Local Roads Reconstruction Project was financed with two Bank loans signed in 2013 and 2015, while in 2017, the Bank signed another loan for the Main Roads Reconstruction Project. TA has again approached the Bank to finance the extension of the Local Roads Reconstruction Project given the Bank’s ability to provide long-term finance as well as its involvement in the Original Project.

<p>Additionality sources:</p> <ul style="list-style-type: none"> • Financing structure • Risk mitigation • Standard-setting: helping projects and clients achieve higher standards • Knowledge, innovation and capacity building • Additionality description or evidence 	<p>EBRD offers financing that is not available in the market from commercial sources on reasonable terms and conditions, e.g. a longer grace period than the market average, restricted foreign currency financing etc. Such financing is necessary to structure the project.</p> <p>EBRD offers a tenor above the market average, which is necessary to complete the project.</p> <p>EBRD helps the client to mitigate environmental, social and governance (“ESG”) risks, through identification of risks related to the depletion of natural capital assets, raw materials and water availability etc., and to manage these risks.</p> <p>TA seeks EBRD expertise on best international procurement as well as environmental and social standards.</p> <p>EBRD provides expertise, innovation, knowledge and/or capabilities that are material to the timely implementation of the project’s objectives, including support to strengthen the capacity of the client with the RAMS TC.</p> <p>Public sector: EBRD investment is needed to close the funding gap. At the same time, EBRD does not crowd out other sources, such as from IFIs, government, commercial banks, and/or complements them.</p>
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1.6 SOUND BANKING - KEY RISKS

Risks	Probability / Effect	Comments
Macro-economic risk	Medium/ Medium	Montenegro saw a significant increase in its public debt over the last decade. The public debt-to-GDP ratio rose from 32% in 2007 to close to 77% of GDP in 2019, reaching EUR 3.8 billion. This increase is mainly a consequence of an external loan to fund the construction of the first section of the Bar-Boljare highway. On the positive side, around 80% of its public debt is at fixed interest rates and in local currency. Fighting the coronavirus impact on the economy will lead to a temporary spike in the country’s public debt in 2020. Large-scale fiscal measures to combat the pandemic will cause a sharp deepening of Montenegro’s budget deficit in 2020. According to the IMF, the deficit might be above 10% of GDP. Taking this into account, as well as the EBRD GDP forecast (fall of 9%), Montenegrin public debt might exceed 90% of GDP by end-2020. On 1 May 2020, Standard & Poor’s affirmed Montenegro's sovereign credit ratings at B but cut the outlook to negative from stable. For more details, please see Annex 3.
Completion risk	Low/Medium	TA has significant experience in implementing road projects. Cost overruns of the Original Project were forecasted upon completion of

		<p>the detailed design with additional increases due to an unexpected ground water and rock composition in the tunnel as well as a price adjustment table included in the contract (in line with EBRD good practices).</p> <p>As mentioned above, project implementation has been supported by external supervision consultants funded from the loan proceeds. The Project's implementation plan is presented in Annex 4.</p> <p>TA has successfully implemented Regional Roads Reconstruction Project financed by the Bank (OpID 34727) and is implementing Main Roads Reconstruction Project – OpID 49075).</p>
<i>Political Risk</i>	High/ Medium	<p>Montenegro joined NATO in 2017 and is the most advanced EU member candidate. End August 2020 opposition parties won the parliamentary elections. A new Government is to be formed until mid-November and initial feedback is that they will support this project given its importance for the economic development of relatively poor northern Montenegro which strongly supported the parties that won the election</p>

2. MEASURING / MONITORING SUCCESS

<i>Overall objectives of project</i>	<i>Monitoring benchmarks</i>	<i>Implementation timing</i>
<ul style="list-style-type: none"> - Compliance with construction budget and completion schedule in accordance with project implementation plan - Compliance with design standards and specifications for works Compliance with environmental and social standards of the Bank 	<ul style="list-style-type: none"> - Completion on time and within budget according to the design - ESAP implementation 	[REDACTED]

Primary Quality: Integrated

Obj. No.	Monitoring indicator	Details	Baseline	Target	Duration
1.1	Physical Capacity of the client extended or modernised: Length of roads	The road will directly link the north-eastern regional centre, Berane, to Kolasin and reduce the distance to the capital of Podgorica by 39 km. The road is on the main route from central Serbia and Kosovo to Podgorica and the Montenegrin coast.	[REDACTED]	[REDACTED]	[REDACTED]
1.2	Improved quality of infrastructure across regions	The road will reduce the travel time from north-eastern regional centre Berane to Kolasin and the capital of Podgorica by 25 minutes. Road safety will be	[REDACTED]	[REDACTED]	[REDACTED]

		improved by implementation of road safety measures incorporated in the road design.			
1.3	Net increase in road infrastructure usage and/or capacity	Number of passengers per year based on Annual Average Daily Traffic (estimated AADT of 1,824 vehicles per day and at least 1.2 passengers per vehicle).	[REDACTED]	[REDACTED]	[REDACTED]

Secondary Quality: Resilient

Obj. No.	Monitoring indicator	Details	Baseline	Target	Due Date
2.1	Performance or Action plan implemented by the client.	Roads Asset Management Plan adoption	[REDACTED]	[REDACTED]	[REDACTED]
2.2	Practices of the relevant stakeholder improved.	Road Maintenance Manual with specified Standards for the Roads Maintenance	[REDACTED]	[REDACTED]	[REDACTED]
2.3	Recommended policy or strategy agreed by relevant stakeholder	Roads Financing Strategy	[REDACTED]	[REDACTED]	[REDACTED]

Additional Indicators

	Monitoring indicator	Details	Baseline	Target	Due date
3.1	Legal, institutional or regulatory frameworks in target areas improved	Secondary legislation on road safety in line with EU Directives 2004/54/EC and 2008/96/EC adoption.	[REDACTED]	[REDACTED]	[REDACTED]

The above additional indicator related to the adoption of secondary legislation on road safety was not achieved under the original project closed for TIMS monitoring. The Bank will require the Client to fulfil this indicator and will monitor compliance under the new loan.

3. KEY PARTIES

3.1 BORROWER

The Borrower is Montenegro represented by the Ministry of Finance.

The current long-term sovereign credit ratings of Montenegro are B1 (Stable Outlook, March 2020) by Moody's and B+ (Negative Outlook, May 2020) by S&P.

Key Macroeconomic Indicators	2015	2016	2017	2018	2019
Real GDP growth (%)	3.4%	2.9%	4.7%	5.1%	3.6%
CPI average prices, (%)	1.5%	-0.3%	2.4%	2.6%	0.4%
Unemployment (%)	17.5%	17.7%	16.1%	15.5%	15.8%
Current account balance (% of GDP)	-11.0%	-16.2%	-16.1%	-17.0%	-15.1%
Public debt (% of GDP) w/o guarant.	64.6%	64.4%	65.7%	70.1%	77.2%

Source: IMF, MoF Montenegro

Montenegro saw a significant increase in public debt over the last decade. The public debt-to-GDP ratio rose from 32% in 2007 to close to 77% of GDP in 2019 (without sovereign guarantees), reaching EUR 3.8bn. The increase since 2014 was mainly a consequence of an external loan to fund the construction of the first section of the Bar-Boljare highway. On the positive side, around 80% of the public debt is at fixed interest rates and in local currency.

Fighting the coronavirus impact on the economy will lead to a temporary spike in the public debt in 2020. Large-scale fiscal measures to combat the pandemic will cause an increase in the budget deficit in 2020. According to the IMF, the deficit might be above 10% of GDP. Taking this into account, as well as the EBRD GDP forecast (fall of 9%), Montenegrin public debt will probably exceed 90% of GDP by end-2020. As of end-June 2020, public debt was at the level of EUR 3.66bn including EUR 321 million of borrowed funds in 2Q 2020. Under the assumption of the pandemics subsiding in short term, which would lead to a rebound in GDP in 2021 (by 5.0%) and a significant decrease in budget deficit thereafter, public debt would start to fall in 2021. Still, it might take long before it gets below the “safe” 50% of GDP level, which poses sustainability concerns. Sustainability risks come from the high starting level of the debt, expected large growth shock and limited possibility for monetary financing given that Montenegro has unilaterally adopted the Euro. A more detailed sovereign debt analysis is given in Annex 3.

3.2 CLIENT

In Montenegro, the Ministry of Transport and Maritime Affairs (“MoTMA”) has overall responsibility for transport policy and strategic decisions, while responsibility for construction and maintenance of the Montenegrin road network is divided between the TA and local governments. TA, which is the client and beneficiary, is a Government agency responsible for main and regional roads maintenance and construction.

TA was established in 2006 under the terms of the EBRD’s first road sector loan in Montenegro signed in 2005. Its responsibilities, as detailed in the Law on Roads dated 2004, include planning, implementation and monitoring of construction, rehabilitation and maintenance of the national and regional road networks. The organisational chart of TA is given in Annex 1

4. MARKET CONTEXT

The latest survey done by World Economic Forum in 2019 on the quality of roads placed Montenegro at 88th position, out of 137 countries. This is behind Croatia and Slovenia but better than Serbia at the 100th and Bosnia and Herzegovina at the 109th position. Montenegro's road network totals about 7,000 km out of which TA manages around 1,800 of main and regional roads and municipalities manage around 5,200 km.

Since Montenegro's independence in 2006, the improvement and maintenance of national roads has taken priority for central government funding. National roads cover the main radial routes from Montenegro's capital city Podgorica to the primary border crossings with Bosnia and Herzegovina, Serbia and Albania and also the main route from Podgorica to the Adriatic coast near Bar. These national routes are vital for international transit traffic travelling through Montenegro but also for international and national tourist and goods traffic travelling to the Adriatic coast. The Government is now extending its attention to the backlog of improvement and maintenance works on the regional road network, which connects regional centres and is vital for development of the country's agricultural and tourism sectors.

One of the key infrastructure projects currently undertaken in Montenegro is the construction of the Podgorica – Matesevo, a 42 km-long section, which is part of the highway Bar – Boljare - Belgrade. It is financed by a Chinese bilateral loan and implemented by CRBC of China.

Most of the local roads, however, are in poor or very poor condition providing a low level of service in terms of speed restrictions, long journey times, and low infrastructure safety, due mainly to poor conditions of the alignments, lack of free sight distances (for stopping and overtaking), lack of retaining devices, lack of adequate drainage systems, poor slope stability, poor conditions of the pavements and narrow paved sections of the carriageways.

The poor condition of the local road network deters investment in developing the local economy and places a severe constraint on access to markets, as well as local education, health and administrative services. In turn, this has led to a decline in agricultural production. In addition, the potential for winter and summer tourism development in mountainous areas has not been exploited.

Although the main function of the local road network is to link population centres and local markets to each municipal centre, some of these roads have the potential for carrying significantly higher regional traffic. This potential is often stifled by the poor condition of the local roads. The importance of local roads is increased by the relatively low density of regional roads and Montenegro's mountainous terrain, which limits available transport corridors. As the Government recognised that institutional limitations of the local authorities, both fiscal and resource-wise, prevent them from ensuring adequate maintenance and upgrade of the local road network, it decided to select priority key local network sections and to transfer the responsibility for their modernisation to TA, in the meanwhile upgrading their status from local to regional roads. The technical review and survey of the road network done in 2012 identified a list of priority investments with Lubnice – Jezerine – Jelovica as the first priority for upgrade.

The Project will facilitate the economic development of the Bjelasica region, where the priority road section is located. Through its transition impact conditionalities, the Project will also

support further reforms in the road sector and implementation of road safety management measures.

5. FINANCIAL / ECONOMIC ANALYSIS

5.1 ECONOMIC ANALYSIS

[REDACTED]

5.2 PROJECTED PROFITABILITY FOR THE BANK

[REDACTED]

6. OTHER KEY CONSIDERATIONS

6.1 ENVIRONMENT

Categorised B (2019 ESP) Medium – High risk. The environmental and social due diligence (“ESDD”) was based on the findings of an independent review carried out in 2012 (for DTM 43060 and DTM 48169), results of a joint EBRD and third party consultant monitoring visit in 2018, review of annual environmental and social (“E&S”) reports submitted by the Client and supervision engineer reports covering environmental health and safety (“EHS”) performance, plus interviews with the Client and the contractor EHS manager.

The ESDD identified that a part of the existing road section to be upgraded will for a short distance encroach the buffer zone of a protected area, the Biogradska Gora National Park, but showed that impacts on the protected area would be localised and can be mitigated through design and adherence to good international practice in project preparation and construction. ESDD also ascertained that the Project will require limited land acquisition along existing route, but that no resettlement is required. The construction works commenced in 2017 and are ongoing. The land acquisition has been completed. According to national legislation, the Project was exempt from the environmental and impact assessment (“EIA”) process with exception of the 2.5 km long tunnel, for which the positive EIA decision was granted in 2018.

An additional environmental assessment was undertaken in 2015, when detailed design was available, and financed by EBRD TC and resulting in additional mitigation measures that were incorporated into an environmental and social action plan (“ESAP”). The implementation of the ESAP has been slow by both the Client and the contractor. The Client has improved its E&S capacity through participation in the Banks funded training on contractor management and up-skilling members of the TA staff, but further efforts in monitoring of the contractors EHS performance are required.

The Project had a number of EHS issues in the past two years, which were brought to EBRD’s attention through supervision engineer reporting, without adequate oversight from the

Client. Unexpected volumes of groundwater encountered during tunnel construction in spring 2018 had posed some additional health and safety (“H&S”) risks. These were, however, later addressed through revision of the design and review of the risks mitigation. In 2019, the project was required to address issues regarding illegal disposal of excavated material following an inspection by the national Environment Agency and complaints from the local community. A set of corrective actions were implemented in cooperation the Environment Agency and the EBRD. Due to these issues, ESD have specifically requested that disbursements be conditional to ESDs confirmation of satisfactory compliance with ESAP implementation.

The ESAP has been revised to reflect the current status of the Project and focuses on overall improvements of EHS management at site, adequate management of waste and waste waters, appropriate disposal of excavated material, improvements to ongoing stakeholder engagement activities, review of H&S and labour influx risks and controls in regards to Covid 19. The ESAP will be agreed prior to the Board approval. The Bank will continue to closely monitor the Project through review of annual reports, works supervision reports and site visits as required.

6.2 INTEGRITY

In conjunction with OCCO, integrity due diligence was undertaken on the Montenegrin TA and its senior management. The [REDACTED] Project does not pose an unacceptable integrity or reputational risk to the Bank. The TA is an existing client of the Bank and the experience to date has been positive.

All actions required by applicable EBRD procedures relevant to the prevention of money laundering, terrorist financing and other integrity issues have been taken with respect to the Project, and the Project files contain the integrity checklists and other required documentation which have been properly and accurately completed to proceed with the Project.

6.3 PROCUREMENT

The proceeds of the loan will be used to finance the increased cost of works and consultancy supervision services for the existing Lubnice – Jelovica – Jezerine road section. As such, it will not affect the scope of the Original Project. For procurement purposes, the Project is classified as a ‘public’ sector project.

- (i) *Works contract* – Civil Works of Tunnel Construction and Road Reconstruction on Lubnice – Jezerine road section, chainage from km 10+321.91 to Km 24+757.54

The procurement of the works contract was e under the EBRD’s competitive open tendering procedures to which five companies were provided bids. The invitation to tender was issued on 16 February 2016. Following the tender evaluation and the Bank’s no-objection, the contract was awarded to Euro-Asfalt d.o.o from Bosnia and Herzegovina. [REDACTED]

The Bank has reviewed the entire procurement process and documentation received and has confirmed that the Contractor was awarded fully in accordance with the Bank’s Open Tendering procedures and has been reviewed and no-objected by the Bank. The Bank is satisfied that the procurement process complied with the principles and considerations of the Bank’s PP&R and can therefore be considered acceptable. [REDACTED]

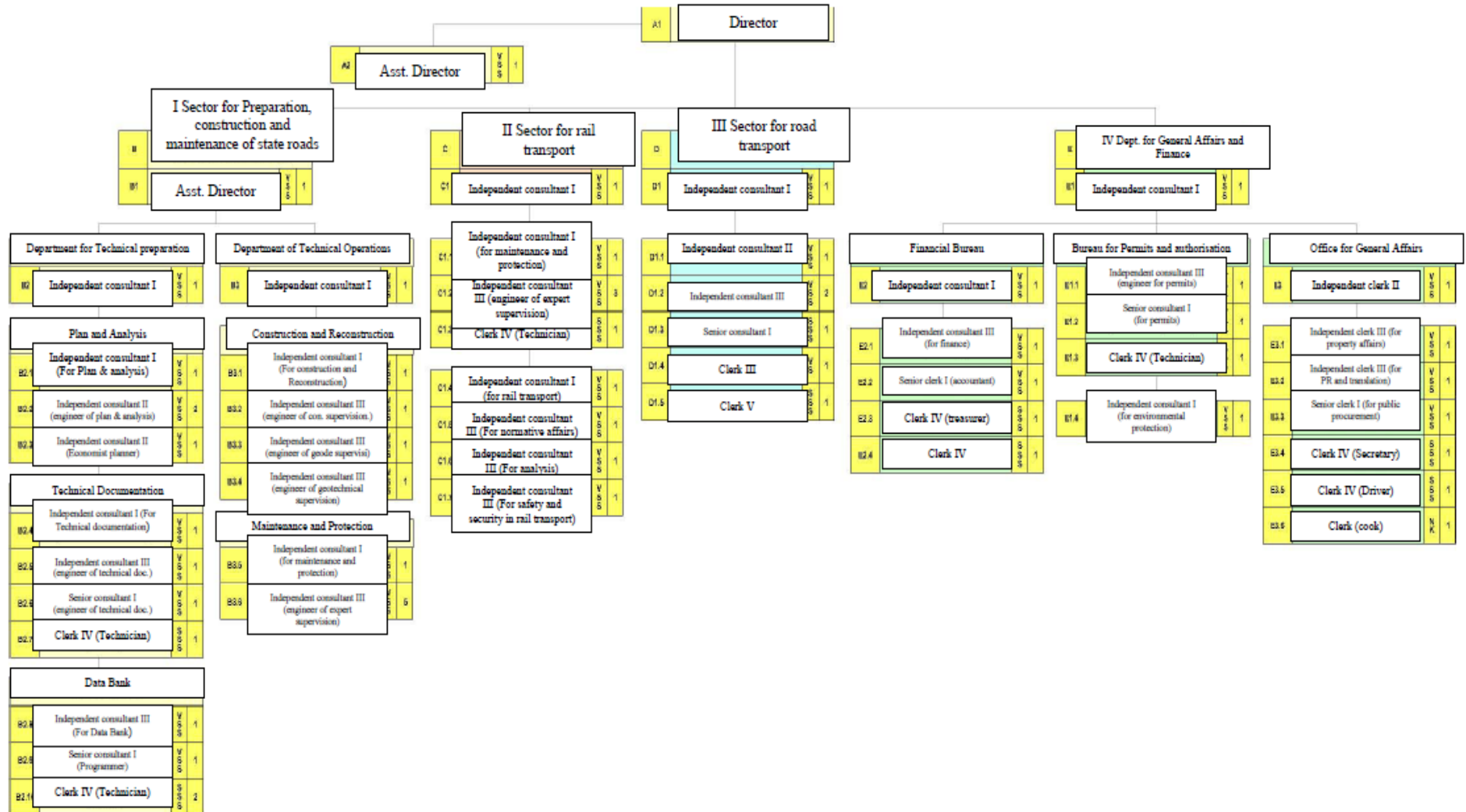
(ii) *Supervision services*

The selection of the supervision consultant was carried out under EBRD's PP&R. The Invitation for Expression of Interest was published in May 2015. Four proposals were received. Following the evaluation of proposals, IRD was awarded the contract and the contract was signed in December 2016. [REDACTED] Similar to the works contract, the amendment of the supervision contract with the existing consultant is envisaged and is deemed to fall under the Direct Selection method as justified in Section 5.8 (c) of the Bank's PP&R. [REDACTED]

ANNEXES TO OPERATION REPORT

Annex 1. Transport Administration organisational structure
Annex 2. Traffic and Economic Analysis
Annex 3. Sovereign Debt Analysis on Montenegro
Annex 4. Procurement Plan
Annex 5. Transition Impact Scoring Chart

ANNEX 1 - ORGANISATIONAL STRUCTURE OF TRANSPORT ADMINISTRATION



ANNEX 2 - TRAFFIC AND ECONOMICS

1. TRAFFIC

1.1 Existing Traffic Flows

Data on existing traffic in the 2018 base year has been obtained from automatic traffic counters installed on national and regional roads by the Traffic Directorate (“TD”), as well as other manual classified traffic counts. The traffic flows obtained from the manual counts have been converted into annual average daily traffic (“AADT”) by applying seasonality factors computed from an analysis of the long-term automatic traffic counter records.

Base year 2018 traffic flows on the sections of the Berane – Kolasin road to be improved under the project are shown below in Table 3.1.

Improvement of these road sections will offer a new, shorter route for traffic entering Montenegro from Kosovo, central and southern Serbia on the E65 route, which will then travel to Podgorica, and the Adriatic coast on the E80 route. The section of this route between Berane and Kolasin is 71 km long. Completion of the improvement and reconstruction works on the new Berane – Jezerine – Kolasin road will upgrade the road to a regional road standard with a length of 36 km. This alternative route will therefore reduce the distance between Berane and Kolasin by 35 km and significant traffic using the E65 / E80 route is expected to divert to the new route.

The existing E65 traffic from Kosovo recorded at an automatic traffic counter near Berane is also shown in Table 3.1 below.

Table 3.1: Existing 2018 Base Year Traffic Flows on the Berane – Jelovica Road (AADT)

Berane – Jezerine – Kolasin Road		2018 Base Year Traffic
Section 1	Berane to Lubnice	497
Section 2	Lubnice to Jelovica	335
Section 3	Jelovica to Jezerine	335
E65 Traffic at Berane		
Serbia and Kosovo border to Berane		2,482

Source: Montenegro Transport Administration, 2019

On average, 66% of the traffic on the Berane – Jezerine – Kolasin road was cars, 6% buses, 15% light goods vehicles and 13% heavy trucks.

1.2 Traffic Growth

Traffic growth rates were derived by applying income elasticity of demand factors for passenger and freight vehicles to forecasts of economic growth, expressed as growth in GDP.

Montenegro’s economic growth peaked at 5.1% in 2018, mainly due to investments in the construction of some large highway projects, real estate projects on the coast, a strong tourist season and a rise in private consumption. With the completion of large investment projects and ongoing fiscal consolidation, growth is expected to moderate significantly, to 2.8% in 2019 and

2.6% in 2020. Weaker growth in the European Union is one of the main risks to continued healthy medium term growth. A cautious view has been taken for predicting Montenegro's medium term and long term economic growth, with GDP growth of 2.5% up to 2025, then 2.3% up to 2030 and 2.0% up to 2046.

Table 3.2 below shows the derivation of the traffic growth rates adopted in the traffic forecasts used for the economic assessment of the project. Growth rates for passenger vehicles were derived by applying a conservative income elasticity factor of 1.2 to GDP per capita growth and growth rates for freight vehicles were derived by applying an income elasticity factor of 1.0 to GDP growth.

Table 3.2: GDP and Traffic Growth

Year	GDP Growth	GDP / Capita Growth	Elasticity Factor		Annual Traffic Growth Rate	
			Passenger Vehicles	Freight Vehicles	Passenger Vehicles	Freight Vehicles
2016	2.9%	2.9%	1.2	1.0	3.5%	2.9%
2017	4.7%	4.7%	1.2	1.0	5.6%	4.7%
2018	4.9%	4.9%	1.2	1.0	5.8%	4.9%
2019	2.8%	2.8%	1.2	1.0	3.3%	2.8%
2020	2.6%	2.6%	1.2	1.0	3.1%	2.6%
2021 - 2025	2.5%	2.5%	1.2	1.0	2.9%	2.5%
2026 – 2030	2.3%	2.3%	1.2	1.0	2.7%	2.3%
2031 - 2046	2.0%	2.0%	1.2	1.0	2.3%	2.0%

Source: EBRD Office of Chief Economist and Independent Consultant

1.3 Forecast Traffic on the Project Roads

The opening year of the full project for the improved Berane to Jezerine road with the tunnel was assumed 2022, following a six-year construction period between in 2016 and 2021.

Forecasts of traffic using the reconstructed road sections have been prepared by applying the annual growth rates shown in Table 3.2 to the existing 2018 base year traffic on the four sections of the Berane to Jezerine road.

Traffic diverting to the improved road from the E65 / E80 route between Berane and Kolasin was forecast by applying a price elasticity demand factor of 0.5 to the total time savings and vehicle operating cost savings offered by the new shorter alternative route in the tunnel-opening year of 2022. Using this method, it was forecast that 60% of the existing traffic travelling from Kosovo to Berane on the long E65 route will divert to the improved project road, to take advantage of the significant distance saving.

Forecast traffic on the project roads in a 25-year operating period from 2022 to 2046 is shown in Table 3.3.

Table 3.3: Forecast Traffic on the Berane to Kolasin Road (AADT)

Section		Length (km)		2022	2026	2031	2036	2041	2046
1.	Berane to Lubnice	10.3	Local Traffic	573	639	727	811	905	1,011
			Diverted Traffic	1,413	1,581	1,737	1,939	2,164	2,415
			Total Traffic	1,986	2,220	2,464	2,750	3,069	3,426
2.	Lubnice to Jelovica	8.3	Local Traffic	386	431	490	547	610	686
			Diverted Traffic	1,438	1,589	1,773	1,979	2,209	2,460
			Total Traffic	1,824	2,020	2,263	2,526	2,819	3,146
3.	Jelovica to Jezerine	5.6	Local Traffic	386	431	490	547	610	686
			Diverted Traffic	1,438	1,589	1,773	1,979	2,209	2,460
			Total Traffic	1,824	2,020	2,263	2,526	2,819	3,146
4.	Jezerine to Kolasin	11.7	Local Traffic	386	431	490	547	610	686
			Diverted Traffic	1,438	1,589	1,773	1,979	2,209	2,460
			Total Traffic	1,824	2,020	2,263	2,526	2,819	3,146

Source: EBRD Independent Consultant

2. ECONOMIC ANALYSIS

2.1 Methodology

[REDACTED]

2.2 Data

[REDACTED]

2.3 Results of the Economic Analysis

[REDACTED]

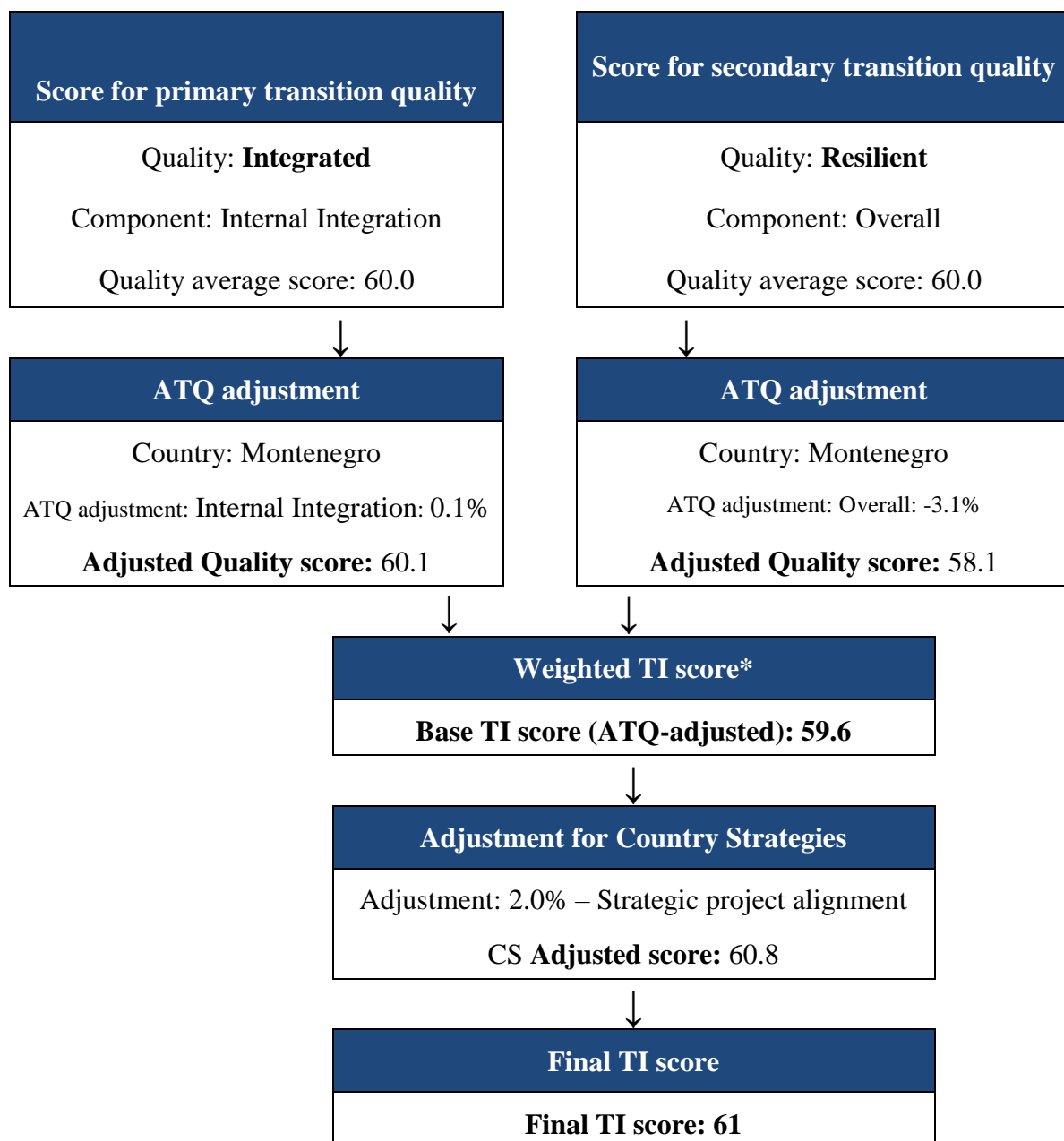
ANNEX 3 - SOVEREIGN DEBT ANALYSIS ON MONTENEGRO

[REDACTED]

ANNEX 4 - PROCUREMENT PLAN

[REDACTED]

ANNEX 5 – TRANSITION IMPACT SCORING CHART



*The Primary Quality score is weighted 75% for the calculation of the Base TI Score. The Secondary Quality is weighted 25%.