

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

Approved by the Board of Directors on 19 October 2022¹

SERBIA

SERBIA CARGO ROLLING STOCK RENEWAL

[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.

For the avoidance of any doubt, the information set out here was accurate as at the date of preparation of this document, prior to consideration and approval of the project.

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ABBREVIATIONS / CURRENCY CONVERSIONS

CAPEX	Capital Expenditures
CFADS	Cash Flows Available for Debt Service
CFF	Cash Flow from Financing
CFI	Cash Flow from Investments
CFO	Cash Flow from Operations
CO2	Carbon Dioxide
CGAP	Corporate Governance Action Plan
CP	Condition Precedent
CBA	Cost Benefit Analysis
DSCR	Debt Service Cover Ratio
EBITDA	Earnings Before Interest Tax and Depreciation
EIRR	Economic Rate of Return
EURIBOR	European Inter-Bank Offer Rate
ESAP	Environmental and Social Action Plan
GET	Green Economy Transition
GoS	Government of Serbia
KPI	Key Performance Indicator
LTT	Legal Transition Team
LMA	Lender's Monitor Advisor
MCTI	Ministry of Construction, Traffic and Infrastructure
MoF	Ministry of Finance of the Republic of Serbia
Ntkm	Net tons per kilometre
PIU	Project Implementation Unit
PRs	EBRD Performance Requirements
RSD	Serbian Dinar
SSC	Sector Skills Counsel
SSF	EBRD Shareholder Special Fund
ToR	Terms of reference
WACC	Weighted Average Cost of Capital

Currency conversion

EUR 1 = RSD 117.6

PRESIDENT'S RECOMMENDATION

This recommendation and the attached Report concerning an operation in favour of Joint Stock Company for Freight Railway Transport Serbia Cargo (“Serbia Cargo” or the “Company”), the national rail freight operator incorporated in the Republic of Serbia, are submitted for consideration by the Board of Directors.

The facility will consist of a sovereign guaranteed loan to Serbia Cargo in the amount of up to EUR 43 million to modernise its fleet through the purchase of new locomotives, wagons and wagon overhaul, to replace obsolete rolling stock [REDACTED] in order to improve the quality and volumes of freight services on network. The project will enable the Bank to continue its work in supporting the development of Serbia’s rail sector and the modal shift from road to rail.

The expected transition impact of the project includes Well-Governed and Inclusive qualities through improvements of corporate governance addressed through a corporate governance action plan, and by developing policy recommendations on improved sector-wide skills development for the railway sector. Furthermore, the Project will lead to [REDACTED] emission savings as a result of the modal shift from road to rail freight and will be attributed 92% GET. This shift will divert traffic from high carbon intensity road vehicles to lower carbon intensity rail rolling stock.

EBRD’s Shareholder Special Fund (“SSF”) provided TC support to carry out the economic and technical analysis.

I am satisfied that the operation is consistent with the Bank’s Transport Sector Strategy, Strategy for Serbia, The Green Economy Transition (“GET”) approach, Equality of Opportunity Strategy, Strategy for the Promotion of Gender Equality and with the Agreement Establishing the Bank.

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

Odile Renaud-Basso

BOARD DECISION SHEET

SERBIA – SERBIA CARGO ROLLING STOCK RENEWAL - DTM 53274	
Transaction / Board Decision	Board approval ² is sought for a sovereign guaranteed loan of up to EUR 43 million in favour of Serbia Cargo, a joint stock company established under the laws of Serbia. The loan will finance procurement of modern diesel freight and shunting locomotives, procurement of new wagons, overhaul of wagons and PIU and supervision consultants (the “Project”). Procurement will be carried out in accordance with the Bank’s PP&R.
Client	Serbia Cargo provides rail freight transportation services and is 100% owned by the Republic of Serbia. It was unbundled from vertically integrated Serbian Railways in 2015. [REDACTED].
Main Elements of the Proposal	<p>Transition impact: Transition impact stems from the <i>Well governed</i> and <i>Inclusive</i> qualities. The Project will result in improvements of corporate governance with identified deficiencies addressed through a CGAP; [REDACTED] the current skills development framework in the railway sector will be targeted through policy dialogue activities with the aim to contribute to the establishment of a new sector skills council model.</p> <p>Additionality:</p> <p><i>Financing Structure:</i> EBRD offers financing that is not available in the market from commercial sources on reasonable terms and conditions including longer maturity [REDACTED]. EBRD does not crowd out other sources.</p> <p><i>Standard-setting:</i> By helping the Company, to achieve higher standards, EBRD’s value added comes from support on corporate governance improvements, skills development and gender inclusion.</p> <p>Sound banking: The proposed loan benefits from a sovereign guarantee. Serbia’s credit risk is acceptable to the Bank.</p>
Key Risks	The risks identified are related to the Company’s capacity to implement the Project within schedule, which will be mitigated by engaging a loan-funded PIU and supervision consultants to assist the Company with project implementation. Additionally, the Bank will engage a Lender’s Monitor Advisor (“LMA”). The risk of limited debt service capacity of the Company is mitigated through the sovereign guarantee.
Strategic Fit Summary	The Project is in line with: The Strategy for Serbia by improving the transport network and supporting regional economic connectivity, and the Transport Sector Strategy which acknowledges that “...railway plays a central role to create a multimodal, environmentally friendly, efficient and safe transport system”. The Project will also make a contribution towards the EBRD’s The Green Economy Transition (“GET”) approach, which acknowledges the potential for incremental activity in the rail sector to support the transition to low carbon economies, as well as towards the EBRD’s human capital development agenda as per the Equality of Opportunity Strategy , and the 2021 Strategy for the Promotion of Gender Equality by promoting access to skills and employment in Serbia’s railway sector.

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

ADDITIONAL SUMMARY TERMS FACTSHEET

EBRD Transaction	Sovereign guaranteed loan of up to EUR 43 million to Serbia Cargo.
Existing Exposure	<ul style="list-style-type: none"> • [REDACTED]. • Serbia Cargo is an existing client of the Bank under the Serbian Railways Corridor X-I project (OpId: 48406). The Bank provided a EUR 64 million sovereign guaranteed loan [REDACTED] for the purchase of 16 cargo multi-system electric locomotives. All locomotives were delivered and in operation [REDACTED] with a final TIMS rating of good with negligible risk (PTI equivalent score of 90).
Repayment	15 years [REDACTED].
Potential AMI eligible financing	None.
Use of Proceeds	<p>Proceeds of the loan will finance procurement of main line and shunting locomotives, freight wagons, overhaul of wagons, and a PIU Support and Supervision Consultants, to replace obsolete rolling stock [REDACTED] in order to improve the quality and volumes of freight services on network, supporting the modal shift from road to rail (the “Project”).</p> <p>The use of proceeds will be [REDACTED] monitored through the receipt of the documentary evidence and reporting.</p>
Investment Plan	[REDACTED]
Financing Plan	[REDACTED]
Key Parties Involved	<ul style="list-style-type: none"> • Serbia Cargo; • Ministry of Finance of the Republic of Serbia (“MoF”); • Ministry of Construction, Transport and Infrastructure (“MCTI”) of Serbia.
Conditions to effectiveness	[REDACTED]
Conditions to disbursement	[REDACTED]
Key Covenants	[REDACTED] Satisfactory implementation of the Environmental and Social Action Plan (“ESAP”); Satisfactory implementation of Corporate Governance Action Plan (“CGAP”) [REDACTED]
Security / Guarantees	Sovereign guarantee.
Other material agreements	Guarantee Agreement with the Republic of Serbia.
Associated Donor Funded TC and co-investment grants/concessional finance	<p>A. Technical Cooperation (TC)</p> <p><u>Pre-Signing</u></p> <ul style="list-style-type: none"> • TC1: Economic and technical analysis including Paris alignment assessment [REDACTED] funded by SSF [REDACTED]. <p><u>Post-Signing</u></p> <ul style="list-style-type: none"> • TC2: Assistance for the implementation of corporate governance improvements, including corporate governance specialist consultants/legal consultants, [REDACTED] financed by an international donor or SSF. • TC3: Lender’s Monitor Advisor to ensure timely and cost effective implementation of the Project and compliance with EBRD’s PP&R. [REDACTED] [T]o be financed by an international donor or SSF. • TC4: H&S assessment will look at technological and organisational measures that can help prevent or mitigate in the event of any derailments. The assessment will provide an independent review of the risk and provided recommendations. [REDACTED] [F]inanced from ESD framework. <p>Cost Sharing: The Company will be responsible for paying all VAT (if applicable) and other indirect taxes that are applied to any post-signing TCs as a parallel cost</p>

	sharing contribution to the Project (VAT is levied at 20% in Serbia). The Company will also make a parallel contribution [REDACTED] from the Loan to finance i) PIU Support and ii) Supervision Consultants.
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[REDACTED]

INVESTMENT PROPOSAL SUMMARY

1. STRATEGIC FIT AND KEY ISSUES

1.1 STRATEGIC CONTEXT

Modernisation of the railway sector with the aim to increase the share of railway transportation is a key priority for the Government of Serbia (“GoS”). Since the early 1990s, the Serbian railway sector has suffered from [REDACTED] under investment coupled with inadequate maintenance, which resulted in deteriorated rail infrastructure and rolling stock, low transportation speeds and unreliable services. To reverse this trend, the Serbian government is undertaking **considerable investments in the rail sector**, first and foremost to modernise infrastructure (Corridor X) but also to support Serbia Cargo in improving its freight services to promote a modal shift from dominant road (59%) to rail freight (26% in 2021). The modal shift from road to rail achieves net GHG savings as rail transport is the second most energy-efficient and least carbon-intensive way of carrying goods only below shipping. The carbon intensity of modern rolling stock is one-third of the carbon intensity of road transportation (80 kgCO₂eq/000 ntkm vs. 25 kgCO₂eq/000 ntkm), thus the more freight shift from road to rail, the more GHG savings is achieved. In this purpose, in 2019 Serbia Cargo procured 16 new electric Vectron locomotives (financed by EBRD) demonstrating its commitment to procuring high performance and sustainable technologies. The proposed loan will finance the rolling stock renewal and modernisation of the fleet by replacing old inefficient rolling stock with the ultimate aim to improve the quality of rail freight services.

An extensive investment programme “Serbia 2025” is targeting EUR 3.5 billion investment in upgrading rail infrastructure, including electrification. However, a large part (c.67%) of the network has not yet been electrified. Moreover, full electrification is not likely to occur during the economic lifespan of the locomotives, in particular on secondary and branch lines with relatively low traffic. Additionally, Serbia Cargo is facing the long term closure of electrified corridors due to ongoing and planned modernisation of key lines. Therefore, as confirmed by the Bank’s technical consultant, modern diesel locomotives were assessed as the optimal technology choice in this instance in order to provide the necessary service across the network and **maximise the modal shift from road to rail freight**, delivering the largest emissions reduction outcome. The Project will lead to [REDACTED] emission savings as a result of the modal shift from road to rail freight and will be attributed 92% GET. Additionally, the project is fully aligned with the new **Transport Community’s Strategy for Sustainable and Smart Mobility in the Western Balkans** with the final aim in making transport greener, sustainable and healthier for citizens of Western Balkans. Flagship 4 – “Greening Freight Transport” emphasises the importance of shifting inland freight carried today by road to rail and inland waterways. *An economic assessment* of the Project was done by external advisor [REDACTED]. Please refer to Annex 8 for more details.

The Project will further support the Bank’s broader reform agenda in Serbian rail sector with a focus on modal shift to rail and low-carbon transition, financial sustainability,

improved well-governance, skills development and gender responsiveness. The proposed investment will reduce Serbia Cargo's operational expenses due to lower maintenance costs associated with the new fleet and increase its revenues as a result of an improved capacity, frequency, and higher level of service, leading Serbia Cargo towards more **financially sustainable** operations. The Project will also tackle other impediments to further modernisation of the Company through: (i) **corporate governance improvements** through implementation of a CGAP. The CGAP measures are aligned with and reinforce Serbia's state ownership policy, developed with EBRD assistance and adopted in April 2021, including through strengthening the exercise of the State's ownership function and implementing practices at the level of the Company which are consistent with best international practices. This will complement the planned work led by the World Bank on Serbia Cargo's commercialisation. The Project will also work towards alleviating human capital challenges in the sector by (ii) **developing recommendations on sector-wide skills development policies**. This will enable Serbia Cargo to take action on preventing the substantial workforce shortages expected in the future due to aging work force cohorts and a change in the skills required. This is already a priority for MoCTI being addressed through the introduction of dual education programs and the development of a training centre. This Project will complement these activities by contributing to the assessment and re-design of the Sector Skill Council ("SCC") for railway transport, a key platform to ensure sector skills policies correspond to the needs of the labour market. Serbia Cargo will provide industry-specific knowledge and experience in this process, review the assessment findings and help to shape final recommendations to be issued to policy stakeholders.

Considering the above, the Project is in line with:

- The **Strategy for Serbia** by improving the transport network and supporting regional economic connectivity, while also foster competitiveness and governance by reforming selected state owned enterprises.
- The **Transport Sector Strategy** which acknowledges that "...railway plays a central role to create a multimodal, environmentally friendly, efficient and safe transport system". As part of its Operational Approach, as it is stated in the Strategy, "*The Bank will continue to engage in the rail sector, working across both the public and private sectors, financing infrastructure rehabilitation, upgrade or new construction, rolling stock renewal...Through its investments, the Bank will support the ongoing reforms in the region*".
- The **Green Economy Transition ("GET")** approach, which acknowledges the potential for incremental activity in the rail sector to support the transition to low carbon economies.
- Finally, the Project will make a contribution towards the EBRD's **Equality of Opportunity Strategy** and its **Strategy for the Promotion of Gender Equality (SPGE)** by promoting access to skills and employment for young women and men in Serbia's railway sector.

1.2 TRANSITION IMPACT

The table below sets out the transition objectives and details of the Project.

Primary Quality: Well-Governed

Obj No.	Objective	Details
1.1	<i>The Company will improve its corporate governance practices.</i>	<p>During due diligence, the Bank reviewed the corporate governance practices of the Company and identified areas for improvement. While the Company has an oversight body, i.e. its supervisory board, more can be done to strengthen both its composition and definition of its responsibilities.</p> <p>Other areas of improvements were identified including composition and responsibilities of the audit committee, board support, internal control systems, introduction of succession planning and improvement in non-financial disclosure.</p>
1.2	<i>The CGAP addresses all the CG issues identified in the company.</i>	<ul style="list-style-type: none"> • Based on the results of the review, the formulated CGAP will address all the issues highlighted in the review. More specifically, the CGAP includes key building blocks including the following main ones: Defining the rationale for state ownership in the Company and setting out the main commercial and non-commercial long-term and medium-term objectives; • Subject to definition of main objectives, updating the Company's long-term strategic plan so that it serves as a basis for annual business plans and oversight of Company's performance; • Adopting a Nomination Policy for the Company's supervisory board and appointing at least one independent member; • Strengthening the composition, role, responsibilities and functioning of the supervisory board of the Company; • Restructuring an audit committee as a subcommittee of the supervisory board with appropriate responsibilities; • Introducing a compliance function and introducing a risk management function; • Strengthening the Internal Audit function; • Introducing Succession Planning; [REDACTED]. <p>The Company will be required to designate an officer to be in charge of ensuring CGAP implementation and reporting to EBRD.</p>
1.3	<i>All CGAP actions are covenanted.</i>	The CGAP will be annexed to the loan agreement and its implementation will be covenanted.
1.4	<i>The CGAP is expected to have impact beyond the client.</i>	Due to the policy nature of the work with the Serbian authorities (EBRD's assistance to the Ministry of Economy in developing a state ownership policy), and the corporate governance improvements done in other transactions in the rail sector the implementation of the CGAP is likely to extend beyond the Company as it is a direct opportunity to implement good practices referenced in the state ownership policy. Further, having in mind that the implementation of the CGAP will be supported by a targeted TC, the CGAP should have positive demonstration effects by

		highlighting the changes the authorities can undertake with respect to other state owned companies.
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Secondary Quality: Inclusive

Obj. No.	Objective	Details
2.1	<i>The project will develop policy recommendations for relevant government authorities including through the contribution to existing policy engagements</i>	The Company will actively contribute to the Bank-led policy dialogue aiming to ensure greater effectiveness of the Sector Skill Council for railway transport, which will in the long run positively impact the future skilled labour supply for railway companies. The Project will implement an assessment of the current set-up and organisation of Sector Skill Councils in Serbia and develop recommendations for their greater effectiveness and involvement of all railway companies, including private sector companies.

1.3 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).	This is a repeat transaction with the Company. In 2018 the Bank extended a EUR 64 million sovereign guaranteed loan for the purchase of 16 cargo multi-system electric locomotives.

Additionality sources	Evidence of additionality sources
Financing structure: <ul style="list-style-type: none"> EBRD offers financing that is not available in the market from commercial sources on reasonable terms and conditions [REDACTED]. Such financing is necessary to structure the project. EBRD offers a tenor, which is longer than available to the client in the market on reasonable terms and conditions. EBRD offers a large volume instrument that fills a market funding gap and is required to structure the project. 	Proposed 15 year tenor [REDACTED] and loan size of EUR 43 million cannot be obtained from local commercial banks [REDACTED]. The Company does not have any commercial bank financing due to nature of its investments which are sizable and require longer tenors. Financing from other IFIs for the sector has typically been aimed for infrastructure where most of rail related investments have been concentrated recently.
Standard-setting: helping projects and clients achieve higher standards <ul style="list-style-type: none"> Client seeks/makes use of EBRD expertise on corporate governance improvements, including for climate risk management. 	Corporate Governance will be improved with the help of the Bank which has produced CGAP and will support with its implementation.

<ul style="list-style-type: none"> – Gender SMART: Client seeks/makes use of EBRD expertise for the adoption of gender standards and/or equal opportunities action plans (e.g. improving women's access to safe transport and/or women-led businesses participation in the client supply chain). – Client seeks/makes use of EBRD expertise on higher environmental standards, above 'business as usual' (e.g. adoption of emissions standards, climate-related ISO standards etc.) – Client seeks/makes use of EBRD expertise on best international procurement standards. 	<p>The Company will participate in a cross-company working group to develop approaches to improve outreach practices and cooperation with schools in order to attract girls to choose male dominated occupations in the railway sector. The enrolment of girls in the railway vocational high schools is aimed to increase [REDACTED].</p> <p>The ESAP agreed with the Company will ensure compliance and implementation of best practice.</p> <p>The Company will benefit from Bank's expertise and guidance with regards to implementing Bank's PP&R and thereby achieve the optimal result with regards to procurement.</p>
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1.4 SOUND BANKING - KEY RISKS

Risks	Probability / Effect	Comments
Project implementation risk	<i>Medium/ Medium</i>	<p>The main implementation risk is relating to overhaul of wagons component which is challenging and needs to be closely monitored.</p> <p>Mitigation: Project preparation will incorporate procurement planning, budgeting and procurement procedure selection. In particular the risk is mitigated via the following:</p> <ul style="list-style-type: none"> • A Lender's Monitor that will provide assistance to the Bank on all technical matters and on monitoring the implementation of the Project. • A supervisor of freight wagon overhaul works will be commissioned and will provide assurance that works are carried out in a timely manner and within budget, assurance including both pre- and post-works inspections with detailed technical records kept. • An experienced PIU Support Consultant will be appointed to assist the Company in drafting the technical requirements, conducting a market research, and supporting the tendering process.

High asset price volatility	<i>High/ Medium</i>	<ul style="list-style-type: none"> Based on technical consultant's due diligence findings, cost estimates for the proposed Project are [REDACTED] higher than the Company's estimates due to most recent market developments. <p>Mitigation:</p> <ul style="list-style-type: none"> [REDACTED] [T]he quantity of locomotives or works will have to be adjusted if actual costs are higher than estimates.
Company's creditworthiness	<i>High/Low</i>	<p>The Company's creditworthiness has been affected over the past years due to increased costs caused by Covid 19 pandemic slowdown, infrastructure works and their tariffs which remain regulated. [REDACTED].</p> <p>Mitigation:</p> <ul style="list-style-type: none"> The World Bank has engaged consultants to work on the Company's commercialisation which along with the CGAP proposed by the Bank will support the Company in optimising its performance. GoS will directly and indirectly support the Company as the main operator in the market on which a number of strategically important companies depend. Ultimately the risk is mitigated by the sovereign guarantee which ensures debt service for sovereign guaranteed loans.

2. MEASURING / MONITORING SUCCESS

<i>Overall objectives of project</i>	<i>Monitoring benchmarks</i>	<i>Implementation timing</i>
<ul style="list-style-type: none"> - On-time project implementation - Implementation of CGAP. 	Standard progress reports [REDACTED] CGAP to be implemented [REDACTED]	[REDACTED]

TI indicator(s), primary Quality: Well-Governed

Obj. No.	Monitoring indicator	Details	Baseline	Target	Due date	TC
1.1	Corporate Governance Action Plan (CGAP) approved	The CGAP includes a number of actions the deadlines for which have been tailored according to the actions' priority and the client's capacities, taking into consideration that EBRD will be providing a TC to assist with the implementation of selected actions.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

1.2	Actions in the Corporate Governance Action Plan Implemented.	Define the rationale for state ownership in the Company and set out the definition and monitoring of financial and non-financial KPIs set as a reflection of Shareholder's expectations and Company's strategy.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
1.3	Actions in the Corporate Governance Action Plan Implemented.	Composition, Role, Responsibilities and Functioning of Supervisory Board including changes to the Articles of association [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
1.4	Actions in the Corporate Governance Action Plan Implemented.	The Supervisory Board shall approve a Terms of Reference for the Audit Committee of the Supervisory Board, in line with the CGAP, and the Audit Committee shall be restructured.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
1.5	Actions in the Corporate Governance Action Plan Implemented.	Strengthen the Internal Audit Function.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
1.6	Actions in the Corporate Governance Action Plan Implemented.	Strengthen Company's Disclosure.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

TI indicator(s), secondary Quality: Inclusive

Obj · No.	Monitoring indicator	Details	Base line	Target	Due date	TC
2.1	Client engages in policy dialogue: providing substantial contributions to activities	The Company will actively contribute to the policy dialogue efforts on improving the functioning of the railway transport SSC by providing industry-specific	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

		knowledge, reviewing the assessment of challenges and gaps in the current set-up, and supporting the development of tailored recommendations for the re-design of the SSC to be issued to policy stakeholders.				
2.2	Practices of the relevant stakeholder improved (equal opportunity practices of the client)	Through engagement in the inter-company working group to promote the new dual-learning programmes in the railway sector, the Company will work towards attracting young girls to enrol into the new education profiles, leading to an increase in the share of girls enrolling in railway secondary vocational school [REDACTED].	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

3. KEY PARTIES

3.1 BORROWER

Serbia Cargo was incorporated in 2015 as the national railway freight operator when Serbian Railways was unbundled into three separate companies, Serbia Cargo, Serbia Rail Infrastructure and Serbia Voz. The Company, fully owned by the Government, provides rail freight transportation services, in four principal lines of business – bulk, wagonload, intermodal and transit. It owns [REDACTED] locomotives (of which the majority are over 40 years old), and [REDACTED] freight wagons of which [REDACTED] are out of operation and/or in need of repair.

The Company has been negatively impacted by the lack of investments and due to disruptions caused by major infrastructure works which caused service levels to decline. Hence, it will require Government support through the sovereign guarantee.

3.2 GUARANTOR

The Guarantor is the Republic of Serbia, represented by MoF. The Serbian economy is growing robustly, following a mild 0.9% GDP contraction in 2020, GDP grew by 7.4% in 2021, outperforming the expectations. The expansion reflects a strong expansion of exports and industry due to rebound of the Euro Area, Serbia's main trading partner, robust household consumption on the back of pent up demand and continued investment impulse supported by the sizeable public investments. FDI recovered in 2021 to above the 2019 level, which bodes well for future growth.

The main challenge to Serbia's debt sustainability relate to absence of further structural fiscal adjustment and unfavourable internal and external developments due to different shocks, such as the one related to Covid-19. Near term fiscal risk is reflected in the public sectors' absorption of higher energy prices (electricity and gas in particular) amid surging global market prices. With fiscal costs for the winter of 2021/22 estimated at over EUR 1 billion, the following winter will likely be another challenging one for Serbia [REDACTED] amid continually elevated market prices and only moderate price increases for consumers so far. On the positive side, a majority of Serbia's debt is at fixed interest rates (87.2% of the debt), the average maturity of outstanding debt is long and the share of multilateral and institutional creditors in the external debt is high. Continued engagement with the IMF helps uphold the confidence. [REDACTED]. Serbia currently has a 30-month Policy Coordination Instrument (PCI) with the IMF in place since June 2021, with second review concluded in June 2022. Serbia is rated at BB+ (Positive) by S&P, Ba2 (Stable) by Moody's and BB+ (Stable) by Fitch.

4. MARKET CONTEXT

The Serbian rail freight sector is characterised by aging assets due to years of under-investment in both infrastructure and rolling stock. Therefore, road still has a high freight market share, carrying an estimated 59% of freight compared to 26% by rail. The Company operates on rail infrastructure owned by Serbia Rail Infrastructure (Bank client) which consists of 3,819 km of tracks, of which around 3,500 km are single railways lines, and only 1,283 km is electrified. Investments in infrastructure have increased in recent years with a high-speed rail line under construction from Serbia to Hungary, the electrification of the line from Nis to Bulgaria and improvements on the Corridor X from Belgrade to Nis envisaged to be financed by EU, EIB and EBRD.

Although the current and planned infrastructure works will bring clear benefits in the long term, their implementation is causing difficulties in train operations, [REDACTED] weakening the competitiveness of the transit route (Corridor X) through Serbia, in comparison with the parallel Corridor IV and maritime transport, as well as weakening the domestic competitiveness of the railway in comparison with other traffic modes. The Novi Sad – Subotica section has been completely closed from the end of 2021 until its expected reopening in early 2025 due to infrastructure works, which has caused all trains to operate via a secondary non-electrified route, leading to higher costs [REDACTED].

Cargo transported by the Company has remained relatively stable over the last decade, with some losses due to new entrants and infrastructure works north of Belgrade [REDACTED]. A modest recovery is evidenced in 2021 [REDACTED].

During last 10 year period (2012-2022) transit traffic reduced by around 35% due to ongoing infrastructure works but also due to the development of an ‘all-EU’ route through Romania and Bulgaria, combined with the emergence of open-access operators and the generally poor condition of the main transit corridors. In 2022, the Company expects a further fall [REDACTED] due to the reconstruction of the link to Hungary, a major source of transit traffic. As transit traffic travels by far the longest distance on the network, net ton-km (ntkm), which takes into account the length of haul as well as the tonnage, has declined from 2.8 billion in 2012 to the planned 2.2 billion in 2022 with the fall in transit traffic partially compensated by an increase of 40% in domestic, import and export traffic. [REDACTED].

Competition: The market was liberalised in 2016 and is highly concentrated with the Company currently holding an 84% market share in 2021 as measured by net ton/km. The remainder is covered by several private operators, including Kombinovani Prevoz, Despotija, Eurorail, Pannon Rail, AB Prevoz, Rail Transport Logistic and others. It should be noted that the Borrower as the largest operator with most extensive fleet fills a market gap for less profitable transport of goods (e.g. stone and other construction materials, waste materials, other bulk goods) which are not attractive for private operators but vital for certain segments of the economy.

Regulatory: Licensing of rail transport is regulated by the Rail Directorate which oversees licensing and allotment of slots for use of rail infrastructure. The Company pays a fee for use of infrastructure [REDACTED].

5. FINANCIAL / ECONOMIC ANALYSIS

5.1 FINANCIAL PROJECTIONS

[REDACTED]

5.2 SENSITIVITY ANALYSIS

[REDACTED]

5.3 PROJECTED PROFITABILITY FOR THE BANK

[REDACTED]

6. OTHER KEY CONSIDERATIONS

6.1 ENVIRONMENT

Categorised B (ESP 2019). The Environmental and Social Due Diligence (“ESDD”) for the Project was carried out internally by ESD and comprised of an environmental and social (“E&S”) assessment of the Project, a review of the current operations as it relates to the transport of goods and a review of the company’s E&S capacity to manage risks and impacts.

ESDD included a review of corporate E&S arrangements by means of interviews, site visit to a maintenance depot in Belgrade and review of documentation related to existing E&S practices of the company. ESDD confirmed a clear understanding of the E&S arrangements currently implemented. Various E&S documents were shared including operating permits, environmental procedures, monitoring data and training records. Serbia Cargo has various internal rulebooks, operational procedures, guidelines and formal mechanisms. ESDD confirmed that the Company has the organisational capacity for managing E&S risks and impacts with its current operations and plans to further develop their existing management systems to align with ISO 14001 and 45001 within the next few years.

Serbia Cargo is required to meet National Labour laws and sector-specific regulations related to rail transport in Serbia. Serbia Cargo has an active Collective Agreement in place and a written internal Code of Conduct for employees. Serbia Cargo has a well-established HR function which manages labour and working conditions adequately. The Company has regular environmental inspections and ESDD confirmed arrangement for meeting national requirements related to wastewater/waste management and emergency preparedness and response are in place. ESDD also confirmed an energy efficiency function was recently established and this function intends to undertake an assessment and implement a plan to improve energy efficiency. Adequate H&S risk management and internal capacity has been established for managing risks to workers. Policies and procedures reviewed during ESDD also align with good international practice. Contractor and supply chain management is managed through standard tender documents and public procurement laws, although Serbia Cargo will need to strengthen their organisations arrangements to reduce E&S risk by assigning roles and responsibilities to key staff for oversight.

Serbia Cargo engages with various stakeholders, publicises relevant company information, has contact details on the company’s web-site and generally has an operational grievance mechanism in place. A further formalisation of this would be beneficial including updating their complaints procedure on their website. Serbia Cargo is exposed to a higher risk of derailments due to the condition of the existing infrastructure and plan to explore how this risk can be reduced using technology solutions. An ESAP for the project has been developed and agreed with the Company and includes review of internal capacity related to contractor management and supply chains; requirements to undertake an energy efficiency assessment and further develop the promotion of their existing operational grievance mechanism. The Bank will continue to monitor Serbia Cargo activities through annual E&S monitoring reports and site visits if necessary.

6.2 INTEGRITY

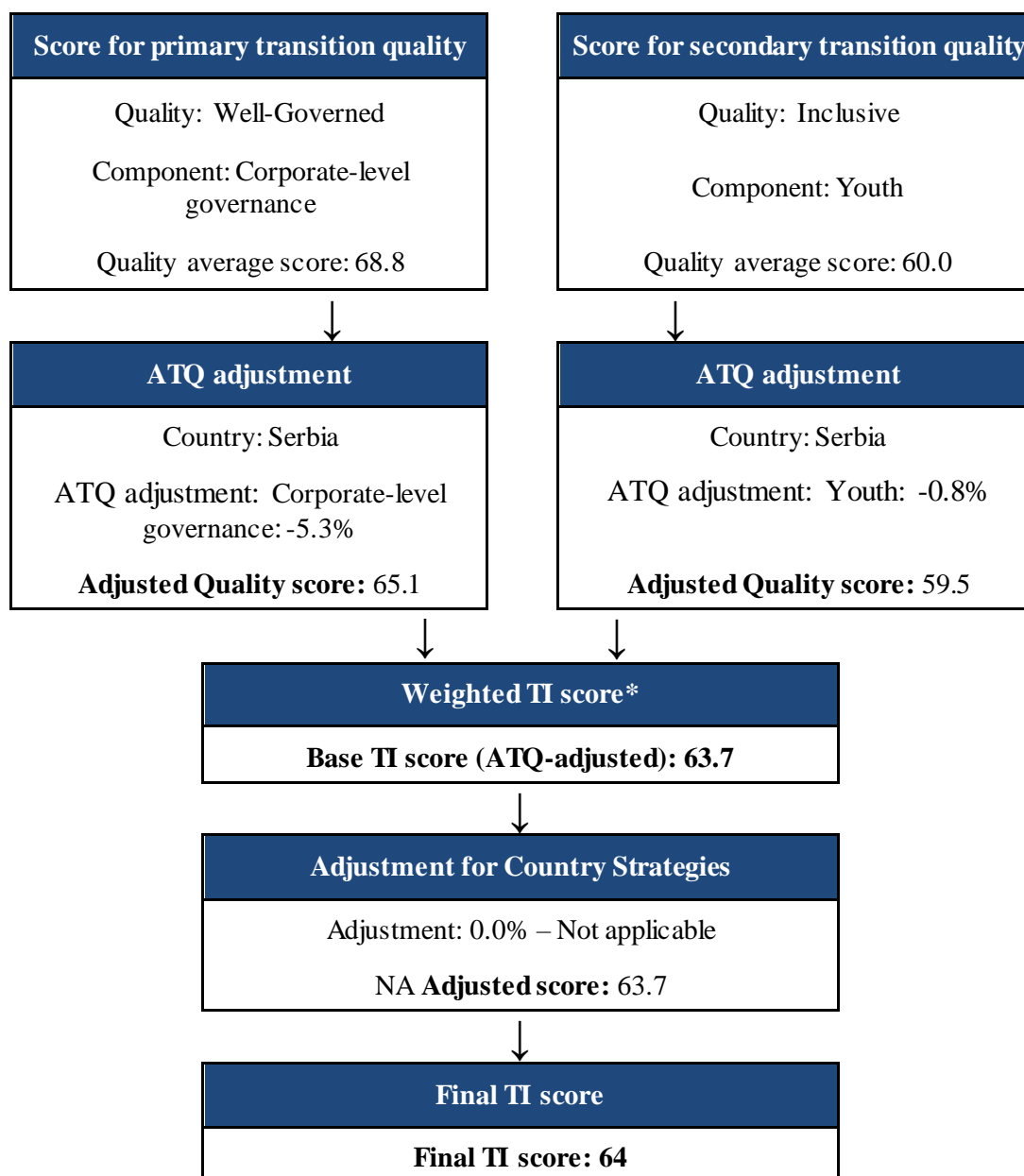
In conjunction with OCCO an updated integrity due diligence was undertaken on the joint-stock company Serbia Cargo, Ministry of Construction, Transport and Infrastructure, Ministry of Finance, their key officials, management and Board of Directors. [REDACTED]. It has been therefore concluded that this project does not pose an unacceptable reputational or integrity risk to the Bank. Serbia Cargo is a longstanding client of the Bank and the experience to date has been positive.

All actions required by applicable EBRD procedures relevant to the prevention of 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.

ANNEXES TO OPERATION REPORT

ANNEX 1	Transition Impact Scoring Chart
ANNEX 2	Shareholding Structure
ANNEX 3	Project Description
ANNEX 4	Green Assessments
ANNEX 5	Historical Financial Statements
ANNEX 6	Project Implementation
ANNEX 7	Serbia Macroeconomic Update and Sovereign Debt Assessment
ANNEX 8	Economic Evaluation

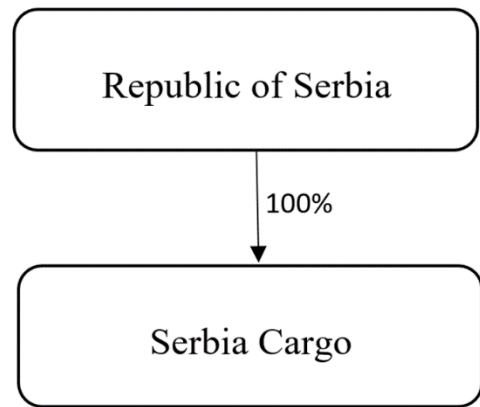
ANNEX 1- TRANSITION IMPACT SCORING CHART



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

ANNEX 2 – SHAREHOLDING STRUCTURE

The Company is fully and directly by the Government of Serbia shown in the graph below.



ANNEX 3 - PROJECT DESCRIPTION

Infrastructure condition and limitations for freight rolling stock

Infrastructure condition is a primary consideration when selecting new locomotives. New main line locomotives would be primarily used on the following non-electrified routes: Ruma – Šabac – Bratina, Niš – Zaječar – Prahovo Pristanište, Požarevac – Majdanpek – Prahovo Pristanište; and Pančevo – Vršac. Maximum line speed exceeds 100 km/h in only 2.6% of the network. The maximum allowable train speed on about 50% of the network is below 60 km/h. The bearing capacity in around 38% of the total railway line length is below 200 kN. Over 75% of the routes are categorised track “C” and “D”, i.e. having an axle load limit of at least 20t.

Procurement of main line locomotives

The current fleet of Serbia Cargo main line diesel locomotives is beyond its normal economic life. Well-maintained locomotives that are of good manufacturing design and build quality often have a life of up to 35 years that can sometimes be extended to 45 years. It is rare for locomotives older than that to be in general main-line service because their reliability and availability reduces to unacceptably low levels.

The normal availability of a fleet of locomotives is over 90%. This means that over 90% of a locomotive fleet is in operational service with a maximum of 10% undergoing maintenance or repair. In comparison Serbia Cargo's fleet availability is below 25%. Such a situation faces all railway operators with old rolling stock fleets. Maintenance costs rise concurrently due to the rising volume of repairs and cost of aged components, some of which may have to be specially manufactured. In addition, reliability declines resulting in failures in service that often cause considerable service disruption. The main line diesel fleet numbers 26 of which 4 (Class 661) are unrepairable and permanently out of service. The locomotive fleet has an average age of 56 years. This is well above the 40-year age for locomotives that is considered commercially viable for rail freight operation.

Procurement of shunting locomotives

Shunting locomotives are required that can operate over both electric and non-electrified lines in Serbia. Only diesel locomotives fulfil this criterion. Shunting locomotives are required to undertake both train marshalling in sidings and yards, and to move freight trains short distances from one freight yard or terminal to another. Of the current fleet of 48 diesel shunters, 17 are serviceable. Of the serviceable locomotives, 8 are 15 years old and the others are up to 49 years old.

Procurement of new wagons

One new flat wagon type is proposed for investment, of Series 455. The number of serviceable wagons of Series 455 will fall [REDACTED], while Serbia Cargo estimates the traffic demand for this type of wagon [REDACTED]. It is on this basis that Serbia Cargo proposes to invest in new flat wagons. The Company aims to procure wagons that have modern, low levels of noise generation which is consistent with European trends regarding noise reduction in railway traffic, and used for the transport of loads of up to 70 t, e.g. containers, road vehicles, construction machinery, etc.

Procurement of overhaul of 1,250 freight wagons

It is the case in many railway administrations that the condition of freight wagon fleets has been allowed to deteriorate. For various reasons, running repairs of wagons and heavy overhaul have not kept pace with their rate of deterioration. This applies also to Serbia Cargo's wagon fleet. It is estimated that [REDACTED] Serbia Cargo wagons require repair including of buffing and coupling equipment replacement of floors, wheelsets and braking equipment.

[REDACTED]. The proposed Project component will provide the Company with a rapid improvement in its freight fleet availability. The Company estimates that in the absence of the proposed Project its fleet availability will reduce [REDACTED].

The wagons are intended for transport of goods which can be transported in the open, such as ore, gravel, brick, roof tile, wood, waste materials, semi-finished construction products, metal products, finished concrete products, coiled steel, general construction materials and road vehicles.

ANNEX 4 – GREEN ASSESSMENTS

1. Introduction

Proceeds of the loan will finance procurement of (i) 4 modern diesel main line locomotives for traction of freight trains, (ii) 6 diesel shunting locomotives, (iii) 50 new freight wagons, (iv) overhaul of 1,250 freight wagons, and (v) a PIU Support and Supervision Consultants. The project was assessed for Paris Agreement (“PA”) alignment and GET. As a sovereign transaction, it was not subject to climate-related financial risk assessment.

The project is assessed as positively aligned for both mitigation and adaptation goals of the PA and is attributed as 92% GET, as a result of the significant modal shift from road to rail, resulting in [REDACTED] GHG savings [REDACTED].

2. Paris alignment assessment

General screening of alignment with the mitigation goals of Paris Agreement

- The project/economic activity is **not included** in the 'aligned list'.
- Regarding project/economic activity(ies), there are **no** activities included in the 'non-aligned list'.

Specific assessments undertaken

NDC (Nationally Determined Contributions) reviewed:

The project is not inconsistent with the first Serbian NDC submitted to the UNFCCC in 2017.³ Serbia’s Law on Climate Change (passed in 2021)⁴ mandates the adoption of a low-carbon development strategy and an associated action plan for the implementation of the strategy. Whilst this has yet to be formally adopted, a draft version indicated as an action the “Renewal of the freight fleet and promotion of sustainable freight transport” with an indicator to “maintain the share of freight transport on railways and waterways in total freight transport” at 45%.

Low-carbon pathways and related benchmarks/criteria used to assess:

Serbia Cargo is exclusively focused on freight transportation. There is no specific low-carbon pathway for (rail) freight services in Serbia. As such, regional and international pathways for freight and rail freight are examined.

The Sustainable and Smart Mobility Strategy in the Western Balkans is intended to mirror the EUs Strategy (of the same name) which has a long-term goal of reducing transport related greenhouse gas emissions by 90% by 2050. Flagship 4 – “Greening Freight Transport” emphasises the importance of shifting inland freight carried today by road to rail and inland waterways.⁵ A key issue identified as a barrier is the “*evident gap of modern and efficient rail fleet which can accommodate the required shift to rail since most of the traction and wagon capacities in the Western Balkans are almost outdated and not aligned with the current economic needs.... to enable the move to rail*”

³ <https://www4.unfccc.int/sites/NDCStaging/Pages/Party.aspx?party=SRB&prototype=1>

⁴ <http://www.parlament.gov.rs/upload/archive/files/cir/pdf/zakoni/2021/337-21.pdf>

⁵ <https://www.transport-community.org/wp-content/uploads/2021/06/Strategy-for-Sustainable-and-Smart-Mobility-in-the-Western-Balkans.pdf>

and support the greening of transport, the Regional Parties need to ensure the renewal of the rail fleet.” Another barrier is poor quality of rail infrastructure in Serbia. Large investments are underway to build new and reconstruct old railway lines in order to enable greater transport of good and passengers by rail. The Strategy targets an increase in rail freight traffic by 20%, and for this to double by 2050. This project is aligned with this strategy in terms of the modal shift from road to rail that the project enables.

The International Energy Agency Net Zero by 2050 scenario⁶ indicates that “rail transport is the most energy-efficient and least carbon-intensive way to move people and second only to shipping for carrying goods.” A modal shift from road to rail is envisaged, as well as full decarbonisation through electrification. All high traffic rail-lines are to be electrified, and where electrification is not economic, hydrogen and / or battery-electric trains should be introduced. Globally the share of electrified rail lines grows from 34% to 65%.

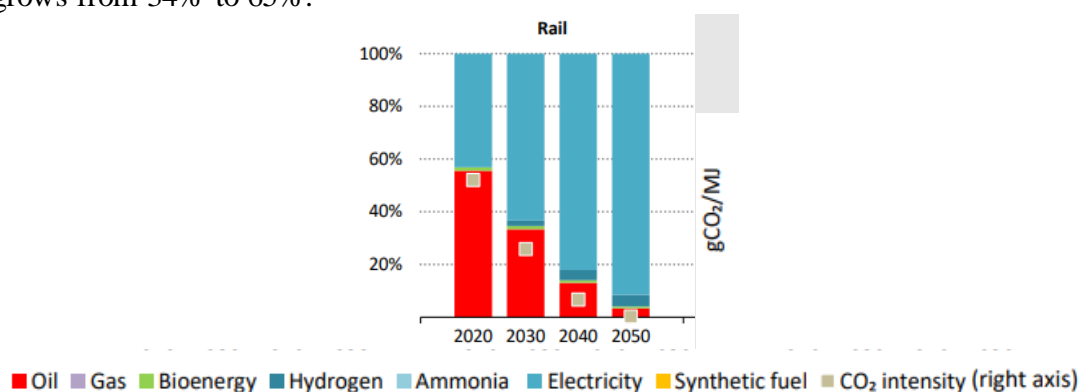


Figure 1: IEA Net Zero Scenario – rail low-carbon pathway

In Serbia, the main rail corridors are electrified (or in the course of electrification), corresponding to 1,279 km of track (33.6% of the network).⁷ Responsibility for electrification of rail lines lies with national authorities. An extensive investment programme “Serbia 2025” is targeting €3.5bn investment in upgrading rail infrastructure, including electrification.⁸ The last main line to be electrified is Nis – Dimitrovgrad (Bulgaria) which is underway. Other priority investments include the finalisation of fast rail line Novi-Sad to Subotica (Belgrade – Novi Sad was finalised at the beginning of 2022, Belgrade – Niš high-speed rail link (another investment under consideration by the Bank) as well as a new dispatch centre to control all train movements on the Serbian rail network, and construction of an intermodal freight terminal in Batajnica.

The Company is not able to procure fully electric locomotives because it needs to service parts of the network that are not electrified including secondary lines with relatively low traffic. The Company explored a variety of alternatives to diesel-only locomotives (including hybrid and fully-battery electric), however the costs of these technologies are approximately 100% higher, which is largely due to the nascent stage of these technologies. Procuring these technologies would result in less locomotives

⁶ https://iea.blob.core.windows.net/assets/deebef5d-0c34-4539-9d0c-10b13d840027/NetZeroBy2050-ARoadmapfortheGlobalEnergySector_CORR.pdf

⁷ http://www.parlament.rs/upload/archive/files/cir/pdf/akta_procedura/2017/859-17.pdf

⁸ <https://www.railjournal.com/infrastructure/serbia-2025-programme-includes-e3-5bn-for-rail/>

being produced for the same capital outlay. For every locomotive that is brought into service, more road freight trips are avoided (modal shift). From an emissions perspective, given the current high emissions intensity of the Serbian grid, the decision to procure a higher number of modern diesel locomotives offers at least the same emissions benefit than procuring less of the more expensive hybrid or battery technologies. If the level of network electrification increases, grid emissions reduce, and cost of alternative technologies reduces, this emissions assessment may change. Future assessments regarding emissions impact of diesel only fleet renewal decisions will need to revisit these variables.

Carbon lock-in assessment

The locomotives have a technical lifespan of 30-40 years, with a mid-span overhaul after 15-20 years. The economic lifespan is approximately 20-25 years (period for full accounting depreciation of the asset)⁹. At the mid-life overhaul, there is the possibility to convert the locomotives into fully electric locomotives, if network electrification is expanded by national authorities. This has recently been undertaken in India on a pilot basis.¹⁰ This investment decision into <10% of the fleet renewal will not lock the Company into this technology – the locomotive can be retired at any stage, and the Company already has made significant investments into all-electric locomotives, so has the capacity and know-how to deal with both technologies. It is also technically possible to run the locomotives on biodiesel, if adequate feedstock become available.

Economic viability test

The Project is below the threshold for which an economic assessment is required. The project reduces emissions on a net basis (see GET analysis below) [REDACTED].

The Project satisfies all of the tests in the specific assessment, and as such is considered aligned with the mitigation goals of the Paris Agreement.

Alignment with the adaptation goals of Paris Agreement

Step 1: Evaluation of the physical climate risk and vulnerability context:

A screening of the project identified a potential exposure to extreme heat events. Results from most recent Coupled Model Inter-comparison Project (CMIP) 6, which supports IPCCs Sixth Assessment Report, indicates in summer periods there will be an increase of approximately 8-9 summer days above 35 degrees C by 2030.

⁹ E.g <https://www.depreciationrates.net.au/locomotive>

¹⁰ <https://www.businessinsider.in/diesel-locomotive-converted-to-electric-in-india-first-in-the-world/articleshow/68060415.cms>

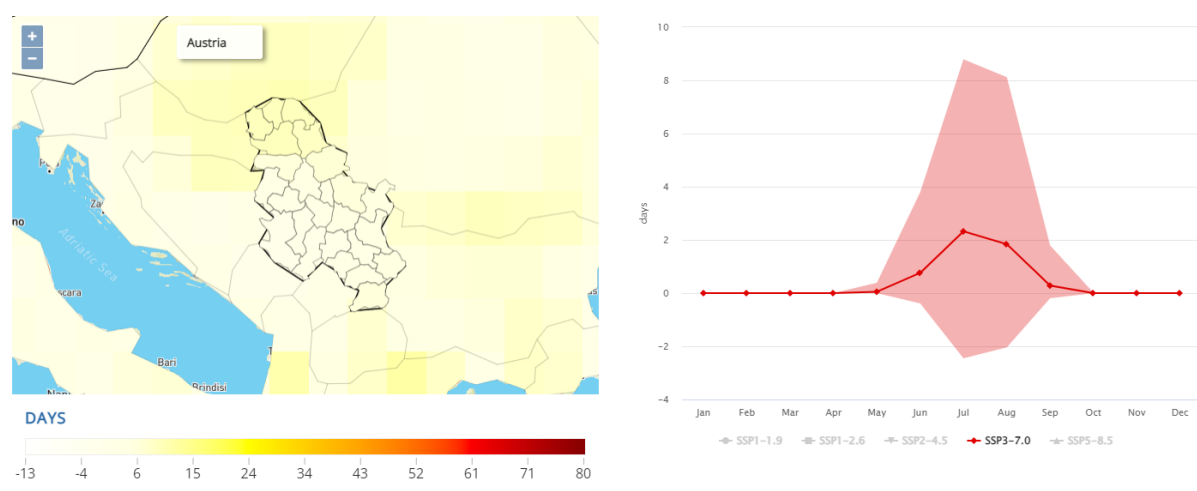


Figure 1: Projected number of hot days ($T_{max} > 35$ degrees C), anomaly for 2020-2039, Reference period 1995-2014, SSP3-7.0, multi-model ensemble. Source: World Bank Group Climate Change Knowledge Portal. Accessed April 2022.

Extreme heat can result in disruption to rail systems, and empirical studies¹¹ have quantified the key vulnerabilities of these systems to this climate hazard per asset type. Key potential issues to rail systems include:

Asset type	Potential consequence of extreme heat events
Track	Thermal expansion of track in hot weather can cause rail buckling and train derailment (Dobney <i>et al.</i> , 2009). When rail temperatures exceed certain thresholds, disruption to services may occur.
Signalling	Signal equipment failure may occur if electronics/power supply fail in extreme temperatures due to non-compliant temperature control
Power supply	Excessive heat stress on electricity provision networks can reduce asset life expectancy (Chapman <i>et al.</i> , 2013).
Locomotives (diesel)	Reduced efficiency of operation if not maintained to manufacturer's standard.
Locomotives (electric)	Potential power supply disruption (see above).
Passenger carriages	Thermal comfort of passengers may be compromised.
Freight wagons	Temperature sensitive cargo (e.g. if refrigerated wagons are not maintained to manufacturer's specification.) may be spoiled
Station infrastructure / depots	Thermal comfort of employees may be compromised.

Whilst the operation of the assets to be procured under the Project may be impacted by impact of climate change on other assets of the system (for example if rail infrastructure buckling), the physical climate risk faced by the assets being financed by the Bank are not material. Specifically:

- Diesel locomotives operational efficiency will reduce in higher temperatures, and in very extreme cases there may be excess pressure on cooling systems for

¹¹ See for example "The impact of high temperatures and extreme heat to delays on the London Underground rail network: An empirical study" 2020 <https://rmets.onlinelibrary.wiley.com/doi/10.1002/met.1910>

the engine which could result in temporary shutdown if the cooling system is not maintained to manufacturer's specification. The operational efficiency loss will be marginal over the course of the year, and cooling system failure is more likely to occur in older locomotives. Further, diesel locomotives are more resilient to power supply failure than electrified lines, bringing an element of resilience to the system.

- Freight wagons are not anticipated to carry sensitive cargo, and thus temperature increases will have a negligible impact.

As the Bank's use of proceeds demonstrate an acceptable level of resilience to climate risks, no adaptation measures to the locomotives or wagons were deemed necessary.

Step 2: Definition of climate resilience measures:

No specific climate resilience measures have been incorporated, as no material risks to the assets being financed by the Bank were identified.

Step 3: Appraisal of broader climate resilience context:

The project does not undermine the resilience of wider systems and is not inconsistent with the national policy for context adaptation.

The Project satisfies the three steps of the adaptation approach, and is thus considered aligned with adaptation goals of the Paris Agreement.

3. GET attribution

The Project will lead to annual savings [REDACTED] of CO₂eq, [REDACTED] of SO₂ [REDACTED], of NO_x [REDACTED] and [REDACTED] of PM [REDACTED].

For the Facility 82487 (EUR 43m): 92% GET eligibility is attributed as the project is compliant with the criteria set up in the point A.5.3.1.2. of the GET Handbook, criteria transport projects with direct emission (fleet and infrastructure), being the requirements achieving at least 15% environmental benefits from baseline (GHG, SO_x, NO_x, PM) and complying with the minimum emission standard for locomotives and railcars (Stage V for Counties with less than 10ppm of sulphur content in fuel). Serbia Cargo has an annual transported weight of fossil fuel below 8% of its total, hence we have pro-rated the GET share claimed to 92% in accordance to A.5.3.1.3 'exclusions' of the GET Handbook.

The new JMDB mitigation category that fits this project best would be **'Low-Carbon interurban transport' 3. Inter-urban railway projects for freight or passengers**

Criteria:

- The entity applying the Common Principles shall demonstrate a modal shift from a higher-carbon mode.
- Activities dedicated to transport of fossil fuels or blended fossil fuels (where a high proportion of the blended fuel is a fossil fuel) shall not be eligible.

GHG, SO₂, NO_x and PM emissions calculation: [REDACTED]

ANNEX 5: HISTORICAL FINANCIAL STATEMENTS

[REDACTED]

ANNEX 6: PROJECT IMPLEMENTATION

Procurement classification – *Public sovereign*

[REDACTED]

This project is implemented by an existing Company of EBRD which successfully implemented in 2018 the Project Serbian Railways Corridor X-I project (OpId: 48406). Although at that time a PIU was set up for the implementation of the Project, the nature of the Project which covered only one contract for the purchase of 16 cargo multi-system electric locomotives, did not require a standing PIU but rather staff assigned to the PIU to perform the temporary tasks needed for the implementation of the project. As such, the necessary skills for the implementation of the current EBRD projects have not been retained by the Company. [REDACTED].

To mitigate such risk, the Company will appoint a PIU Support consultant that will assist the Client PIU to manage the implementation of the Project.

Contracts risk assessment

- High

The Project envisages three (3) supplies contracts and two (2) consultancy contracts.

The two of the supply contracts, specifically the contract for procurement of diesel locomotives and the freight wagons for transport of containers are not particular challenging since there are sufficient number of manufacturers on the market that can secure a healthy completion. The main challenges with the implementation of these contracts are the content of the technical specifications, which shall be carefully drafted to be opened to wider competition and at the same time respond to the specific needs of the Company, and the price adjustment formula stated in the contracts, which shall take into account the contemporary inflationary environment.

[REDACTED]. The risks come from the fact that the market for such services is localised, the exact cost of overhaul and repair of each wagon is difficult to estimate upfront, and the contractual arrangements and the monitoring of such contract implementation is time consuming and cumbersome.

To address all these risks, the Company will be supported a PIU Support Consultant that will be tasked to conduct a market research, develop the requirements and appropriate contract forms for the contracts to be funded from the Project proceeds and assist the Company with the selection of the suppliers and consultants.

Additionally, the Company will engage a consultant for the supervision of the contract for the overhaul and repairs of 1,250 freight wagons, which will assist them with the day to day management of such complex contract.

Project implementation arrangements:

The Company will appoint a PIU which will be supported by loan funded independent PIU Support Consultant as well as a Supervision consultant for the that will ensure

that the specification as well the contract for the overhaul and repairs of 1,250 freight wagons.

Additionally, a Lender's Monitor will be appointed to ensure the review of the outcome of the tendering process as well as of any subsequent changes in the contract scope and conditions.

Procurement arrangements:

The project envisages the following five (5) contracts:

- 1) Procurement of diesel locomotives – to be procured through multi stage open tender in accordance with Chapter 3 of the Bank's PP&R for public sector operations and EBRD Standard Tender Documents and Contract Form for Goods.
- 2) Procurement of approximately 50 new freight wagons of S series for transport of containers - to be procured through stage open tender in accordance with Chapter 3 of the Bank's PP&R for public sector operations and EBRD Standard Tender Documents and Contract Form for Goods.
- 3) Overhaul and repairs of 1,250 freight wagons (several lots) - to be procured through multi stage open tender, following a prequalification process, in accordance with Chapter 3 of the Bank's PP&R for public sector operations and EBRD Standard Tender Documents and Contract Form for Supply and Install.
- 4) PIU Support Consultant - to be procured through open competitive selection, following a prequalification process, in accordance with Chapter 5 of the Bank's PP&R for public sector operations and EBRD Standard Request for Proposal and Contract Form for Consultancy Services.
- 5) Supervision of overhaul and repair of 1,250 freight wagons - to be procured through Two Stage Open Competitive Selection, in accordance with Chapter 5 of the Bank's PP&R for public sector operations and EBRD Standard Request For Proposal and Contract Form for Consultancy Services.

In selection of the PIU support consultant, the PIU will be assisted by the Project Implementation Adviser as well as Lender Monitor.

All contracts will be subject to prior review by the Bank.

Additional information: The scope (specifically the quantities of goods) and the value of the contracts, as well as the procurements strategy presented in the attached Procurement Plan will be subject to revision by the PIU Support Consultant and Bank's prior no objection. [REDACTED].

ANNEX 7: SERBIA MACROECONOMIC UPDATE AND SOVEREIGN DEBT ASSESSMENT

The economy continues to grow [REDACTED]. Following a strong expansion of 7.4 per cent in 2021, GDP grew by 4.3 per cent year-on-year (y/y) in the first quarter of 2022 and by 3.9 per cent y/y in the second quarter. While the broad-based expansion in 2021 was supported by a rebounding external sector and pent-up domestic demand, the slowdown in 2022 reflects the worsening of the macroeconomic environment. Inflation increased to 4.0 per cent in 2021, outside the target band of 3 per cent +/- 1.5 per cent, and further to 13.2 per cent in August. The price increase is driven by the global energy (largely petroleum given the regulated electricity prices in Serbia) and food prices (partly due to poor weather conditions hampering domestic yield). Higher import volume under elevated prices reflected on external accounts with the current account deficit annually increasing five-fold in the first half of 2022. The National Bank of Serbia increased the policy rate six times, from the historically low 1 per cent in March to 3.5 per cent in September. Serbian dinar remained stable against the euro as the NBS continues to tightly manage the exchange rate.

Economic activity is expected to moderate. GDP growth is forecasted at 3.3 per cent in 2022 (EBRD REP, September 2022). Risks to the near term are reflected in rising inflation weighing on disposable incomes, expected slowdown of growth in European markets, Serbia's main export destination, and tightening financial conditions. The continuation of sizeable public investment bodes well for the outlook, whereas the protracted energy crisis would be a drain on fiscal resources.

The country's energy sector is vulnerable to rising market prices. Energy security concerns increased as high global energy prices exacerbated by the war on Ukraine intersected with vulnerabilities in domestic electricity production. The government capped utility prices for consumers and covered the losses of the gas utility company through the state budget, with estimates of total fiscal cost at some EUR 1.2 billion or 2% of GDP for the 6-month heating season of 2021/22 as estimated by the Fiscal Council. Higher import volumes under elevated prices also reflected on the country's external accounts, with the current account deficit annually increasing five-fold in the first half of 2022. The energy regulator approved a 9 per cent hike in the price of gas and a 6.5 per cent increase in electricity price, valid from August and September 2022 respectively. Nonetheless, the following winter is likely to be another challenging one as long-term structural issues in the sector largely remain unresolved and energy prices surge in global markets.

Public debt is elevated, but considered to be manageable. Despite a significant fall since 2015, Serbia's public debt remained above 45 per cent of GDP prior to the pandemic. As a response to the shock, the government implemented large aid packages in 2020-21 to cushion the impact and support the recovery, increasing budget deficit significantly. Unlike other countries in the Western Balkan region, Serbia did not access rapid financing from the IMF or other official sources during 2020-21 to finance the fiscal gap.¹² Instead it stepped up domestic and external borrowing, raising around EUR

¹² Serbia completed a non-financial agreement with the IMF (a 30-month Policy Coordination Instrument) in January 2021, and signed another one in June 2021. Second programme review was concluded in June 2022.

3 billion through two Eurobond issuances in 2020 and EUR 2.75 billion in 2021 via three additional Eurobonds. Public debt increased from 52.8 per cent of GDP in 2019 to 57.9 per cent of GDP in 2020 before slightly declining to 57.2 per cent of GDP in 2021. IMF (country report, June 2022) assesses the public debt to be ‘sustainable with high probability’ and expects it to remain on a declining trajectory over the medium term, from 55.1 per cent of GDP at end-2022 to 47.2 per cent of GDP in 2024.

Main vulnerability to the public debt sustainability stems from the large shares of foreign currency debt and debt held by non-residents, though this is mitigated by the large share of multilateral and institutional creditors to whom external debt is owed, the long average maturity of outstanding debt [REDACTED]. The medium term outlook for the debt profile and financing needs hinges on strong growth and fiscal outcomes, including the containment of contingent liabilities. Authorities remain committed to fiscal consolidation under the non-financial IMF programme and intend to accommodate potential further support measures within the agreed fiscal deficit of 3 per cent of GDP in 2022 (down from 4.1 per cent of GDP in 2021 and 8.0 per cent of GDP in 2020). However, energy sector is a significant source of risk in the near term which could put additional pressure on the government budget. Liquidity management is carefully monitored in light of tightened financing conditions on external markets, but supported by the adequate reserves, availability of financing from development partners and track record of relatively high FDI inflows. The international reserves of the National Bank of Serbia stood at EUR 15.9 billion in end-August 2022. According to the IMF, in case of contingent liabilities shock which is ‘much more severe’ than the shock from the energy crisis in winter 2021/22, Serbia’s public debt would not be unsustainable, but it could still send a negative signal to the markets at an uncertain time for the global economy. This risk highlights the need for adequate crisis management, timely return to fiscal discipline and structural adjustments, in particular in the large SOE sector. Serbia is rated at BB+ by S&P with outlook revised from Positive to Stable in June 2022 due to expected Russia-Ukraine conflict fallout, Ba2 (Stable) by Moody’s as affirmed in September 2022 and BB+ (Stable) by Fitch, affirmed in August 2022.

ANNEX 8. ECONOMIC EVALUATION

[REDACTED]