

PUBLIC

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

**STRATEGY FOR
BULGARIA**

As approved by the Board of Directors at its meeting on 8 July 2015

PUBLIC

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EXECUTIVE SUMMARY

Bulgaria is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

Bulgaria's entry into the EU in 2007 followed a sustained period of reforms, strong economic growth, and increasing integration into European and global markets. Since then, however, the country has been buffeted by the global economic crisis in 2008/09 and the subsequent Eurozone crisis, compounded more recently by a period of political instability. Several years of recession or anaemic growth have been accompanied by higher unemployment, lower investment and increasing regional disparities. In this environment, progress in transition has been much more hesitant than in the run-up to EU accession and has even reversed in some cases. This has made it more difficult for the Bank to utilise its financing to promote reforms, especially at state and municipal levels, while demand for Bank funding in the corporate and financial sectors has also been subdued due to the overall economic situation and lower levels of investment. Notwithstanding Bulgaria's status as an EU member and the advanced state of reforms in many areas, the country still faces significant reform challenges in the years to come.

In this context, the overarching goal of the Bank's activities in the forthcoming Strategy period in Bulgaria will be to create a new impetus for reforms in order to support growth through investment and policy dialogue and re-energise transition. The Bank will pursue this objective in the following ways:

- **Enhancing competitiveness through improved efficiency, governance and innovation:** Although corporate governance and business standards have improved since accession to the EU in 2007, there remain large opportunities to bring skills, governance and management practices closer to international standards. Conditions for doing business in Bulgaria have improved in several respects over recent years, but issues clearly remain which hinder investment. Competitiveness of Bulgarian firms is also impacted by the small-scale nature of operations in key sectors. Given the above issues, the Bank will support financial restructurings and provide long term finance for competitiveness enhancement, and energy efficiency investments. The Bank will also support regional economic integration by providing financing for cross-border investments and exports. For smaller companies, the Bank will work with and through financial intermediaries to ensure sufficient access to funds and explore expanding its business advisory activities provided adequate resources can be identified. Finally, on a national level, targeted advisory assignments will address obstacles to doing business.
- **Strengthen the financial sector intermediation through targeted investments and improved governance:** Profitability has fallen across the banking sector and consolidation in the sector may be necessary. Following the recent closure of Corporate Commercial Bank, the National Bank and the Government have started work on a number of initiatives – independently and jointly with international partners – which are designed to fully restore public confidence to the sector. They have also signalled their intention to opt-in into the Single Supervisory

Mechanism (SSM) where the ECB is the direct supervisor of major cross border banks. Given the high level of liquidity in Bulgarian commercial banks at present, the Bank will explore risk sharing products or products blended with grant resources, in order to support overall intermediation and in particular MSME development. It will also support sector consolidation where needed, and help address the issue of high NPLs. The Bank will also seek to support the deposit insurance fund with a combination of investment and policy dialogue.

- **Narrowing the infrastructure gap through commercialisation, reform and efficiency:** Years of underinvestment and limited private sector involvement have led to deteriorated quality of municipal and national infrastructure. In particular, municipalities and state agencies need to strengthen technical skills in planning, procurement and project management in order to benefit from available funding. Gas transportation and storage facilities, which are key to the country's, as well as regional, energy security, would benefit from expanded commercialisation and investment. The energy system operates in an unsustainable fashion. End-user tariffs are below production costs which inhibits long-term investments. The country remains the least energy efficient economy in the EU and the current energy policies do not provide a framework conducive to investments in the sector. Given the above issues, the Bank will seek to support commercialisation and private sector participation in transport and gas infrastructure, as well as at the municipal level. The Bank will work with the authorities to facilitate leveraging of available EU structural funds through newly designed financial instruments with clear linkage to transition considerations. In the energy sector, the Bank is ready to renew its dialogue with the authorities with the view to support the development and implementation of a long-term energy strategy, including strengthening the regulator and reviewing tariff policies, and subsequently would provide investments to support public utilities financial and operational performance, while continuing energy efficiency investment across the economy.

Through these three strategic priorities, the proposed Country Strategy operationalises the Bank's Medium-Term Directions in the specific context of Bulgaria's transition challenges.

1. OVERVIEW OF THE BANK'S ACTIVITIES TO DATE

1.1 The Bank's current portfolio

In the strategy period¹, the Bank signed 55 new transactions involving Bank financing of approximately Euro 535 million. The Bank has been most active in this period in providing financing for private corporates and the banking sector, with a limited involvement vis-a-vis municipalities. During the period, the portfolio has declined from Euro 1.3 billion to Euro 1.1 billion and operating assets have fallen as well. Annual volumes of investment have varied between Euro 80 million and Euro 250 million.

EBRD Portfolio at end May 2015

Private sector share: 88 per cent

Sector Group	Sector Team	Portfolio no of operations	Portfolio (€m)	% Portfolio	Op Assets	% Op Assets
Energy	Natural Resources	4	74	8%	56	7%
	Power and Energy	6	207	21%	187	23%
		10	281	29%	243	30%
Financial Institutions	Depository Credit (banks)	13	122	13%	98	12%
	Insurance, Pension, Mutual Funds	1	3	0%	2	0%
	Leasing Finance	3	14	1%	14	2%
	Non-depository Credit (non-bank)	4	5	0%	5	1%
		21	143	15%	117	14%
Industry, Commerce & Agribusiness	Agribusiness	8	116	12%	106	13%
	Equity Funds	28	101	10%	66	8%
	ICT	3	27	3%	24	3%
	Manufacturing & Services	8	151	16%	151	19%
	Property and Tourism	5	36	4%	35	4%
		52	432	44%	382	47%
Infrastructure	Municipal & Env Inf	15	117	12%	74	9%
	Transport	0	0	0%	0	0%
		15	117	12%	74	9%
Summary		98	973	100%	816	100%

1.2 Implementation of the previous strategic directions

The last Country Strategy for Bulgaria (approved on 8 November 2011) stipulated the following priorities:

- Restructuring the power sector and increasing energy efficiency;
- Increasing competitiveness of Bulgarian firms;
- Strengthening infrastructure service provision;
- Supporting financial markets and deepening financial intermediation.

¹EBRD Country Strategy was approved in November 2011. In 2010, as part of its crisis response, EBRD invested Euro 546 million, with a significant share devoted to financial sector activities.

In H2 2012 via a mid-year Country Strategy Update, the Bank amended the priorities in light of a Government request to abstain from further investments in renewable energy.

In spite of intermittent headwind impacting Strategy implementation, the Bank was able to achieve good results in some of the priority areas, particularly through its corporate and financial sector activities. Key achievements included:

- The Bank's support to commercial banks helped them maintain adequate levels of lending despite pressure on parent banks to de-leverage and an overall subdued risk appetite in the financial sector. In the early period, the Bank was disbursing under significant facilities which were signed as part of the Bank's crisis response/Vienna Initiative. After 2011, the Bank further focused its activities on energy efficiency, through various Sustainable Energy Finance Facilities (SEFFs), aiming to build capacity on residential and SME energy efficiency lending by introducing a streamlined approach for smaller investments. The Bank also allowed to expand and develop the market for energy audits and energy efficiency-related technical studies on a sustainable basis. SEFFs reached more than 500 industrial clients and more than 47,000 residential clients. Total estimated energy savings from projects financed by SEFFs equalled 1.4 million MWh equivalent and CO₂ emissions were estimated to have been reduced by more than 1 million tonnes. Through the Energy Efficiency and Competitive Industry Financing Facility (BEECIFF), the Bank also for the first time organised a co-financing facility combining EBRD, SME's own funds and EU grants. This was a significant learning exercise for the authorities, leading to financial engineering skills transfers.
- The Bank's financing for high profile corporates, major exporters and cross-border investors has helped strengthen their competitive position, restructure their balance sheets, and finance resource efficiency upgrades. Through its projects with corporate clients such as KCM, Sisecam, SofiaMed, Dundee and Prista/Monbat, the Bank effectively demonstrated the positive effects of restructurings (both Prista Oil and Sofia Med are successfully responding to difficult market and operational environments), improved corporate governance and standards – e.g., improved board structures, policies and reporting in KCM (metals), Sofia Med (metals), Dundee (natural resources), introduced innovative products and skills (such as implemented by Teklas (automotive) – and achieved notable emissions and waste reductions.
- In addition to reaching SMEs through partner bank credit lines, the Bank supported directly smaller local companies in the printing, agribusiness, leasing and asset management sectors through its Local Enterprise Facility (LEF). The Bank support allowed clients to restructure their balance sheets, support equipment upgrade, and finance capacity expansion, to help them realise their growth potential.

Nonetheless, the Bank has faced difficulties achieving some of its key strategy objectives, especially in infrastructure and energy sectors. In the municipal infrastructure sector, the Bank's ability to provide financing was limited due to low demand from state and municipal entities. Despite new investments, total portfolio and operating assets actually decreased during the strategy period in the sector. The Bank has been seeking to advance commercialisation of the urban transport sector in large municipalities (Varna, Burgas and Plovdiv), through its projects blending EU grants. Implementation of the public services contract is progressing well in the City of Varna, however delays have occurred in the case of Burgas project. The City of Plovdiv is rolling out an innovative performance-based contract for road rehabilitation and management. The Bank provided a second loan to the Fund for Local Authorities and Governments (FLAG), which on-lends to smaller municipalities.

FLAG was established in March 2007 in order to assist Bulgarian municipalities in absorbing EU funds, by providing long-term loans in support of the municipalities' own contributions to the projects. To date, FLAG has had a significant impact and has been commercially successful and highly popular among the municipalities (632 loans to 180 municipalities for an amount of Euro 308 million). However, it should be noted that FLAG has predominantly provided bridge lending, which has been helpful to facilitate smooth absorption of EU grants, but is not fully in line with the objective of promoting long term debt to medium tier municipal borrowers. Beyond those projects, the Bank expected to have more impact on the municipal sector, but did not find suitable opportunities for financing transport and municipal infrastructure through private structures.

Prior to the Strategy period, the Bank provided significant support to the Bulgarian energy sector, including through provision of financing for production, transmission and distribution and by arranging advisory assignments to help develop an independent regulator, a sustainable energy action plan (SEAP) and through policy advice regarding privatisation of electricity distribution. However, while the Bank's exposure to the sector is around Euro 200 million, during the Strategy period, the Bank was unable to identify further investment opportunities (excluding energy efficiency credit lines and grant financing from the Kozloduy International Decommissioning Support Fund – see Annex 6 –), as a result *inter alia* of stalled reforms in the sector. In addition, in 2012, the Government requested that the Bank cease new financing in the renewables sector due to the sector's unsustainable structure and tariffs. Since then, the Bank has focused on managing the portfolio and maintaining a sectoral policy dialogue.

Throughout the Strategy period the Bank continued its policy dialogue on certain key issues. Examples of achievements include:

- Supporting regional integration of stock exchanges (including the Sofia, Skopje and Zagreb Stock Exchanges) through the creation of a system for processing trades by a newly created company based in FYR Macedonia. The project is expected to increase liquidity in individual markets and the region, enhancing its attractiveness to both issuers and investors;
- Contributing to improve both framework and individual company contracts between municipalities and utilities/public operators;
- Working with the authorities to develop new structures to leverage grant resources, particularly related to energy and resource efficiency initiatives (including addressing insufficient knowledge about energy efficiency technologies, nascent development of the market for efficiency auditing and verification), as well as water sector investments;
- Enabling more private sector participation in public sector and housing energy efficiency through ESCOs and Energy Performance Contracting.
- Strengthening e-procurement rules and procedures managed by the Bulgarian Procurement Agency (on-going utilising EU grant funds);

Toward the end of the Strategy period, the Bank signed a Memorandum of Understanding which facilitates the use of available EC grant funds by the Government to finance EBRD advisory assignments. The first assignment implemented under the MOU is an E-Procurement initiative, which has been a strong success. The first two stages are completed and the third and final stage will be completed in the course of 2015. The Government intends to rollout a new unified procurement platform in the second half of 2015 which will improve transparency and governance for public contracting. Following this successful

initiative, additional assignments can be developed in the new Strategy period. For example, the Bank has proposed an advisory assignment for the State Commission for Energy and Water Regulation and also to utilise EU Funds to initiate the Small Business Service advisory projects.

1.3. Lessons learnt

In the corporate sector, low economic growth, of around 1 per cent in each of the past few years, and low levels of investment activities, have limited opportunities to engage. Moreover, unlike in some other EBRD countries of operation, the Bank does not have access to grant resources to support the development of SME projects for direct financing (LEF) nor to support SME clients during implementation. For this reason, the Bank is seeking support from the Bulgarian government to utilise EU Funds for a re-start of the SBS Advisory Services.

In the financial sector, high liquidity of local banks, not only limited demand for the Bank's funding products, but also created unhealthy competition in a very fragmented market. In that context, the Bank will seek to foster consolidation in the sector, and explore risk sharing products to further entice banks' lending to the SME sector.

In the municipal infrastructure sector, the Bank's ability to provide financing and, leveraging on it, to achieve its transition objectives, has been limited by the wide availability of EU grants, and specialised investment vehicles (JESSICA, KIDS Fund), the fragmentation of the municipal and utility sectors and the political instability, particularly after 2013, which has limited private sector interest in the public sector. Implementation of municipal infrastructure projects remained slow and in at least one municipality, complicated procurement procedures delayed significantly disbursement. Lack of technical assistance for capacity support, which could help prevent those procurement and implementation delays. In the energy sector, a series of measures, which retroactively reduced the feed-in tariff for renewable energy producers, has threatened the viability of existing investments and made further investment practically impossible. The Government has also sought to limit new investments in power generation and in particular in renewable energy capacity. Those limiting factors are not likely to change materially in the new strategy period and the Bank will therefore adopt a staged-approach in the energy sector, seeking to build on the recently reopened reform dialogue before considering further investments.

The Bank's ability to effectively implement its policy dialogue objectives is also impacted by a lack of funds for advisory assignments. The only significant source of funding (for either advice or co-financing) has been the EU Structural Funds, whose access is cumbersome due to difficulty applying Bulgarian, EU and EBRD policies in implementation. Lack of technical assistance has meant that the Bank has not been able to deliver significant impact on necessary regulatory reforms to support investments. In the forthcoming strategy period, the Bank will seek greater coordination with the EU and the various authorities implementing EU supported initiatives in the country, in order to better leverage EU funds through newly designed financial instruments with a stronger linkage to transition considerations.

2. OPERATIONAL ENVIRONMENT

2.1 Political Context

The current government was established on 7 November 2014 following early general elections that took place in October 2014. This is a coalition government comprising centre-right political party “Citizens for European Development of Bulgaria” (GERB) and the alliance of centre-right parties “Reformist Bloc”, as well as the centre-left “Alternative for Bulgarian Renaissance” (ABV). Although short of the absolute minority in the newly elected highly fragmented parliament, the governing coalition is sufficiently stable and able to adopt necessary bills and implement its policies. The new government’s programme envisages acceleration of the economic development and strengthening of the rule of law as its top priorities.

This government is the outcome of a second early election in less than two years, which reflects accumulated popular frustrations and the erosion of trust in the political establishment. Restoring the trust of citizens in the state institutions and their support to the objective of reenergising reforms represents one of the key challenges for the Bulgarian authorities, without which the implementation of consistent policies may be difficult to achieve.

2.2 Macroeconomic context

The economic growth edged up in 2014. Despite the banking crisis in June 2014, economy grew at an estimated 1.5 per cent year-on-year in 2014, following 0.5 and 1.1 per cent growth in 2012 and 2013, respectively. The major driver of growth was domestic demand. The increase in wages and deflation pushed disposable income up, leading to higher household consumption. Meanwhile, deflation is persistent since August 2013. Prices were falling at a rate of 0.9 per cent year-on-year in December 2014, on the back of lower food prices, partly affected by the Russian import ban leading to an oversupply, and lower global oil prices.

The government has maintained a prudent fiscal policy, but fiscal pressures may arise with resolution of banking difficulties. Against the initial fiscal deficit target of 1.8 per cent of GDP for 2014, the recently elected government passed a budget review, which foresees a 3.7 per cent deficit in 2014. Deterioration is driven by both underperforming revenues and over-expenditures. The decline in revenues is fuelled by lower tax collection, whereas government expenditure rose due to spending associated with bank bailout efforts and infrastructure spending after summer floods. After the bank run on Corporate Commercial Bank (CCB) in June, government approved a loan of up to BGN 2 billion to the Deposit Insurance Fund, which can be used to cover the guaranteed deposits in the CCB. Higher-than-expected fiscal deficit and more intensive borrowing to supply liquidity into the financial sector are expected to push government debt to around 28 per cent in 2014. Nevertheless, Bulgaria’s level of public debt remains the second lowest in the EU (after Estonia) relative to GDP, providing space for fiscal reaction.

Growth is expected to further moderate in 2015. Deferment of the full resolution of banking challenges to 2015 is likely to limit fiscal space and credit growth, thus lowering the contribution of domestic demand to growth. Investment is expected to remain weak due to on-going deleveraging in private sector and slowdown of EU-funded investment programmes as the 2007-2013 programming period comes to an end, as well as cancellation of the South Stream pipeline. In addition, exports will likely be constrained by continuing euro area weakness. Overall, we expect growth in 2015 to moderate to 0.8 per cent.

Key risks for the 2015 economic outlook are prolonged difficulties in the banking sector, protracted recovery in Eurozone, and worsening geopolitical tensions. The negative spill-over effects in the banking sector, if the forthcoming resolution is not fully credible, may weaken credit growth further. The prolonged weakness in Eurozone might weigh further on net exports, as Europe is the main trading partner of Bulgaria. Finally, worsening recession in Russia and geopolitical tensions in Ukraine might affect Bulgaria through exports and secondary effects, as well as deteriorating confidence, in circumstances where external debt remains high (not far short of 100 per cent of GDP), in particular for private sector.

2.3 Structural reform context

Despite the advanced state of transition, it is clear that the structural reform agenda in recent years has been adversely affected by the weak economic environment and political uncertainty. Like much of the transition region, Bulgaria's transition has become "stuck" in several respects. Significant structural challenges remain, including the following:

- A key priority is to develop the municipal sector so that it is financially sustainable and well-regulated. The necessary steps include decentralisation, strengthening the municipalities' ability to meet contractual obligations and to attract commercial financing, supporting innovative practices in protecting the environment (e.g. energy efficient street lighting, reduction of water losses, improved waste utilisation, etc.), and boosting the country's capacity to absorb EU funds targeted for investment in municipal infrastructure.
- Further market opening in the power sector in consultation with all key sector shareholders is another key priority. This requires a gradual reduction in the share of electricity sales subject to regulated tariffs, careful consideration of the stranded costs associated with the existing power purchase agreements, well-defined regulation, and contractual arrangements and political support that encourage investments in the network capacity and interconnectivity with neighbouring countries.
- As revealed by the failure of the fourth largest commercial bank in June 2014, improving the corporate governance in banks and further fostering credibility of banking supervision are necessary to contain future banking difficulties and preserve public confidence. The authorities have already publicly expressed their intention to: (i) conduct an asset quality review in late 2015, (ii) conduct an FSAP with the IMF/World Bank, due to commence with at least some modules in early 2015, and (iii) start the preparation for entering the close cooperation agreement on single supervisory mechanism (SSM) with the European Central Bank (the so-called 'opt in for SSM'), which would help improve supervisory environment and anchor the confidence, although this process may not be completed in 2015. There are also concerns about non-bank institutions, including in the insurance and pensions sector, and Government has recently proposed amendments to the structure.

2.4 Business environment and legal context

Business environment

The conditions for doing business in Bulgaria have improved in recent years, but significant problems remain, and contribute to explain the low, and falling, level of FDI in the country. According to the World Bank's Doing Business 2014 report, Bulgaria is ranked 58th out of

189 countries. The report highlights significant shortcomings in areas such as dealing with construction permits, resolving insolvency and getting electricity. Furthermore, in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) Bulgarian companies identified an inadequately educated workforce, difficulties in accessing finance and competition from the informal sector as obstacles to development. The Government has made efforts in the fight against organised crime and corruption, as recognised by the European Commission (EC) in its regular reports under the cooperation and verification mechanism. However, the latest CVM indicated continuing shortcomings, especially in the judiciary and Transparency International's 2013 Corruption Perception Index has ranked Bulgaria in 77th position (out of 177 countries), among the lowest in the EU. From a competitiveness point of view, the quality of public institutions, including those regulating energy and water utilities, in Bulgaria is weak compared to most EU countries. According to the World Economic Forum's Global Competitiveness Report, Bulgaria ranks at 112th place out of 148 countries in terms of the quality of its public institutions. On overall competitiveness, Bulgaria fares relatively better at 57th place.

Legal context

Since joining the EU in 2007, Bulgaria has continued to upgrade its commercial law framework in order to comply with EU requirements. Recent positive developments include amendments to the Corporate Governance Code, amendments to the Commercial Act in the field of insolvency law, and the introduction of a Public-Private Partnership Act. Moreover, the legal framework for secured transactions is considered one of the most advanced in the region.

Despite significant progress that has been achieved in commercial legislation in recent years, the lack of enforcement of laws has been reported as a major weakness in various areas, including in particular corporate governance and public procurement. And one of the biggest challenges in the Bulgarian commercial law framework is the judicial system. The most widespread concerns from the EU regarding the judiciary include ambiguity in the independence of the judiciary and the need for greater transparency and efficiency.

Bulgaria is fully integrated into the internal market within the European Union, and market liberalisation has been completed in most sectors. The remaining enterprises to be partly or fully privatised include a few energy utilities and some transport operators. There should also be room for further public-private partnerships related to some of the country's large-scale construction projects in the energy sector.

2.5 Access to capital

The current environment provides mixed signals about Bulgaria's and the local borrowers' access to capital. On the positive side, the Government has maintained very strong fiscal and macroeconomic policies (evident in the current debt to GDP ratio of 23 per cent). This macroeconomic performance has helped to support strong ratings from the major ratings agencies. The government bond market is well developed, however secondary market liquidity remains insufficient. Thanks to the prudent fiscal policy pursued in the last several years the yields in recent issues has been favourable.

Private sources of capital

Banking sector: Despite the high liquidity in the banking system, lending growth is modest as banks remain conservative in their lending decisions and the demand for investment financing is almost entirely driven by EU-supported grants or risk-sharing schemes.

The Bulgarian banking sector is largely foreign-owned (77 per cent market share), consisting of 28 banks, with the top ten banks controlling over 80 per cent of the assets of the sector. Since 2007, the level of banking sector assets has been relatively constant as a share of the nominal GDP, reaching 110 per cent in 2013, around the average for the CEE region, but significantly below developed market levels. In spite of the crisis that affected two banks in the summer of 2014, the banking sector remains stable, well-capitalised and highly liquid, with liquid assets representing one third of the total assets of the system, as deposits have been growing faster than loans. Yet, the level of non-performing loans (NPLs) is high at 16.7 per cent at the end of 2014, although it fell moderately from the peak of 18.1 per cent in September 2014.

Gross customer loans growth has dropped significantly since the pre-crisis boom years and was around 3 per cent in 2012, 0.4 per cent in 2013 and 1 per cent for the first nine months of 2014 (with KTB group excluded from 2013 year-end and September 2014 figures), primarily directed to the corporate sector. Deposit growth remains strong at above 8 per cent for 2012 and 2013, and 6.4 per cent in the first nine months of 2014 (KTB group excluded) with deposits accounting for more than 80 per cent of total liabilities in the banking sector, and loans-to-deposit ratio at close to 80 per cent. Increased deposit base and lowering interest rates on deposits, stronger competition among banks on the market and subsidised conditions of EU-funded finance on the market have pushed lending yields down. Based on BNB and Ministry of Finance reporting, the average yield on customer loans for the banking sector was 6.4 per cent in the first nine months of 2014 (2013: 7.2 per cent, 2012: 7.7 per cent).

Microfinance: The microfinance segment is dominated by fast loan providers (which offer loans at rather high interest rates) and bank-captive companies for consumer and micro-finance. There are few traditional microfinance institutions, which also use EU funded programmes (such as the Progress Microfinance Facility). The vast majority of the portfolios in this segment belong to individuals. The average quality of the loan portfolios in the microfinance segment is poor and many of the lenders in this niche have difficulties in obtaining funding. Most banks prefer to focus their lending activities on stronger companies with lower-risk profile. Thus, microfinance remains an underdeveloped part of the market with the overall supply of credit declining.

Equity funds: Private equity and venture capital activities in the country are largely limited to EU-funds supported programmes (i.e. Jeremie). The demand for equity finance is still low, to a certain extent because of insufficient capacity of entrepreneurs to utilise this form of finance and due to high valuation expectations. At present, most companies obtaining early stage equity financing operate in ICT, mobile and web applications, e-commerce and digital media.

Capital markets in Bulgaria are underdeveloped and markets are relatively illiquid. The low stock of government debt and the unrestricted access to the primary auction process means that there is very limited secondary market trading activity. While 380 companies are listed on the Bulgaria Stock Exchange (“BSE”), capitalisation and turnover in the post-crisis period remain low, and new listings are scarce. The State is still the majority shareholder of the BSE, although there have been initial discussions and preparations for its privatisation.

Given the issues in the banking system and the emergence of pension funds, there may be some room to increase the use of non-bank financing instruments such as corporate bonds and IPOs to raise capital. Central to this would be a review of the cost structure of issuance as well as the ownership and operational structure of the BSE and the CSD. The recent SEE link project, supported by EBRD, is expected to strengthen regional stock exchanges integration and improve the options for raising funding through capital markets.

European Union and multilateral development bank finance

During the Strategy period, there has been very limited financial involvement of other international financial institutions, with the exception of the European Investment Bank (EIB). The World Bank has not provided new financing, but has continued to advise the Government through its reimbursable advisory services in the areas of toll road revenues, retail sector competition and trading practices, water supply and sanitation, as well as innovation. The IFC has invested approximately Euro 50 million per year on average. The Black Sea Trade and Development Bank has not financed new projects during the period.

EU funds: In the last few years the EU funds absorption has been the main driver behind the financing of public and private projects in Bulgaria, providing grant and subsidised financing terms, often leveraged by the IFIs, the local banking sector and the private equity funds. It is in fact estimated that infrastructure funding, much of which financed by EU Funds, has supported Bulgaria to retain its positive, albeit small, growth in the past few years.

Projects in the municipal, water and road infrastructure sectors have been financed through the EU Structural Funds Operational Programmes (the largest programmes being OP Regional Development and OP Environment) with very high grant levels and bridge and/or co-financing for the projects provided mainly from the state-owned fund FLAG, co-financed by EBRD and commercial banks. The public sector development has been supported and financed by the EIB as well. During the Strategy period, political instability, delayed reforms, poor financial standing of public beneficiaries, as well as problems related to project management and implementation and public procurement, created difficulties in the efficient and timely utilisation of EU funds and in fact a number of OPs were suspended during 2014. The current Government has been able to release frozen funding and is focused on finalising use of 2007-2013 OPs and thereafter the effective use of 2014-2020 OPs (as at end 2014, Bulgaria had absorbed approximately 65.5 per cent of available EU funding in the 2007-2013 programming period, but disbursements will continue throughout 2015). In addition, in early 2015 Bulgaria submitted 18 projects to the Special Task Force on Investment in the EU, to be assessed as part of the comprehensive Jobs, Growth and Investment package (“Junker Plan”). Projects submitted are in the areas of transport, energy, innovation and environment, and envisages a total financing of Euro 3.5 billion, out of which only 4 per cent would be potentially open to private financing.

EU funds have also played a significant role in the private sector financing, with funding involving both grant financing (up to 50 per cent of the project investment for SMEs and up to 70 per cent for energy efficiency for residential buildings), as well as subsidized terms for lending and equity financing (Jeremie Funds, see below).

European Investment Fund (Jeremie Funds): The revolving Jeremie Holding fund, managed by EIF, manages Euro 350 million from the OP Competitiveness, covering almost

the whole spectrum of SME financing, from seed funds, venture capital funds, co-investment funds to commercial banks (with first loss portfolio guarantee and portfolio risk sharing loan), which through leverage from the commercial banks and private equity funds is expected to reach Euro 800 million in financing for SMEs by 2015.

The funds channelled through commercial banks (about Euro 260 million) have been utilised at about 80 per cent in the 2 years since the start of the programme. The Jeremie equity funds have also been quite successful, especially the two seed funds Eleven and Launchhub, focused mainly on IT start-up companies, and managing a portfolio of Euro 30 million. These funds are unique for the region, and entrepreneurs from neighbouring countries are able to access the funding (as long as they register a company in Bulgaria).

European Investment Bank: EIB has provided large infrastructure financing (Euro 300 million per year on average over the past 4 years, mostly transport and waste management), often in cooperation with EU grant funded projects. EIB and EIF also have worked with banks to provide low-interest lending to the corporate sector and with fund managers to create equity funds for smaller companies. Over the 2012-2015 period, its financing has benefited broadly equally the private and the public sectors.

2.6 Social context

The level of unemployment has been a persistent problem in Bulgaria throughout the past five years. As of end 2014, the overall unemployment rate was 11.5 per cent, with a slightly higher rate among males (12.3 per cent) relative to females (10.4 per cent). Around 60 per cent of those unemployed have been so for over a year. Youth unemployment is particularly severe, reaching 23.9 per cent in 2014. The overall labour force activity rate at 68.4 per cent in 2013 is close to the EU average of 71.9 per cent.

In 2013, Bulgaria ranked 38th out of 148 countries (12th out of the Bank's 35 countries of operations) in the Gender Inequality Index, a composite measure of gender gaps in reproductive health, labour force participation and political representation. The same year, female labour force participation was 48 per cent compared to 59 per cent for men. Bulgarian women are well represented in business and political leadership positions and hold 25% of the seats in Parliament and nearly a third of Government ministries. Gender gaps in access to finance are medium. However, despite substantial improvements in legislation and government action, trafficking of women remains an important gender problem. The situation of women and girls within minorities deserves also particular attention as they tend to combine the consequences of exclusion based on their gender and their ethnic group.

2.7 Energy efficiency and climate change context

Bulgaria's energy intensity remains over 5 times the EU-28 average and despite having cut by half its energy intensity since the early 1990s, Bulgaria remains the least efficient energy economy in the EU (namely 1.31 versus 0.24 CO₂/GDP). In addition, the electricity sector faces a serious liquidity crisis (with payments delayed throughout the energy cycle from raw materials (coal, gas), through to energy producers, distribution and final purchasers). Stability in the sector will require price adjustments, new capital and, most importantly, improved regulation. The current system of low tariffs and cross subsidisation does not provide incentives for energy savings. Energy efficiency improvements across the sectors are therefore important to mitigate the increasing electricity demand and support a more

sustainable economic development. In addition an ESCO advisory assistance programme would help municipalities consider and structure ESCO contracting for public buildings maintenance.

In terms of adaptation activities, there is potential in developing climate resilience/water efficiency activities in water infrastructure and water efficiency in industry (including manufacturing, agribusiness, mining, etc.).

3. STRATEGIC ORIENTATIONS

3.1 Strategic Directions

Bulgaria's entry into the EU in 2007 followed a sustained period of reforms, strong economic growth, and increasing integration into European and global markets. Since then, however, the country has been buffeted by the global economic crisis in 2008/09 and the subsequent Eurozone crisis, compounded more recently by a period of political instability. Several years of recession or anaemic growth have been accompanied by higher unemployment, lower investment and increasing regional disparities. In this environment, progress in transition has been much more hesitant than in the run-up to EU accession and has even reversed in some cases. This has made it more difficult for the Bank to utilise its financing to promote reforms, especially at state and municipal levels, while demand for Bank funding in the corporate and financial sectors has also been subdued due to the overall economic situation and lower levels of investment. Notwithstanding Bulgaria's status as an EU member and the advanced state of reforms in many areas, the country still faces significant reform challenges in the years to come.

In this context, the overarching goal of the Bank's activities in the forthcoming Strategy period in Bulgaria will be to create a new impetus for reforms in order to support growth through investment and policy dialogue and re-energise transition. The Bank will pursue this objective in the following ways:

- **Enhancing Competitiveness through Improved Efficiency, Governance and Innovation:** Although corporate governance and business standards have improved since accession to the EU in 2007, there remain large opportunities to bring skills, governance and management practices closer to international standards. Conditions for doing business in Bulgaria have improved in several respects over recent years, but issues clearly remain which hinder investment, notably with respect to dealing with permits and licences, labour contracts and insolvency procedures. Competitiveness of Bulgarian firms is also impacted by the small-scale nature of operations in key sectors. Given the above issues, the Bank will support financial restructurings and provide long term finance for competitiveness enhancement, and energy and resource efficiency investments. The Bank will also support regional economic integration by providing financing for cross-border investments and exports. For smaller companies, the Bank will work with and through financial intermediaries to ensure sufficient access to funds. The Bank could expand business advisory activities, although this depends on access to donor or budget resources. Finally, on a national level, targeted advisory assignments will address obstacles to doing business.

- Strengthen the financial sector intermediation through targeted investments and improved governance:** Profitability has fallen across the banking sector and consolidation in the sector may be necessary. Following the recent closure of Corporate Commercial Bank, the National Bank and the Government have started work on a number of initiatives – independently and jointly with international partners – which are designed to fully restore public confidence to the sector. They have also signalled their intention to opt-in into the Single Supervisory Mechanism (SSM) where the ECB is the direct supervisor of major cross border banks. Given the high level of liquidity in Bulgarian commercial banks at present, the Bank will explore risk sharing products or products blended with grant resources, in order to support overall intermediation and in particular MSME development. It will also support sector consolidation where needed, and help address the issue of high NPLs. The Bank will also seek to support the deposit insurance fund with a combination of investment and policy dialogue.
- Narrowing the Infrastructure Gap through Commercialisation, Reform and Efficiency:** Years of underinvestment and limited private sector involvement have led to deteriorated quality of municipal and national infrastructure. In particular, municipalities and state agencies need to strengthen technical skills in planning, procurement and project management in order to benefit from available funding. Gas transportation and storage facilities, which are key to the country’s energy security, would benefit from expanded commercialisation and investment. The energy system operates in an unsustainable fashion. End-user tariffs are below production costs which inhibits long-term investments. The country remains the least energy efficient economy in the EU and the current energy policies do not provide a framework conducive to investments in the sector. In that context, the Bank will seek to support commercialisation and private sector participation in transport and gas infrastructure, as well as at the municipal level, in areas such as water and waste management, district heating and urban, national and cross-border transportation. The Bank will work with the authorities to facilitate leveraging of available EU structural funds through newly designed financial instruments with clear linkage to transition considerations. In the energy sector, the Bank is ready to renew its dialogue with the authorities with the view to support the development and implementation of a long-term energy strategy, including strengthening the regulator and reviewing tariff policies. Provided that this engagement leads to an improvement in the institutional and regulatory environment of the sector, the Bank would subsequently provide investments to support public utilities financial and operational performance, while continuing energy efficiency investment across the economy.

3.2 Key challenges and Bank activities

Theme 1: Enhancing Competitiveness through Improved Efficiency, Governance and Innovation

Transition Challenges

- Standards of management, governance and skills in private sector companies often lag behind Bulgaria’s international competitors. The most recent Transition Report highlighted the need to improve innovation throughout the economy – in terms of

process, product, marketing, or organisational innovation. This would help raise efficiency and thus productivity, as a potential growth driver against the background of shrinking population, from nearly 9 million in 1990 to around 7 million currently.

- Growth prospects in important sectors such as agribusiness and tourism are held back by the small scale of operations. Consolidation in certain cases would allow Bulgarian firms to compete more effectively in the international environment with greater financial or technical resources.
- Concerns about application of laws in non-transparent or arbitrary manners undermine investor confidence which, alongside cyclical economic issues, has led to falling FDI inflows, both in terms of projects' size and number of investments. FDI have decreased from a peak of more than 30% of GDP in 2007 to less than 3% in 2014. Addressing investor concerns could help attract needed investment which will contribute to competitiveness in the corporate sector through skills transfers and increased competitiveness. Other aspects of the business environment where businesses have expressed concern include delays and lack of transparency in receiving permits and licences.

Operational Response

Through its investments and policy advice, the Bank will seek to address these transition challenges by facilitating private sector-led growth. Specifically, the Bank will:

- Support firms which are investing to upgrade equipment and technology and also which require improvements in operational standards and governance. Of particular importance is the Bank's ability to offer a variety of long-term financing, both equity and debt products. While it is acknowledged that certain sectors of the economy have benefited from greater access to commercial bank financing, the Bank continues to be additional across sectors – manufacturing, property, agribusiness across the value chain, and services – as companies in all key sectors face similar obstacles to longer-term finance.
- For smaller companies, the Bank has proposed to re-launch small business advisory services programmes, to support SMEs on operational improvements, financial management and adoption of best standards. However, this is dependent on access to donor funds or Government budget funds. This would be subject to devising an appropriate 'hand-over' strategy whereby the Bank's involvement should not be necessary following a 3-5 year period. Other instruments to support SMEs will continue to be pursued, including risk sharing products to encourage banks and leasing companies to extend finance to SMEs and utilise currently high liquidity, PE funds, as well as direct investments by the Bank.
- Support the development of the innovation/'knowledge' economy, which benefits from the country's strength in education, engineering and computing. The Local Enterprise Facility (LEF) and revitalised equity and quasi-equity fund activities may be particularly relevant given the size of most Bulgarian companies in this sector. For example, the Bank has been working with the authorities and EIF to put in place a mezzanine capital fund for mid-size companies with growth opportunities.
- As companies seek to reduce leverage and restart credible business plans, work with co-financiers (banks and funds) to assist financial and operational restructurings with high demonstration effect, aiming at market consolidation and/or improvement in management and corporate governance.
- Support in-bound and out-bound FDI, especially projects with important skill or technology transfer components, or bringing higher standards into the country, with a

particular focus on sponsors and projects from the region, which represent an increasing share of the foreign investment inflows. Continue facilitating exports through cross-border and pre-export trade finance, as well as potentially SMEs business advisory to improve export readiness.

- Support investors in outlying, traditionally under-served regions, especially those parts of the country where unemployment is high and certain social groups are excluded from economic opportunities. In fact, corporations from neighbouring countries have often located their investments in outlying regions along shared borders. As a business development tool, the Bank will continue to engage with the private sector and deliver energy audits directly to private companies across sectors as a means to identify sustainable investment opportunities consistent with the Bank's Sustainable Energy Initiative across the sectors and industries in Bulgaria. In addition the EBRD will expand operations to address resource efficiency under the Bank's Sustainable Resource Initiative and contribute positively to the pressing issue of water efficiency in the private sector (e.g., agribusiness) and municipal sector.

Policy Dialogue

- The Bank will continue its active participation in investor working groups and business associations, as well as its wide-ranging dialogue with Government and between IFIs in order to address perceived problems in the business climate.
- The Bank will continue to provide targeted legal transition advice on issues which impact business development. This could include advice to the Ministry of Justice to improve the Corporate Insolvency Law, as well training initiatives for judges/courts to develop capacity in dealing with business related cases, with particular emphasis on disputes involving financial and business transactions.
- If the small business advisory programme is restarted, the Bank will provide advice to the authorities on how to manage it in a sustainable manner, in order to facilitate the hand-over of the programme.

Theme 1: Enhancing Competitiveness through Improved Efficiency, Governance and Innovation				
#	CHALLENGES	OBJECTIVES	ACTIVITIES	INDICATORS [metric/ baseline]
1.1	Competitiveness is hampered by small size of local companies, and weak corporate governance and management skills	Improve management skills and governance for the benefit of competitiveness, support sector consolidation	<ul style="list-style-type: none"> ▪ Direct investments, including financial restructurings, supporting improved governance and market consolidation ▪ Facilitate the re-launch of the Bank's Small Business Services in Bulgaria 	<ul style="list-style-type: none"> ▪ Evidence of financial / operational improvements, as well as enhanced corporate governance and business standards by clients (<i>Baseline – 0</i>) ▪ SBS / TIMS indicators on number of client firms that reported increased productivity / employment (<i>Baseline – established at projects approval</i>) and SBS re-launched and sustainable through local funding sources [target: by 2018] (<i>Baseline – N/A</i>)
1.2	Need to improve innovation throughout the economy to help raise efficiency and thus productivity	Support corporate innovation in terms of processes, products and marketing	<ul style="list-style-type: none"> ▪ Direct investment supporting new products development, technology and processes upgrades and skill transfers ▪ Co-financing activities with foreign and local investors in 'knowledge economy' bringing higher standards or skills ▪ Support to equity funds. 	<ul style="list-style-type: none"> ▪ Evidence of successful introduction of new innovative processes, products and standards by client firms (number of successful projects and qualitative account) (<i>Baseline – established at project's approval</i>)
1.3	Business environment leaves room for improvement in several areas: e.g. insolvency procedures, dealing with permits and licences, and labour contracts	Help enhance business environment in selected areas	<ul style="list-style-type: none"> ▪ Policy dialogue/ advisory services on selected topics such as insolvency law 	<ul style="list-style-type: none"> ▪ Evidence of successful improvements in business environment (e.g., insolvency law) as a result of the Bank's policy dialogue (<i>Baseline – N/A</i>)
Context indicator: Δ Business sophistication index (2014 baseline: 105 th). <i>Source: Global Competitive Index (World Economic Forum)</i>				

Theme 2: Strengthen the financial sector intermediation through targeted investments and improved governance:

Transition Challenges

- Despite quick successful actions by the authorities following the run on two large banks in summer 2014, questions have been raised about the need to strengthen banking and non-banking financial regulation, banking supervision, and corporate governance. Although the authorities' intention to commence the preparation for entering the Single Supervisory Mechanism (SSM) with the European Central Bank (ECB) will be a challenging process for the authorities and banks themselves, and will likely take some time, it should also help restore the full confidence in the sector's governance, regulation and supervision.
- Given low profitability amongst a high number of commercial banks, some consolidation would help address the capital constraints faced by some smaller players and some foreign-owned subsidiaries.
- Although level of NPLs remains high, there seem to be no coordinated action towards their sustainable resolution. A functioning NPL servicing industry, especially for corporate and secured loans, should therefore be developed.
- Bank lending and investments in general are hindered by shortcomings in the judicial system and in particular the insolvency regime. Banks and corporates have repeatedly expressed concerns about their ability to enforce loan agreements and other contracts.
- Despite ample liquidity in the banking sector, lack of eligible collateral has constrained finance for MSMEs and start-ups, especially in the regions. Increasing non-collateralised bank lending, particularly for MSMEs, remains a challenge. In addition, access to equity for small firms and innovative enterprises is limited. Local funding opportunities through bond issuance, syndicated lending, and various equity opportunities need to be developed for the banking sector.
- The corporate bond market is underdeveloped and volume outside government bonds remains small.

Operational Response

- The Bank will work with banks and the regulator to encourage sales of NPLs, including through investing in NPL portfolios, mobilising specialised NPL investors or financing NPL asset management companies. Additionally, the Bank will support the establishment of credible local corporate and secured NPL asset managers that can more efficiently service corporate and secured NPLs outside the banking system.
- To increase public confidence in the banking sector, the Bank will seek to provide stand-by funding and potentially technical assistance to the Bulgarian Deposit Insurance Fund, in order to bridge its funding needs until sufficient reserves are accumulated, and support legislation and procedural reforms. This will be coordinated with both Bulgarian and international partners to develop a well-structured response to address concerns in the sector.
- As opportunities arise, the Bank could work with strategic or financial investors to support M&A in the sector in order to ensure a healthy and competitive banking system and help improve corporate governance practices.
- In order to improve access to finance for smaller and mid-size companies, the Bank will provide credit lines to banks and leasing companies for MSME finance, energy efficiency through sustainable energy financing facilities (SEFFs), trade finance and

factoring. Funding lines will likely need to be dedicated to specific underserved objectives or, given risk appetite of commercial banks, linked to risk-sharing products. In this regard, EBRD will work with its bank partners and the national authorities to consider and develop risk-sharing products to facilitate the banks in extending finance to the SME sector.

- As liquidity from short term deposits is not expected to remain as significant a share of funding as at present, the Bank will seek to support bond issuances by banks and corporates and syndicated lending transactions, to contribute to the development of the capital markets in the country. The Bank will also seek to support capital market solutions as a potential source of equity finance for local companies.
- EBRD will aim to provide support for institutions and capacity building to strengthen the capital market infrastructure in the country, e.g. by supporting the privatisation of the stock exchange and enhancing capital market links with other neighbouring countries.
- The Bank will continue to monitor opportunities to engage in the insurance and pension sectors, and as needed can respond with policy dialogue and also funding to support consolidation in the industry and especially to further strengthen the private pension fund industry.

Policy Dialogue

- In close coordination with other IFIs, the Bank will provide assistance to the Deposit Insurance Fund and other relevant financial authorities upon request to support implementation of appropriate organisational and procedural changes, as well as capacity building, as recommended by relevant technical assessments to improve the regulatory framework.
- Providing the authorities' interest and commitment, the Bank will engage with Bulgaria's financial and judicial authorities, market participants and other IFIs, under the umbrella of the Bank's Vienna Initiative framework and in other ways, to advance the NPLs resolution agenda. As mentioned above under Theme 1, the Bank could provide technical assistance and advice to improve the Corporate Insolvency Law and help to build the capacity of judges handling bankruptcy (reorganisation) and enforcement cases. In addition, the Bank will seek to support commercial banks with training on corporate restructurings best practices. This would assist banks and secondary investors by providing them with more effective tools for resolving and realising value from NPLs.
- As noted above, the Bank is available to provide policy guidance on pensions reforms if requested, where the country to date has been a leader through development of a 3-pillar public and private pension system.

Theme 2: Strengthen the financial sector intermediation through targeted investments and improved governance:				
#	CHALLENGES	OBJECTIVES	ACTIVITIES	INDICATORS [metric/ baseline]
2.1	Some important shortcomings remain in banking and non-banking financial regulation and corporate governance, heightened by the fragmentation of the market	Support improvements in the deposit insurance framework, and assist market consolidation as opportunities arise	<ul style="list-style-type: none"> ▪ Advisory to the deposit insurance fund ▪ Support M&A in the banking sector 	<ul style="list-style-type: none"> ▪ Evidence of improvements in deposit insurance framework, as a result of the Bank's policy dialogue (<i>Baseline – N/A</i>)
2.2	Access to finance remain difficult for SMEs, hampered by high levels of NPLs on banks' balance sheets	Address obstacles to access to finance for underserved segments, including seeking to resolve the issue of high NPLs	<ul style="list-style-type: none"> ▪ SME financing through credit lines to partner banks, and private equity and venture capital funds ▪ NPL resolution/sales, support to NPL asset management industry ▪ Policy dialogue on NPL resolution (including judicial Corporate Insolvency and enforcement framework) 	<ul style="list-style-type: none"> ▪ Number and volume of total loans and leases extended by client banks/ leasing companies to MSME (e.g. through SEFFs) (<i>Baseline – established at project's approval</i>) ▪ Decrease in sector-wide NPL ratios, and, as appropriate, attribution to the Bank's activities (<i>Baseline 2014 – 16.7%</i>)
2.3	Capital markets remain underdeveloped, in particular debt markets where volume outside government bonds remains small	Support development of capital markets, in particular corporate bond market	<ul style="list-style-type: none"> ▪ Support bond issuances by banks and corporates ▪ Support development of capital market instruments for SME equity financing ▪ Investment and advice in capital market infrastructure 	<ul style="list-style-type: none"> ▪ Evidence of improvement in equity and corporate bond markets (e.g., new issuers, [<i>Baseline 2013: 381 listed companies</i>] increased volumes, [<i>Baseline 2013: corporate bonds outstanding: 2.8% GDP, market capitalisation: 13.1% GDP, %</i>]) and, as appropriate, attribution to the Bank's activities
Context indicator: Δ Financial market development (<i>2014 baseline: 60th / 4.2</i>). Source: Global Competitive Index (World Economic Forum)				

Theme 3: Narrowing the Infrastructure Gap through Commercialisation, Reform and Efficiency

Transition Challenges

- Most municipalities are quite small and lack financial and technical strength. Nearly all municipalities need to strengthen their technical skills in planning, procurement and project management. Consolidation of the municipal sector and decentralisation of decision making to municipal levels has not proceeded and local communities face difficulties managing operations, for example in water, waste and transport, and in particular developing projects where the private sector can contribute to public services.
- The road sector suffers from lack of commercialisation and private sector involvement. Longer-term service contracts between the national rail company and the private operators could be designed to offer better value for the State and also provide greater certainty to private operators.
- Inconsistent regulatory policies make it difficult for investors to commit to long-term investment plans. Uncertain regulation, cross subsidies and under-pricing constrain private and public investment in utilities, as well as in alternative sources of energy such as gas (and also gas storage), putting at risk Bulgaria's energy security. The absence of electricity and gas exchanges and a lack of transparency in the wholesale market remain key obstacles to improving the functioning of energy markets. Despite the role of an 'independent' regulator, tariff setting and regulatory policy remain of concern to investors.
- Despite some progress in recent years, Bulgaria has the least energy efficient economy in the EU. Further energy efficiency and CO2 reductions require improvements in legislation, regulation and infrastructure, including an overall reform plan to move to cost reflective tariffs that providing effective price signals for consumers and producers.
- Significant grant resources are available from EU Operational Programmes. However, Bulgaria has often faced difficulties absorbing EU funds and there is potential to better leverage these funds to finance infrastructure projects.

Operational Response

- The Bank will seek to work with larger municipalities directly, as well as with municipal companies in water and waste management, district heating and urban transport, to support commercialisation of operations. Focus will be on long-term planning and contracting, in order to enhance predictability for both the authorities and the contractors. Building on experience with FLAG, the Bank will consider further framework arrangements which would allow to effectively support smaller municipalities and local utilities.
- The Bank will continue to co-invest alongside EU with the aim to enhance efficiency and long-term sustainability of EU-funded projects, with a particular focus on projects promoting regional interconnectivity.
- The Bank will help to restructure state owned and municipal-owned utilities and transport entities, within an appropriate Government policy framework, and in this way assist in the absorption of EU funds through blending and co-investment. Individual projects will likely be linked to advisory assistance to improve capacity, commercialisation, and also the contractual frameworks.

- Continue to engage with the public gas companies and the regulator to finance the expansion and modernization of the national gas infrastructure, promote tariff reforms for gas transmission and storage services that will be supportive of investments and increased commercialisation of the gas infrastructure sector.
- The Bank will continue to support energy efficiency through its SEFF projects for municipal and residential companies, but will also work with Government to consider new mechanisms for supporting energy efficiency for the residential and municipal sector (through ESCOs and Energy Performance Contracting). Goal will be for EBRD to work with the Government to develop sustainable financing approaches. This will require new financial engineering instruments, involving technical cooperation, grant and investment resources.
- The Bank has remained engaged with the authorities on the overall reform of the energy sector and has recently seen an improved level of dialogue. Provided that the institutional and regulatory environment of the sector continues to improve, the Bank will seek to provide financing to private distribution companies and possibly also state companies – including Bulgaria Energy Holding, National Electric Company, Electricity System Operator – to address balance sheet restructuring needs and to improve their long-term financial positions.
- In addition, the Bank could address energy security issues by financing commercially viable alternative energy sources and sustainable buildings.
- The Bank will continue to manage the KIDSFund resources, although there are limited resources now available for non-nuclear activities, and most of the ongoing initiatives will be related to decommissioning.

Policy Dialogue

To address the transition challenges noted, the Bank will seek to supplement its infrastructure investment with advisory assistance to support commercialisation and efficiency of public infrastructure. However, as the Bank has very limited access to donor resources for Bulgaria, we expect to implement a limited number of carefully focused advisory projects, mostly financed through EU funds, which can now be used to finance EBRD-managed technical assistance, in accordance with the Memorandum of Understanding the Bank entered with the Bulgarian Government.

- The Bank will work with Government and Parliament to improve legislation impacting on utilities. For example, the Bank will continue to work to improve and implement Bulgaria's Water Act and related regulations which would help improve the efficiency, the service quality and the transparency in the sector.
- Having completed 2 stages of a 3-stage assignment, the Bank will complete ongoing assistance on E-Procurement which should lead to major improvements in policies and technical procedures for public procurement. This is the first Bank initiative to be financed under the MOU which utilises EU Operational Programme resources managed by the Bulgarian Government.
- The authorities have recently reengaged with the Bank on the need to develop a long-term strategy for the energy sector, without which further investments in the sector will be very challenging, starting with a request for advice to the energy regulator. Follow-on policy projects could include reform of the legal regime and support to key sector actors in improving their operational capacity.
- The Bank is currently implementing an ESCO advisory assistance programme to help municipalities consider and structure ESCO contracting for public buildings

maintenance. The Bank will seek to expand access of corporates to energy audits which will help target their energy reduction potential.

- The Bank will explore opportunities to help the Government develop efficient structures for utilising and leveraging EU grants for key sectors such as water, municipal infrastructure and energy efficiency. This could include both advice on government strategy, as well as at the fund level for best standards of fund management.

Theme 3: Narrowing the Infrastructure Gap through Commercialisation, Reform and Efficiency				
	CHALLENGES	OBJECTIVES	ACTIVITIES	INDICATORS [metric/ baseline]
3.1	Lack of incentives for private sector engagement in infrastructure and utilities sector has led to deteriorated quality of municipal and national infrastructure and weakening in in management capacities	Encourage commercialisation and private sector participation in the infrastructure sector	<ul style="list-style-type: none"> ▪ Investments and TC for municipal water and waste management, district heating and urban transport to support commercialisation of operations ▪ Support to modernization of the national gas infrastructure ▪ Restructuring of public transport entities together with EU funds in support of commercialisation and efficiency improvements 	<ul style="list-style-type: none"> ▪ Evidence of improvements in efficiency and service delivery on revenue side (including tariff increases) and cost/profit side (cost reductions and profitability improvements) at client level (<i>Baseline – established at project’s approval</i>) ▪ Infrastructure services (number of successful projects and qualitative account) successfully outsourced to private sector (e.g. concession, PPP (BOT), lease of assets, management contracts) (<i>Baseline – 0</i>)
3.2	Key reforms have stalled or reversed, inconsistent regulatory policies make it difficult for investors to commit to long-term investment plans	Support the Government in selective areas where there is reform appetite (e.g., Water Act, E-Procurement, Energy sector)	<ul style="list-style-type: none"> ▪ Policy dialogue/ TC under the MOUs TC on implementation of Bulgaria’s Water Act and related regulations ▪ Policy advice on long-term strategy for the energy sector (including strengthening regulator) ▪ Assistance on E-Procurement 	<ul style="list-style-type: none"> ▪ Evidence of targeted regulatory/ institutional reforms successfully implemented (e.g., implementation of e-procurement by national procurement office and major SOEs, progress on Water act, progress on Energy regulator reforms) (<i>Baseline – N/A</i>)
Context indicator: : Δ in relevant ATC scores (<i>Baseline 2014 - Natural Resources (Small, 3+), Power (Medium, 3), Water (Medium, 3), Urban Transport (Small, 3+), Roads (Medium, 3-), Railways (Small, 3+)</i>)				

3.3 Potential risks to Country Strategy implementation

Successful implementation of the Country Strategy will necessarily depend on a number of factors, some of which are outside the Bank's control.

- Given its focus on the private sector, the general macroeconomic environment will be important in determining the commitment of companies to invest and the Bank's ability to work with local and foreign investors on sustainable business initiatives.
- Investment volumes and the ability of the Bank to deliver its strategy objectives will greatly depend on a supportive political environment in Bulgaria and the authorities' overall reform commitment. In particular, in the energy sector, the Bank's strategy is dependent on an active reform dialogue, for which the Bank has proposed both advice and funding. Absent of progress on reforms, it is likely that the sector will continue to suffer financial losses and the Bank will not be able to progress in its objectives. Successful implementation of objectives in the municipal sector relies on a progressive delegation of decision-making power and financing capacity to local governments. To a significant degree these measures can be politically contentious and in any case require consultations with governmental and legislative bodies.
- Success on strengthening financial intermediation, under Theme 2, may be challenged by the ongoing difficulties in the banking system, including high levels of NPLs, which absorb managerial time and discourage new lending. In order to achieve these objectives, this will require commitment of financial authorities and full alignment on areas of engagement between the authorities and the Bank.
- Success on narrowing the infrastructure gap, under Theme 3, may be challenged if absorption rate of EU cohesion funds allocated for infrastructure and environment projects is not maintained. For 2014-2020 budgeting period, EU funds granted to Bulgaria amount to almost Euro 7.6 billion, but the Bulgarian government needs to contribute financially to the projects. If rising fiscal deficit lowers the domestic funds available, Bulgarian government might end up spending less than the total amount granted. On the other hand, a bid to maintain recently accelerated absorption rate (currently at 65,5 per cent) may also pose a risk if processing project bids and tenders too fast results in sub-optimal infrastructure investment choices.
- The Bank has limited access to grant resources for providing policy advice. The Government should confirm its readiness to utilise EU Funds under framework arrangements to benefit from IFI advisory assignments.
- The presence of high intensity EU grants and concessional IFI lending makes commercial-based lending unattractive for the public sector.

3.4 Environmental and Social Implications of Bank Proposed Activities

As an EU member state, Bulgaria has adopted environmental and social legislation that is aligned both with EU Directives and the EBRD's Environmental and Social Policy and Performance Requirements (PRs).

The Bank's recently approved Environmental and Social Policy will apply to all projects carried out in Bulgaria. As part of the Project appraisal process, the Bank will work closely with clients on developing Environmental and Social Action Plans (ESAPs) for all Projects which have the objective of mitigating potential negative impacts and ensuring compliance with the Bank's PRs. Similarly, Project monitoring shall include regular review of existing ESAPs to determine compliance.

It is noted that the Strategy going forward will include a focus on specific sectors such as the development of transport, water, district heating, waste and municipal infrastructure and this may involve land acquisition or economic displacement for local populations and the Bank's Performance Requirements will apply in such cases. It will be important to identify any vulnerable populations that may be disproportionately affected by the projects and to ensure that stakeholder engagement activities include any marginalised groups.

Health and safety is also an important consideration for all projects and the Bank will work with clients and sponsors to promote the development of an appropriate safety culture.

The Bank has an interest in a number of nuclear safety funds related to the decommissioning of old and redundant generating capacity throughout the region. This includes work being carried out on the Kozloduy plant in Bulgaria (see Annex 6 for more details). All work related to the use of such funds will be subject to the Bank's Performance Requirements.

According to the assessment of gender gaps of the Strategic Gender Initiative (SGI), Bulgaria exhibits medium size gaps in women's access to finance and women's employment and firm ownership. With respect to labour, while the gaps relating to labour policy are small, gaps in labour practice are large, which indicates an implementation gap between laws and policies and the actual situation and experiences of female employees. EBRD will address this gender gap in two ways. First, by strengthening application of labour related policy requirements under the Environmental and Social Policy 2014 during ESD due diligence of Bank projects. And second, by identifying opportunities to have demonstration effect in this area through the implementation of targeted Equal Opportunities projects in selected, high-profile EBRD clients in Bulgaria. Special attention will also be paid during ESD due diligence to those women who may experience discrimination due to their ethnicity such as Roma.

3.5 Cooperation with the EU and other MDBs and Donors

EBRD has a regular and consistent dialogue with other international institutions operating in Bulgaria. The main "donor" in the country will continue to be the European Union, which is in the process of initiating a seven-year funding programme for the period 2014-20. The EU has allocated Euro 7.6 billion (current prices) in total Cohesion Policy funding across seven Operational Programmes. EBRD has already been able to co-finance projects during the last financial framework, including with funds from the Competitiveness and Regional Development programmes. The Bank is reviewing projects which will promote regional integration and which can benefit from EU funds for regional integration.

As noted already, Bank lending has been instrumental in supporting projects which are co-financed with EU grants. The Bank will continue to coordinate with Bulgarian authorities and the EU to bring its resources and expertise to Operational Programmes (OPs) in areas such as Regional Development, Environment and Competitiveness. These OPs are geared to helping Bulgaria address needs in the areas of municipal infrastructure (incl. water, wastes, district heating), SME development and energy efficiency, amongst others. The Bank can assist the Government and EU in structuring appropriate financial instruments that combine EU grants with commercial financing to improve EU funds absorption, mobilise additional commercial resources to cover existing infrastructure gaps and improve the efficiency and sustainability of the investment projects. In addition, JASPERS has helped Bulgaria develop significant infrastructure projects, including municipal transport projects which have been financed by the Bank.

In order to support Bulgaria in its absorption of EU funds, the Government requested all three major IFIs – the World Bank, the European Investment Bank and the EBRD – to enter into Memoranda of Understanding to create frameworks for the provision of advisory assistance on key policy reforms. The three institutions have initiated a regular cooperative dialogue and are working to ensure that advisory initiatives are coordinated and based on the particular expertise of each institution. Major policy dialogue in the areas of energy, water, transport and financial sector reforms requires close cooperation between international and domestic partners.

The Bank expects to continue an active dialogue on private sector reform alongside the IFC and the Black Sea Trade and Development Bank (BSTDB), and will likely co-finance projects with these institutions on a case by case basis. To date, EIB's focus in Bulgaria has centred on large infrastructure, SME/Mid-Cap credit lines as well as co-financing with the EU for regional development projects. The Bank can co-finance alongside EIB for both national and municipal infrastructure, as well as in selected cases, for private borrowers. The two institutions provided joint financing to support the glassware producer Sisecam. The Bank has also been working with EIF to put in place a mezzanine capital fund for mid-size companies with growth opportunities. IFC is less active, averaging roughly one investment per year across a range of sectors – not all of which have signed.

ANNEX 1 – POLITICAL ASSESSMENT

Bulgaria is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, guarantees for fundamental rights and the protection of minorities, and for a meaningful role of civil society are largely in line with international and European standards, as assessed by the Council of Europe. Elections are conducted in a manner deemed by the OSCE and the Council of Europe to be free and in line with international standards.

In the period since the adoption of the previous Strategy, Bulgaria has made further progress in all areas of democratic reform, facilitated by the deepening of its integration into the European Union (EU), which the country joined in 2007. At the same time, certain challenges remain in the area of the rule of law. Despite the fact that necessary legislative and institutional frameworks have been put in place, some gaps remain. According to the European Commission (EC), existing weaknesses relate to failings in the application of the law, as well as some structural weaknesses. The Cooperation and Verification Mechanism, which was established by the EC in 2007 in order to assist Bulgaria in overcoming shortcomings in the areas of judicial reform, the fight against corruption and organised crime, initially envisaged for three years, is still in place eight years later.

Free Elections and Representative Government

Free, fair and competitive elections

The existing legal framework provides a sound basis for democratic elections, as assessed by the OSCE's Office for Democratic Institutions and Human Rights (OSCE/ODIHR). The legal framework has benefited from a series of reforms over the years. The most recent changes included amendments to the Electoral Code adopted in the beginning of 2013 and in spring 2014.

However, certain aspects of the legislation could benefit from further refinement. According to OSCE/ODIHR's view, which is shared by the Council of Europe's European Commission for Democracy through Law (Venice Commission), individuals that identify themselves as belonging to minorities should be allowed to use their mother tongue in an election campaign, and election material could be provided in minority languages. The OSCE/ODIHR has also recommended additional efforts that are needed to address the persistent issue of allegations of vote-buying in order to restore confidence in the electoral process, as well as to review the provisions on delineation of constituencies to ensure compliance with the principle of equal suffrage².

² OSCE/ODIHR, Early parliamentary elections 2013, Election Assessment Mission, Final report, 25 July 2013, p.24; OSCE/ODIHR, Early parliamentary elections 2014, Election Assessment Mission, Statement of Preliminary Findings and Conclusions, 6 October 2014, p.4; and Joint Opinion on the Draft Election Code of Bulgaria by the Council of Europe's European Commission for Democracy through Law (Venice Commission) and OSCE/ODIHR, 24 March 2014

Under the Constitution, the parliament (National Assembly) is a unicameral body consisting of 240 MPs elected under a proportional system. Previous elections in the country were assessed as “free and fair” by observers from the ODIHR, as well as by other competent international observers. All general elections since the beginning of the transition have brought to power different political parties than those in power at the time of the elections.

Assessing the last general elections, which took place in October 2014, international observers stressed that they were held in a competitive but calm environment, with respect to fundamental freedoms, and were managed professionally. At the same time, they also noted weakened public confidence in the electoral process and certain electoral and political fatigue due to the fact that these were the second early elections in less than 18 months³.

Separation of powers and effective checks and balances

The constitutional and legislative framework for a parliamentary democracy – underpinned by the separation of powers and checks and balances in the political system, an independent legislature and well established procedures of legislative oversight in prescribed domains of decision-making – is in place in Bulgaria and is in line with international and European standards. The scope of powers of the legislature to hold the government to account and to exercise parliamentary oversight is largely in line with international standards. An appropriate system to ensure the accountability of elected officials is in place.

The functioning of the parliament is in line with democratic practices. The government participates in weekly Q&A sessions with members of parliament (MPs). They also respond in writing to enquiries from MPs. Both Ministers and Prime Minister participate in the interpellations requested by the parliamentary opposition, as well as in hearings at the parliamentary committees. The parliamentary committees and MPs exercise their right to initiate and amend legislation.

Effective power to govern of elected officials

Bulgaria has established institutional, legal, and financial arrangements for elected officials to exercise effective power to govern, which are not constrained by any non-democratic veto powers or other undue influences.

Civil Society, Media and Participation

Scale and independence of civil society

There is a satisfactory legal framework for civil society organisations. There is a diverse network of institutions responsible for cooperation between the government and CSOs.

The right to form trade unions and their freedoms are enshrined in the law and respected in practice. The right to strike is recognised by the Labour Code.

Independence and pluralism of media operating without censorship

³ OSCE/ODIHR, Early parliamentary elections 2014, Election Assessment Mission, Statement of Preliminary Findings and Conclusions, 6 October 2014

Bulgaria has a pluralistic media environment, which includes public and private broadcasters and which offers citizens a wide range of political views. Pluralism in the media, which operate freely and without censorship, has increased overall in recent years. A legal framework is largely in place and in line with international standards. At the same time, media ownership and funding lack transparency. Growing concentration of media ownership in the hands of a restricted circle of businessmen, as well as the presence of off-shore companies in the media market, give rise to concerns among the public about undue economic pressure on the independence of media.

The public broadcasters – Bulgarian National Television (BNT) and Bulgarian National Radio (BNR) – have three national television and three radio channels. Commercial television includes three main national stations. Television remains the predominant source of public information, since circulation of printed media is relatively narrow. Recent years have witnessed a rapid growth in internet access. According to the International Telecommunication Union (ITU), the percentage of the population with internet access grew from 5.37 per cent in 2000 to 55.15 per cent in 2012.⁴ Social media is playing an increasingly important role. In 2012, 35.8 per cent of Bulgarians were active Facebook users.⁵

Multiple channels of civic and political participation

Multiple channels of civic and political participation are in place. The system of public consultations is largely in place, although its rules are not always enforced.

Freedom to form political parties and existence of organised opposition

The freedom to form political parties is guaranteed by the Constitution and implemented in practice, as highlighted by the existence of a significant and diverse opposition able to campaign freely and oppose government initiatives. 18 political parties and 7 coalitions participated in the last general elections in Bulgaria. The number of parties represented in the newly elected parliament has doubled as compared to the composition of the previous parliament.

Rule of Law and Access to Justice

Supremacy of the law

Necessary legislative and institutional safeguards for the supremacy of the law are in place. The Constitution recognises the right of any individual to have recourse to the judicial system to defend his or her rights. Citizens have the right to a free and fair trial, and are free from arbitrary arrest or detention. In the years preceding accession to the EU, Bulgaria made progress in aligning its judiciary with European standards and legislation. The work has continued since then.

Independence of the judiciary

The independence of the judiciary is guaranteed by the Constitution and key safeguards are in place to ensure its impartiality. Constitutional amendments of 2007, in particular, set the framework for judicial independence. Judges can be dismissed only if they have committed a

⁴ ITU (2012) <http://www.itu.int/en/ITU-D/Statistics/Pages/stat/default.aspx>

⁵ Internet World Stats (2012) <http://www.internetworldstats.com/europa.htm>

crime or become incapable of carrying out their duties. Their work is overseen by the independent Supreme Council of the Judiciary. Judges may not be members of political parties and they enjoy the same immunities as members of parliament.

According to the EC's comprehensive assessment of the progress achieved since 2007, the efforts undertaken by Bulgarian authorities have not yet led to significant improvements in judicial accountability and "questions remain about judicial independence".⁶ The public perception of the independence of the judiciary remains low.

Government and citizens equally subject to the law

There has been progress in access to justice for citizens. However, the process of dispensing justice in Bulgaria is still marked by serious shortcomings. The courts are overburdened with work and take a long time to deliver their judgments. Persistent delays in court proceedings compromise the transparency and effectiveness of the judicial process and may undermine access to justice.

Effective policies and institutions to prevent corruption

According to the EU Anti-Corruption Report, published by the EC in 2014, "corruption remains a serious challenge in Bulgaria at different levels"⁷. According to the latest (2014) Transparency International Corruption Perception Index (CPI), Bulgaria occupies the 77th place out of 175 countries, which is among the lowest positions among EU countries and in the region of south east Europe⁸.

When Bulgaria joined the EU in 2007, the EC established a Cooperation and Verification Mechanism (CVM) designed to help Bulgaria address the shortcomings in the area of the rule of law, focussing particularly on the fight against corruption. In 2012 the EC produced an assessment of the progress so far. It concluded that despite a significant progress, which included establishing necessary legislative and institutional frameworks, serious shortcomings remain in the area of corruption, particularly in the fight against high-level corruption. There has been lack of conclusive trials for high-level corruption cases, which are processed very slowly and have a disproportionately high number of acquittals. Public procurement remains a particularly high risk area in terms of corruption. The CVM, initially envisaged to run for three years after Bulgaria joined the EU, is still in place eight years after.

At the same time, the latest report under CVM, issued in January 2015, hailed the recent informal evaluation of the impact so far of the anti-corruption strategy, which has been undertaken by the new Bulgarian authorities, as an "important contribution" and an "honest assessment of the shortcomings". Corruption remains a serious issue in Bulgaria.⁹ The forthcoming full evaluation of the anti-corruption strategy should provide a useful analysis of the challenges and help in starting tackling the problems.

According to the Council of Europe's Group of States against Corruption (GRECO), the necessary legal framework to prevent corruption is largely in place, with some room for improvement, but there are weaknesses in investigative and judicial practice.¹⁰ In its

⁶ Report from the Commission on Progress in Bulgaria under the CVM, 18.7.2012, p.5

⁷ EU Anti-Corruption Report, Report from the Commission to the Council and the European Parliament, 3.2.2014, p.14

⁸ Transparency International, Corruption Perceptions Index (CPI), December 2014

⁹ Report from the EC on Progress in Bulgaria under the Cooperation and Verification Mechanism, 28.01.2015, p.7

¹⁰ <http://www.coe.int/t/dghl/monitoring/greco>

Evaluation Report on transparency of party funding, adopted in 2010, GRECO noted a number of shortcomings and issued 16 specific recommendations. In its compliance report adopted in October 2012, GRECO concluded that the Bulgarian authorities implemented or dealt with two-thirds of the recommendations in a satisfactory manner.¹¹

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly and private property

Overall civil and political rights continue to be well respected in Bulgaria. The last assessment of Bulgaria's track record in the area of human rights in the framework of the United Nations Universal Periodic Review (UPR) was adopted in 2010. The top two recommendations for Bulgaria included rights of the child (24.09 percent of all recommendations) and minorities (21.17 percent). Bulgaria accepted 87.59 per cent of the recommendations made in the course of the review process.¹²

Bulgaria is a signatory to major international human rights instruments. The Constitution guarantees basic freedoms and rights of citizens recognized in international law. Freedom of speech, information, religion and conscience, movement, association and assembly are therefore fully guaranteed. The Constitution and relevant laws prohibit discrimination on grounds of sex, race, language, religion, national or social origin, property or social status. Property rights are generally respected and protected.

Political inclusiveness for women, ethnic and other minorities

According to the last census conducted in 2011, ethnic Bulgarians were 84.8 per cent of the population. Among minorities the largest groups are ethnic Turks (8.8 per cent of the population), and Roma (4.9 per cent); other ethnic minorities fall below one per cent of the population.

The Constitution provides for the right of individuals to self-identification. However, it does not make a clear reference to ethnic minorities. Furthermore, the Constitution prohibits the formation of political parties on an ethnic basis. According to the opinion of the Advisory Committee on the Framework Convention for the Protection of National Minorities, the legislation prohibiting formation of political parties on ethnic basis can lead to unwarranted limitations of their rights.¹³ The provision of the Electoral Code regarding the use of Bulgarian language only in the election campaign contradicts OSCE commitments that refer to the right to use minority languages in the electoral process.¹⁴

Roma continue to face various problems and their general living conditions and level of inclusion is below average. Efforts have been made in various areas in recent years in order to improve the situation. In 2012, Bulgaria adopted a National Roma Integration Strategy and respective Action Plan.

¹¹ GRECO, Compliance Report on Bulgaria, 19 October 2012

¹² United Nations, Universal Periodic Review (UPR), Bulgaria, 2010, and UPR Info Statistics

¹³ Advisory Committee, Council of Europe Framework Convention for Protection of National Minorities, Opinion on Bulgaria, 27 May 2004

¹⁴ OSCE/ODIHR, Early parliamentary elections, Election Assessment Mission, Final report, 25 July 2013, and OSCE/ODIHR, Early parliamentary elections 2014, Election Assessment Mission, Statement of Preliminary Findings and Conclusions, 6 October 2014, p.10

The key legislative elements for gender equality are in place in Bulgaria. Women are active at the grassroots level and have a few high-profile representatives at the national level. The share of women in the national parliament has increased from 20 per cent in 2009 to 25 per cent in 2014. One third of the members of the current Bulgarian government are women.

Although the Constitution and relevant laws stipulate that equal opportunities and equal treatment of women and men should be ensured as regards pay and other income arising from employment relationship, on average women in Bulgaria earn more than 10 per cent less than men with equal level of professional qualifications.

Freedom from harassment, intimidation and torture

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice.

A delegation of the Council of Europe's European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT) carried out a periodic visit to Bulgaria from 24 March to 4 April 2014 to assess progress made since the previous visit and the extent to which the Committee's recommendations were implemented, particularly in the areas of police custody and imprisonment, and the treatment of juveniles in penitentiary establishments. The previous report by the CPT, while acknowledging the efforts made by the Bulgarian authorities to improve the conditions in prisons, noted that they remained difficult and also noted allegations of physical ill-treatment in the penal institutions.¹⁵

¹⁵ Council of Europe, European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT), 4 December 2012, p. 11ff.

ANNEX 2 – SELECTED ECONOMIC INDICATORS

	2006	2007	2008	2009	2010	2011	2012	2013
Output and Expenditure	<i>(Percentage change in real terms, s.a.)</i>							
GDP	6.5	6.9	5.8	-5.0	0.7	2.0	0.5	1.1
Private consumption	8.6	11.3	3.7	-6.4	0.5	1.8	3.9	-2.3
Public consumption	3.8	1.3	-1.0	-7.7	2.1	1.8	-1.0	2.8
Gross fixed capital formation	13.0	13.1	22.0	-17.4	-18.3	-4.6	2.0	-0.1
Exports of goods and services	7.7	19.6	2.5	-11.7	17.2	11.5	0.8	9.2
Imports of goods and services	15.9	22.6	4.9	-21.5	4.1	8.5	4.5	4.9
Industrial gross output	5.2	9.2	-8.7	-13.1	5.2	-0.5	5.9	-0.4
Labour market	<i>(Percentage change)</i>							
Gross average monthly wages (end-year)	13.0	22.4	22.9	8.9	8.6	8.2	4.1	7.6
Real LCU wage growth
	<i>(In per cent of labour force)</i>							
Unemployment rate	8.9	6.9	5.6	6.8	10.2	11.3	12.3	12.9
Prices	<i>(Percentage change)</i>							
Consumer prices (annual average)	7.4	7.6	12.0	2.5	6.0	3.4	2.4	0.4
Consumer prices (end-year)	6.1	11.6	7.2	1.6	4.4	2.0	2.8	-0.9
Fiscal Indicators	<i>(In per cent of GDP)</i>							
General government balance	3.3	3.3	2.9	-0.9	-4.0	-2.0	-0.5	-1.9
General government revenues	37.0	38.2	38.0	35.3	32.7	32.4	34.0	35.5
General government expenditure	29.2	29.0	29.1	31.1	32.4	30.5	29.8	32.3
General government debt	23.4	18.6	15.5	15.6	14.9	15.4	17.5	16.4
Monetary and Financial Sectors	<i>(Percentage change)</i>							
Broad money (M2, end-year)	26.9	31.3	8.9	4.2	6.3	12.2	8.4	8.9
Credit to the private sector (end-year)	19.4	72.4	32.3	2.3	2.5	5.4	5.0	0.1
	<i>(In per cent of total loans)</i>							
Non-performing loans ratio	2.2	2.1	2.4	6.4	11.9	15.0	16.6	16.9
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>							
Local currency deposit rate	3.2	3.7	4.4	6.2	4.1	3.4	3.1	2.4
Foreign currency deposit rate	2.8	3.5	4.8	4.5	3.1	3.3	3.3	2.2
Lending rate	8.9	10.0	10.8	11.3	11.1	10.6	9.7	9.1
Interbank rate (end-month)	3.6	5.4	6.4	2.8	2.1	1.8	0.5	0.3
Policy rate (Rediscount rate)	3.3	4.6	5.8	0.6	0.2	0.2	0.0	0.0
	<i>(RON per US dollar)</i>							
Exchange rate (end-year)	1.49	1.33	1.39	1.36	1.47	1.51	1.48	1.42
Exchange rate (annual average)	1.56	1.43	1.34	1.41	1.48	1.41	1.52	1.47
External sector	<i>(In per cent of GDP)</i>							
Current account	-19.7	-28.9	-25.7	-8.5	-1.5	0.1	-1.1	2.1
Trade balance	-24.3	-26.1	-27.3	-14.3	-10.0	-7.8	-11.5	-8.8
Merchandise exports	44.6	42.2	41.9	32.3	42.4	50.5	50.8	54.1
Merchandise imports	68.9	68.3	69.2	46.6	52.4	58.3	62.3	62.9
Foreign direct investment	23.4	32.7	15.2	10.9	4.0	9.2	-3.0	-0.3
Gross reserves, excluding gold (end-year)	32.3	37.5	31.5	33.9	31.7	27.3	35.0	33.6
External debt stock	77.1	91.0	102.2	104.8	100.7	90.5	92.1	90.0
Public external debt	13.8	9.7	6.9	7.8	7.8	7.0	8.7	8.3
Private external debt	63.3	81.3	95.3	97.0	92.9	83.6	83.4	81.6
	<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	4.9	5.3	4.8	7.4	6.7	5.3	6.4	6.3
Memorandum items	<i>(Denominations as indicated)</i>							
Population (mid-year, millions)	7.7	7.5	7.5	7.4	7.4	7.3	7.3	7.3
GDP (in billions of leva, nominal)	52.5	62.4	71.3	70.6	71.9	78.4	80.0	80.3
GDP per capita (in USD, nominal)	4,370.6	5,783.0	7,115.9	6,738.1	6,580.5	7,588.8	7,198.0	7,498.8
Share of industry in GDP (in per cent)	30.4	31.2	30.2	30.9	27.8	30.0	30.1	27.9
Share of agriculture in GDP (in per cent)	7.4	5.6	7.2	5.1	5.1	5.4	5.4	5.5
FDI inflow (in billions of USD)	7.9	13.9	10.3	3.9	1.9	2.1	1.6	1.9
External debt - reserves (In US\$ billion)	16.2	26.3	34.7	32.9	33.1	30.0	30.1	33.1
External debt/exports of goods and services (per cent)	127.5	159.4	165.0	227.1	180.1	128.9	144.9	138.3

ANNEX 3 - ASSESSMENT OF TRANSITION CHALLENGES

Rating for: Market Structure	Rating for Market Institutions	Remaining Key challenges:
CORPORATES		
Agribusiness		
<i>Small</i>	<i>Medium</i>	<ul style="list-style-type: none"> • <i>encouraging land consolidation to facilitate economies of scale and thus productivity improvements</i> • <i>expanding the legal framework for effective, market-based financing tools to ease access to finance to primary agriculture</i> • <i>improving and developing grain infrastructure supportive of effective agribusiness development (primarily irrigation systems, warehouse facilities, grain terminal and ports along Danube River and Black Sea)</i>
Manufacturing and Services		
Small	Medium	<ul style="list-style-type: none"> • <i>reforming the regulatory regime in order to improve the business environment, including with respect to dealing with permits and licences, labour contracts and insolvency procedures;</i> • <i>reforming the education system and vocational training policies in order to address the needs of the business community</i> • <i>providing adequate incentives for efficient use of energy and water and gas as well as for R&D investments conducive to productivity increase.</i>
Real Estate		
Medium	Small	<ul style="list-style-type: none"> • <i>further increasing the supply of modern sustainable commercial property</i> • <i>further increasing the focus on energy efficiency and sustainability.</i>
ICT		
Small	Small	<ul style="list-style-type: none"> • <i>continuing to develop the telecommunications infrastructure (broadband internet)</i> • <i>increasing competition in the fixed segment.</i>
ENERGY		
Natural Resources		
Small	Medium	<ul style="list-style-type: none"> • <i>taking steps to bolster the financial position of Bulgartransgaz and complete the restructuring and commercialisation of the gas sector</i> • <i>achieving technical upgrades in the coal sector</i> • <i>taking steps towards the privatization of coal assets</i> • <i>reinforcing the governance and transparency in the mining sector.</i>
Sustainable Energy		
Large	Small	<ul style="list-style-type: none"> • <i>strengthening legal and institutional framework for supporting sustainable energy</i> • <i>refurbishment of the inefficient capital stock in the</i>

Rating for: Market Structure	Rating for Market Institutions	Remaining Key challenges:
		<p><i>economy to reduce energy intensity</i></p> <ul style="list-style-type: none"> • <i>further project and capacity development for climate change initiatives improving collections in the sector.</i>
Power		
Large	Medium	<ul style="list-style-type: none"> • <i>strengthening the independence of the regulator</i> • <i>increasing competition in both the wholesale and retail energy markets</i> • <i>removing end user price regulation and cross subsidies</i> • <i>improving cross border trading</i> • <i>introducing cost reflective tariffs for end consumers</i> • <i>increasing cross border trade.</i>
INFRASTRUCTURE		
Water and wastewater		
Medium	Small	<ul style="list-style-type: none"> • <i>full decentralisation of water infrastructure to local authorities</i> • <i>improvements in the predictability of regulatory practices</i> • <i>introduction of good contractual arrangements, where utility companies are accountable towards their local community and customer base.</i>
Urban Transport		
Small	Medium	<ul style="list-style-type: none"> • <i>more integrated urban transport planning, including adequate implementation of a robust Public Service Contract structure, consolidation of the small operators, implementation of the EU compliant legislation and regulation for the urban transport sector</i> • <i>contractual improvements related in particular to the tariff setting which is controlled by the local governments; and strengthening the role of private sector in some cities through the implementation of new or revised public service contracts in order to make operators creditworthy from a contractual standpoint.</i>
Roads		
Medium	Medium	<ul style="list-style-type: none"> • <i>greater independence for the road agency</i> • <i>better articulated use of road user charges</i> • <i>development of road PPPs</i>
Railways		
Small	Medium	<ul style="list-style-type: none"> • <i>improvements in financial mechanisms including fine-tuning PSO and access charge contracts</i> • <i>further enhancement of PSP and competition in the market</i> • <i>further commercialisation and restructuring of incumbent railway companies</i> • <i>improvements in regulation.</i>
FINANCIAL INSTITUTIONS		
Banking		

Rating for: Market Structure	Rating for Market Institutions	Remaining Key challenges:
Small	Medium	<ul style="list-style-type: none"> • <i>consolidating the market in order to address the capital constraints faced by some smaller players and some foreign owned subsidiaries</i> • <i>developing local funding opportunities through bond issuance and syndicated lending</i> • <i>improving bankruptcy legislation.</i>
Insurance and other financial services		
Small	Small	<ul style="list-style-type: none"> • <i>improving insurance supervision.</i>
Micro, Small and Medium-sized enterprises		
Small	Medium	<ul style="list-style-type: none"> • <i>developing limited funding available to SMEs and support for newly established and small growing firms</i> • <i>expanding the coverage of credit information services and establishing a geographically unified collateral registry.</i>
Private equity		
Medium	Small	<ul style="list-style-type: none"> • <i>developing additional investment strategies</i> • <i>developing local investor base.</i>
Capital Markets		
Medium	Small	<ul style="list-style-type: none"> • <i>developing money market benchmarks and forward markets</i> • <i>expanding corporate bond market.</i>

ANNEX 4 – LEGAL TRANSITION

This annex offers an analysis of legal sectors directly relevant to the Bank’s investment strategy for the forthcoming period. It is based on the research and assessments conducted by the EBRD Legal Transition Programme.¹⁶ First, the annex will consider laws and regulations supporting competitiveness, then a number of specific legal topics relevant to the infrastructure sector.

Corporate Governance

The Commercial Act enacted in 1991 (and amended several times thereafter) is the main legal text setting forth the rules on the establishment and operation of companies. In addition, a National Corporate Governance Code was enacted in October 2007 and amended in February 2012. The Code contains recommendations to Bulgarian companies on the application of good corporate governance practices and principles. The Code is to be implemented according to the so-called “comply or explain” principle.

The most recent EBRD assessment on corporate governance showed Bulgaria being in “Medium Compliance” with the OECD Principles of Corporate Governance. The assessment revealed challenges especially in the “responsibilities of the board” sector. The framework has been improved by the progressive transposition of the *Acquis Communautaire*. At 18 January 2012 (last data available online),¹⁷ Bulgaria appears to have duly transposed 90 per cent of all *Acquis* in the field of company law. However, while the legal framework “on the books” has improved, still some gaps exist. In particular, the regulator may wish to be more vigilant on how companies “comply or explain” with the national corporate governance code and should develop a model corporate governance disclosure template that companies can adopt for their “comply or explain” disclosure.

Insolvency/ Bankruptcy and Restructuring

The Commercial Act is also the main source of legislation for insolvency matters. There is one bankruptcy procedure, which can, in theory, result in either the liquidation of a business or in its rescue pursuant to a reorganisation plan. In practice, the bankruptcy framework is overwhelmingly liquidation focused and very few reorganisation plans are proposed and/or succeed. Judicial reorganisation under the bankruptcy provisions of the Commercial Act is only available for businesses that are technically insolvent and is not, as is common now in other jurisdictions, available also for businesses that are at risk of insolvency. The law provides that the creditors’ committee may vote on a reorganisation plan. Nevertheless the formulation of the reorganisation plan is debtor driven and occurs late in the bankruptcy proceedings, once the date of the initial insolvency has been determined and creditors’ claims have been submitted. There is no mechanism for agreement of an accelerated or pre-packaged reorganisation plan under the Commercial Act. A recent European Commission recommendation on insolvency, issued in March 2014, sets out a number of principles to be reflected by Member States, including Bulgaria, in their national insolvency/ bankruptcy legislation. An accompanying press release from the Commission cited Bulgaria as one of the EU countries that currently fail to promote the early judicial reorganisation of businesses.

¹⁶ See www.ebrd.com/law

¹⁷ http://ec.europa.eu/internal_market/company/official/index_en.htm

In addition to the issue of the weak judicial reorganisation procedure referred to above, concerns were expressed by stakeholders during policy dialogue meetings in 2014 about the general process for admission and approval of claims in bankruptcy, including the admission of bogus unsecured claims and failure by certain debtors to list or notify existing creditors of the bankruptcy proceedings; underrepresentation of secured creditor interests in the creditors' committee; lack of cooperation and information sharing by debtor's management and shareholders with the appointed trustee or receiver and inability to compel their assistance with the office holder; and an overall lack of transparency and information-sharing during the judicial process with creditors.

The bankruptcy system relies on strong judicial control. Although creditors are free to select the insolvency office holder and determine his/ her remuneration, the appointee is required to submit monthly reports to the Court and to obtain permission from the Court to carry out key tasks in the administration of the bankruptcy case.

The Commercial Act was reformed in 2013 to limit the previously open-ended claw back provisions, which had caused significant legal and commercial uncertainty for local creditors. Both the EBRD and the IMF contributed their views and international experience to the reform debate and advocated the importance of clearer, more balanced provisions.

Going forward, Bulgaria should examine how it could strengthen its judicial reorganisation procedure by creating a wider entry point for debtors at risk of insolvency and promoting a faster track process. Treatment of creditors within the bankruptcy process should also be re-examined to ensure that there is sufficient protection of genuine creditors from bogus claims and greater transparency of information provided to all creditors.

Contract enforcement / judicial capacity

Bulgaria's judiciary comprises courts of general jurisdiction dealing with all civil (including commercial) and criminal matters, as well as administrative courts. Commercial matters are brought before either regional or district courts, depending on the value and type of dispute, with appeals lying generally to courts of appeal and the Supreme Court of Cassation. At courts of all levels, commercial matters are heard by specialised commercial panels (divisions). The State Judicial Council is responsible for judicial appointments and discipline and for the overall management of the judiciary. The National Institute of Justice is responsible for professional training of judges; it conducts a mandatory initial judicial training programme, as well as continuous training courses for judges and magistrates. Continuous training embraces modules of commercial law and related disciplines such as accounting skills, an area developed with EBRD assistance which has since become a model for a regional training programme.

Public confidence in the judiciary remains low, and concerns persist about lack of judicial independence and corruption. Bulgaria remains subject to the Cooperation and Verification Mechanism (CVM), established by the European Commission when Bulgaria joined the European Union in 2007 in order to assess the commitments made by Bulgaria in the areas of judicial reform up accession. The Commission's most recent progress report noted improvements in appointment procedures and reducing judicial backlogs, however overall progress was assessed to be fragile, with more work remaining to be done. Controversies have continued to arise, such as judicial appointments having to be cancelled due to integrity issues, and revelations about political influence on judges in particular cases. Further, there

remain rather few cases in which cases of corruption have been brought to conclusion in court.

The *EBRD Judicial Decisions Assessment* found court judgments in commercial law matters in Bulgaria to be generally predictable and of reasonable technical quality. Case law is accessible to the public through a centralised online system for the publication of judgments of all courts. Guidance notes issued by the superior courts are mandatory for all lower courts, which contributes to a certain degree of uniformity of jurisprudence. The ability of practitioners to request such guidance through the Bar Association allows the guidance to tackle on controversial practical matters. Enforcement of court judgments has improved recently, however the rates of enforcement remain quite low, particularly in relation to disputes with government authorities, which are within the exclusive competence of the state agents. The speed of justice remains a concern, although improvements have been achieved, in particular through introducing a “fast track” procedure for relatively simple cases.

The focus of Bulgaria’s judicial reform efforts in the medium term should be on implementing all recommendations of, and making substantial progress under the CVM, such that the mechanism can ultimately be discontinued. This would represent a substantial achievement and instil greater public and investor confidence in the reliability of the court system.

Public-Private Partnerships (PPP)/Concessions

Bulgarian PPP/Concessions legislation is centred on the Concessions Act of 2006 (the “Concessions Act”) and the recent Public-Private Partnership Act of 2012 (the “PPP Act”), supported by a number of implementing regulations.

The Concessions Act regulates various forms of concessions such as BOT (Build-Operate-Transfer) and some of the derived models, including BOO (Build-Own-Operate) and BOOT (Build-Own-Operate-Transfer). Concessions can be granted for the majority of sectors, through a competitive procedure and in a flexible project agreement framework. Application of fair and transparent tender selection process is mandatory under the law, as well as proper remedies for breach are available.

However, the Concessions Act does not deal with non-concessionary forms of PPPs, which has been deemed a substantive bottleneck for development and implementation of a wider range of PPP projects, in particular PFI-type projects in “non-cash-generating” sectors. Addressing this gap has been the major goal of the government in promulgating the PPP Act in 2012.

The PPP Act regulates contracts where public sector finance provision is restricted or where consumer fee is insufficient to attract private sector interest. The PPP Act therefore allows Private Finance Initiative-type of projects and overall creates quite comprehensive framework for the PPP projects. In particular, the PPP Act defines sectors in which PPP projects can be developed, including urban and social infrastructure, and guides through the principles of distribution of risks between the public and private partner. The PPP Act further sets forth rules of selecting a private partner to a PPP project and governs the key terms of a PPP contract. The PPP Act employs several modern instruments, such as unsolicited proposals and institutional forms of PPP.

Despite the significant progress brought by the PPP Act, it has provided a major legal obstacle to implementing most PPPs in the country with the addition of Article 18a to Chapter Two of the Concession Act which extends the liability of the project company concessionaire under the Concession Law to its shareholders contrarily to the basic principle of project financing.

The PPP-based models have been used in transport and municipal sector with a number of new projects foreseen in the pipeline in transport, energy and social infrastructure.

Public Procurement

The current Public Procurement Act was adopted in 2004 and has undergone 25 amendments since. The Bulgarian legislation follows principles of EU public procurement directives and covers all public contracts in state and utilities sector. In the EBRD 2010 assessment Bulgarian law and practice scored medium-to-high compliance with international standards and it was found that several transparency safeguards and efficiency instruments were not incorporated in legislation. The 2010 assessment revealed that local procurement practice is outdated and bureaucratic, electronic communication is not mandatory by law and is not used in practice and frequent changes to the public procurement laws cause severe implementation problems. Some improvements to the public procurement legislation were recorded by the EBRD review completed in 2012, but overall Bulgarian public procurement framework is in a need of reform to meet standards of the 2014 EU public procurement directives.

Bulgaria is currently developing an Implementation Plan of the National Strategy for Developing the Public Procurement Sector in Bulgaria for the Period 2014 – 2016 with the EU Commission, which includes a public procurement reform program. The public procurement reform programme is based on implementing eProcurement procedures and tools, according to the new 2014 EU Directives. The EBRD provides policy advice to prepare and implement eProcurement reforms in Bulgaria, under the PISSA (Project Implementation Support Service Agreement) signed with Bulgarian government in 2013.

To address current problems, the new legislation needs to be developed and adopted, regulating all stages of the public procurement process in compliance with the 2014 EU directives. The reform should aim to establish modern procurement procedures and a new institutional framework, with eProcurement procedures and tools increasing transparency and accountability of procurement decisions. The main policy recommendations include introducing the following:

- new procedural rules for transferring all public procurement methods to electronic environment, as prescribed by 2014 EU Directives;
- new procurement methods as proposed by 2014 EU Directives;
- institutional structures for enabling eProcurement procedures and tools to be used by all contracting entities for public procurement in state and utilities sector in the country;
- new institutional framework for regulatory and reporting obligations;
- institutional framework for central purchasing, based on electronic purchasing and/or framework agreements and e-catalogues and dynamic purchasing systems for low value contracts.

ANNEX 5 – EBRD AND THE DONOR COMMUNITY

The Bank has limited donor funding available in Bulgaria, but where possible will provide technical assistance (TC) in Bulgaria in support of selected investment projects and policy dialogue. TC is required in areas of municipal infrastructure and sustainable energy as well as to support legal transition and strengthening capacities of public sector institutions. The Bank will aim to engage donor funds, for instance the EBRD-ELENA (European Local Energy Assistance) Facility, as well as its own resources to support this goal. The Bank will also consider engaging with Bulgarian authorities on utilising EU Structural and Investment Funds through financial instruments and EBRD advisory assignments.

- **Bilateral donors:** grants will be sought from donors through their bilateral donor accounts administered by the EBRD, although availability of such funds is likely to continue to be scarce.
- **The EU:** The Bank will strive to develop new business opportunities by maximising EU co-financing opportunities in Bulgaria. Under the 2014-2020 multiannual financial framework, the EU is committed to a more effective use of the European structural and investment funds, notably through an increase of the use of structured financial instruments. The Bank will aim to engage with the EU, Bulgarian authorities and other partners in an effort to devise new financial instruments and to secure co-financing synergies with EU financial facilities.
- **Kozoduy International Decommissioning Support Fund (KIDSF)** was established at the EBRD in 2001 with the purpose of financing projects in support of the decommissioning of Kozloduy Nuclear Power Plant Units 1-4, projects in the energy sector consequential to the early closure of the four nuclear units as well as energy efficiency measures. As part of the EU accession process Bulgaria agreed to close Units 1 and 2 in 2003 and Units 3 and 4 in 2006. The European Community recognised the financial consequences of the early closure and committed €870 million for the Kozloduy decommissioning programme in the period from 1999 to 2013. In 2013, the EU decided to extend its assistance programme to 2020 and committed an additional €293 million. As of the end of 2013 the overall contributions to KIDSF from the EU and ten governments reached €882.647 million, of which €867.7 million was from the EU.
- **EBRD Shareholder Special Fund (SSF)** endowed by the Bank's net income. The SSF is a complementary facility to donor resources and will provide TC and non-TC support in areas where there is a shortage or lack of support, but where it remains as a priority area for the Bank to advance transition.