DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR BULGARIA

As approved by the Board of Directors on 15 October 2003

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EXECUTIVE SUMMARY

Bulgaria continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. Under Prime Minister Simeon Saxe-Coburg-Gotha, in office since June 2001, the country has been well regarded for its pursuit of economic and financial reforms. It is a candidate for EU membership at the next accession round in 2007. Improved political stability on a regional level has led to signing of free trade agreements with all neighbouring countries and an increasing role for Bulgaria as a regional energy hub. The proposed strategy aims to provide strong support to Bulgaria's efforts to accede to the EU.

Over the past few years, Bulgaria has capitalised upon the good macroeconomic performance and strong financial discipline achieved following the adoption of a currency board regime in 1997 and the implementation of a tight fiscal policy thereafter. GDP growth has been robust, reaching 4.8 per cent in 2002, thanks to strong domestic investment growth, fuelled by a rapid expansion of credit to the private sector and further progress in structural reforms. Exports have continued to perform well in spite of the economic slowdown in the EU, Bulgaria's main trading partner. A lower trade deficit, higher receipts from a booming tourism sector, and lower interest payments on debt, have contributed to a significant reduction in the current account deficit in 2002. However, FDI remains low in per capita and cumulative terms compared to the more advanced accession countries, partly a reflection of Bulgaria's weak, albeit improving, investment climate. Sustained growth, together with a tight fiscal policy and an active debt management policy, contributed to a sharp fall in Bulgaria's public and external debt ratios.

Against the background of this strong macroeconomic picture, the political agenda has of late encroached somewhat upon the remaining privatisation and structural reform agenda, with progress in both areas slowing down as a result. This can be witnessed in the difficulties surrounding the attempts to complete the sale of the tobacco and telecom companies. Added to this is the need to proceed further with judicial reform and combating corruption. Despite achievements in improving living standards and reducing unemployment, the population at large is yet to feel much better off. Income inequality has increased since the beginning of transition and, according to the latest World Bank household survey data, 24 per cent of the population is still living in poverty.

The government now needs to press ahead to complete the reform agenda. This is necessary to position the country as an FDI location of choice, to succeed with EU accession, and to continue to promote the integration of South East Europe through regional projects and good neighbourliness. The key transition challenges for Bulgaria are to:

- Implement judicial reform to improve the country's investment climate and attract much-needed FDI;
- Complete the privatisation process in a transparent manner and accelerate the restructuring of public utilities;
- Accelerate the deregulation and privatisation of the energy sector, already under way in generation and distribution;
- Strengthen the administrative and implementation capacity of the public administration, resulting in greater utilisation of EU pre-accession funds;
- Focus on social issues and sustainable improvement of living standards while maintaining macroeconomic stability.

The Bank's activities and portfolio have increased substantially over the last 24 months, reflecting the positive developments in the country. The Bank is a major catalyst for investment in Bulgaria (cumulative business volume of €784.2 million as part of total funds mobilised of €3.2 billion) and is positioned to play a crucial role in helping the country through the challenges ahead. The objective is to fully and proactively support Bulgaria by further supporting the development of the private sector and expanding activities in infrastructure. The Bank's strategic priorities and transition goals are therefore:

- **Private Sector Development**. The Bank will seek to play a key role in promoting post-privatisation investment and greenfield private sector projects in industry, tourism, agribusiness and natural resources, as the main source of attracting new FDI for the country. The Bank will broaden its geographical coverage of the micro, small and medium-sized private enterprises through carefully selected additional Bulgarian partner banks benefiting from SME credit lines. Technical assistance, such as provided by the EC, will support institution building and the implementation of effective and efficient lending programmes. The Bank will also place a key emphasis on supporting the development of non-banking FI sector, including the development of a three-pillar pension system, private insurance markets, leasing and mortgage financing.

- **Infrastructure.**

The Bank will focus on the following areas:

- Energy and Energy Efficiency - the Bank's first priority will be to support the privatisation of the energy sector, both in generation and distribution, as well as financing new generation capacity. Given Bulgaria's high energy intensity (one of the highest in the world), the Bank will promote improvements in energy efficiency and renewable energy resources. Capitalising on its experience to date, the Bank will support rehabilitation and commercialisation of the district heating networks. Close co-operation will be maintained with donor community of the Kozloduy International Decommissioning Support Fund established at the Bank in order to provide grant financing for decommissioning of unsafe nuclear units, and energy and energy efficiency measures consequential to the closure of nuclear units. Furthermore, the Bank will continue its policy dialogue with the authorities to promote improvements to the legal and regulatory framework in the sector.
- Municipalities - The Bank will support decentralisation and commercialisation of the MEI sector, by increasing the share of private sector involvement and facilitating ISPA co-financing. This must be accompanied by institutional and regulatory reforms. By directly providing investment financing to municipalities and municipal and regional utilities without a state guarantee, the Bank will support decentralisation of financing responsibilities and will contribute to the enhancement of the creditworthiness of municipal borrowers, thereby developing their long-term capacity for financing capital improvements on a sustainable basis.
- Telecommunications - The Bank is ready to support and facilitate the privatisation of the incumbent operator, Bulgarian Telecommunications Company (BuTeCo), through the provision of post-privatisation long term financing, and support a fully competitive environment in both the fixed and mobile sectors. The Bank will encourage the development of an effective regulatory regime fully consistent with EU accession principles and demonstrably independent of government.

Co-Financing and Pre-Accession Funds. The Bank will continue to be a major catalyst in mobilising co-financing, both commercial and donor, as in the recent Maritsa East III, Sofia District Heating and Sofia Transport projects. The syndication of project financing to both foreign and local commercial banks will therefore be strongly sought, as will co-financing opportunities with other IFIs and EU programmes to address, among other things the environmental or social components of projects. The Bank's policy dialogue will be closely co-ordinated with IMF, the World Bank and the EC in order to ensure the successful implementation of this strategy.

The Bank will continue to ensure that all EBRD operations in Bulgaria are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans.

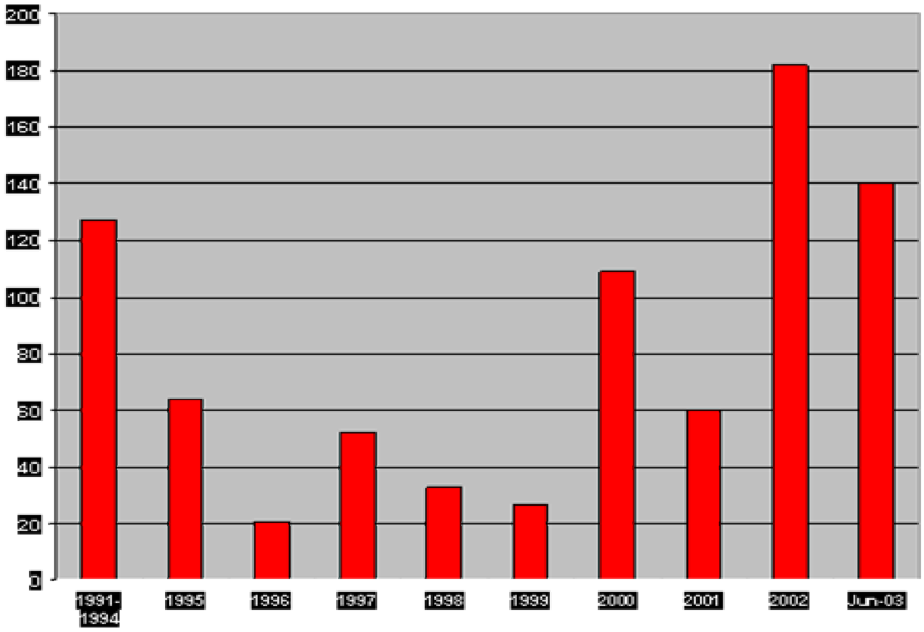
1. The Bank's Portfolio

The Bank has achieved the operational objectives set out in the 2001 Strategy. The cumulative transition impact has been considerable, portfolio performance is satisfactory and the Bank is very keen to build on success thus far and continue to add significant value to the completion of reforms in Bulgaria.

1.1 Overview of Activities to Date

As of end-July 2003, the Bank had achieved a cumulative business volume of €784.2 million (US$ 907 million) in sectors such as banking, energy, municipalities, agribusiness, general industry and other, 40% of which since the last strategy in December 2001 (see chart below):

Annual Business Volume in € millions



The Bank has signed 76 individual transactions, 35 of which are follow-up operations with existing clients, thus yielding a total of 41 investments, including allocations from 12 regional projects, and mobilising total funding of €3.2 billion (US$ 3.7 billion). The outstanding portfolio amounts to €551.7 million (US$ 638.1 million), of which €284.8 million (US$ 329.4 million) operating assets. The portfolio growth over the last two years was significant, 42 per cent. However, the staged nature of some large projects in the energy sector and the depreciation of the US$ against the Euro over the last year, have led to a 36 per cent gap between the portfolio and operating assets. The gap should gradually close by end-2005, when most of the significant energy projects have been implemented. Table 1 gives an overview of portfolio development since the last strategy. A more detailed description of the portfolio by sector is given in Annex 4B.

Table 1: Bulgaria Portfolio Development (2001 – 2003)

	September 2001				September 2003*			
Indicators	Number	%	Amount	%	Number	%	Amount	%
Projects in public sector	5	10	115	29	8	14	163.2	30
Projects in private sector	46	90	278	71	48	86	388.6	70
Total:	**51**	**100**	**394**	**100**	**56**	**100**	**551.7**	**100**
- of which: Loans	24	47	325	84	24	43	475.6	86
- of which: Equity	27	53	69	16	32	57	76.2	14

Note: Some projects include both loans and equity. Figures are net of full repayments and cancellations. Amounts are in € millions

The distribution of the Bank's portfolio in Bulgaria is broad with no single sector dominating. In relative terms, the largest exposure is in energy (€198.1 million - US$ 229.1 million, 35.9 per cent of total portfolio), then financial institutions (€ 107 million - US$ 123.8 million, 19.4 per cent), general industry (€68 million - US$ 78.6 million, 12.3 per cent), transport (€41 million - US$ 47.4 million, 7.4 per cent) and agribusiness (€60.7 million - US$ 70.2 million, 11 per cent). The debt to equity portfolio ratio is 86 per cent to 14 per cent. The share of equity investments has fallen somewhat since 2001 (previous ratio 71 per cent/29 per cent).

The overall performance of the Bank's portfolio has been satisfactory, although several projects with weak local and international sponsors have had to be restructured. The total number of impaired operations is five, totaling €33.2 million (US$ 38.4 million), equal to 11.7 per cent of operating assets of €284.4 million (US$ 328.9 million). These projects reflect the first wave of private projects done in the mid-nineties, when FDI inflows were particularly weak and the Bank was keen to encourage private sector investment. Whilst the potential for further sovereign operations is limited, there is considerable scope for sub-sovereign public projects (with sponsors such as municipalities and regions), which would increase public sector portfolio volumes.

Finally, 62 technical co-operation projects totalling €19.7 million (US$ 22.8 million) have been approved (see Annex 5). In addition, one Nuclear Safety Account grant of €24 million (US$ 27.8 million) for the Kozloduy nuclear plant was committed in 1993.

1.2 Implementation of the Previous Country Strategy

The last country strategy, approved in December 2001, outlined the following strategic priorities for the Bank in Bulgaria:

(i) promote the corporatisation, commercialisation and privatisation of public infrastructure and services, the power sector and municipal infrastructure in particular;

(ii) continue involvement in privatisation and post privatisation projects in the industrial and agribusiness sectors, primarily with foreign direct investment through green field projects; and

(iii) further support the development of financial sector by working with new intermediaries and by offering new instruments.

During this period, the Bank completed 14 operations, split 70/30 between private and public sector. Energy and infrastructure project financing was a prominent part of this. A total of €213 million (US$ 246.3 million) was approved for the upgrade of the power transmission network and Sofia district heating and transport improvements, as well as for the financing of the landmark Maritsa East III project, the first large privatisation in the power sector and the largest foreign investment to date in the country. The Bank's investment was part of a €350 million (US$ 404.8 million) limited recourse package with participation of nine foreign and local banks. In addition, the Bank has played an important role in the drafting of the new Energy Law providing for liberalisation of the market and is also mobilising technical assistance for the privatisation of power distribution companies.

In support of private sector development, total financing of €65 million (US$ 75.2 million) was provided. The Bank extended its investment in Sodi Devnya, the top local soda ash producer, for a further five years and restructured and took control of a paper factory project, preserving full employment in the factory and developing new markets for its products.

In the financial sector the Bank provided two new SME credit lines totalling €20 million (US$ 23.1 million) to local banks, and concluded its first equity investment in a local bank since 1997.

1.3 Transition Impact of the Bank's Portfolio

The Bank has played a major role in promoting and supporting Bulgaria's transition to a free market economy. This role has evolved in response to the country's changing needs during the transition process and can be summarised as significant, according to the findings of the Bank's Transition Impact Retrospective (TIR) in 2001[1].

BULGARIA – Transition Impact Retrospective	
FINANCIAL INSTITUTIONS	
Banking	Significant
Non-Banking Financial Institutions	Significant
SMEs	Moderate
SPECIALISED and GENERAL INDUSTRIES	
General Industry	Significant
Telecommunications	Moderate
Property & Tourism	Minimal
Agribusiness	Significant
INFRASTRUCTURE	
Transport	Moderate
Municipal & Environmental Infrastructure	Very Significant
ENERGY	
Energy Efficiency	Moderate
Natural Resources	Minimal
Power	Very Significant

Since then, the Bank's operations have been focused on sectors in which the TIR found that we had achieved only moderate or minimal transition impact (SMEs, Telecoms, Natural Resources, Transport, Energy Efficiency and Tourism). More details are provided in Annex 4.

1.3.1 The Enterprise Sector

- The Bank has been active in supporting privatisation and restructuring of companies sponsored by both local management and foreign partners by providing long-term limited recourse finance, especially in the early and mid 1990's when such finance was otherwise unavailable. In 1996 the bank was involved in one of the first industrial privatisations, the sale of a personal care products manufacturer to a local investor. In 1997 the Bank participated in one of the biggest privatisations in the country - Sodi Devnya, the world's largest synthetic soda ash plant - to a foreign strategic investor. This privatisation has been successful and included a US$ 200 million (€173 million) modernisation and restructuring programme. In 2001, the Bank extended a loan to the largest pharmaceuticals producer in Bulgaria, as part of an investment programme to achieve GMP standards. Where possible, the Bank has made equity investments and has had an overall positive experience.
- The Bank has supported a number of projects in the agribusiness sector, although a few of them have only been moderately successful. Weaknesses in the selected sponsors limited the Bank's transition impact in Storco and Domaine Boyar, although the Bank's participation in the latter played a significant role in increasing competitive pressure in the sector and its policy dialogue resulted in a new grape law. The Bank's investment in Danone-Serdika brought to the country a strong sponsor with significant skill and demonstration effects. Through its participation in the Grain Receipts Programme jointly with local financial institutions, the Bank has devised innovative tools aimed at providing farmers with highly needed working capital financing.
- Early efforts of the Bank in the telecommunications sector, were aimed at preparing the dominant market operator, BuTeCo, for privatisation and market liberalisation through digitisation, restructuring and tariff rebalancing.

[1] The purpose of the TIR is to identify the pattern of the Bank's successes and under-achievements in promoting transition using a consistent assessment across all sectors and countries. The TIR looked at the Bank's impact on transition from five different angles: impact on capital flows, project level impact, sector level impact; impact on legal systems; and impact on the environment.

1.3.2 Infrastructure and Environment

- The Bank has played a key role in Bulgaria's power sector, with its first involvement in 1992 - when the sector was totally unreformed - in the Maritsa East II completion project. The project resulted in transformation of the entity into a joint-stock company, introduction of IAS and external audit, introduction of commercial management system, preparation of action plan for sector reform and partial success in tariff adjustment. In 2002 jointly with EIB the Bank financed an upgrade to Bulgaria's transmission network. In 2003 the Bank supported the first thermal power generation privatisation in the country by two major foreign investors, by leading a consortium of 9 other international and local banks in providing a EUR 350 million (US$ 404.8 million) syndicated loan to Maritsa East III, the largest direct foreign investment project to date. Over the last few years, the Bank has worked together with other IFIs and the authorities towards radical sector reform. This has moved forward the passing of the Energy Law and its subsequent update, setting up of an independent regulator, drafting of secondary legislation, separation of generation, transmission and distribution.
- In the energy efficiency sector, the Bank, complemented by parallel efforts from the World Bank, has had an extensive policy dialogue with the authorities in the preparation of the Sofia District Heating project. This dialogue has resulted in the identification of, and agreement on, the main regulatory and reform needs. The Bank is now working towards the implementation of these agreements in the course of the project.
- In the Municipal and Environmental sector, the Bank worked closely with the Sofia Municipality in its efforts to select a concessionaire for the city's water and waste-water system. After developing a concept paper for the city, the Bank mobilised a team of Phare-funded international consultants to advise and assist the city in an international competitive bid, which resulted in the selection of a concessionaire in 1999. Subsequently, the Bank arranged financing for the concessionaire with further scope for demonstration effects from the planned increased metering and tariff adjustment mechanism, as well as from attaining EU water quality standards. Important elements of the concession contract and dispute resolution provisions are likely to be reflected in the national regulatory framework. The Water and Waste Water Project Facility, currently under preparation in close coordination with EC, which is preparing ISPA grant co-finance, aims at repeating this positive experience with other cities.
- In the transport sector, slow reform and slow restructuring of the railway sector has hampered the Bank's efforts, although the financing of Bulgarian Railways led to an improved management information system, introduction of Public Service Obligation in the context of an agreed Restructuring Action Plan and exposure to Export Credit Agency ("ECA") financing. More recently the Bank has increased its presence in the sector through a non-sovereign syndicated loan to the City of Sofia to support the development of its urban transport system. This project brought about involvement of the private sector in the provision of bus services and maintenance work for the first time in Bulgaria.

1.3.3 The Financial Sector

- The Bank has played a major role in banking sector development, facilitating privatisation and involvement of strategic foreign investors. In 1997, the Bank participated in the first banking privatisation in Bulgaria, that of United Bulgarian Bank (UBB). Through an active role in the board of UBB the Bank has contributed significantly towards its institutional strengthening and balance sheet restructuring, helping UBB become the third largest bank in terms of assets and second in terms of capital and reserves. The Bank has supported foreign bank entry through an equity participation in BNP-Dresdner Bank, the creation of Pro-Credit Bank, and the development of new private banks through equity, credit lines and trade facilitation programmes. The Bank has been successful in reaching the SME segment, first through sectorial credit lines and more recently through dedicated credit lines (under the EBRD-EU SME Facility), for which momentum is growing.

- The Bank's investment in Bulstrad has facilitated the privatisation of one of the largest insurance companies in the country. This company ha1s also established the largest Bulgarian voluntary pension fund and is one of the six companies to receive a license for the management of the mandatory pillar of the new pensions system.

1.4 Lessons Learned

As seen above, the Bank has invested in a considerable number of projects to support private sector and infrastructure development. Through these investments the Bank has been able to improve corporate governance practices and policy dialogue. The Bank has also drawn valuable lessons related to coordination with, and between, various government bodies, monitoring of TC funding, turnaround management, and debt absorption capacities of public entities. The Bank will build on this experience to strengthen further the co-operation between the Bulgarian authorities and the business community, to support the restructuring and modernisation of the remaining companies due for privatisation, especially in the energy and energy efficiency and municipal sectors, and the development of the SME market.

The Bank's experience in Bulgaria has provided some general lessons to be taken into consideration for future operations:

- A thorough due diligence of project sponsors and investee companies should be conducted in each case;
- Make sure that management structure provides for adequate checks and balances to ensure sound corporate governance and control;
- Strong sponsor commitment is needed to support restructuring in difficult market conditions;
- For markets with higher risks, a phased project with clearly identifiable benchmarks is recommendable; and
- To maintain transition momentum, the Bank must increasingly consider more innovative, smaller and riskier projects with smaller local or foreign corporate or sub-sovereign sponsors requiring flexible structured products.

1.5 Portfolio Ratio

Based on the portfolio of €551.7 million (US$ 638.1 million), the private/public portfolio ratio stands at 70/30 per cent, virtually unchanged since the last strategy.

1.6 Mobilisation of Co-financing

In addition to its own investments, the Bank helped to mobilise a further € 2.42 billion (US$ 2.8 billion) of co-investment over the 1991- June 2003 period, representing a multiplier of 4.1x[2]. The total value of projects in which the Bank participated is € 3.2 billion (US$ 3.7 billion).

The Bank remains ready and able to help generate large co-financings, particularly for infrastructure projects or in the framework of large syndicated transactions in more difficult sectors such as energy, telecoms, etc. The Bank's risk mitigation and coordination role was key in mobilising co-financing for the Maritsa East III project, Sofia District Heating and Sofia Public Transport.

[2] Calculated as total project costs/cumulative business volume (EBRD commitments).

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political developments

The Union of Democratic Forces (UDF), which came to power in 1997, pursued economic and financial reforms in most sectors of the economy, but its popularity suffered from the austerity measures accompanying the reforms, infighting within the government coalition and allegations of corruption. In the 17 June 2001 election, both the UDF and its chief rival, the Bulgarian Socialist Party (BSP), were defeated by the National Movement of Simeon II (SIINM), set up only in April 2001, which obtained half of all the seats.

The former King, Simeon Saxe-Coburg-Gotha, became Prime Minister and formed a coalition with the Movement for Rights and Freedoms (MRF), the fourth largest party in the Parliament, supported mainly by Bulgaria's Turkish minority. SIINM's victory raised large expectations and provided a new lease of life and new enthusiasm for Bulgaria's reform programme. Its victory also confirmed the national consensus in favour of joining the EU and NATO. However, two years on, the ruling party has lost popularity among the electorate, having dropped to the third place behind the BSP and the UDF in recent poll ratings, and continues to face defections. The Government's mandate expires only in 2005, but it faces important local elections on 26 October 2003.

2.1.2 EU accession, NATO membership and regional integration

Bulgaria was invited in December 1999 to start membership talks with the EU. Since their start in March 2000, Bulgaria has achieved significant progress in reaching the objectives set by Brussels for candidate countries. The regular annual report on Bulgaria's progress towards EU accession by the European Commission published in October 2002 stated that Bulgaria was a "fully functioning market economy". At the Copenhagen summit in December 2002, Bulgaria's accession in 2007 was officially mentioned as a realistic prospect. By September 2003, Bulgaria had closed 25 out of the 30 chapters of the EU *acquis communautaire* opened so far, leaving the following chapters still to be dealt with: justice and home affairs; competition policy; agriculture; regional policy; financial and budgetary provisions. Some serious issues remain, notably that of the closure, as required by the EU, of the outdated and unsafe units at the nuclear power plant at Kozloduy.

Bulgaria has been a member of NATO's Partnership for Peace Programme (PfP) since 1994 and has since then concluded military co-operation agreements with a number of NATO member-states. In November 2002 it was invited to join NATO. The national consensus in favour of NATO membership, though it exists, is not as strong as that over the EU. The government's strong support for the United States over Iraq and its provision of bases for the US in Bulgaria, and its decision to send a small military force to Iraq have provoked criticism from the left, including from President Georgi Parvanov, a former leader of the BSP elected to his post in November 2001.

In South-Eastern Europe Bulgaria has been playing a constructive role in various regional co-operation schemes such as the Stability Pact for South East Europe. Bulgaria's relations with all its immediate neighbours (Turkey, Greece, Former Yugoslav Republic of Macedonia, Serbia & Montenegro and Romania) are good – as are those with Albania. As of August 2003, the country had signed or initialled bilateral Free Trade Agreements with all the South-Eastern European countries of the Stability Pact. These are expected to boost regional integration and trade. Currently, SEE accounts for less than 10 per cent of total Bulgarian exports, against a 55 per cent export share for the EU markets. Relations with Russia, which had cooled under the 1997-2001 UDF government, have improved under that of Prime Minister Simeon Saxe-Coburg-Gotha.

2.1.3 Social conditions

Bulgaria's population, at 8.1 million in 2001, declined significantly from the peak of 9 million in 1989. The decline is mainly the result of the change in the age structure. It also reflects the emigration of the country's ethnic Turks in the last years of the Communist regime and in the early post-Communist period and, lately, the brain drain of young and talented people seeking better employment opportunities in Western Europe and the United States. Poverty and income inequality have increased dramatically since the early years of transition. According to World Bank data based on national surveys, almost 24 per cent of Bulgaria's population was living below $2 a day in 2001[3], compared to less than 2 per cent in Poland and the Czech Republic. Poverty rates are higher in rural areas – especially among the ethnic minorities. Two out of five Bulgarian Turks and four out of five Roma live in poverty. Per capita income at purchasing power parity (PPP) was estimated by the World Bank at about US$ 6,740 in 2001, only 25 per cent of the EU average.

In the 2001 census, 4.6 per cent of the population identified themselves as Roma and 9.4 per cent as of Turkish origin. According to the EU Commission report of October 2002, the Turkish minority is integrated into political life through elected representatives at national and local levels but more needs to be done for the socio-economic integration of those ethnic Turks who live in economically underdeveloped areas. As regards the Roma, the report notes that Bulgaria has a good framework programme on integration of minorities especially targeted on Roma, but this has not yet been put into practice. The reports lists high rates of Roma unemployment, poor living conditions, problems regarding access to the healthcare system and low participation by Roma children in the state education system (of those Roma children who do enter school, very few go on to secondary education).

2.1.4 Labour issues

Labour market conditions in Bulgaria have improved since 2001. While the employment rate of the working-age population increased to reach 50.6 per cent in 2002, the unemployment rate (ILO definition) decreased to 13.7 per cent by end-June 2003, from 19.5 per cent at the end of 2001. The net job creation is mainly the result of a booming private sector, dominated by SMEs, but also of the active social policies undertaken by the Ministry of Labour and Social Affairs. The latter include the provision of incentives to encourage job creation in areas of high unemployment, by granting profit tax exemptions, and the creation of several national programmes designed to target specific groups of unemployed people and reduce the skills mismatch. The implementation of new measures to fight the grey economy (estimated at about 37 per cent of GNP in 2001), by giving incentives to firms to register their businesses and workers with unofficial jobs to drop from the unemployment registers, should help bring the official unemployment rate further down.

Despite these positive developments, long-term chronic unemployment still accounts for about 12 per cent of the Bulgarian active labour force (or more than two thirds of total unemployment), and regional differences in unemployment rates remain very pronounced, with the north-western region of the country well above the national average.

In 2002, gross average monthly earnings in the economy equalled EUR 128 (US$ 148), significantly lower than the EU and CEE average. Productivity gains have been higher than the increase in real wages in 2002, preserving Bulgaria's external competitiveness. Estimates of the size of the unionised share of the workforce range from 30 to 50 per cent, but this share continues to decrease as large firms lay off workers and most new jobs appear in small, non-unionised firms. The two largest trade unions are the Confederation of Independent Trade Unions of Bulgaria (KNSB), with an estimated 600,000 members, and Podkrepa, with an estimated membership of 150,000.

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[3] The country official 12.8 per cent poverty rate, reported in the Bulgaria 2001 Poverty Assessment by the World Bank, is based on a different poverty line definition. The World Bank study used a relative poverty line of two-thirds of the 1997 average per capita consumption, deflated by 2001 prices.

2.1.5 Integrity issues

Crime and corruption are concerns both of the public and of the government in Bulgaria and remain high on the public agenda, despite improvements in the situation. The level of corruption is commonly attributed to factors such as low salaries, imperfect legislation, lack of transparent administrative controls and poor functioning of the judicial system. A National Anti-Corruption Strategy was adopted by the Bulgarian parliament in October 2001, and an Action Plan for the Implementation of the Strategy covering the 2002-2003 period adopted by the cabinet in February 2002. The government's overall strategy is to create an institutional and legal environment for tackling and preventing corruption, by improving financial and fiscal control, reforming the customs agency, adopting measures in the Ministry of the Interior, improving the functioning of the authorities at local level, creating more transparency in financing of political parties and strengthening the role of Parliament in combating corruption. According to the EC report on Bulgaria's progress towards EU accession, published in October 2002, most elements have been followed up in the Action Plan, but, in the words of the report, “the challenge now will be to maintain the momentum to ensure the full implementation of the programme”.

The US State Department noted in March 2003 that in 2002 Bulgaria’s parliament had approved amendments to the penal code that prohibited the solicitation of bribes and had amended the law on privatisation to provide for a post-privatisation control mechanism. The report said that politicians and NGOs continue to criticise the Prosecutor-General's Office for its failure to prosecute vigorously large numbers of serious criminal cases, leaving the impression that the government lacked the will to crack down on organised crime and corruption.

Bulgaria's ranking in the Transparency International Corruption Perceptions Index for 2003 was 54th (together with the Czech Republic) out of 133 countries. It was ranked 44th out of 102 countries in 2002; and 47th (together with Croatia and the CzechRepublic) out of 91 countries in 2001. The Corruption Perceptions Index, first launched in 1995 and focusing on corruption by public officials, reflects the perceptions of businesspeople, academics and country analysts.

The European Commission in its regular report on Bulgaria’s progress towards EU accession published in October 2002 has drawn attention to the fact that Bulgaria is ‘a country of origin, transit and to a lesser extent destination for women and girls trafficked for the purpose of sexual exploitation’ The report notes that the Bulgarian government is making ‘significant efforts’ to tackle this and that it is cooperating closely with international organisations and NGOs to prevent trafficking. In October 2002 the Bulgarian parliament made trafficking in persons a criminal offence.

2.1.6 Legal reform

In recent years Bulgaria has significantly reformed its commercial framework, which has, to some extent, boosted public confidence in the rule of law and private contract enforcement. The country has been making consistent efforts in bringing its legal system into conformity with the European Union (EU) requirements and as a result Bulgaria’s commercial laws have reached a state of development largely comparable with international standards.

While overall progress has been good, several commercial law areas require further improvement in order to adequately respond to the expectations of local and international businesses and investors. This was especially true of bankruptcy laws. Recent amendments to the bankruptcy laws , discussed in more detail in Annex 2, Legal Transition, may help speed up insolvency proceedings.

The improvement in Bulgaria’s legal and regulatory framework had not until recently been matched by sufficient progress in reforming the judiciary, which remained the main weakness of the country’s legal system and was widely viewed as the key obstacle to the enforcement of foreign investors’ rights in local courts. However, in a major boost for judicial reform, in early 2003 all main political parties reached a formal agreement to overhaul the judiciary in line with EU recommendations, including by amending the Constitution. Then, at the beginning of September 2003, the Bulgarian Parliament approved constitutional changes that finalise significant reform of the justice system. These changes will make the judiciary democratically accountable and will limit its immunity. The Supreme Judicial Council will be able to dismiss judges and prosecutors who perform their duties inadequately or compromise the integrity of their position. The judiciary will only be granted life tenure after a five year probationary period. It is hoped that these changes will significantly improve the efficiency and reliability of the judicial systems and the effect of these changes will be watched with interest by the international community.

2.1.7 Environmental issues

Environmental policy objectives gained considerable recognition in Bulgaria due to the consistent effort by the Ministry of Environment and Water of Bulgaria in implementing the National Strategy for the Environment and Action Plan 2000-2006. The latest EU report on Accession Partnership with Bulgaria states that substantial progress has already been made in the approximation of environmental legislation to the EU *acquis* and in meeting environmental and sustainability priorities. A considerable decrease in ambient air pollutant emissions has been observed during the period 1998-2002 and resulted in improvement of the air quality. Water quality has also improved, though pollution of the Danube River and the Black Sea remain a concern. Bulgaria improved compliance of its environmental legislation with that of the EU and with the principles for sustainable development; continued the integration of its environmental policy in the process of structural reform and privatisation; moved further in achieving wider implementation of best environmental management principles in enterprises, and utilised a broader range of economic instruments to address pressing environmental issues.

Despite the progress made in the approximation of environmental legislation to the EU environmental *acquis,* further assessment is needed to identify the remaining gaps. Particular emphasis should be given to further improving access to information, air quality, waste management, water quality, nature protection, industrial pollution and risk management as well as nuclear safety and radiation protection. Bulgaria needs to ensure that the Environmental Impact Assessment Directive is properly implemented in preparing large-scale infrastructure projects. Bulgaria also needs to be more proactive in reducing the energy intensity of its economy, at all stages of the energy cycle, with a view to enhancing support for improving energy efficiency, increasing energy savings and enhancing the use of renewable energy sources. Further strengthening of regional inspectorates, municipalities and other public environment and energy-related bodies at the local level is required, as well as adequate training and improved staff development plans.

2.2 Progress in Transition and the Economy’s Response

2.2.1 Macroeconomic conditions for Bank operations

Since the last strategy was presented to the Board in 2001, macroeconomic developments have been favourable despite the sharp deterioration in the external environment. In 2002, the Bulgarian economy grew by 4.8 per cent, up from the 4.0 per cent GDP growth rate recorded in 2001. On the demand side, GDP growth has increasingly been driven by domestic demand and, in particular, by strong fixed investment (up by 18 per cent y-o-y in 2002), fuelled by a rapid expansion in credit to the private sector. A tight fiscal policy helped maintain the growth of household consumption to below 4 per cent in 2002. In spite of the slowdown in the EU, Bulgaria’s main trading partner, export growth in 2002 was strong and positively contributed to GDP growth. Strong growth in services and agriculture drove growth from the supply side. Over the short-term, annual GDP growth is likely to remain in the range of 4-4.5 per cent, as investment needs pick up ahead of EU accession, and net exports benefit from the expected moderate recovery of the EU markets. However, advances in structural reforms are needed to bring about further productivity increases in the medium/longer run, as wage differentials with the EU will gradually narrow.

End-year inflation moderated significantly to 3.9 per cent in 2002, following an increase in the first quarter, when electricity prices to end users and the prices of a number of administered goods, including medicines and tobacco, were increased sharply. The strengthening of the Euro and lower food prices have contributed to a further decline in inflation to below 2 per cent in the first half of 2003. The exchange rate remains anchored to the Euro through a currency board regime. After the 1996 crisis, confidence in the banking system has improved and strong domestic credit growth to the private sector (up by 38 per cent in real terms in 2002 from 27 per cent in 2001) is sustaining domestic demand. However, total domestic credit as a percentage of GDP remains low by international standards, at just 25 per cent of GDP by end-2002.

Since the introduction of the currency board in 1997, fiscal policy has been tight and the consolidated general government deficits never exceeded 1 per cent of GDP. In 2002, the fiscal performance was better than programmed thanks to a strong revenue performance and cautious discretionary spending, resulting in a consolidated government budget deficit of 0.6 per cent of GDP. In the first half of 2003, the consolidated fiscal balance turned into a surplus of Lev 627 million - about €334 million (US$ 386 million) or 1.8 per cent of projected GDP. The government's target this year is for a consolidated budget deficit of 0.7 per cent of GDP. As in 2002, discretionary spending during the first three quarters of 2003 will be limited to 88 per cent of total budgetary allocations for that period, providing flexibility for a fiscal adjustment in the last quarter of the year, if needed.

The external position is sound but vulnerable to a delayed recovery in the EU markets or a future increase in oil prices. Despite the weak external environment, the current account deficit narrowed to 4.4 per cent of GDP in 2002, from 6.5 per cent in 2001. However, net FDI inflows were low, at only €372 million (US$ 430 million), mainly due to a shortfall in privatisation revenues due to delays in the privatisation of BuTeCo, the fixed-line telecommunication company, and Bulgartabac, the state tobacco company. The privatisation of the former savings bank, DSK, to OTP Hungary secured € 311 millions of revenues this year, and the investment in the thermo-power plants of Maritsa East and other greenfield investments should further boost FDI, which is cautiously projected at about €778 million (US$ 900 million) in 2003.

In the first half of 2003, the trade and current account deficits almost doubled in nominal terms with respect to the same period of last year, due mainly to increased imports of raw materials and investment goods, as well as higher oil prices in the first quarter of 2003. Lower interest payments on external debt, high revenues from tourism and an increase in transfers from the EU and from Bulgarians living abroad should partly offset the deficit in the trade balance, resulting in a current account deficit of about 5 per cent of GDP in 2003.

The combination of a more active debt management policy and the recent appreciation of the Euro led to a sharp reduction in Bulgaria's debt ratios. Tight fiscal policy, two successful Brady bond swaps in 2002, and depreciation of the dollar were the main contributing factors to the decline in both total public and external debt ratios over GDP. By end-2002, total public debt (external and domestic) to GDP had decreased to 55.1 per cent, from 69.7 per cent at the end of 2001. Total gross external debt (public and private) also declined to 70.3 per cent of GDP in 2002 from 78.3 per cent one year earlier. Debt service obligations (public and private) peaked in 2001 at US$ 1.5 billion (€1.3 billion), and are forecast to decrease to US$ 950 million (€821.4 million) this year. Debt repayment is not at risk in the short-term, given that the government has accumulated fiscal reserves in excess of US$ 2 billion (€1.73 billion).

2.2.2. Transition success and transition challenges

Significant progress in social and structural reforms has recently been made in many areas, including the liberalisation of markets and trade, the privatisation of small and large scale enterprises and the restructuring of the financial sector. However, a legacy of slow and inconsistent reforms until 1996 has left Bulgaria economically behind other countries in central and Eastern Europe and the Baltics (CEB) in some other areas. Corporate governance and enterprise restructuring are weak, and financial intermediation is still low compared to the other EU accession countries of CEB.

Progress towards reaching the standards of a market economy can be assessed by contrasting Bulgaria's EBRD transition indicators with those of other EU applicant countries. As shown in

Table 2, first phase reforms, i.e. price and trade liberalisation together with enterprise privatisation, had almost been completed in Bulgaria by mid-2002.

Table 2: Transition Indicators[4] of EU accession countries, 2002

	Small-scale p/sation	Price liberali-sation	Trade & foreign exchange system	Large-scale p/sation	Governance & enterprise restructuring	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infrastructure reform
Bulgaria	**4-**	**4+**	**4+**	**4-**	**2+**	**2+**	**3+**	**2+**	**3-**
Czech Rep.	4+	4+	4+	4	3+	3	4-	3	3
Estonia	4+	4	4+	4	3+	3-	4-	3+	3+
Hungary	4+	4+	4+	4	3+	3	4	4-	4-
Latvia	4+	4+	4+	3+	3-	2+	4-	3	3
Lithuania	4+	4+	4+	4-	3	3	3	3	3-
Poland	4+	4+	4+	3+	3+	3	3+	4-	4-
Romania	4-	4+	4	3+	2	2+	3-	2	3
Slovak Rep.	4+	4+	4+	4	3	3	3+	2+	2+
Slovenia	4+	4	4+	3	3	3-	3+	3-	3+

However, Bulgaria now needs to push ahead firmly with second phase reforms, which focus on institution-building. They involve competition policy, enterprise restructuring, infrastructure reform, and the development of banking and non-bank financial institutions. As shown in Table 2, Bulgaria scores below the average of the "2004" group of EU accession countries in many of these areas. The country's good macroeconomic performance over the past few years has yet to translate into a noticeable improvement at the micro level and the government faces a significant challenge in fulfilling its electoral promises to improve living standards. Although the Bank does not have an explicit mandate to reduce poverty, it could contribute indirectly to this goal by supporting private sector development and net job creation through its projects.

The key transition challenges that the Bank can help address, either through projects or policy dialogue, are:

- to ***improve the country's investment climate***. Bulgaria has made good progress in recent years in building the legislative and regulatory framework to support private sector activity. Nonetheless, there is scope for improving the implementation of legislation. The ineffectiveness, unreliability, and slowness of civil courts have been increasingly recognised by investors as one of the most serious obstacles to market entry/exit. As described in Section 2.1.6 (legal reform), amendments to the Commercial Code were, however, introduced in June 2003 to speed up market exit. The government has also had some success in addressing the burden of administrative procedures, as indicated by the approval of the principle of "silent consent" in June 2003, which will enter into force in December 2003. However, business establishment and registration procedures can be further streamlined.

- to ***finalise the privatisation process on fair and transparent terms, and accelerate the restructuring of public utilities***. While most small and medium-sized enterprises have been privatised in Bulgaria, the process of privatisation and restructuring of some large state-owned enterprises and public utilities is still on-going. A total of about 275 companies were privatised in 2002, and an additional 95 were sold in the first half of 2003. The State still holds majority shares in about 355 companies. These include some large enterprises like the tobacco, railways and shipping companies and most of the public utilities, both at central and local government level. The completion of the much delayed privatisations of Bulgartabac and BuTeCo on fair and transparent terms is important for preserving foreign investors' confidence in Bulgaria.

- to ***support reforms in the energy sector and accelerate the ongoing deregulation and privatisation process***. The Energy Strategy adopted by the Government in 2002, and the new draft Energy Law under discussion in Parliament, provide for further privatisation and restructuring in the sector, increased competition via private investment, and enhanced regional trade in energy. The aim is also to establish a solid regulatory regime with an independent

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[4] *The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies.*

Source: EBRD Transition Report 2002

regulator with authority and autonomy to protect consumers. The previous government had commenced the process of restructuring with the break-up of NEK, the vertically integrated national electricity company, into separate generation, distribution and transmission companies. While NEK will retain its transmission functions as a regulated monopoly, power distribution and generation will be private and deregulated. The Government plans to privatise the small hydro-power generation capacity first, followed by privatisation of power distribution and other power generation. The sale of existing assets started successfully in April 2003 with the finalisation of the Maritsa East III investment project (EBRD co-financed), which involves the modernisation of the four existing generation units of the thermo-power plant. The government also plans to sell a 67 per cent stake in seven regional electricity distribution companies by end-2003. Attracting investments by strategic investors in the sector represents one of the major challenges for the country over the next 2 years. Bringing energy tariffs to cost recovery levels will be key to increase the sector attractiveness to private investors.

- to ***promote institution building and improve utilisation of EU pre-accession funds.*** EU financial assistance to Bulgaria will increase considerably prior to accession (up to an estimated €1.2 billion over the 2004-2006 period through various programmes), envisaged in 2007 at the earliest. Entry to the EU is, however, conditional on progress in implementing the country roadmap and on a significant improvement in the public administration's ability to manage and make effective use of EU funds.

2.3 Access to Capital

In November 2001, Bulgaria accessed the international capital markets with a €250 million Eurobond issue with a five years maturity. This issue, which was substantially oversubscribed, allowed the Ministry of Finance (MoF) to establish a benchmark for Bulgarian bonds and embark on its strategy of gradually shifting the currency composition of external debt from US dollars to Euro. Further supporting this strategy, the MoF completed a Brady swap in March 2002, exchanging US$ 1.3 billion of Brady bonds for US$ 1.2 billion of new global dollar and Euro denominated bonds maturing in 2015 and 2013 respectively. In September 2002, the MoF announced a further US$ 800 million swap of Brady bonds for dollar denominated Eurobonds, maturing in 2015. The MoF did not issue new bonds on the international markets in 2003 and announced that it will not undertake any further Brady swaps next year. However, the country might enter the derivatives market to reduce interest and exchange rate risks on its external public debt, and use fiscal reserves in excess of the minimum requirement to buy back debt.

Good macroeconomic performance and reduced debt burden have warranted Bulgaria a series of upgrades by the major investment rating agencies, from single B in 2000 to one notch below investment grade. Bulgaria's long-term foreign currency sovereign debt rating is BB+ according to S&P's and Fitch, and Ba2 by Moody's. The five-years Eurobond expiring in March 2007 is now traded at 168 basis points above the € benchmark, significantly down from the launch spread of 376 basis points.

Given the decreasing but still high level of public indebtedness, the main sources of external financing remain FDI and official funds (WB, IMF and EU pre-accession funds). Despite some delays in large-scale privatisation, FDI covered about 65 per cent of the current deficit in 2002. What is more important, greenfield investments accounted for more than 70 per cent of total FDI in 2002, and their share is expected to increase in the coming years as the privatisation process nears completion. In addition to FDI, Balance of Payment support comes from other IFIs and from EU funds. The World Bank (WB) recently approved the first Programmatic Adjustment Loan (PAL) to Bulgaria of US$ 150 million (€140 million). The EU estimates that a total of €1.2 billion (US$ 1.39 billion) will be disbursed to Bulgaria over the 2004-06 period, summing up ISPA, PHARE and SAPARD funds.

Private sector access to medium or long-term financing remains limited, as banks are still cautious in their lending activities, and the development of the local capital markets is still in its early days. Despite a large number of quoted companies, total stock market capitalisation was about 5 per cent of GDP by mid-2003 and turnover remained low. In order to boost the securities markets, the Privatisation Agency decided to sell minority stakes in 11 large state-owned Bulgarian companies on the stock exchange in 2003. These include up to 30 per cent in the Bulgarian Maritime Shipping Company, 20 per cent in both BuTeCo and the State Insurance Institute (DZI), and up to 12.8 per cent in Bulgartabac, the national tobacco company.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

The Bank will support the government's efforts towards completion of the reform agenda, and work to improve the country's investment climate. The Bank's business activities will be mainly focused on the development of the private sector and infrastructure. The Bank will leverage its close working relationship with the government and its active and constructive dialogue with local business associations and with foreign investors in order to pursue these goals. The current active project pipeline amounts to €245.6 million (US$ 353.2 million) or 45 per cent of current commitments (more details are presented in Annex 4). In line with the transition challenges identified in section 2.2.2, over the coming two years, the Bank's main priorities will be in the areas of:

- Private sector development, including banking and non-banking FI development;
- Infrastructure financing and development; and
- Co-financing and improved utilisation of pre-accession funds.

In line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects, all EBRD operations in Bulgaria are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence. The Bank will focus on minimising the environmental impact of its operations and optimising the environmental benefits associated with the prioritised areas of investment in Bulgaria. This is consistent with actions required by the process of adoption of the EU *acquis*.

3.2 Sectorial Challenges and Bank Objectives

3.2.1 Private Sector Development

3.2.1.1 Corporate Sector

SECTORIAL CHALLENGES

Several key challenges associated with the development of the private sector remain, related to a number of external and (mainly) internal factors. Among the main constraints to attracting investment capital in Bulgaria are: a relatively poor (although improving) investment climate, corruption, bureaucratic delays, complicated licensing regime and liquidation procedures, an inefficient judicial system (although progress is underway) and lack of coordination between state institutions. In addition, political interference appears to have increased in certain cases, especially in the privatisation of the few remaining large state-owned assets. These factors, combined with corporate governance and management skills at an early stage of development, limited domestic capital, and a shortage of long term-financing (other that from IFIs) explain, to a large extent, why FDI levels in Bulgaria have been historically on the low side (totalling €3,795 million (US$ 4,390 million) from 1989 to 2002, or €484 (US$ 560) in per capita terms over the same period), and why several entities including the tobacco monopoly, the gas distributor, the incumbent telecoms operator and the main shipyard in the country remain in state hands.

While the banking sector is maturing, local banks still do not have significant long-term resources, and the risk appetite to finance locally owned firms is only now developing.

OPERATIONAL OBJECTIVES

As privatisation in the industrial sector in Bulgaria is almost complete, the Bank will focus on promoting post-privatisation investment either through loans, or quasi-equity and equity, including DIF. The Bank will strongly support greenfield private sector projects in industry, tourism, agribusiness, and natural resources as the main source of attracting new FDI for the country.

Agribusiness. The Bank's aim remains financing private agro-processing enterprises, either in collaboration with strategic industry players or investing alongside local entrepreneurs. This will support the Bank's ultimate strategy, securing market access for farmers' produce. An important sub-sector in Bulgaria has been food retail where the Bank has been involved in two projects to date (Migros and Billa), and is discussing and encouraging other international and local food retailers to invest. This move is expected to deepen demand for food products, standardise quality and improve availability and prices of foodstuffs for the consumers. Building on its key role and excellent experience in the introduction and financing of the Grain Receipt Programme, now taken over by the local banking sector, the Bank will continue to develop, together with local banks new facilities for financing agribusiness-related SMEs. In the grain trade sector, the Bank could assist with efforts in improving the grain-related infrastructure such as grain terminals and storage facilities.

Property and Tourism. The Bank will promote tourism projects, as part of its effort to encourage SME investment, by establishing credit lines with selected local banks active in the sector, through its equity funds, or with established tour operators. The Bank will selectively support projects that promote better logistics and retail infrastructure in response to demand.

Natural resources. The Bank will assist in the privatisation and restructuring of state oil, gas and mining assets in the longer-term context of integration into the EU, to allow rationalisation, increase private sector participation and promote FDI. The Bank will encourage regional collaboration, especially in the construction of new transport routes (e.g. pipelines from the Black Sea) and modernisation of existing projects to reduce bottlenecks, ensure competitive market access and assist in development of new legislative regimes and concession-based systems in the longer term. The Bank will assist in the improvement of regulatory framework, in raising the standards of business conduct and environmental practices.

3.2.1.2 The Financial Sector and SMEs

SECTORIAL CHALLENGES

Banking Sector

The privatisation of the banking sector has now been completed with the successful sale of Biochim to BankAustria (HVB Group) in 2002 and DSK Bank (the former State Savings Bank) to OTP of Hungary in 2003.[5] As a result more than 85 per cent of banking assets are controlled by foreign investors. However, the sector still faces a number of challenges, such as: (a) consolidation (the number of banks remains high with 28 banks and six branches of foreign banks); (b) specialisation; and (c) increased intermediation and product diversity.

SME and Micro Sector

The SME and micro sector access to finance has been improving over the last few years thanks to the introduction of the EU PHARE SME Facility and the increase in EU pre-accession funds. Most of the leading banks in Bulgaria have been introducing specialised SME products to capture a larger market share in this segment. At the same time, based on the limited transparency and capacity by SME and micro clients, they are still underbanked compared to large corporates.

Equity Funds

Currently, there is increased interest from international fund managers. Moreover when taking Bulgaria, Romania, and Serbia and Montenegro together these fund managers could be presented with a market large and attractive enough to focus on.

[5] There is only one exception: the small Encouragement bank, created as a microfinance bank, remains state owned.

Non-Banking Financial Sector

The insurance sector, which is now fully privatised, has experienced premium growth of more than 20 per cent per annum over the last five years, while the mandatory and voluntary pillars of the pension reform have been introduced, together with a single non-bank financial institutions regulator to cover insurance, pensions and capital markets to ensure consistency of supervision across these sectors.

At the same time a number of issues remain. First, insurance penetration remains at low levels compared to Central Europe. The sector will require consolidation as it has more than 30 insurance companies at present. Second, the level of contributions into pension funds remains low with the contribution rate into mandatory funds currently set at only 2 per cent. Third, demand for leasing is high at both the corporate and retail end; however, leasing penetration remains one of the lowest in the region. Finally, capital markets development is expected to be slow, despite the Government taking steps to support this development by listing minority stakes from several large companies and despite some issues of corporate and mortgage bonds.

OPERATIONAL OBJECTIVES

Banking Sector

The Bank's main operational objectives will be focused on:

- *Further development of the primary banking market.* The Bank will aim at expanding the existing EU PHARE SME Facility and focus on introducing mortgage credit lines to eligible partner banks. These lines would ensure standardisation of mortgage loan and security documentation, which would facilitate refinancing of mortgage receivables on the secondary market. The Bank will also seek to develop other specialised credit lines for on-lending by partner banks in priority sectors such as energy efficiency/renewable energy.
- *Support for development of secondary market.* The Bank will encourage banks to access capital markets to refinance their mortgage receivables by issuing mortgage bonds or by setting up SPVs for these purposes. This would ensure access to longer term funding for banks with a more diversified set of lenders.
- *Consolidation.* The Bank would seek to contribute to the consolidation of the sector by participating in a merger or acquisition of a smaller Bulgarian bank, possibly alongside an existing equity investment of the Bank.

SME and Micro Sector

Given the importance of this sector for the growth of the economy, the EBRD will actively seek to further expand the EU PHARE SME Facility through either existing or new partners. In the micro sector, the EBRD's focus will be on the further support of banks focusing on micro lending within the EU PHARE SME Facility as well as on the further support for ProCredit Bank.

Equity Funds

With the establishment of the SME focused Global Bulgaria and Romania Growth Fund the Bank has attempted to address the equity needs of SMEs. The Bank will continue its support for this fund and other existing equity funds where it is an investor. Should the opportunity arise the Bank will also support other strong fund managers with commitment and experience in the region.

Non-Banking Financial Sector

The Bank will focus on the following key objectives:

- *Insurance and pensions.* The Bank will continue its involvement in the insurance and pension sectors through its indirect participation in the pension and insurance companies, Bulstrad and Doverie. The Bank will also continue its policy dialogue with the regulator.

- *Leasing.* The Bank will continue its involvement in the sector though its indirect participation in the TBI leasing operations in the country. The Bank will also seek to introduce the leasing instrument of the EU PHARE SME Facility through a strong leasing partner.
- *Capital markets and asset management.* The Bank will encourage its banking partners in the issue of mortgage bonds by buying a portion of such an issue. The Bank will also look at supporting the establishment of SPVs to securitise receivables under the newly adopted law. In the area of asset management the Bank is continuously promoting the development of retail mutual funds in Bulgaria, particularly following the poor history of collective savings schemes in the country.

EBRD has provided environmental assessment training for a number of Bulgarian banks and equity funds such as Caresbac Bulgaria, Bulgarian Investment Bank, United Bulgarian Bank, Unionbank, Post Privatisation Fund, Hebros Bank, ProCredit Bank and Raiffeisen Bank Bulgaria. The training ensures that the Bank's financial intermediaries (FIs) are capable of implementing environmental due diligence procedures which are incorporated into the FIs' credit/investment appraisal process. The Bank will continue to provide such training to any new partner financial institutions.

3.2.2. Infrastructure.

SECTORIAL CHALLENGES

Recently the Bank has focused its activities on developing private and non-sovereign projects in the infrastructure sector. It has sought to help the Government develop a suitable environment for these types of investments. Although there has been improvement, particularly in the power sector, the following challenges remain:

Power and Energy Efficiency**:** In the electricity sector, the Bank is supporting the Government's restructuring efforts. Issues include a) the need to implement replacement investments to enable the closure of unsafe nuclear units; b) the importance of strengthening the independence of the regulatory environment, which will play an important role in bringing new investment into the sector; and c) strengthening the linkage with Southeast Europe networks in order to promote regional integration and increase the role of Bulgaria as a regional energy hub.

Bulgaria's energy intensity is among the highest in the world, and the district heating system is in need of urgent reform. Tariffs are low and, despite recent years' increases, do not reflect the cost of production. Moreover, elimination of the remaining price distortions in the energy sector, in particular for household electricity and heating prices is essential for compliance with EU requirements. Therefore, achieving this compliance, coupled with improvements in energy efficiency, increases in energy savings and the promotion of renewable energy sources will be a key challenge in the energy sector over the next two years.

The EBRD is the manager of Kozloduy International Decommissioning Support Fund - KIDSF - a multilateral grant facility (to exceed €200 million over 10 years, mainly from the European Commission) aimed at assisting Bulgaria to close unsafe nuclear units through provision of grant financing for decommissioning facilities as well as for energy and energy efficiency projects consequential to the closure. The decision to create the Fund was linked to a commitment by the country, as EU accession candidate, to close Kozloduy's ageing nuclear generation facilities. The purpose of the Fund is to provide technical assistance, public information, consultancy, civil works and engineering services, and other services necessary to ensure safe decommissioning of the units and contribute to the improvement of management of radioactive waste.

Municipal and Environmental Infrastructure**:** Bulgaria's cities have significant investment needs in water, wastewater, solid waste and urban transport. Estimates of the investment required to meet EU standards in the water and waste water sector approach US$ 1.3 billion (€1.15 billion) or US$ 150 (€138) per capita. About 70 per cent of the population have no access to waste water treatment. Water supply assets are in poor condition with an increase in unaccounted for water loss reported at 56 per cent in 2001 compared to 15 per cent in 1980. At the same time the institutional capacity for addressing sector requirements is underdeveloped both at the level of individual water utilities and with respect to appropriate supervisory and regulatory entities. In addition, the lack of reform in central and local government fiscal relations has left secondary cities (outside of Sofia) without stable and predictable sources of revenues. Cities and municipal governments, therefore, have limited creditworthiness. Local banks are reluctant to make long term loans given the current fiscal arrangements.

Telecommunications. The Government's intention is to liberalise the telecoms market. BuTeCo's monopoly legally ended on 31 December 2002, but fixed line voice services effectively remain monopolised as BuTeCo's privatisation has not yet concluded. In 1999 the Government could not come to terms with the selected strategic investor consortium of OTE and KPN while more recently, the selected Advent consortium was denied support at the Supervisory Board of the Privatisation Agency, a move currently challenged in the courts. In the meantime, delays in implementing a cost-based tariff regime (by removing cross-subsidisation of local calls through long distance and international call tariffs), and payments of dividends and distributions of reserves in recent years have further impacted BuTeCo's value and its ability to face up to competition. The challenge is therefore to remedy this situation by giving maximum support for the present privatisation attempt.

The mobile sector has been under the effective monopoly of Mtel for several years, dominating the market and imposing high tariffs. The second GSM licence was awarded to Globul of OTE only two-and-a-half years ago. Whilst the main structural elements for effective regulation have been established, the necessary level of staffing, competence and processes remain at an early stage of development. Significant resources will need to be devoted to this if the benefits of the free market in telecoms from end 2002 are to be realised.

Transport: BDZ, the Bulgarian railway company, continues to experience losses due to increased road competition and a decline in demand from heavy industry. Passenger fares remain heavily subsidised. Road infrastructure requires substantial improvements. On the other hand, the rapidly expanding tourist industry is creating the environment for private sector involvement at the airports located on the Black Sea resorts of Bourgas and Varna.

OPERATIONAL OBJECTIVES

The Bank will continue its focus on non-sovereign finance and public-private partnerships, particularly in the electricity and water sectors. Nonetheless, the Bank recognises that in some critical areas, such as the railways and district heating, sovereign support of some kind may continue to be needed to finance necessary infrastructure improvements. In developing projects, the Bank will focus on investments that will help ensure the long-term viability and self-sustainability of the sector as well as assist the Bulgarian government as it moves closer towards EU accession. For projects which do require a sovereign guarantee, and if a sovereign guarantee is available, the Bank will focus on those investments that have a high transition impact or a regional dimension and promote decentralisation and commercialisation of infrastructure and infrastructure services.

Power and Energy Efficiency. The Bank will take a leading role in financing the privatisation of existing and the construction of new power generation capacity, and jointly with EU ISPA will assist in the rehabilitation of the current generation capacity to ensure compliance with emission requirements under the Sulphur Protocol and EU *acquis communautaire*. The Bank also expects to play a significant role in the financing of a second large independent power project (IPP) – Maritsa East I, with total financing needs of €980 million (US$ 1.13 billion), helping ensure the eventual closure of the unsafe nuclear units at Kozloduy, as committed under the NSA Agreement. The Bank has been assisting the Bulgarian Government with the privatisation of the electricity distribution companies through a substantial technical cooperation programme under which an investment bank has been mandated. The due diligence process and the sale strategy are expected to be finalised by October 2003, and the target date to complete the sale of the distribution companies to strategic investors is end-2003, subject to market appetite. The Bank expects to play a significant role in financing the modernisation needs of the privatised companies in 2004. The Bank also intends to assist the Government in identifying the appropriate strategy for the establishment of a low-pressure gas network in the country. Capitalising on the success of the Sofia District Heating Project, one of the largest energy conservation projects ever undertaken, the Bank's strategy is to continue support for the rehabilitation and commercialisation of the district heating sector, where possible on a non-sovereign basis. The Bank will work to develop new mechanisms for providing finance for energy efficiency improvements in private sector companies (particularly addressing the industrial sector) and to identify opportunities for renewable energy projects. Where appropriate, grant funds (e.g. KIDSF) will be sought to co-finance the Bank's projects. Finally, the Bank will continue its policy dialogue with the authorities to promote improvements to the legal and regulatory framework in the sector.

Municipal and Environmental Infrastructure. In view of the limited creditworthiness of municipalities the Bank is exploring an approach to the financing of public services, especially water and waste water services, through regional (multi-municipal) companies. Regional water companies are majority or fully owned by the central government which facilitates a security structure involving sub-sovereign project support commitments. The Bank is preparing at the request of the Government, a Water and Waste Water Project Facility under which Plovdiv and Bourgas are being considered for pilot transactions. Both loans are being developed in close coordination with the EC, which is preparing ISPA grant co-finance. The Bank will work with the Government to ensure there are appropriate reforms put in place to rationalise central/local fiscal relations in a manner which decentralises fiscal authority to municipalities and improves their creditworthiness. EBRD will continue to implement its existing project and may offer additional support to its client Sofiska Voda which operates the water concession in Sofia. It will explore opportunities with Sofia and other municipalities for solid waste and urban transport (including parking infrastructure) transactions. The Bank will involve the private sector wherever possible in its transactions but given current conditions in Bulgaria, it is likely that sub-sovereign structures for loans to state-owned entities will remain appropriate for the time being.

Telecommunications. The Bank will support the privatisation of the incumbent telecoms operator, BuTeCo, through the provision of long-term financing. The Bank will encourage a fully competitive environment in both the fixed and mobile sectors by supporting new potential competitors to BuTeCo and striving to assist in the acquisition of the top GSM operator Mtel by a strategic player. In addition, the Bank will encourage the development of an effective regulatory regime fully consistent with EU accession principles and demonstrably independent of government on a day to day basis.

Transport. The Bank will support private sector investment for airport infrastructure and, in parallel, the necessary changes to the legal and regulatory environment required. The EBRD will consider extending financing when a tender is organised for the modernisation and management of the airports of Bourgas and Varna. This could, if successful, form the basis of a pilot scheme for the region. The Bank will also consider providing financing for railway rollingstock, which would be done on a sovereign basis, as and when sovereign guarantees are available, given the current financial position of the railways. In addition, the Bank could consider providing financing for road infrastructure improvements under a concessionaire/toll road scheme. In evaluating projects in this sector, the Bank would continue to press for policy reforms, commercialisation and rationalisation of services to increase productivity.

3.2.3 Co-Financing and Pre-Accession Funds.

The Bank will continue to be a major catalyst in mobilising co-financing, both commercial and donor, as in the recent Maritsa East III, Sofia District Heating and Sofia Transport projects. Some of the largest transactions in the pipeline have already been structured to allow for syndication of 60 per cent or more of the projects' commitments, to syndicates of foreign and local banks. Such syndication will be strongly sought in the future, as will co-financing opportunities with other IFIs and EU programmes to address, among other things the environmental or social components of projects, as is the case in the Water and Waste Water Project Facility, where close cooperation with the ISPA programme is ongoing.

3.2.4 Policy Dialogue

The Bank has had a long-standing and fruitful policy dialogue with the Bulgarian authorities, particularly the case in the municipal sector where the bank has successfully developed water, district heating and public transportation projects with the Municipality of Sofia and efforts are ongoing to replicate the model in other Bulgarian cities. The Bank also works closely with the other donors including WB, EU and USAID to support reforms in the energy sector. Benefits of the policy dialogue are reflected in the new draft energy and telecoms laws, expected to be considered later this year. During the next strategy period, the Bank will continue the policy dialogue with the Government and governmental agencies to assist in the development of a legal framework conducive to private sector involvement and investment in infrastructure projects.

4. COOPERATION WITH DONORS AND OTHER IFIS

Donor and IFIs Co-operation

The Bank maintains excellent working relationships with the IMF, the World Bank, the European Union, the EIB and bilateral institutions in order to maintain a co-ordinated approach, enhance the successful implementation of its strategy, and optimise the impact of each respective institution. The relationships with EU/Phare and ISPA and the World Bank on various sectoral as well as environmental issues and projects related to institutional strengthening, district heating improvements and pollution reduction are also well-developed and will be critical to the success of the Bank's strategy over the course of the next two years.

4.1 European Union

Total EU multilateral grant-financed pre-accession assistance to Bulgaria is now running at almost €300 million (US$ 347 million) a year. This is the highest amount to any candidate country, apart from Poland and Romania, and is equivalent to about 2 per cent of Bulgaria's GDP. The assistance was channelled through several programmes.

Phare: Phare commitments to Bulgaria during the period 1992-2002 totalled €1.5 billion (US$ 1.73 billion). Bulgaria's indicative Phare allocation is €100 million (US$ 115.7 million) a year, though over the past three years this figure was augmented by exceptional allocations from the reserve. The indicative allocation for 2004 is €157 million. All these figures exclude the benefits to Bulgaria from Phare-supported horizontal and multi-country programmes, including TAIEX and the SME Finance Facility. In addition to Bulgaria's normal annual Phare allocation, the Commission has agreed to provide additional Phare funds for nuclear decommissioning and associated measures in the energy sector, in connection with the agreement reached in 1999 with the Bulgarian authorities on early closure of units 1-4 of the Kozloduy nuclear power plant. A total of €200 million (US$ 231 million) will be committed over the period 2000-2006, subject to satisfactory progress with agreed closure dates and decommissioning of the relevant units.

ISPA: The ISPA programme (commenced in 2000) supports major environmental and transport infrastructure projects. Bulgaria's annual allocation is €104 million (US$ 120 million), €106 million (US$ 122.6 million) for 2003. The ISPA programming framework is governed by environment and transport strategies drawn up by the Bulgarian authorities and agreed with the Commission. So far ISPA has supported 19 projects in Bulgaria, for a total cost of €909.2 million (US$ 1.05 billion), with ISPA contribution of €526.9 million (US$ 609.4 million). Six of the ISPA-supported projects during 2002 concerned waste-water collection treatment in the towns of Targovishte, Bourgas, Sevlievo, Montana, Lovech and Popovo.

SAPARD: The SAPARD programme (commenced in 2000) supports agricultural and rural development measures. Bulgaria's allocation from SAPARD from 2000 has been €53 million (US$ 61.2 million) per year; its indicative allocation for 2003 is €54 million (US$ 62.4 million). The SAPARD programming framework is governed by a multi-annual Rural Development Plan, drawn up the Bulgarian authorities and agreed with the Commission.

In contrast to Phare and ISPA, SAPARD is a decentralised programme under which the Bulgarian authorities themselves select projects consistent with the agreed framework. A Multi-annual Financing Agreement setting the conditions for SAPARD support has been concluded by the Commission and the Bulgarian authorities. The SAPARD Agency was accredited in May 2001 (making Bulgaria the first candidate country to gain accreditation) and payments began shortly afterwards. 607 projects for a total cost of €200 million (US$ 231 million) were approved until end of June 2003, with the committed financial aid being half of this amount.

4.2 European Investment Bank (EIB)

EIB has an outstanding portfolio of €1.08 billion (US$ 1.25 billion), with disbursements to date of €445 million (US$ 515 million), covering 23 projects in transportation (roads, airport and railways), energy, telecoms, environment, industry and SMEs. Four projects, representing 17 per cent of EIB's outstanding commitments were co-financed with the Bank and discussions are underway for co-operation regarding the development of a water and waste water program. EIB plans to increase its support for Bulgaria in the coming years and to further its cooperation with the Bank. EIB plans to focus its efforts on (i) priority projects which will prepare Bulgaria for EU accession, focusing on transport, energy and environmental protection; (ii) support for the development of SMEs; (iii) support for private sector projects, notably with international sponsors, where EIB support can effectively release the Borrower from political risks; and (iv) develop projects in the health and education sectors.

4.3 International Monetary Fund (IMF)

Bulgaria has a close relationship with the IMF. Bulgaria's economic program is supported by a two-year Stand-By Arrangement with the IMF in an amount of SDR240 million (about US$330 million or €304 million), which was approved in February 2002. This facility is intended to help the country maintain macroeconomic stability, achieve strong economic growth, and higher living standards. The program is centred on the currency board, supported by a prudent fiscal policy including the objective of balancing the budget by 2005, and a strict wage policy for state-owned enterprises. The third review of the Stand-By Arrangement was completed in July 2003. In the context of this review the IMF noted that macroeconomic performance under the program continued to be strong, and that structural reform has advanced in a number of areas, including the energy and railway sectors, tax administration and the sale of the last major state-owned bank. However, it was noted that more decisive progress in other key areas, including corporate governance, judicial and regulatory reform, and increased labour market flexibility, will be needed to improve the business and investment environment and ensure broad-based, sustainable growth over the medium term. Bulgaria is currently contemplating the possibility of another IMF programme after the expiration of the current facility on 26 February 2004. As of July 2003, Bulgaria's total outstanding from the IMF amount to SDR 800.3 million (about US$ 1.2 billion or €1.02 billion).

The IMF also provides Bulgaria with technical assistance on an on-going basis in a variety of areas. The primary beneficiaries of this assistance have been the Bulgarian National Bank, the Ministry of Finance, and the National Statistics Institute, in the areas of fiscal policy, implementation, management of the financial system, and general economic statistics.

4.4 World Bank Group

The World Bank commenced operations in Bulgaria in the beginning of the 1990s and has since committed in excess of US$ 1.6 billion (€1.38 billion) to 29 projects. This includes 10 adjustment loans (US$ 900.8 million or €778.8 million), 17 investment projects (US$ 682.4 million or €590 million) and two Bank managed Global Environmental Fund (GEF) grants. In infrastructure, EBRD and World Bank have co-operated closely during the past twelve years, jointly financing three projects, including the Sofia District Heating in 2002. In addition to infrastructure, other sectors of importance for the World Bank include social sectors, the environment and agriculture.

The World Bank's Country Assistance Strategy (CAS) for the period 2002-2004 was approved by its Board on 9 May 2002. The main pillars of this strategy include a) promotion of competitive private sector-led growth; b) strengthening public administration reforms and anti-corruption initiatives; and c) mitigating the social impact of restructuring and delivering social services more effectively. The Country Assistance Strategy preparation envisages close consultations with all major stakeholders, including the Government, local and national, the private sector, civil society, trade unions, academia and others.

International Financial Corporation (IFC) complements the World Bank's efforts in private sector development by focusing on four key areas: restructuring of municipal infrastructure, financing for post-privatisation restructuring; supporting capital markets and SME development, and selected private sector investments. IFC has committed to-date more than US$ 178 million (€154 million) in support of 16 investments in industries such as building materials, paper, leasing and the financial sector, tourism, real estate development, general industry and metal processing. The potential for co-operation between IFC and EBRD is good, given the similarities of operational priorities. To date, EBRD and IFC have co-financed one project in the industrial sector.

ANNEX 1

Political Assessment

Since the Communist monopoly of power, imposed in the aftermath of the Second World War, ended in 1990, the country has always been ruled by coalition governments of the left or of the right. Following an economic and financial collapse in 1996-97 which had occurred under a government led by the Bulgarian Socialist Party (BSP), elections were held in April 1997. A new government was formed in May 1997 by the Union of Democratic Forces (UDF), a centre-right political grouping. The UDF government established a currency board in July 1997, stabilised the economy, concluded a three-year agreement with the IMF and embarked on a series of economic reforms that included the privatisation of much of the Bulgarian industry. Originally high, the government's popularity waned, not least because of public concern over corruption at senior levels in the government. Before the June 2001 election, the UDF and the opposition BSP were running neck and neck. In the end, the winner was neither of the two parties but a completely new political formation under the leadership of Simeon Saxe-Coburg-Gotha, the former King Simeon II. He had been removed from the throne, aged 11, in 1946 and exiled to the West. His Simeon II National Movement (SIINM), set up only in April 2001, won half of the 240 parliamentary seats. The new government set up in July 2001 promised to eliminate corruption, improve living standards and reform the economy. It took as its coalition partner the Movement for Rights and Freedoms (MRF), a party mainly supported by the country's ethnic Turks. There were also two Ministers from the BSP serving in an individual capacity.

Almost two years on, the government is collecting good opinions from foreigners for its budget and debt management and its other achievements in the economic field. However, despite its credible domestic record and its successes in foreign policy (NATO membership and invitation to join the EU – though not before 2007), the government has lost its popularity at home. There is a widespread public perception that the government has failed to deliver on its, admittedly, numerous promises, notably on welfare, back in 2001. The Prime Minister's style of leadership has also contributed to the government's low standing in the opinion polls – well behind the Socialists and just behind the UDF. On 29 May 2003 the government survived a vote of no-confidence tabled by the UDF and backed by the BSP. The government obtained 129 votes against 104 for the opposition, with seven abstentions. The junior coalition partner, the MRF, voted with the government. However, it is possible the MRF, might decide to go with a different political partner – the Socialists, for example - at some stage in the near future. Local elections are due in October.

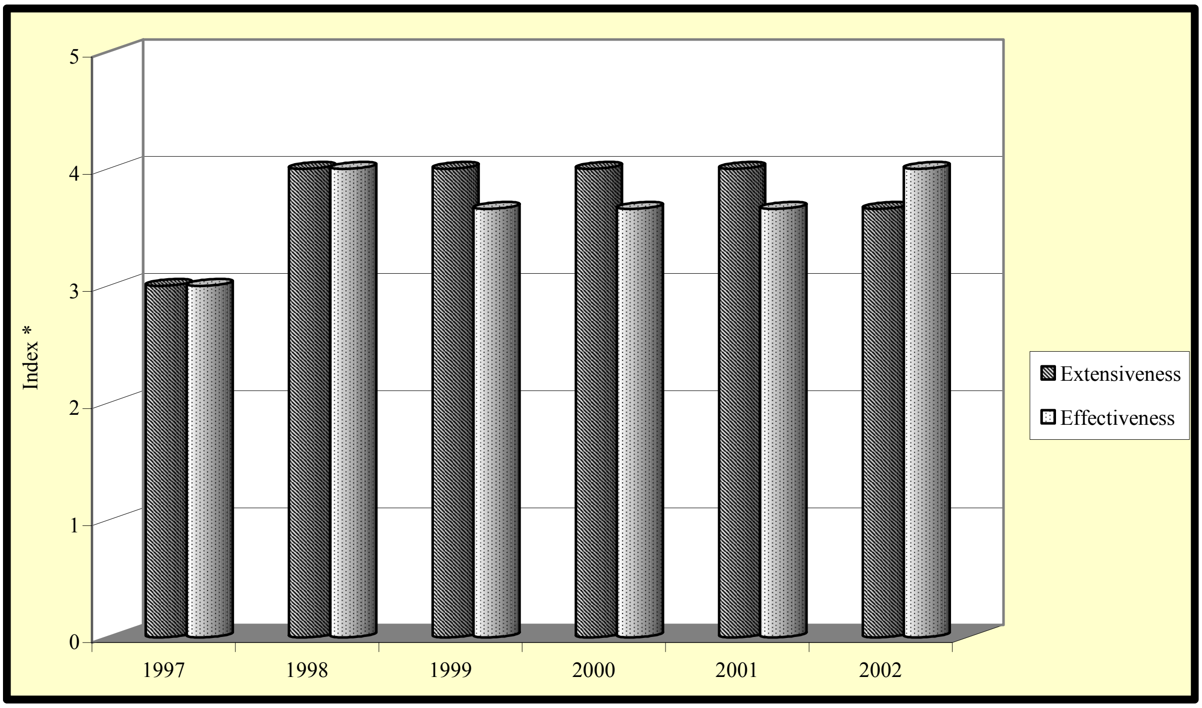
ANNEX 2

Legal Transition

COMPARATIVE ASSESSMENT OF BULGARIA'S COMMERCIAL LAWS

I. Assessment Over Time

Extensiveness and Effectiveness of Bulgaria's Commercial Laws[6]



Source: OGC Legal Indicator Surveys; 1997 - 2002
**Note:* Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

Bulgaria's concessions, banking, telecommunications, and secured transactions laws are based on relevant EU directives and are regarded by practitioners in the country as relatively sophisticated and advanced. The Annual EBRD Legal Indicator Surveys over the past six years confirm the view that Bulgarian commercial laws are approaching standards that are generally acceptable internationally.

II. Situation in Other Transition Countries

Bulgarian commercial laws surpass the laws of several other EBRD countries of operations in the region in terms of legal sophistication and compliance with EU law. Based on the 2002 EBRD Legal Indicator Survey, which measured the perception of lawyers familiar with

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[6] The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extent these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

Bulgarian law, the commercial laws of Bulgaria can be characterised as adequate for supporting investment and other commercial activity, broadly on par with those of Estonia, Latvia, and Romania.

LEGAL SECTOR ASSESSMENT

Bankruptcy

The Bulgarian bankruptcy legislation is contained in Part IV of the Commercial Code (the "Bankruptcy Law"), which came into effect in August 1994 and has been subsequently amended several times. The current regime is considered by practitioners to be fairly clear and adequate, but some streamlining of the bankruptcy court procedures is necessary in order to improve efficiency.

The Bankruptcy Law provides rules for reorganisation, restructuring, or liquidation of commercial enterprises and attempts to maximise asset recovery while guaranteeing fair and equal distribution among all creditors. The Bankruptcy Law applies to all commercial entities, except banks, insurance companies, public monopolies, and state-owned companies established by a special act of government, for which special insolvency rules apply. The legislation on bankruptcies of banks and insurance companies is contained in chapter 14 of the Law on Banks and chapter 11 of the Law on Insurance, respectively.

Until recently, under the Bankruptcy Law, there were two grounds on which bankruptcy proceedings could be initiated, namely "insolvency" and "over-indebtedness." Insolvency was defined as the inability of the debtor to perform a pecuniary obligation that is non-disputed, matured and derived from a commercial transaction or a debt of public nature. Insolvency was presumed when the debtor has stopped payments. Over-indebtedness is defined as insufficiency of assets for the purposes of covering debtor's liabilities. The definitions of insolvency and over-indebtedness had caused significant uncertainty among the business community. Recent amendments to the Bankruptcy Law (effective July 2003) were designed to improve efficiency of bankruptcy procedures. One of those amendments was to change the definition of insolvency. The new definition is failure to pay a debt within 60 days of the due date. It is hoped that this will help speed up bankruptcy proceedings (currently it can take up to a year for a company to be declared insolvent). Amongst other changes also introduced by the 2003 amendments are compulsory valuation of assets before they are sold off (previously valuation only took place upon creditor request.

The rehabilitation and stabilisation of companies in bankruptcy context has been encouraged by amendments to the Commercial Code. Any of the debtors, the trustee, the creditors holding at least one third of the secured assets, the creditors holding at least one third of the unsecured assets is among the persons empowered to propose the adoption of restructuring plan. The Bankruptcy Law explicitly prohibits the proposal of a restructuring plan when it is obvious under the circumstances that further continuation of the debtor's activities may damage the bankruptcy estate.

Capital Markets

A new Financial Supervision Commission Act (the "FSCA") came into force on 1 March 2003, pursuant to which the Financial Supervision Commission (the "FSC") was established in the same month. The main purpose of the FSC is to consolidate the state supervision over the non-banking sectors in Bulgaria by replacing the Bulgarian National Securities Commission, the Insurance Supervision Agency and the State Insurance Supervision Agency with three corresponding departments in the FSC -- Investment Activities Supervision, Insurance Supervision and Social Insurance Supervision. Each of the said departments is led by a deputy chairman of the FSC. The FSC is a collective state authority, which consists of seven members including a Chairman and three deputy chairmen. All members of the FSC are elected by the Bulgarian Parliament. Since the FSC is a newly established institution, it remains to be seen how effective it will be in terms of supervising the non-banking financial sector of Bulgaria.

The primary legislation governing the Bulgarian capital market is the Law on Public Offering of Securities (the "Securities Law"), which became effective in January 2000. The Securities Law brought the capital markets legal and regulatory framework of Bulgaria in line with EU accession requirements. The Securities Law sets forth, among other things, rules on mergers and acquisitions, mandatory and voluntary bids, as well as disclosure requirements. Regarding the insurance sector, the existing Insurance Act was passed in 1997, which improved regulation and conditions in the sector by raising the minimum capital and debarred insurers from other activities. Also, prudential requirements were enhanced and a re-licensing process was completed in 1998. In addition, the Bulgarian Government launched a new pension system in 2000. The new system is a modern three-pillar system, consisting of a strengthened version of the existing pay-as-you-go system (first pillar) and two fully funded pillars (a mandatory public pillar for new entrants, and a voluntary private one). The legislative basis for strengthening the first pillar was adopted by parliament in 1999, and phased implementation started from the beginning of 2000.

Company Law and Corporate Governance

The primary legislation governing corporate governance issues in Bulgaria includes the Commerce Act (enacted in 1991 and amended many times since, with most recent ones in 2002) and the Law on Public Offering of Securities (enacted in 2000). According to the Commerce Act, five types of commercial institutions can be formed, including limited liability company and joint-stock company ("JSC"). An institution formed in accordance with the Commerce Act shall register itself with a commercial register held by the relevant district court. In the case of a JSC, a shareholders' register shall be maintained by the company. One special feature of the Commerce Act is that a JSC can choose to establish either a one-tier or two-tier system of board of directors. In terms of protecting shareholder's rights, measures provided for by the Commerce Act include that each shareholder in a JSC is entitled to acquire a part of the newly issued shares in proportion to its original shareholding in the company. Shareholders holding at least 10% of the total issued and outstanding shares are entitled to request to convene a general meeting of shareholders. Shareholders of 5% of the company's stock may submit a claim to the district court for amenability of members of the supervisory and the managing boards for damages caused by them to company. Shareholders of 5% of the company's stock may also request the general meeting or the district court to appoint a comptroller to audit the annual financial statements and to submit a report on his findings. Shareholders in a company also have the right to bring an action against the company for the repeal of a resolution of the general meeting when such resolution is inconsistent with a mandatory provision of the law or with the articles or, respectively, the by-laws of the company.

According to the 2002 results of the EBRD's Corporate Governance Sector Assessment Project, Bulgaria is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were rated among "medium compliance" countries -- a category which many other EU accession countries were in. General reform priorities for countries in this category are to improve effective implementation and enforcement of existing legislation, while continuing to refine their existing laws.

Concessions

Bulgaria has had a Concessions Act (the "Concessions Law") since 1995. It has been amended a few times since, most recently in 2002.

The Concessions Law is of general framework nature and is applicable to infrastructure, mineral resources and utilities sectors, concession of which is in the governmental jurisdiction. Municipal concessions are governed by a separate act (see below). Under the Concessions Law concessions are granted for a period of up to 35 years but maybe extended to a maximum overall term of 50 years. Decisions to grant concessions are made by the Council of Ministers. Concession granting procedures may not necessarily be with an auction or tender.

The Concessions Law may not be regarded as comprehensive or detailed. It should be used in conjunction with various other acts and general contract law provisions. The Concessions Law leaves for parties of a concession contract to agree on a method of dispute settlement and is not clear about the choice of an applicable law.

Under the Law the Ministry of Finance sets up a Concessions Cost Recovery Fund which accumulates 15 percent of all revenues from the granting of concessions and the use thereof.

Other relevant laws include the Municipal Ownership Law, Procurement Act, Energy Efficiency Act, Roads Act, Sea and Internal Water Routes and Ports Act and the Foreign Investment Act.

The Municipal Ownership Law governs the process of granting concessions for municipal utilities and infrastructure and some public services. Municipal concessions may be granted initially for a period of up to 15 years and extended to a maximum of 25 years.

Although not comprehensive, current regime does allow for private sector participation in public projects. According to the 2002 Legal Indicator Survey current concessions legal framework in Bulgaria was considered adequate.

Secured Transactions

Security over movables is governed by the Law on Registered Pledges that entered into force on 1 April 1997, the Law on Obligations and Contracts (art 133-182), and the Commerce Act. There are two main types of charge in Bulgarian law: the possessory charge (governed by the Law on Obligations and Contracts), and the non-possessory registered charge (governed by the Registered Pledge Law). There is also a commercial charge (governed by the Commerce Act, the Registered Pledge Law and the Law on Obligations and Contracts).

The non-possessory registered charge now represents the most common way of taking security over movable assets. It can be granted by a "merchant", as defined in article 1 of the Commerce Act (natural or legal person engaged by occupation in any of the commercial transactions listed in the article), or any of the persons listed in article 2 Commerce Act (mainly farmers, artisans and members of the professions). The charged property may be:

- chattels (exclusive of ships and aircraft);
- accounts receivable and other selected intangible property;
- shares of equity in general and limited partnerships, limited partnerships with shares or limited liability companies;
- groups of accounts receivable, of machines and equipment, of inventory or materials; and
- commercial enterprises.

Commercial charges concern mainly tangible and bearer securities (art 310 Commerce Act).

The registered, non-possessory pledge must be registered in the Central Pledge Registry upon the request of the interested party. Application and a copy of the pledge agreement and the loan agreement are required. The registry is supervised by the Ministry of Justice and is based in Sofia, and there are a number of regional offices. The central registry is computerised and this facilitates the process of registration and searching. Sales with retention of title and contracts of leasing must also be registered.

Priority is determined from the time of registration. The pledgee will be paid ahead of all other creditors but after the following expenses and debts:

- enforcement costs;
- costs for court actions initiated by other parties in order to preserve the property or actions in compensation for harm caused by the debtor;
- claims of the state on taxes on a certain property out of the value of that property.

Where the pledgor is declared bankrupt, the pledgee is satisfied ahead of all other creditors and the commencement of bankruptcy proceedings does not suspend foreclosure of a pledged property commenced under the Registered Pledge Law.

Enforcement is meant to be quick and efficient: the pledgee can obtain possession of the pledged assets after he commences foreclosure of the pledged property and can take all measures to preserve the pledged property. He can obtain realisation by selling the pledged assets (via a depositor appointed by him) two weeks after registration of the statement for commencement of foreclosure, provided that the conditions and method of sale are expressly stipulated in the pledge agreement. A court order will be required:

- if the pledgor opposes the seizure and transfer of possession of the pledged property to the pledgee;
- when a joint creditor disputes the receipt of compensation for the pledged property, or the receipt of value against transfer of pledged property; or
- when the pledgor challenges the existence of the secured debt or the pledge.

It should be noted that debtors challenge the procedure in the majority of cases, making out-of-court enforcement rare in practice.

Telecommunications

The telecommunications sector is currently regulated by a combination of the Ministry of Transport and Communications (the "Ministry"), the National Council on Radio Frequency Spectrum and the Commission on Regulation of Communications ("CRC") and is governed by the Telecommunications Act of 1998 (the "Telecoms Law"), as amended in 2002. Pursuant to the Telecoms Law, the Ministry performs strategic policy making functions and the CRC is an independent agency responsible for overall regulation of telecom services, issuing licenses to telecom operators, cable operators, radio and TV broadcasting operators. The CRC is also responsible for price regulation of operators occupying a significant position in the marketplace for telecom services.

Bulgarian Telecommunications Company ("BuTeCo") is the incumbent national telecommunications operator covering voice and data communication, radio/TV transmission and Internet and is responsible for the existing fixed network. Bulgaria appears committed to liberalisation of its telecommunications industry ahead of European Union (EU) accession - envisaged in 2007, along with Romania and possibly Croatia - and in accordance with the World Trade Organization's ("WTO") principles. The Bulgarian market was formally fully liberalised at the beginning of 2003, with the first licences to competing fixed-line services issued by the CRC in July 2003.

The privatisation of BuTeCo is currently ongoing, though the disputes and irregularities that have arisen between the authorities and bidders, US Advent Consortium and the Turkish Koc Consortium has delayed the sale of BuTeCo and impacted upon foreign investor perception of the privatisation process and investment climate.

To date Bulgaria has made good progress in harmonising the telecoms law with EU *acquis* and the EU telecommunications chapter has already been provisionally closed. While Bulgaria is generally meeting accession commitments, in telecommunications, focus now needs to be concentrated upon encouraging and supporting competition at this crucial stage. In addition, Bulgaria will need to make further improvements to the legislative framework for the sector and implement the relevant elements of the updated EU framework, such as interconnection, local loop unbundling and cost-oriented tariffing. Bulgaria will also need to ensure timely provision is made for implementation of number portability in the run up to the expiry of the EU transitory period in December 2008.

ANNEX 3

Selected Economic Indicators

Bulgaria

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.8	4.5
Private consumption	-0.5	-5.7	-10.0	2.6	9.3	4.9	4.5	3.9	5.6
Public consumption	-8.2	-33.2	-3.9	23.4	4.1	13.3	4.7	6.2	2.0
Gross fixed capital formation	16.1	-21.2	-20.9	35.2	20.8	15.4	19.9	9.3	15.0
Exports of goods and services	na	na	12.8	-4.7	-5.0	16.6	8.5	6.2	7.0
Imports of goods and services	na	na	10.9	12.1	9.3	18.6	13.0	4.7	6.5
Industrial gross output	-5.4	-11.8	-13.7	-5.8	-4.3	12.0	0.7	2.6	15.0
Agricultural gross output	16.0	-10.9	13.7	-0.6	2.7	-9.1	-0.3	na	na
Employment					*(Percentage change)*				
Labour force (end-year)	-6.9	-0.7	-2.3	0.5	-1.2	-9.1	0.9	6.9	na
Employment (end-year)	1.3	0.1	-3.9	-0.1	-2.1	-9.5	-3.4	10.9	na
					(In per cent of labour force)				
Unemployment (end-year)	13.7	13.0	14.5	15.0	15.7	16.1	19.7	16.8	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	62.0	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.0
Consumer prices (end-year)	32.9	310.8	578.6	0.9	6.2	11.4	4.8	3.9	3.8
Producer prices (annual average)	52.7	126.9	901.8	17.1	4.4	17.3	7.4	3.4	na
Producer prices (end-year)	38.9	356.7	472.6	0.5	14.0	14.7	-3.3	6.3	na
Gross average monthly earnings in economy (annual average)	53.2	89.4	815.9	46.5	5.1	15.7	11.9	4.2	na
Government sector [1]					*(In per cent of GDP)*				
General government balance	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.7
General government expenditure	41.3	42.0	33.1	37.0	39.6	39.7	38.6	37.2	37.4
General government debt [2]	114.9	319.8	122.2	95.6	98.7	88.8	69.7	55.1	51.9
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	40.3	117.2	356.8	11.9	13.0	12.2	49.3	12.2	12.3
Domestic credit (end-year)	18.0	216.5	93.6	-8.4	5.8	31.4	24.1	31.4	19.1
					(In per cent of GDP)				
Broad money (M2, end-year)	65.4	71.0	32.8	28.5	30.3	30.3	40.9	42.0	44.5
Interest and exchange rates					*(In per cent per annum, end-year)*				
Base interest rate [3]	34.0	180.0	6.7	5.1	4.5	4.6	4.7	3.3	na
Inter-bank interest rate (up to 1 month)	53.1	119.9	66.4	2.5	2.9	3.0	3.7	2.5	na
Deposit rate (1 month)	25.3	211.8	3.0	3.3	3.3	3.1	2.9	2.8	na
Lending rate (less than 1 year)	51.4	480.8	13.9	13.3	14.1	11.5	11.1	9.4	na
					(Leva per US dollar)				
Exchange rate (end-year) [4]	0.071	0.487	1.777	1.675	1.947	2.100	2.219	1.885	1.730
Exchange rate (annual average) [4]	0.067	0.178	1.674	1.760	1.836	2.123	2.185	2.077	1.739
External sector					*(In millions of US dollars)*				
Current account	-26	16	428	-62	-685	-701	-878	-679	-965
Trade balance	121	188	380	-381	-1,081	-1,175	-1,566	-1,619	-1,825
Merchandise exports	5,345	4,890	4,940	4,193	4,006	4,812	5,099	5,578	5,895
Merchandise imports	5,224	4,703	4,559	4,574	5,087	5,988	6,665	7,197	7,720
Foreign direct investment, net	98	138	507	537	789	1,003	641	430	900
Gross reserves (end-year), excluding gold	1,236	518	2,121	2,679	2,900	3,460	3,591	4,407	4,950
External debt stock	10,148	9,602	9,760	10,274	10,204	11,202	10,616	10,933	11,416
						(In months of imports of goods and services)			
Gross reserves (end-year), excluding gold	2.3	1.0	4.4	5.4	5.3	5.4	5.0	5.8	6.0
						(In per cent of exports of goods and services)			
Debt service	13.5	16.8	13.8	19.0	18.0	16.8	20.2	15.8	11.0
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	8.4	8.3	8.3	8.2	8.2	8.1	8.1	8.0	8.0
GDP (in millions of leva) [4]	880	1,761	17,433	22,421	23,790	26,753	29,618	32,324	34,249
GDP per capita (in US dollars)	1,563	1,187	1,257	1,548	1,582	1,551	1,679	1,940	2,470
Share of industry in GDP (in per cent) [5]	31.0	29.0	25.0	22.3	25.1	25.8	25.2	24.5	na
Share of agriculture in GDP (in per cent) [5]	12.7	14.2	23.4	16.8	14.5	12.3	12.1	11.0	na
Current account/GDP (in per cent)	-0.2	0.2	4.1	-0.5	-5.3	-5.6	-6.5	-4.4	-4.9

External debt - reserves, in US$ millions	8,912	9,084	7,639	7,595	7,304	7,742	7,025	6,526	6,466
External debt/GDP (in per cent)	77.4	97.0	93.7	80.6	78.7	88.9	78.3	70.3	58.0
External debt/exports of goods and services (in per cent)	149.8	153.5	155.5	171.8	176.1	160.3	141.1	133.9	132.5

[1] General government includes the state, municipalities and extra-budgetary funds.

[2] From April 2001, direct debt to the Bulgarian National Bank (BNB) is excluded from domestic debt to avoid double reporting of IMF credit extended through the BNB.

[3] Effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary actions.

[4] On 5 July 1999, the lev was re-denominated. The post-July rate is equal to 1,000 of the pre-July 1999 leva. All data are expressed in terms of post-5 July 1999 lev.

[5] From 1995, the industrial classification changed. Using the old classification, industry as a share of GDP was 32.4 per cent in 1996 and the share of agriculture in GDP was 12.8 per cent.

ANNEX 4

CURRENT PORTFOLIO STOCK
(as of 31 August 2003, € millions)

	Portfolio	Portfolio Risk Rating	Undrawn Commitment	% Undrawn / Portfolio	Operating Assets	Impaired Assets	Performing Assets	% Performing / Operating
BULGARIA	**551.7**	**5.87**	**266.9**	**48%**	**284.8**	**33.2**	**251.6**	**88%**
DEBT	471.8	5.81	244.5	52%	227.3	17.6	209.7	92%
EQUITY	76.2	6.36	18.6	24%	57.5	15.7	41.9	73%
GUARANTEE	3.8	5.30	3.8	100%	0.0	0.0	0.0	0%
Non-Sovereign	408.6	5.84	201.1	49%	207.4	33.2	174.2	84%
Sovereign	143.2	6.01	65.8	46%	77.4	0.0	77.4	100%
PRIVATE	388.6	5.83	181.4	47%	207.1	33.2	173.9	84%
STATE	163.2	6.01	85.5	52%	77.7	0.0	77.7	100%
Direct	480.8	5.98	224.2	47%	256.5	33.2	223.3	87%
Regional	71.0	5.21	42.7	60%	28.3	0.0	28.3	100%
Energy	198.5	6.08	177.8	90%	20.7	0.0	20.7	100%
Financial Institutions	107.0	6.00	24.6	23%	82.4	4.2	78.2	95%
General Industry	68.0	5.11	4.2	6%	63.7	0.0	63.7	100%
Infrastructure	79.5	5.60	19.7	25%	59.7	0.0	59.7	100%
Specialised Industries	98.8	6.14	40.5	41%	58.3	29.1	29.3	50%
Agribusiness	60.7	6.49	23.6	39%	37.2	25.9	11.3	30%
Bank Equity	34.3	6.00	0.0	0%	34.3	0.0	34.3	100%
Bank Lending	34.7	5.78	14.4	42%	20.3	0.0	20.3	100%
Energy Efficiency	30.0	6.50	26.3	88%	3.7	0.0	3.7	100%
Equity Funds	23.3	6.34	7.4	32%	15.9	4.2	11.7	74%
General Industry	68.0	5.11	4.3	6%	63.7	0.0	63.7	100%
Municipal & Env Inf	38.5	5.52	19.7	51%	18.8	0.0	18.8	100%
Non Bank Financial Institutions	9.2	6.00	2.8	30%	6.5	0.0	6.5	100%
Power and Energy	168.5	6.00	151.2	90%	17.0	0.0	17.0	100%
Prop Tour and Ship	26.0	5.00	17.0	65%	9.1	0.0	9.1	100%
Small Business Finance	5.5	6.00	0.0	0%	5.5	0.0	5.5	100%
Telecoms Informatics & Media	12.1	6.79	0.0	0%	12.1	3.2	8.9	74%
Transport	41.0	5.67	0.0	0%	41.0	0.0	41.0	100%

ANNEX 5

Bilateral Assistance (TC) + Bilateral donor support

Annex 5A -- TC Projects

Commitment Number	TC OPID	Commitment Name	Fund Short Code	Euro Committed	Fund Approved Date	Commit. Stage Name
ECP2000-2001-11-01	7567	Sofia District Heating: Engineering & Procurement Consultant	ECP	580,250	22/11/01	Committed
ECP2000-2002-05-01	26816	Power Distribution Privatisation Advisory Services	ECP	48,000	07/05/02	Disbursing
ECP2000-2002-08-07	26816	Advisory Services for the Privatisation of Electricity Distribution Companies in Bulgaria	ECP	950,000	06/08/02	Disbursing
ECP98-98-12-50	5731	Advisory services for establishment of independent power producers	ECP	892,439	14/12/98	Closed
ECP99-2001-11-98	7567	Sofia District Heating: Engineering & Procurement Consultant	ECP	1,000,000	22/11/01	Disbursing
FIN-2000-04-02	5891	District Heating Investment Strategy Adviser	FIN	31,884	12/04/00	Closed
GERK-1996-05-06	3409	Sofia District Heating Company - technical and economical appraisal	GERK	37,544	01/05/96	Closed
GERK-2000-01-02	10369	District Heating Policy Adviser	GERK	48,813	17/01/00	Closed
HOL-1994-06-09	860	Energy project support unit	HOL	119,598	14/06/94	Closed
IRL-1999-05-05	5814	Advisory Services for Separation of Transmission Assets	IRL	40,350	26/05/99	Closed
UKC-1999-06-05	5814	Financial appraisal of power transmission project	UKC	24,718	01/06/99	Closed
UKF-2002-09-03	29570	Sofia District Heating Public Awareness Campaign	UKF	50,000	05/09/02	Committed
EC-1993-03-10	748	United Bulgarian Bank - due diligence and design of treasury and credit policies and procedures	ECP	455,925	20/03/93	Closed
EC-1993-06-18	745	Bulgarian Investment Bank - management, training and systems establishment	ECP	841,893	20/06/93	Closed
EC-1993-07-25	745	Bulgarian Investment Bank - due diligence and registration documentation	ECP	100,000	20/07/93	Closed
ECP2000-2002-12-09	25318	Unionbank: Institutional Development - Adviser to Senior Management	ECP	237,798	18/12/02	Disbursing
ECP2000-2002-12-10	25318	Unionbank: Institutional Development - Credit Advisor	ECP	237,798	18/12/02	Disbursing
ECP96-97-01-38	4144	United Bulgarian Bank - twinning programme	ECP	832,008	30/01/97	Closed
EUBPP-02-03-02F	6000	PPF - Bulgarian PPF - Legal Advisory Services B	EUBPP	200,000	22/03/02	Committed
EUBPP-02-03-03F	6000	PPF - Bulgarian PPF - Legal Advisory Services A	EUBPP	200,000	22/03/02	Disbursing
EUBPP-2001-03-01	5795	Bulgarian Post-Privatisation Fund - Fund Manager (Year 4)	EUBPP	863,162	07/03/01	Closed
EUBPP-2001-11-03F	6001	Bulgaria Post Privatisation Fund - investment advisory services	EUBPP	343,275	07/11/01	Disbursing
EUBPP-2001-11-04F	6001	Bulgarian Post Privatisation Fund - investment advisory services	EUBPP	264,111	07/11/01	Disbursing
EUBPP-2001-11-05F	6000	Bulgarian Post Privatisation Fund - Legal Advisory Services	EUBPP	94,236	07/11/01	Disbursing
EUBPP-2002-01-01	5795	Bulgarian Post Privatisation Fund - Fund Manager	EUBPP	808,836	09/01/02	Disbursing
EUBPP-98-07-01	5795	Fund manager	EUBPP	713,000	08/07/98	Closed
EUBPP-98-07-02	5797	PPF - Bulgarian PPF - Specialised Advisory Services	EUBPP	652,595	08/07/98	Closed

Commitment Number	TC OPID	Commitment Name	Fund Short Code	Euro Committed	Fund Approved Date	Commit. Stage Name
EUBPP-99-03-01	6000	Bulgarian PPF: Legal Advisory Services I - Eversheds	EUBPP	90,783	17/03/99	Disbursing
EUBPP-99-03-02	6000	Bulgarian PPF: Legal Advisory Services II - Salans Hertzfeld & Heilbronn	EUBPP	70,764	17/03/99	Disbursing
EUBPP-99-03-03	6001	Bulgarian PPF - Investment Advisory Services-1	EUBPP	240,090	17/03/99	Closed
EUBPP-99-03-04	6001	Bulgarian PPF: Investment Advisory Services - 2 - PricewaterhouseCoopers	EUBPP	171,433	17/03/99	Closed
EUBPP-99-03-05	5797	Bulgarian PPF - Specialist Advisory Services - individual contracts - 2	EUBPP	418,157	31/03/99	Disbursing
EUBPP-99-03-06	5795	PPF - Bulgarian PPF - Fund Manager - 2 & 3	EUBPP	1,615,002	31/03/99	Closed
JAP-1994-05-16	748	United Bulgarian Bank pre-privatisation (Phase II)	JAP	173,949	16/05/94	Closed
USSP-2001-06-03	19103	Microfinance Bank of Bulgaria - Credit Advisers	USSP	383,480	18/06/01	Closed
USSP-2001-10-09	19103	Microfinance Bank of Bulgaria (MBB) - Micro and Small Enterprise Credit Advisors	USSP	1,306,540	24/10/01	Disbursing
USSP-2003-04-02	25685	ProCredit Bank Regional Expansion	USSP	889,838	30/04/03	Committed
CAN-1999-06-04	6583	Bulgarian Railways - costing model	CAN2	49,140	30/06/99	Closed
EC-1993-12-67	1018	Preparation of Black Sea Priority Urban Investment Programme (Phase I)	ECP	228,774	17/12/93	Closed
ECP97-97-12-52	5452	Sofia water supply improvement project	ECP	650,000	03/12/97	Closed
ECP98-2000-12-79	5452	Sofia water supply improvement project	ECP	150,000	19/12/00	Closed
ECP99-99-09-13	6314	Bulgarian Railways - financial accounting assistance for BDZ	ECP	369,375	07/09/99	Closed
JAP-1993-07-19	888	Sofia public transport study	JAP	321,897	01/07/93	Closed
JAP-1993-07-28	885	Port of Varna masterplan	JAP	620,000	01/07/93	Closed
UKC-1994-06-03	1339	Sofia municipal asset management fund	UKC	66,902	01/06/94	Closed
UKC-1994-10-11	1719	Rail modernisation project	UKC	23,763	31/08/94	Closed
UKC-1995-04-08	2411	Sofia public transport - guarantee study	UKC	50,635	05/04/95	Closed
UKC-1995-04-09	2411	Sofia public transport - public transport adviser	UKC	10,006	05/04/95	Closed
UKC-1995-04-10	2411	Sofia public transport - legal adviser	UKC	37,035	05/04/95	Closed
UKC-1999-03-01	5452	Sofia water supply improvement project	UKC	24,997	01/03/99	Closed
BRSF-2001-06-03	12795	TAM Programme in central, eastern & southern Europe - Aptechno Stara Zagora JSC	BRSF	48,400	20/06/01	Committed
GERK-1998-03-02	4887	Flue gas desulphurisation options for Maritsa East 3 project	GERK	40,392	09/03/98	Closed
ITA-2000-07-07	12795	TAM Programme (TAM) - Alcomet	ITA	48,400	03/07/00	Closed
WAL-2000-12-02	12795	TurnAround Management Programme (TAM) - SNS JSC	WAL	48,400	06/12/00	Disbursing
ITA-1997-03-04	4002	Target market screening for the Bulgarian Post-privatisation Fund	ITA	144,334	04/03/97	Closed
SWE-1995-11-04	3060	Regional study of trade finance needs	SWE	11,573	01/11/95	Closed
UKC-1996-01-01	1637	Review of export trade finance needs	UKC	12,237	01/01/96	Closed
GER-1993-04-03	1440	Sofia wholesale market - feasibility study	GER	183,297	20/04/93	Closed

Commitment Number	TC OPID	Commitment Name	Fund Short Code	Euro Committed	Fund Approved Date	Commit. Stage Name
JAP-1994-05-20	1470	Dairy investment	JAP	375,000	16/05/94	Closed
UKC-1996-03-09	5314	Wholesale market project	UKC	52,582	22/03/96	Closed
UKC-1998-09-05	5819	Tourism line of credit - tourism sector market study	UKC	70,584	04/09/98	Closed
USA-1999-06-02	4526	Bulgarian grain receipt program	USA	36,958	16/06/99	Closed
		Country Total Euro Amount:		**19,702,948**		
		Report Total Euro Amount:		**19,702,948**		
		No of Commitments:		**62**		

Annex 5B -TC Funds and Donors -- aggregate commitments

Donor	*EUR Committed*
European Commission	14,319,704
US TC Fund Total	2,616,816
Japan TC Fund Total	1,490,845
UK TC Funds Total	423,459
German TC Fund Total	341,929
Italian TC Fund Total	192,734
Dutch TC Fund Total	119,598
Canadian TC Fund Total	49,140
Welsh TC Fund Total	48,400
Irish TC Fund Total	40,350
Finnish TC Fund Total	31,884
Swedish TC Fund Total	11,573

ANNEX 6

Turnaround Management and the Business Advisory Services Programme in Bulgaria

Turnaround Management (TAM) Programme

The TAM Programme brings industry specific management expertise to enterprises. Providing the advisory services of experienced former CEOs and directors of large companies from economically developed countries, TAM assists enterprises to operate successfully and develop new business skills at the senior management level. To date, Donors have committed €64 million, allowing TAM to undertake nearly 1000 projects.

The TAM Programme was developed in the early nineties by the EBRD and the United Nations Development Programme, with the support of the European Union Phare Programme. TAM works directly with individual enterprises, providing industry-specific advice, developing management skills, and assisting them to operate successfully in a market economy

The TAM Programme supports economic reform by transferring management and technical know-how, conveying the principles of responsible corporate governance and sharing commercial experience directly with potentially viable enterprises.

As at July 2003 TAM had undertaken 46 projects in Bulgaria utilising approximately €2.7 million of Donor funding. This includes major contributions from the EU Phare (87 per cent), and the UK TC (10 per cent). These projects were in the following sectors: food (34 per cent), heavy manufacturing (18 per cent), pharmaceuticals (13 percent), light manufacturing (13 per cent), textiles (13 per cent) and other sectors (9 per cent).

Business Advisory Services (BAS) Programme

The EBRD BUSINESS ADVISORY SERVICE (BAS) PROGRAMME operates a network to assist the development of small and medium sized enterprises in the Baltics, Asia, NW Russia, the Samara region and South Eastern Europe. The BAS programme is currently operational in 8 countries and has completed successfully more than 1,500 projects. The programme is funded by the Central European Initiative (CEI), the European Union Phare Programme and the UK Department for International Development (DFID)

Objectives of the BAS Programme include: 1) Assisting the growth and competitiveness of small and medium sized enterprises by financially supporting business advice and consulting activities to benefit from the best local consultants; and 2) Developing and strengthening the skills and quality of local consultant's capacity to serve enterprise needs.

The BAS Programme offers cooperation in selecting the most suitable local consultants to solve specific business problems and to carry out particular consulting assignments. Where the local expertise is not available to meet the particular needs of an enterprise, outside consultants are brought in to work and share their skills with the local consultants. The Programme will offer a grant of up to 50% of the total net cost of a project to a maximum of EUR 10,000.

Since October 2001, BAS Bulgaria has initiated 104 projects of which 95 have been completed, and 9 are in pipeline. These projects were in the following main sectors: wholesale, retail and tourism (40 per cent), food and beverages (20 per cent), metals and machinery (12 percent), etc., and focussed on the improvement of management effectiveness and market performance, introduction of quality management and certification and cost reduction.

ANNEX 7

Transition Impact Evaluation and Lessons Learned

Transition Impact Evaluation

Op ID	Op Name	Work Year	Report Type	Overall Rating	PED Transition Impact
665	International Commercial Bank (Bulgaria) - (Formerly BIB)	1996	OPER	Partly Successful	Low
672	Danone-Serdika	1996	XMRA	Partly Successful	Medium
1681	BNP-Paribas (Bulgaria) A.D. (equity)	1997	OPER	Partly Successful	Low
371	Delta Dairy	1997	XMRA	Partly Successful	Low
324	Maritza East II Power Project	1998	OPER	Partly Successful	Medium
130	Bulgarian Telecom	1998	XMRA	Successful	High
4119	Sodi Privatisation	1999	XMRA	Successful	High
3039	Astera Investment Project	1999	XMRA	Partly Successful	Low
5423	Isiklar/Celhart	2000	OPER	Partly Successful	Satisfactory
2790	First Investment Bank	2000	OPER	Successful	Good
4639	Domaine Boyar AD	2001	XMRA	Partly Successful	Satisfactory
1682	Caresbac Bulgaria AD	2002	OPER	Unsuccessful	Marginal

Lessons Learned: Summary of Bank Reviews Since the Last Strategy

Caresbac Bulgaria - OPER report 2002

THE PROJECT

In August 1994 the Board approved an equity investment of up to USD 4 million in CARESBAC-Bulgaria A.D. (CB), an investment vehicle established as a joint-stock company in Bulgaria. CB had been formed earlier in the year by two founder-shareholders, CARE Small Business Assistance Corporation (CARESBAC) and the Agency for International Assistance (AIA) of the Republic of Bulgaria. With the entry of the Bank, the shares of CARESBAC and AIA carrying full voting rights became designated as Class A shares. In October 1994, the Bank made its first tranche of investment in CB as a non-voting Class B shareholder, amounting to the equivalent of approximately USD 830,000. By May 1995 the Bank purchased two further tranches of shares to match the contributions from the proceeds of butter sales credited to CARESBAC and AIA. Later in 1995 serious difficulties arose with the AIA, leading to the suspension of the project by the Bank in July 1996. Prior to the suspension, the Bank twice granted a waiver in respect of the deadline established in the project documentation for meeting the intended capital increase. However, the AIA's refusal to co-operate with the venture made it impossible for CB to function. The reasons for the AIA's stance were, and remain, unclear. Eventually, however, the AIA agreed to the transfer of its shares in CB to CARESBAC, which in the interim had become known as Small Enterprise Assistance Funds (SEAF). The transfer took place in October 1997, leaving CB with two shareholders, namely SEAF (with all of the issued voting Class A shares representing 50 per cent of the nominal value of shares issued) and the EBRD (with all of the issued non-voting Class B shares). When the project was suspended in July 1996, the Bank's disbursements had reached USD 1.4 million.

After lifting the suspension, the Bank invested a further USD 0.7 million bringing its total investment to a little under USD 2.1 million.

LESSONS LEARNED

Organisations whose objectives are primarily developmental are unlikely to be suitable equity partners for the Bank in projects intended to support the growth of entrepreneurialism. Common ground on commercial objectives needs to be established with equity partners at the outset. The Bank should carefully assess the commitment of not-for-profit partners to building the revenue earning capacity of projects that is required to achieve the Bank↕ s transition objectives. Particular attention to the commitment and motives of partners should be paid when, as in this case, the Bank's partners are not putting their own capital at risk, but are utilising charitably given funds as a capital base.

Ensure that project agreements include provision for the Bank to take action it considers necessary in the event of poor performance by fund managers. The Bank must have recourse to remedies required to protect its investments. Where appropriate, shareholders agreements and agreements with other parties should include mechanisms enabling the Bank to rectify the adverse consequences of under-performance. In the present case, the not-for-profit status of the Bank's partners should have alerted the Bank to the possibility that the other shareholders would not give priority to the financial performance of the fund.

Ensure that management structures provide for adequate checks and balances. These are unlikely to be present when one governing body serves simultaneously as supervisory board and investment committee, as in this project. The principle of adequate segregation of functions must be applied throughout the organisation structure to ensure sound governance and control.

Assess carefully the suitability of equity finance and avoid its use in cases where debt finance is more appropriate. In early and intermediate transition countries, where the conditions of the banking sector are not friendly or conducive to lending, the Bank should work with the authorities to bring about the changes necessary to create a facilitating environment that will encourage intermediation. In such conditions, it should not be assumed that equity finance is an effective substitute for debt. Before taking an equity stake in an owner-managed SME, fund managers must establish that the owner understands and accepts the implications of shared ownership, and that the underlying business has the growth potential to provide adequate returns to reward both the fund and the original owners.

Fund managers must carry out full commercial due diligence on sub-projects before making investments. TC, either paid for or on a voluntary basis, may be useful in improving the operations of investee companies. However, it cannot substitute for pre-investment due diligence which must be performed to establish the true financial and commercial condition of potential investees.

If the Bank is buying into an existing fund, it must ensure that the fund manager performed full commercial due diligence on investments in the existing portfolio. In order to assess the risks inherent in the portfolio into which it is buying, the Bank must at least satisfy itself that the fund managers acted prudently in the selection of investments. The Bank should consider performing its own due diligence on the existing portfolio unless the fund can demonstrate that it has followed sound investment guidelines.

Ensure that fund managers have the requisite skills and experience to operate commercially within the host country and that the right calibre of staff is retained. The Bank should not enter a fund unless satisfied with the quality of the fund managers. In assessing the suitability of fund managers, the Bank must also ensure that staff are effectively supervised, and that the compensation structure is adequate to attract and retain experienced, well qualified personnel.

Domaine Boyar - XMR Assessment 2001

THE PROJECT

The operation in favour of Domaine Boyar AD ("Company"), a newly created limited liability company incorporated in Bulgaria, consisted of an investment (loan) in the amount of US$ 28.5 million (ECU 25.9 million) to the Company and a US$ 2.0 million (ECU 1.8 million) equity investment in the Company. Of the US$ 28.5 million (ECU 25.9 million) Loan, the Bank provided a "A" loan for a maximum of US$ 19.0 million (ECU 17.3 million) for its own account and a "B" loan for a minimum of US$ 9.5 million (ECU 8.6 million) for the account of participating banks. The Bank took the full commercial risk on its equity investment.

The project sponsor was Boyar International Ltd ("BI" or "the Sponsor"), a UK registered company controlled by a Bulgarian national, Mr Todorov, and engaged in trading of Bulgarian wine in Western Europe and Japan. Mr Todorov, through BI, had been instrumental in developing exports of Bulgarian wines to Western Europe and Japan and helped establish Bulgaria as a major player on the world wine market. With a total of approximately 65 million bottles exported in 1997, the Sponsor, through its subsidiary and affiliated companies, represented the leading exporter of Bulgarian wines into the UK, Japan, Germany, Holland, and other Western European countries. Through the project, the Sponsor intended to develop and secure Bulgarian wine supply, by modernising its own wineries and building a new state of the art winery which will produce high quality wines with the latest wine processing technology.

Proceeds of the Bank's and the participating bank's investment, together with equity contributions from the Company's shareholders were to enable the Company to (i) modernise and expand the production facilities of two existing Bulgarian wineries Vinprom and Vinis in the towns of Yambol and Shumen, respectively; and (ii) build a state of the art greenfield winery in the town of Sliven.

The project was expected to have a positive transition impact for the Bulgarian economy: (i) support one of the largest private investment in the Bulgarian wine sector; (ii) promote technology transfer and market expansion and raise position of Bulgarian wine in foreign markets; and (iii) maintain and develop employment in rural areas of Bulgaria.

LESSONS LEARNED

Due Diligence Scope. Sensitivity analyses at project appraisal must be based on realistic assumptions taking into account sector specific circumstances and risk factors. This, in turn, may imply that substantive sector studies are required to identify such circumstances and risk factors before project due diligence can even start.

Phasing of Projects. For markets associated with high risks, a phased project approach is recommendable which would use clearly defined benchmarks or yardsticks as criteria for progressing expansions.

Project Horizon. For agribusiness projects, a more comprehensive due diligence process needs to be applied that includes conceptually the upstream raw material supply chain as well as the downstream competition at the retail side. This widening of the due diligence concept above and beyond the focal project area helps in risk mitigation and to appreciate a project more realistically in its natural context.