DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

TRANSPORT

OPERATIONS POLICY

2005-2008

TRANSPORT OPERATIONS POLICY 2005 - 2008

EXECUTIVE SUMMARY

The Transport Operations Policy sets out the general strategic and operational role of the Bank in this sector and establishes the overall framework for the Bank's activities. This will be the third such policy, and replaced the document approved by the Board of Directors in February 1997.

The Transport sector is crucial for the development of the economies and markets of our countries of operation and is therefore an important sector for the Bank. Accordingly, the Bank has undertaken 108 projects in the Transport sector, with an aggregate value of €11.3 billion and a total funding commitment for the Bank of €3.5 billion.

The policy notes the continuing likelihood of a higher volume of transport commitments in the state sector than in the private sector, owing to the difficulty of monetising the benefits of transport infrastructure and the capacity of the state to finance large transport projects. It is expected, however, that in terms of annual business volume the volume of non-sovereign transactions will grow faster than the sovereign one. In addition, there will, however, be an increase in the number of public sector non-sovereign and private sector transactions, as our countries of operation adopt public private partnership ("PPP") structures and commercial interest increases in the Advanced Transition Countries.

The policy re-affirms the key role of an efficient transport sector in the operation of regional markets, as the drive to integration of national economies continues. The Bank will continue to cooperate with the EU on the development of the Trans-European Network corridors and implementation of regional initiatives, such as the REBIS ("Regional Balkans Infrastructure Study") initiative in the Western Balkans and the TRACECA ("Transport Corridor, Europe - Caucasus-Asia") initiative in Central Asia and the Caucasus. Continuing co-operation with other IFIs, such as the EIB, International Monetary Fund, World Bank Group and the regional development banks is also a feature of our strategic approach. Environmental issues arising from developments in transport have been highlighted and the Bank will continue to cooperate also with other IFIs in seeking to address these issues in the most appropriate manner.

As the Bank's countries of operation make the transition towards fully functioning market economies, the channels of achieving transition also change. In countries where the reform process is most advanced, the strength of demonstration impact and enhancing access to markets becomes greater. In such countries, the Bank will increasingly undertake projects primarily on the basis of demonstration impact. The market will assess the success of these innovative transactions and replicate those which show promise.

In countries which have not reached an advanced stage in the reform process, institutional and regulatory development will continue to be the principle focus of transition. For state-owned clients undergoing commercialisation and restructuring, the Bank recognises an ongoing need to reinforce transition over a series of transactions. This is because of the complexity of the reform process, which takes time to achieve, and the consequent need to maintain momentum over time in its reform dialogue with clients and governments.

There have been substantial changes in the nature of the transition which can be achieved in the Transport sector since the elaboration of the Transport Operations Policy of 1997. For this reason, a new structure has been adopted for the policy, which seeks to highlight the evolution of the transition process in the sector.

The attached Report addresses these changes and puts forward an approach consistent with the Bank's transition mandate, which is sufficiently flexible to accommodate more widely varying economic circumstances arising as a result of differing speeds of transition within our countries of operation.

A reference to the Bank activities in shipping and shipyards has been added to this document, taking into account that the financing of these facilities is in the perimeter of the activities exercised by the transport team. The full developed strategy for this sub-sector has already been submitted and approved by the Board on 23 October 2001.

1. INTRODUCTION

The Transport Operations Policy sets out the trends in the transport markets in which the Bank operates, reviews the instruments the Bank uses to achieve transition impact in the transport sector in the light of these trends and sets out the main transition challenges for the Bank. It sets out the framework under which the Bank seeks to develop the market economy with respect to transport and how the Bank as a market-led institution expects to be responsive to the market.

The Bank's Vision and guiding principles for Transport development:

The Bank's vision for the sector is set in accordance with the Agreement Establishing the EBRD and set in a contemporary context. Specifically in the Transport sector the Bank will inter alia seek to assist the process of demonopolization, decentralization and privatization;

- Seek to promote productive, competitive private sector activity (this may be by direct finance or by providing the necessary transport infrastructure to allow for such activities);
- to mobilize foreign and domestic capital and support its activities;
- to invest in infrastructure where it is necessary to support private and entrepreneurial activities;
- promote in its full range of activities environmentally sound and sustainable development[1]

Sub-sectoral Trends:

- Railways: Railways are at varying stages of transition in the Bank's countries of operation, reflecting the political sensitivity involved in the restructuring process. The Bank will continue to support railway restructuring and commercialisation, including labour restructuring programmes. In this way the Bank can help to ensure that Railways receive the level of funding commensurate with the benefits associated with this mode of transport. There may be opportunities for private sector financing, as freight forwarders seek to fill the gaps in the market for modern freight wagons. These transactions may be asset-based. The drive to optimise the use of railway assets will provide opportunities for the Bank to finance private concessionaires operating public assets, such as railway stations. There may also be interesting equity opportunities given the expanding market.
- Roads: The Bank will continue to support rehabilitation, upgrading and construction of new roads, where investment needs have increased in line with economic growth and a move towards greater regional integration. Sovereign transactions are expected to dominate the Bank's activity in this sector, as the economic benefits of roads are difficult to monetise. However, the Bank will continue to support institutional development, reform of road sector financing and increased commercialisation of the sector. The Bank will also support the involvement of the private sector through PPPs, as governments seek to benefit from private sector efficiencies and increase the number of projects which can be implemented simultaneously. PPPs will not be limited to construction and operation of road infrastructure, but may also cover the provision of services to road users (catering, rest areas etc.). The Bank will support moves to more transparent road changing, addressing the costs associated with this means of transport. In particular the introduction of vignette schemes and electronic road pricing are seen as useful tools to ensure that road vehicles bear an appropriate cost burden.
- Aviation and airports: in many of the Bank's countries of operation airlines are protected under bilateral arrangements. The Bank will support transactions that prepare these airlines for eventual competition. The Bank will also continue to support investment in

[1] The full range of the Bank's aims is set out in the Agreement Establishing the EBRD, Article 2

infrastructure to improve operating efficiency and national and regional safety. This may involve sovereign lending or corporate financing of fully commercialised public entities and airports operated by private concessionaires. Liberalisation of air traffic markets in the new EU Member States will expose the national carriers to greater competition. There may be scope for the Bank to undertake restructuring transactions in these countries to improve the competitiveness of the airlines. There may also be opportunities to support low cost carriers with either equity or debt, subject to satisfactory risk profiles.

- Shipping: The Bank will continue to support restructuring, commercialisation and privatisation of state-owned shipping companies. The Bank may undertake operations with privatised or commercially run companies, which need to replace ageing and obsolescent fleets. These transactions may involve asset-based financing to mitigate credit risks. In shipbuilding, the Bank will continue to seek restructuring opportunities, where shipyards potentially have a competitive edge. As the financial robustness of the yard can be an issue, finance may be restricted to specific contract orders or sovereign guaranteed transactions.
- Ports: The Bank will support the restructuring and commercialisation of ports, encouraging private sector operation of the superstructure. The Bank may continue to undertake sovereign transactions for rehabilitation, upgrading and development of port infrastructure by landlord ports, where there is an emphasis on restructuring and commercialisation. It will also develop non-sovereign loans to commercialised state-owned entities and loans to the private sector where it is involved in port operations.

Regional Trends:

- In light of the Bank's commitment to achieve more in its poorer countries of operation, an increased emphasis will be placed on developing transport transactions in the Early Transition Countries. The intensive effort required to realise relatively small, risky transactions in these countries can be justified by the potential for strong transition impact. The Bank will tend to focus on smaller transactions in the relatively poorer countries, given the financial constraints and difficulties in bringing large projects to fruition in these countries.
- In the Advanced Transition Countries, there is a trend towards the private sector, including corporate finance and capital market driven transactions, public sector non-sovereign and complex, structured transactions. The Bank will support well structured PPPs, which comply with the Eurostat criteria for risk transfer. These may be driven by the political need to deliver improved infrastructure faster and fiscal pressures. As the appetite of commercial lenders, both foreign and domestic, to undertake relatively straightforward transactions increases, there will be a tendency for the Bank to undertake operations with a higher structural risk, such as subordinated debt. This will allow the Bank to maintain its position on the risk/return curve and provide further demonstration impact.
- The Bank acknowledges the drive to create a single economic space within Russia and the critical role of transport infrastructure in this development. The Bank anticipates increasing non-sovereign activity in Russia, subject to continued legal and institutional reform, enabling private sector engagement and/or limited government support where needed. The Bank is ready to undertake sovereign operations where the nature of the project and sub-sector requires a sovereign guarantee. Kazakhstan is another important market exhibiting similar trends.
- In other Intermediate Transition Countries, the Bank recognises the increasing importance of the regional dimension in such sectors as air-traffic systems, roads and rail networks where the market benefits from regional integration.

Product Trends:

- Asset-based finance: The Bank foresees an increase in the use of this product. This reflects the relatively liquid security of movable assets with a market value and continuing improvements and growth of confidence in the legal systems in our countries of operation.
- PPPs: The Bank anticipates increasing interest in PPPs, driven by value for money, budgetary considerations and the inability of governments to deliver infrastructure improvements in line with the growth of the economy. The Bank will also support refinancing of PPPs where justified.
- Public sector non-sovereign transactions: These may involve re-financing of earlier successful sovereign transactions, where a state-owned company has made the transition to a viable, commercially operated entity. Alternatively, such opportunities may arise where the restructuring of a monolithic state-owned entity creates new, commercially viable entities, which can be differentiated from the less commercially viable ones.
- Cofinancing: The emphasis on cooperation with the EIB will be maintained, particularly in South-East Europe and Russia. The Bank will continue to co-ordinate closely with other International Financial Institutions such as the World Bank, and the IFC, the Nordic investment Bank, the Black Sea Trade Development Bank and the Asian Development Bank, as well as bi-lateral IFIs building on comparative advantage and knowledge sharing opportunities. Increased cofinancing with commercial banks is anticipated in the Advanced Transition countries, with interest extending to some of the Intermediate Transition countries.
- Equity: Liberalisation and enhanced competition in key areas, such as rail freight and airlines have lowered the barriers to entry. This has increased the number of opportunities for the Bank to invest in new entrants based on equity or quasi-equity instruments in high-growth sectors.

1.1 Aims and Scope of the Transport Operations Policy

The principal purpose of the Transport Operations Policy is to review and update the means whereby the Bank achieves its mission in the transport sector, to identify the principal transition challenges facing the Bank and indicate where the Bank proposes to focus its efforts in order to achieve that mission. This Policy also sets out how the Bank's transport sector financing has improved in the past, and will improve in the future, the efficient functioning of the transport sector in its countries of operation while at the same time promoting the general principles embodied in its mandate. It seeks to build on the Transport Operations Policies of 1992 and 1997, drawing on our experiences and how they have compared with our expectations. In 1997 we had the experience of 46 operations to draw on; by end December 2004 this had risen to 108. The restructuring of the Bank's focus in the transport sector has added shipping and shipbuilding, while urban transport has been considered a part of municipal strategy, given the largely municipal impact of such projects.

The Transport Operations Policy covers: airports and aviation; ports, shipping (including inland waterways) and shipbuilding; railways; and road infrastructure. All historical comparative data are made on a like for like basis based on the current areas of responsibility for the Transport Team.

Article 1 of the Agreement Establishing the Bank defines the Bank's purpose as being: "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative[2]" Transition impact is always the key objective in any EBRD project, but the Agreement Establishing the Bank also emphasises that the Bank must:

- be additional to other sources of finance, thereby demonstrating its added value in its sector of operation.
- respect sound banking principles, and
- promote environmentally sound and sustainable development.

A number of other factors are also important when the Bank decides whether to finance a project, for example, the portfolio balance and the country strategy. The Transport Operations Policy clarifies how the Bank should apply these key principles in its transport sector lending.

The environment in which the Bank operates is always changing. The Transport Operations Policy is not a rigid lending programme, but sets out guidelines within which the Bank expects to respond to market demands. It is recognised that, exceptionally, circumstances may arise which are not envisaged in the Transport Operations Policy and that it may be appropriate for the Bank to consider projects that fall outside its specific provisions, provided that they are consistent with the aims of the Bank as set out in the Agreement Establishing the Bank.

1.2 Introduction: The Transport Sector

The Transport Sector is of key importance to the economic well-being of our countries of operation. It represents the lifeblood of the economy, moving people and goods to those places where market forces require them to be, thereby enabling enterprises to compete on the domestic and international markets. An efficient transport sector is therefore of critical importance to allow the efficient functioning of the market; any infrastructure transaction which provides support for private and entrepreneurial initiatives and assists in making a competitive environment and raising productivity thereby contributes to the Bank's transition impact objectives. As a consequence transport operations may achieve transition impact through two modes:

1) Transition impact is normally achieved through the *design, structuring and implementation* of the transport project, the nature of support provided to the Borrower and the conditions attached to the financing. The transition impact will typically relate to the undertaking of identified actions by the financed party related to transition objectives. To maintain the likelihood that the transition objectives are achieved requires setting the objectives and conditions in line with the incentives for compliance by the client and the leverage of the Bank to request and monitor compliance. This approach works best where there is a strong alignment between the transition objectives targeted by the Bank and the interests and perceptions of those parties able to influence and achieve the transition objectives; and

2) The transport sector in our countries of operation is frequently in poor state of repair and often not suited to, and hampering the development of, the free-market economy. To a certain extent, almost all well designed transport projects will therefore have some impact on the level and quality of market development through their physical and economic impact (contributing to the more efficient functioning of the market, by removing excessive time delays, transport costs and barriers to competition, thereby enabling wider participation in the market economy and consequently rendering that economy less vulnerable to distortion or manipulation). In some cases such impact will be sufficiently important for the *project selection* itself to warrant explicit recognition in the assessment of the transition impact potential, for example where the market development concerns

[2] More precisely the Agreement Establishing the EBRD calls for it to: "foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economies".

substantial regional integration and facilitation of trade dimensions within a region where this is of strategic importance to the transition process (Central Asia, Caucasus and South-East Europe are examples).

As a consequence projects may be selected on the basis of transition impact arising out of either, or a combination, of the two modes described above.

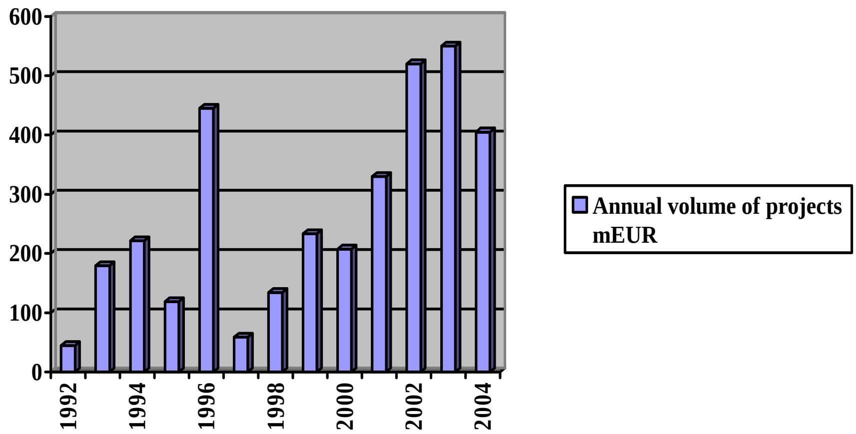
Investment in transport represents a significant proportion of the overall wealth of a country, yet it is often difficult to monetise the full economic benefits of investment in transport infrastructure, such as the improvements in the environment arising from the construction of a ring road, or the enhancement to property values. As a consequence a number of approaches to transport infrastructure financing must be adopted to optimise transition impact.

Section 1 of this document has set out the background to the development of the policy and the aims of the Bank in the sector. Section 2 reviews the Bank's portfolio, its activities in cofinancing and technical cooperation and the lessons we may draw from these experiences. Section 3 looks at the individual sectors of the Transport remit, the challenges faced by our countries of operation in each of them and how the Bank can assist our countries of operation in meeting such challenges. Section 4 presents the Bank's strategic objectives in the Transport Sector, in light of developments in our countries of operation and reviews certain financing instruments and contractual arrangements that may form part of our response to such developments.

2. BANK'S ACTIVITIES TO DATE IN THE TRANSPORT SECTOR

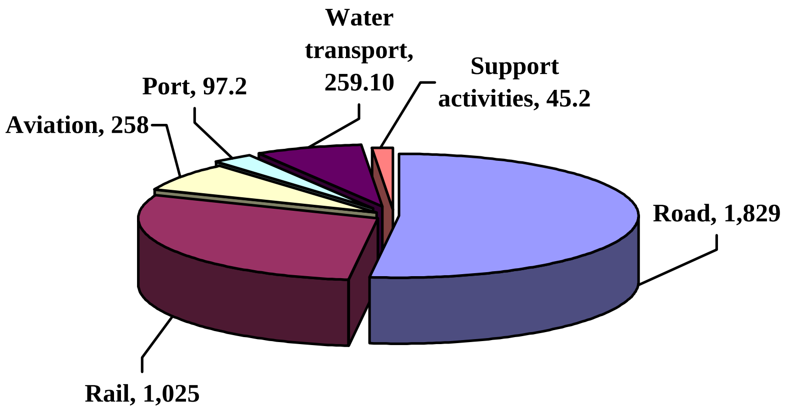
2.1 The Transport Portfolio

The Bank has undertaken 108 transport projects in the period from 1992 to end December 2004, a further 42 operations since the last Transport Operations Policy in 1997. The average EBRD financing has been EUR 33 million, generating an average of EUR 240 million of transport business for the Bank each year. The average number of projects undertaken each year has typically been 9 with numbers of projects in recent years being 2000: 7 projects; 2001: 10 projects; 2002: 9 projects; 2003: 10 projects; and to end December 2004: 10 projects. In the last five years, the average annual volume of transport business was EUR 411 million



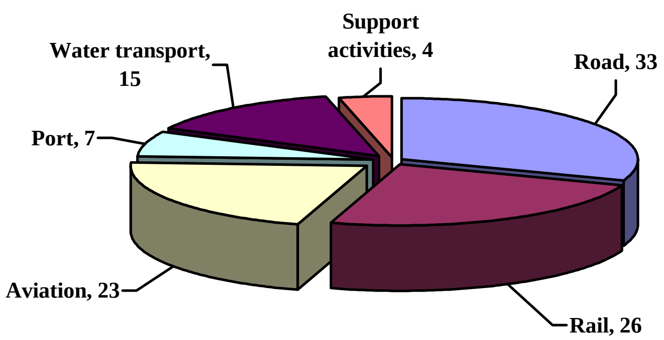
At end December 2004, Road projects have accounted for 52% of the business, and rail projects for another 29%; aviation sector projects accounted for 8%, ports 3%; shipping and water transport projects 7%; and other support activities for Transport 1%.

Sector breakdown by volume at end December 2004

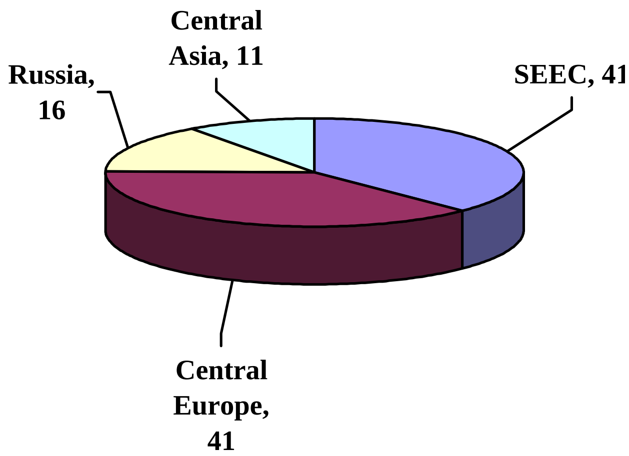


Note: Shipping and shipbuilding comprise the water transport sector.

Sector breakdown by number of projects, at end December 2004



Transport business has been heavily oriented towards the state sector because of the customary involvement of the state in the provision of transport infrastructure, both in our countries of operation and outside them and the issues relating to land acquisition, environmental issues and planning, which militate against a laissez-faire transport system. Out of a total of 108 projects at end December 2004, 77 have been sovereign loans, with a further 4 non-sovereign projects in the state sector. However, the number of private sector projects is increasing: while only 15 private sector projects were signed in the first eight years of operation, 19 such projects have been signed in the period 2000-end December 2004 and private sector projects constitute 43% of an active pipeline. About 39% percent of the lending volume has been in the Central Europe country grouping; 32% in the SEEC country grouping; 19% in Russia; and 10% in Central Asia.



Further details of the Bank's transport portfolio are set out in Annex I.

2.2 Cooperation with Other Finance Providers

2.2.1 Coordination and Cooperation with Multilateral Institutions

The Bank works closely with the other multilateral institutions in the implementation of its remit. It both coordinates those areas of activity where complementary financing is made available and takes into account the policy and other activities of the multilateral institution in which the EBRD does not participate.

The Bank recognises that, because of the definition of its mandate and the principles within which the Bank operates, in many of its countries of operation other multilateral institutions, such as the IMF, the World Bank or the European Union may enjoy a longer or broader relationship with governments than it does itself.

For instance the EBRD is precluded from policy lending, unlike certain other multilaterals, being limited to lending on a project basis by the Agreement Establishing the EBRD. Policy lending typically involves lending to the sovereign with funds being made available for general budgetary purposes, but with the loans being made available conditional upon progress in relation to a particular policy objective. As a consequence, those institutions, such as the World Bank, which engage in policy lending, may expect a closer dialogue with governments in the formulation of their budget allocations and over-arching policies, whereas the EBRD policy dialogue is more closely linked to the individual projects financed by the EBRD.

The EBRD lends to sovereign borrowers at rates set by our sovereign policy. This tends to restrict our operations in the poorest of countries, where the IMF may require that sovereign borrowing be priced on a concessional, non-commercial, basis and as a consequence, the Bank may only lend if it combines its lending with that of a concessional lender, such that the blended interest rate is compliant with the IMF's concessionality requirements. At the opposite end of the spectrum, those countries with access to commercial market funding at finer rates than the Bank's sovereign lending rate typically have much less commercial incentive to borrow from the Bank. They may also have access to other sources of funds more finely priced than those available from the Bank. As a consequence the EBRD's relationship with sovereign borrowers typically is at its strongest between these two stages of development. Other multilaterals, not being bound by such principles are able to maintain a policy dialogue and relationship with the sovereign borrower through all these stages of development.

As a consequence, the EBRD's policy dialogue and transition impact is much more closely tied in to the projects which it undertakes and tend not to relate to programmes, whereas those of other institutions may relate to the overall allocation of government budgetary funding to the transport sector or the strategic governmental decisions relating to the allocation of funding among the individual transport sub-sectors and the establishment of a level playing field among differing modes of transport. Recognising this effect of the EBRD's founding principles, the Bank works on projects to achieve its transition aims and integrate its works with those of institutions better placed to influence the establishment of benign macro-economic policies, such as the IMF, the World Bank and the European Union. The projects are in compliance with the relevant requirements of those institutions and the Bank seeks to integrate them into the broader mandate of the multilateral institutions. Equally, the Bank, in accordance with its mandate will seek progress in respect of the countries of operation on a project by project basis, through engagement and recognising that there may be many steps and several projects to be undertaken to achieve transition goals, such as transparency of funding for transport operations and the establishment of an undistorted market for transport solutions.

In practice the foregoing means that the assessment of a project to be undertaken by the Bank will have due regard to the activities and programmes of the other multilateral institutions. For example, with regard to environmental requirements, World Bank criteria are frequently used where they are more stringent that the requirements of domestic legislation. Another example of this division of labour has been work undertaken in South Eastern Europe where the World Bank has focussed on rehabilitation and reconstruction of existing roads and the EBRD and EIB have focussed on necessary new build roads. The EBRD and the EIB have also established practical cooperation in respect of projects in the Western Balkans and project development in Russia and Ukraine.

2.2.2 Cofinancing

Cofinancing permits EBRD to leverage its resources by mobilising additional sources of finance. In the period 1992 – 2004 some 54 of EBRD's transport projects included an element of cofinancing. This excludes the Borrower's own contribution to the project, but includes commercial co-finance mobilised by the sponsors of private sector transport projects. For these cofinanced operations, EBRD contributed a total of Euro 1.7 billion while cofinancers contributed a further Euro 3.7 billion (more than double EBRD's own contribution).

Approximately 50 percent of cofinancing has been from other IFIs. This was generally undertaken as parallel financing which allows each institution to apply its own procurement policies. IFI cofinancing has brought a number of advantages:

- In some cases a project requires financial commitments in excess of the capacity of a single institution. This applies not only to the cost of financing the project but also, frequently, to the technical cooperation resources required to design and implement the project, and to generate its transition impact.
- The presence of more than one IFI can encourage a government to take difficult decisions with respect to transition (notably for railway restructuring).
- Each IFI tends to have its specific institutional and transition strengths and priorities. The presence of two IFIs can promote transition across a broader front.
- Other IFIs may have access to concessional sources of finance which lower the overall cost of capital for the borrower and in the context of countries operating

under IMF borrowing restrictions, such cooperation may render an operation compliant with the IMF restrictions.

Additional cofinance has been provided by other bilateral financial institutions and by commercial banks. The Bank has successfully cooperated both with bilateral development agencies and with bilateral export credit agencies such as those of France, Switzerland and Austria. The European Commission has provided a significant amount of grant funding to support EBRD's transport projects, particularly in the countries of South Eastern Europe, whereas in a few cases EBRD has been invited to participate in a project initiated by other IFIs.

In the case of private sector projects, EBRD normally expects to finance up to 35% of the total project cost. Additional finance is usually provided primarily through commercial sources of finance mobilised either by the project sponsor or, in some cases, by the Bank. In some cases other IFIs may provide cofinancing for private projects (e.g. IFC, Black Sea Development Bank, etc), or bilateral and export credit agencies may also provide finance. Typically the commercial lenders, except those based in the country of operation, will lend under an "A" loan, "B" loan structure, where the lender of record is EBRD. In this way the commercial lenders can enjoy the benefits of EBRD's IFI status when lending and may be able to apply a more favourable risk weighting to the asset for financial reporting purposes.

2.2.3 Technical Cooperation

Cooperation with donors and official cofinancing agencies has been central to the EBRD's strategy in the infrastructure sectors since the commencement of operations in 1991. It has provided crucial support in carrying out project feasibility studies, project design, due diligence (e.g. environmental analysis, technical assessment of the soundness of a project and its documentary structure) and support for implementation. Provision of grant TC funds has also been central to the Bank's strategy in achieving transition from its state sector transport infrastructure projects, as they have been used to fund projects which have identified and designed appropriate sector reforms and strengthened the institutional capabilities of the agencies responsible for transport provision. Examples of such impact may be found in the restructuring of responsibility for roads financing in Poland, the development work on the preparation of concessions in Romania, the commercialisation of roads in Croatia and restructuring of railways in many of the Bank's countries of operation, see Section 3.4 below.

Within the infrastructure sector, transport has been the largest recipient of donor funds accounting for about 40% of the total. The EU has been the largest donor, through its Tacis programme and, in previous years, the Phare programme. Donor agencies also provide support to EBRD projects through their own bilateral programmes. Funding is available from the EU where the EU has made the assessment that it will achieve its policy objectives by making such contribution. Frequently the EU's own developmental policy is consistent with the aims of the EBRD, but this is not invariably the case, given the EBRD's focus on the development of functioning market economies in its countries of operation, as set out in the Agreement Establishing the EBRD and the EU's own broader policy objectives.

2.3 Summary of Main Lessons Learned

The Bank has implemented a wide range of transport projects covering all the main transport sub-sectors. In reviewing past performance the Bank is able to draw general conclusions relating to Transport activities.

- Arising from transport activities the Bank has experienced that frequently transition impact may be enhanced by cooperation with other International Financial Institutions ("IFIs"). This may be particularly the case where an aspect of transition is likely to prove politically unpopular in the short term, such as circumstances where work force retrenchment is necessary. If the IFIs present a united front under such circumstances, there is a stronger likelihood that the necessary steps will be taken. A recent example of such a transaction was the provision of finance for the Polish State Railway, PKP.
- The Bank has also learnt that it is important to ensure that the obligations of host governments as set out in financing documentation are fully honoured. First the Bank's covenant requirements must be set at a level that is achievable by the Borrower and the Borrower must be sufficiently incentivised to achieve them by the financing from the Bank and by its structure. Policy dialogue in advance of the financing is an important aspect in enabling the Bank to pitch its transition covenants at the right level. For those countries without a pressing need for EBRD's financing, transition covenants might be more difficult to achieve. Documentation must be clear and all sides must understand fully the obligations they are undertaking at the time of signing of documentation. Second, the Bank must be prepared to take action to enforce the performance of such obligations to ensure that the original terms of an agreement are respected. Willingness to take such action is particularly important in the context of a change of government over the lifetime of a Bank financing.

There are also specific lessons that may be learned from individual projects. Of the 108 transport projects, 47 projects have been the subject of evaluation by the Project Evaluation Team. The key lessons are:

When structuring transactions:

- Project selection needs to be based on a rational and robust business/investment planning process and where possible the Bank will through its project appraisal seek to complement the projects of other multilateral institutions. The Bank, in its appraisal of its projects, has due regard for the feasibility and viability of the broader context in which an individual project is developed. This is essential to maximise project returns both in financial and transition terms in the context of sound overall sector business/investment planning.
- Environmental issues need to be identified at an early phase to ensure that a project is environmentally sound and to allow appropriate mitigation measures to be put in place. Each Bank project undergoes environmental appraisal in accordance with the Bank's Environmental Policy and Procedures. The Bank will take into account, where the Bank is financing part of a wider development, the sustainability of the whole plan as appropriate in the context of the Bank's project appraisal.
- The transition achievements of a project are often founded on relationships built up over a period of years with Governments and public sector transport enterprises. As a result more than one operation may be required to reinforce the transition impact and thereby reap the full benefit of the Bank's involvement. The Bank's experience indicates that transition impact tends to remain as it was first conceived for a project. In order for transition impact to be reinforced and also to remain achievable by the recipient of EBRD funding, repeat operations and a step by step approach to achieving transition objectives would appear to offer the best chances of building on solid achievements.
- The regional dimension of a project should be considered, such that the effect of a project is considered not only in a national context, but also with respect to its effect on neighbouring countries. The transition impact of transport infrastructure, which may include its ability to render local and regional markets more efficient, may be enhanced by adopting a co-ordinated regional approach to projects, which ensures complementary road and railway investments are

undertaken by neighbouring countries and appropriate border crossing facilities are put in place. Such an approach is of particular usefulness in areas such as South Eastern Europe, where there is a concentration of smaller countries and a more frequent requirement for transit traffic to cross borders, and in Central Asia. In this respect, cooperation with the European Union on regional initiatives such as REBIS and TRACECA programmes is a helpful guide. The regional approach may give rise to broader transition impact for relatively small additional capital expenditure.

- Because of the special nature of transport projects, there may be ancillary benefits arising, such as the appreciation of property values or the development of entrepreneurial activity made possible by enhanced transport links. Cooperation with other sectoral teams within the Bank may maximise such benefits. There may also be social risks arising from the development of transport infrastructure and these will be taken into account in the assessment of the benefits of the project.

When supervising and monitoring transactions:

- Effective project implementation (including transparent and effective procurement) is of key importance. This means that the Bank must include in its loans adequate provision for the funding of project implementation costs, particularly procurement costs for sovereign transactions.
- Many of the Bank’s borrowers and host governments need assistance in strengthening their project implementation capacity. As a consequence the Bank will seek to provide the necessary funding and support to assist in the development of robust institutional structures and capabilities to allow the administration of detailed projects. There must be adequate, appropriately qualified staff in order to administer and police compliance with contracts. This is particularly important in Public-Private Partnerships (“PPP”s), under which a concessionaire provides a service to the public-sector grantor of the concession over a defined concession period. The agreement between the grantor and the concessionaire tends to be complex and needs to be properly monitored with respect to penalties and incentives for the concessionaire. To the extent possible, funding for technical assistance to strengthen such public sector capabilities may be included in other Bank sovereign operations. Alternatively, if the Bank is consulted in the preparation of the tender, it can advise whether the successful bidder could practically be obliged to fund technical support for the grantor in the policing of the concession.

3. KEY SUB-SECTOR ISSUES AND OBJECTIVES

3.1 Transition Challenges in the Transport Sector

The Bank faces various challenges to achieving transition impact in its countries of operation. In the advanced transition economies there is frequently no longer any financial incentive for the government to borrow from EBRD, given their access to cheaper sources of funds, either commercially or from other non-private sector lenders. These cheaper sources of funds typically do not require the developmental covenants required by EBRD, so may represent a less demanding finance option. The challenge for EBRD in these countries is to achieve transition impact through the encouragement of commercial behaviour in the state sector, the encouragement of the private sector and the development of the financing markets such that similar options are available in the advanced transition countries as may be found in the developed European economies.

Those countries in early and intermediate transition with less access to alternative, less demanding finance sources continue to offer opportunities to achieve transition through covenants and borrower undertakings.

In the smaller and poorer early transition countries the challenge is to achieve transition impact notwithstanding that larger projects are likely to be scarce and that there will be impediments to borrowings by the sovereign if the sovereign is subject to restrictions imposed by the IMF.

The following sections review in more detail the Bank's current involvement, transition challenges and expected future role in the main transport sub-sectors.

3.2 Road Infrastructure

3.2.1 Overview:

The roads portfolio amounts to a total commitment of EUR 1.8 billion, comprising 33 signed projects in 16 of the Bank's countries of operation. Of those projects, over 70% have involved the rehabilitation of existing roads in poor condition and the provision of town centre by passes providing environmental and health and safety benefits. The average project size has been large, mainly because of the amounts needed to reconstruct and develop the road networks in the Bank's countries of operation, particularly in Russia, Kazakhstan and Ukraine and in particular the regional Silk Road route, in respect of which the Bank has provided loans in support of projects with a volume of €480 million. Private sector opportunities have been slow to emerge largely because of the need to develop appropriate legislative and institutional frameworks. As a consequence, the roads portfolio currently is dominated by sovereign financing. These projects involve financing of rehabilitation, upgrading and new construction, typically for roads located on strategic European corridors (i.e. the Trans-European Network ("TENs") or major road axes such as the Silk Road and the Trans –Siberian Highway.

The Bank has been able to achieve a high level of transition in the roads sector by supporting regulatory and institutional reform, commercialisation of activities and greater involvement of the private sector. Transition has been achieved in the following key areas:

- Development of the legal and regulatory framework through the enactment of a Roads Act.

- Regulatory and institutional reform through the separation of policy and management functions by creating a road agency to operate and manage the road network, leaving the Government to determine road sector policy and regulate the sector (e.g. licensing, setting safety and technical standards).

- Reform of road user charges to put road sector financing on a sustainable basis, in particular ensuring adequate funds are allocated to maintain the existing network and, as far as possible, align road user charges with road use.

- Promoting industry reform through the separation of construction and (periodic) maintenance activities from the road agency and creating a competitive market by open tendering of major works contracts.

- Institutional development of the road agency through the development and implementation of medium term business plans and the introduction of MIS, accounting systems and pavement management systems to international standards.

- Greater private sector involvement through open tendering of traditionally-financed contracts for rehabilitation, upgrading and new construction and supporting development of PPP concession arrangements for new construction and rehabilitation & maintenance.

The Bank's involvement in the road sector is additional and complementary to that of other IFIs which are active in this sector in our countries of operation. Given the large amounts of financing required to develop these road networks, all IFIs have a role to play.

Typically, the Bank and other IFIs provide the only source of long term finance, on reasonable terms, to the road sector, which allows a more appropriate matching of financing and asset-life. Where possible, the Bank aims to co-finance road projects with other IFIs to ensure a co-ordinated approach. In total, the Bank's road projects have mobilised cofinancing of almost EUR 1.6 billion.

The Bank's additionality is further reinforced by its well-established relationships with governments and road agencies, which allows the Bank to play a significant role in the reform process. In some cases, co-operation with other IFIs can reduce the transition risk.

Road projects are resource intensive and technical co-operation is an important feature of both project preparation and implementation. To date, EUR 23.7 million in technical co-operation funds have been mobilised to support preparation and implementation of road projects, of which support for achieving transition milestones forms a key part.

As the dominance of sovereign financing indicates, there has been limited private sector activity in the roads sector. A number of early private sector projects have been implemented in ways that have rendered them ineligible for Bank finance, with inadequate process for the selection of concessionaire being the most common hindrance to the participation of the Bank.

3.2.2 Bank's Current Activities:

The Bank's current activities in the road sector continue to have a strong focus on public sector projects, particularly in Russia, Ukraine, Kazakhstan and the SEEC countries, although increasingly the development of PPPs is starting to have an impact on rebalancing the portfolio. Projects once dominated by maintenance and rehabilitation are being replaced by upgrading and new construction. Commitment to reform remains high, particularly in the new EU member states and those countries aspiring to EU accession, and projects are structured with continued emphasis on regulatory and tariff reform, commercialisation and stimulation of private sector activity. Given the Bank's increasing concentration on smaller countries forming a regional grouping (for example South Eastern Europe, Central Asia and the Caucasus), the regional dimension of the project is of increasing importance and can be an important source of transition impact.

Most private sector developments are taking place in the more advanced transition countries, which are able to attract private sector investors to invest substantial sums in infrastructure. The Bank's participation in projects in these countries can be instrumental in giving sufficient comfort to bidders to ensure a fair and transparent bidding process, which results in a truly competitive outcome and can contribute to ensuring a fair risk allocation between public and private sector. Initially focus has been on new-build motorways, but increasingly opportunities are arising in rehabilitation and maintenance of state and regional highways.

3.2.3 Key Opportunities:

In the public sector, a key opportunity will be to continue to develop projects with a regional focus and, to enhance this approach, by working with the EU on regional initiatives such as TRACECA and REBIS.

Cofinancing with other IFIs will provide another key opportunity. In Central Europe and the Western Balkans, for example, cofinancing of roads in the Trans-European network corridors with the EIB and EU is likely to provide the Bank's main opportunities; while in Russia the Bank will seek to co-finance road corridor projects mainly with the EIB and NIB. In Central Asia and the Caucasus, the Bank anticipates further opportunities to co-finance road projects with the World Bank and Asian Development Bank, in particular.

In the private sector the main opportunities will be in the EU accession countries, Romania and Bulgaria which are the most advanced in developing the PPP concept although procurement issues may still need to be resolved. The incentive to develop the concept is strengthened in the EU accession countries because of the requirement to adhere to the Maastricht budgetary criteria.

The recent cancellation of several road PPP schemes, for example, in the Czech Republic and Romania, demonstrates the early stage of transition of these schemes. In many cases, lack of success of such tenders follows an active choice on the part of the grantor to reject the advice of the Bank. Consequently the Bank's advice in subsequent tenders carries additional weight. The additionality and transition impact of the Bank's financing of sustainable PPP projects can be enhanced through replication in other countries. In the medium term, the demonstration effect of the implementation of PPPs in the advanced transition countries is expected to encourage less advanced transition countries to address the legal and structural issues that may be preventing the implementation of such schemes at present.

3.2.4 Issues

The key issues in the road sector concern the transition milestones which the Bank aims to address through its involvement in the sector. Road financing and efficient management and operation of road networks are key issues for the Bank. The road sector, taken as a whole, generally generates substantial revenues from road users, either through the general taxes, particularly fuel taxes, or directly, through tolls, vehicle registration charges and other road user charges. However, there is often little direct linkage between the revenue collected (particularly from general taxes) and the funds made available for road maintenance and investment. Road networks are valuable assets which are an important element of the economy and whose maintenance, replacement and, where justified, expansion needs to be undertaken on an on-going basis. The Bank therefore encourages the funding of roads to be put on a sustainable and predictable a basis in its countries of operation, and will seek to promote transparency of funding for roads.

Given the different administrations responsible for road financing (typically national/federal, provincial and local) there is no single approach that can be universally applied. However, three mechanisms have been successful in a number of countries:

- General taxation is, and will remain, an appropriate funding source for much of the road network, but a more predictable stream of funds can be achieved if part of the fuel taxes currently paid by users is treated as a 'road user charge' along with specific charges, such as vehicles registration charges, and allocated to the road sector.
- Where there are specific costs associated with particular groups of road users, such as

pavement damage from heavy vehicles, these may be recovered through specific road user charges, such as vignettes.

- Parts of the network, particularly new high-standard arterial roads, can be financed through concession agreements, with revenue being collected by the concessionaire in the form of tolls, shadow tolls and/or availability payments.

Some or all of these mechanisms may be adopted. The mix of these mechanisms in the Bank's countries of operation will be a matter of individual transition policy. The Bank is supportive of moves towards the "user pays" principle, particularly where congestion represents an environmental and/or health and safety issue. It recognises, however that there are both political and technical issues to be resolved before "pay per kilometre" programmes may be introduced. Initial steps towards such road pricing may arise either through the use of vignettes and time based, rather than kilometre/usage based payment schemes, which have the advantage that they are relatively cheap and simple to implement or in the introduction of electronic tolling for transit heavy goods vehicles, which is currently under consideration in Slovakia.

The owners of public roads, which need to be defined in national legislation, will normally be public sector entities at state or sub-national level. Ownership of public roads brings with it the responsibility for setting policy and standards, and for funding, administration, management and operation. Where possible, public roads should be administered on a commercial basis on behalf of the owner and the Bank will encourage such initiatives. This could be undertaken by a publicly-owned corporation on an agency basis or by the private sector under a concession agreement. In the former case, some management and operational activities may be delegated to the private sector under competitive contracts.

The main regulatory issues concern vehicle standards and their enforcement, particularly in respect of vehicle weights and dimensions, exhaust emissions, overloading, and safety. Fuel quality standards are also an important issue. In many of the Bank's countries of operation, these issues are already being addressed but, where necessary, the Bank will support initiatives to address these issues.

3.3 Railways

The scale of EBRD involvement to date in the railway sector reflects its significance to local economies and international trade: railways carry more than half of long-distance freight in the region (in Russia more than 70 per cent) and a significant share of the intercity passenger market (typically around a third); the national railway is usually among the six biggest enterprises in any of the Bank's countries of operation.

3.3.1 EBRD Railway Portfolio: Scale, Transition Impact and Additionality

The Bank's lending to publicly owned railway enterprises has been subject to two conditions: (a) the commitment of senior railway management to a commercialisation process and (b) willingness of governments, as owners of the railway companies, to support the commercialisation efforts with an appropriate legislative framework and transparent financial arrangements to support necessary non-commercial railway operations. As a result of both conditions, significant transition impact has been achieved in railway legislation and in the pace and scale of railway sector restructuring in most of the EBRD countries of operations.

Although the pace of the railway reform and its main objectives may differ among the EBRD countries of operations, the Bank financed projects have all included relevant loan conditionalities which resulted in achievement of the following transition steps in majority of the EBRD railway borrowers:

- Separation of operating and policy setting functions;
- Development of legal framework to facilitate industry restructuring;
- Introduction of transparency in the provision of state subsidies;
- Initiation of organisational restructuring through internal or external separation of infrastructure and train operating functions; and
- Introduction of steps or policies for gradual liberalisation of network access.

The Bank recognises that well directed railway lending can reduce reliance on road networks and alleviate congestion, such benefits being taken into account in our economic assessment of a project.

To date, the main sources of financing for medium and long term railway projects were the state budgets and the loans from IFIs. EBRD additionality in the sector has been driven by: (i) the Bank’s ability to match its technical expertise and understanding of the railway sector specific operational circumstances with realistic project conditionalities, (ii) willingness to cooperate and complement efforts of other IFIs in the sector (e.g. EBRD has worked closely with EIB, for example, providing complementary funding for rolling stock which would run on infrastructure and track which had been rehabilitated with EIB funding); and (iii) EBRD’s ability to support its borrowers in preparation of railway reform strategies through mobilised technical cooperation funding for consulting services. A more detailed assessment of the Bank’s transition impact in the railway sector transition can be found in "Plans, timetables and delays: Progress with railway reform in transition economies", produced by the Chief Economist Office, October 2003.

In the last two years some railway operating companies have been able to access commercial funds without sovereign guarantees (e.g. Romania). This however has been more as a result of the market perception of the “implicit” sovereign support for the railway sector rather than successful improvement in creditworthiness of the railway borrowers. Nevertheless, it is expected that in future as the train operating companies improve their credit standing their ability to access commercial financing sources will continue to increase.

3.3.2 EBRD Railway Pipeline

The present EBRD railway pipeline reflects the changes which have taken place in the sector and fragmentation of the client base. There are relatively fewer large loans to vertically integrated railway enterprises and more, smaller size loans to railway sector companies. The EBRD pipeline encompasses not only core railway transportation activities but also support for specific aspects of railway restructuring (financial restructuring, labour restructuring), railway supply industry (equipment manufacturing plants), specific operating facilities (intermodal terminals, station refurbishment, etc) and private asset finance.

The combination of capital constraints at big national railway carriers as well as the rise in the number of independent freight forwarding companies operating in the region has resulted in the creation of high level demand for new rolling stock which is expected to continue in the medium-term. Although new purchase financing at present tends to include a combination of asset-based and corporate support, there has been a steady growth in finance leasing operations secured on rolling stock assets. This trend is expected to continue with EBRD providing active support to private sector investors interested in setting up rolling stock leasing operations in the region (leasing of both wagons and locomotives). The Bank’s knowledge of the region’s railway markets together with its financial product flexibility allows the Bank to recognize and develop project opportunities in rolling stock leasing, which may have a strong demonstration effect in respect of the possibility of undertaking such financings and are expected to be replicated by commercial sources in the future. Well managed private sector freight forwarding companies may also present potential equity investment opportunities.

3.3.3 Railway Sector Directions and Opportunities for the Bank

The scale and pace of railway sector reforms differ markedly among the countries within the EBRD region of operations. The Bank's response to the needs of the sector is based on maximum flexibility of approach. The Bank does not promote a single railway restructuring or reorganisation model; however the support remains conditional upon on-going railway sector commercialisation. The investment policy in the railway sector will encompass an integrated public/private sector strategy to offer financial solutions tailor made to the needs of specific clients – both the railway enterprises and private sector investors. The ability to engage in public and private financing and become partners not only with state owned companies but private sector entities are expected to allow the Bank to remain a major financing source for the railway sector in the region. The Bank expects to take advantage of the existing diverse sector opportunities by supporting the following:

- Selected sovereign supported investments in infrastructure upgrade and cost cutting programmes where the sovereign support is available.
- Labour restructuring programmes.
- Bridge and matching funding schemes for Cohesion and Structural Funds projects in New EU Members.
- Pre-privatisation/privatisation support to train operating companies.
- Concession structuring and financing.
- Rolling stock renewal and rehabilitation (both public and private approach including leasing).
- Railway supply industry investments (manufacturing plants, workshops, track renewal units) and
- Operating facilities (including terminals, stations, etc.).

3.4 Ports and Shipping

3.4.1 Ports

The significance of port development derives from the ports' importance as facilitators of trade and maritime transport, which has significant environmental benefits compared to alternative modes of transport.

The ports in the Bank's countries of operations faced fundamental changes in cargo and passenger flows following the break-up of the established trade flows under the Soviet regime, leaving the ports with significantly less traffic volume and/or ill-equipped to handle their new cargos in an efficient manner. Due to their organisational structure as public institutions and decreasing funding from public budgets coupled with little access to alternative financing sources, they had little flexibility and resources to adapt to these fundamental changes. Operational and financial performances were weak due to lack of market incentives and were further hampered by corruption and obsolete management practices. The industry is also frequently characterised by corrupt practices/smuggling.

Traditionally ports in most countries were owned and managed by public institutions. However, several models for organising port activities have evolved over time. It is common to distinguish between the ownership and operations of *infrastructure* (breakwaters, dredged channels and berths, lights, buoys, quays, road and rail connections etc.) and *superstructure* (handling equipment, warehouses, storage yards, office buildings etc.) with regard to port organisation. In terms of infrastructure, the Bank has encouraged *corporatisation* and *commercialisation* in the ownership and management of assets previously owned and managed by State administrations, i.e. processes aimed at making port institutions work independently from political interference, and to develop rapid responses to market circumstances. In Russia for instance, the Bank has been instrumental in establishing *Rosmorport* in April 2003, a publicly owned entity which will act as landlord for 18 Russian ports separating the port authority function from the Ministry of Finance. In other places however, such as Ukraine and in the Caspian Sea, this process is still pending. The public sector landlord model for port ownership is commonly used in the advanced economies and is a logical sequential step allowing many of the benefits of private sector operation, while allowing the public sector to foster competition within the port. This region will face an increasing demand for transport services in line with the rising level of export of commodities from the region. The Bank will seek to facilitate transition and funding by linking its financing of assets to technical assistance for the development and subsequent implementation of restructuring measures. In these early transition countries, sovereign loans can still play an important role in achieving this.

Elsewhere, where management and ownership of infrastructure has been corporatised, but where port authorities are not yet financially viable, the Bank will focus on full cost recovery through port tariffs, institutional and financial strengthening and other commercialisation measures with the aim to make the port authorities independent of public funding. This will pave the way for lending to publicly owned port authorities without a sovereign guarantee, and, subsequently, to financing from the private market. This strategy is applicable for most corporate port authorities in the Bank's countries of operations, with the possible exception of some port authorities in the Baltic States which already have access to private financing from both local and international banks. In the Baltics, the Bank will concentrate on cofinancing with local banks and on providing long-term financing to match the long-term nature of such infrastructure requirements. In the ports of the Baltic and Adriatic coasts, there are sources of funding from regional development banks complementary to the Bank, which have already been accessed by the corporate port authorities. The Bank will seek to arrange parallel finance with these institutions where appropriate.

With regard to the operation and ownership of superstructure and provision of ancillary services in ports, the Bank has been actively promoting *liberalisation* and *privatisation,* i.e. processes oriented towards reducing monopolistic situations within seaports based on allowing the free entry of new private operators which can compete, and transferring, partially or completely, former public firms to private agents in order to eliminate subsidies, improve efficiency and make users pay the full cost of services. This process has already taken place in numerous ports across the Bank's countries of operations. The Bank's priority has been to support foreign, strategic investors joining forces with private or public local enterprises, in order to take advantage of both the operational expertise of the sponsors and the local knowledge and cost level; such scheme was used to finance a container terminal in Ventspils (Latvia), a barge terminal in Constanta (Romania) and an oil products terminal in Poti (Georgia). The Bank will continue to focus on supporting private entities in the sector, in particular where commercially available financing cannot fully match the long-term nature of the required investments. Equity and/or guarantees will be considered where the Bank can be satisfied that the market risk is acceptable. The Bank can play an important role in ensuring open and transparent tender processes, and in advising port authorities on concession agreements in order to create sound foundations for long-term financing of the privatised entities, thereby also paving the way for future financing business for the Bank.

The port sector includes not only the handling and transportation of cargo for ocean going vessels, but also includes passenger terminals and ports for transportation on inland waterways. The Bank will encourage the development of passenger terminals where this is important to the local tourist industry, such as for the countries on the Adriatic and Baltic seas. Current and anticipated congestion of roads (and rail) and the environmental benefits of relieving the congestion by switching traffic to inland waterways are expected to increase the attractiveness of this transport mode in the medium to long term, and the Bank should support this development by providing financing to river ports, providing that the project economics are acceptable. For those projects where the economic benefits, including the environmental benefits are not captured solely by commercial charging, other structures of payment to reflect the full economic benefit of the infrastructure, including payment by government, may be considered. Multi-modal interoperability, particularly between inland waterway and railway freight transport can give rise to environmental gains and consequently the Bank will be supportive of commercially viable projects in this sector.

Finally, as port charges normally constitute a minor fraction of the total transportation cost of goods, in order to facilitate well functioning, integrated transport chains for the movement of goods and passenger within countries and regions, the development of ports should not be seen separately from the development of other modes of transport, i.e. hinterland connections, multi-modal transport terminals and inland depots and factors such as customs legislation.

3.4.2 Shipping

The Bank's shipping strategy is set out in greater detail in the Shipping Operations Policy approved by the Board 31 October 2001. For the sake of completeness, a summary of that strategy is set out below for information. The Shipping Operations Policy remains, however, the definitive document.

Overview of the shipping industry & the level of transition achieved

The shipping industry in the Bank's countries of operation has undergone significant structural changes which have affected, and will continue to affect the future development of the industry. The most notable developments are the privatisation of formally state-owned companies; financing of fleet renewal funded by private sector sources and increased competition from foreign ship owners following liberalisation of seaborne export trade.

Most of the early privatised companies have been relatively successful in making the initial transition into private enterprises. However, not all managed to move further along the transition path due to their inability to adapt to the new and competitive business environment. Many companies in the Early and Intermediate countries such as Azerbaijan, Bulgaria, and Ukraine have yet to undergo the necessary restructuring, and their problems are further compounded by over aged and obsolete vessels. These factors made them very unappealing to western banks and access to the financial markets therefore remains very difficult. As a result, a number of these countries have lost almost their entire merchant fleet.

However, there are some notable successes, mainly in Russia and the Baltic countries. These companies have managed to make the transition and turn into efficient and well run corporate entities capable of competing in the international markets, and for whom, access to financing is no longer an issue. Companies such as Novoship and Primorsk, for example were very effective in changing their business orientation to profit based operations. They were also receptive to adopting western management tools, such as implementing IAS for financial reporting, costs control and corporate structures which are accountable and transparent. The EBRD has been involved with both of these companies and played a significant role in fostering their transition.

Bank's current activities & factors conditioning key opportunities

The Bank has provided mainly debt finance to privatised or partially privatised entities which have embraced the Bank's objectives, demonstrating one of the tangible benefits of commercialisation and providing encouragement for other entities to follow suit. Most of the Bank's current activities are still concentrated in Russia and Ukraine (due to concentration of larger number of companies), although it is also exploring potential projects in other Early and Intermediate countries such as Bulgaria, Azerbaijan, and Kazakhstan.

The region's continued economic growth and the expansion of seaborne trade - Russia in particular, in the export of raw materials in both dry and wet cargoes - will continue to increase the demand for a modern and efficient merchant fleet. Given that the average age of the vessels is more than 20 years old, the need for fleet renewal will present the Bank with many key opportunities in the financing of new buildings such as deep sea tankers; general cargo vessels (including containers); and offshore supply ships in Russian and the Caspian region. However, the lack of transparency, weak adherence to good business practice and poor corporate governance remain the principle obstacles and challenges to both long term debt finance and direct equity investments from international sponsors, which are considered low compared to other sectors.

3.4.3 Shipbuilding and Shipyards

In tandem with the expansion of world trade, the annual new building activity has been increasing each year. However the majority of the shipyards in the region have not been able to benefit from the growth in this sector, due to weak governmental commitment to privatise the industry; many have remained state-owned and unable to make the transition towards open market economies. As a result, Eastern European yards' share of the world shipbuilding market has fallen from 10-15% to less than 5% in the last 10 years.

Although some yards managed to continue operating, they often have obsolete production methods, are plagued by excessive debt, or are in receipt of government subsidies. State-aid and subsidisation, is a highly sensitive issue in the sector and has led to serious trade disputes between Korea and the EU.

However, quite a number of privatised yards in Romania and Russia would appear to have made a relatively successful transition by focusing on hull construction, conversion and ship repair; and forming strategic alliances with international strategic investors. However, even these yards have experienced difficulty in accessing the financial markets, and a few of them still require further restructuring order to make them attractive to international commercial lenders. As a result, many of them still rely on working capital facilities from their sponsors or partners.

Bank's current activities & factors conditioning key opportunities

The Bank has explored several and approved 2 to 3 projects in the sector but so far concluded only one project in Croatia which is supported by a sovereign guarantee.

Although the most sought-after financing is long term investment and term loans, the Bank is often only able to consider refund guarantees and working capital facilities. Technically, some of the yards are very advanced, but their financial conditions are often not sufficiently robust to cushion the inherent risks of the shipbuilding industry. Therefore, credit facilities are typically tied to specific contract orders, short term, and structured on a revolving basis.

The Bank will continue to target key opportunities involving yards which have benefited from an infusion of management know-how and capital from strategic investors; privately owned yards with proven management experience; and yards in countries where the governments are committed to, and where the Bank's involvement would bring about, restructuring and privatisation.

3.5 The Aviation Sector

3.5.1 Air transport

The end of the communist block left airlines in the Bank's countries of operation laden with fleets of soviet-type aircraft, operating an inefficiently run network, seriously over-staffed and with commercial and management cultures inherited from the command economy. The end of state subsidies, the adjustment of air fares to levels reflecting the true cost of operations and the population's lack of disposable income led to a massive drop in air travel demand all across the region. Whilst the Western European air transportation sector was deregulated, thus giving rise to the development of the low cost airlines, there has been uneven progress in Central and Eastern Europe towards deregulation and opening to competition.

Lack of reform and fear of losing control over national flag carriers has resulted in central and local/regional governments retaining a majority shareholding or significant influence in most airlines. Foreign airlines have sparingly taken direct capital interest (Ukraine Airlines, LOT), and have exercised their growing influence through commercial and technical arrangements. Access to financial markets has generally been non-existent, with very few airlines seeking listing on local stock exchanges. Most airlines remain undercapitalised and dependent upon inadequate and expensive short-term credit to finance their development.

Fleet renewals have already taken place to a large extent in the advanced countries, thanks to the support of the Export Credit Agencies (ECAs) for new aircraft and access to operating and financing leases provided by traditional aircraft leasing companies. Airlines in many of the states of the former USSR and South Eastern Europe have experienced limited access to leasing and have had to rely mainly on ECA support. The pressure to accelerate fleet renewal plans will likely become very acute in the near future as (i) the ICAO's Stage III regulation on noise and emissions is implemented and, in 2006, Stage IV regulation will most probably ban aircraft which were, until now, complying marginally with these regulations (ii) West European Airlines aggressively develop routes across the region, developing hub strategies to feed their main long-haul routes, and thus take passengers away from local airlines on the most profitable routes. Customs barriers preventing the import of new or used aircraft remain substantial, in particular in the Russian Federation, and will further limit the capacity of local airlines to finance acquisition of new or second-hand aircraft. Second hand aircraft may, however, in other countries offer a reasonably priced, appropriate solution to the needs of fleet expansion/modernisation and the Bank will explore opportunities in this area. Legal transition will be playing an important role, as the expected ratification of the Cape Town Convention on mobile equipment (see section 4.1.5.) will provide the necessary legal infrastructure to support access to long-term finance and leasing for airlines in our countries of operation.

Proximity to Western Europe and competitive pressure from western carriers have forced the transition of airlines in Central Europe and the Baltics. National carriers in these countries now operate fleets of modern aircraft with appropriate management and information technology systems. In the process, however, they have had to significantly reduce their networks and lost market share to their western competitors. This process is also underway in South-Eastern Europe, although from a much degraded starting point. Accession to the European Union entails full liberalisation of air transportation in the accession countries. No more State aid will be allowed. Simultaneously, growing levels of disposable income will trigger significant growth in the market. Liberalisation will accelerate industry consolidation and create opportunities for new indigenous or external entrants, such as low fare budget airlines or regional airlines. These new entrants may provide investment opportunities, provided that they are successful in developing a competitive, low cost, business model.

In the Russian Federation, Ukraine, Kazakhstan and Belarus, the break-up of Aeroflot resulted in the creation of a large number of players. The relative lack of foreign competitive pressure and slow pace of reform have resulted in a gradual consolidation of the airline industry. This process will, however, accelerate as obsolete fleets are retired and a limited number of airlines will have access to ECA or long-term finance.

In early transition countries, low levels of disposable income result in low levels of traffic. Although many international airlines have now renewed their fleet, their ability to compete in the international market remains subject to the protective regime of bilateral air service agreements under the Chicago Convention. In the light of the strategic importance of air transport for the development of these countries, a progressive liberalisation of traffic rights may give a few air carriers the time necessary to improve their management, commercial and operational performance. The Bank will consider projects in this direction, with a special focus on air safety and environmental benefits. For example, through its investment in Ukraine Airlines, the Bank has been working with Sair and Austrian airlines to develop competitive operations at Ukraine Airlines. By being present at the Board of Directors, the Bank has been able to support the improvement of corporate governance practices with a view to facilitating privatisation of the remaining state shareholding in due course.

The Bank will be in a position to selectively encourage the consolidation of the airline industry through increasing its equity investments in the privatisation or restructuring of market leaders, whilst remaining mindful of the risks associated with the high level of volatility of the industry. The Bank will also consider indirect support to consolidation in order to address the key challenges of fleet modernisation (with air safety and environmental benefits as a consequence) and corporate restructuring. The Bank will only provide finance for state-owned airlines as part of the process leading to sound commercial corporate structure and governance and ultimately to privatisation. The Bank will seek to obtain undertakings in respect of the timing of privatisation of the state-owned airline in its financing activities. Although the Bank is less likely to finance new western aircraft, it will consider financing second-hand western aircraft and aircraft or equipment manufactured in the region for airlines that will be considered as long-term survivors in a consolidating industry.

Low aircraft lease rates will provide substantial opportunity to enable financing for second-hand long-haul, medium, and regional western aircraft. The pace of the development of this type of financing will depend mainly on the adequacy of the legal system on the ratification of the Cape Town Convention and on the ability of the local airlines to provide the equity alongside the manufacturers to make such operations viable.

The Bank may also provide financing for the purchase of new aircraft manufactured in Russia (e.g. Tu-204-120, RRJ Sukhoi / Boeing, Beriev 200) by providing finance or supporting the provision of finance for the purchaser or by taking the performance risk of the manufacturer, provided that these aircraft meet with the new ICAO Stage III and IV requirements and are certified by the FAA or JAA, thus creating a global market for the aircraft. The involvement of Western Sponsors to support certification and provide marketing and product support are key factors of success in these programmes.

3.5.2 Space Transportation and infrastructure

The end of the Cold War has prompted significant cooperation between leading western aerospace companies and their counterparts in Ukraine and the Russian Federation in marketing launch vehicles or jointly producing satellites.

The space infrastructure of the former CIS countries is aging, thus prompting the need to renew satellites covering the region as satellite coverage is essential to maintain access to telecommunications and media in remote regions. The traditional satellite manufacturers in Ukraine or the Russian Federation have tried to respond to the demand in association with Western equipment manufacturers who provide some of the critical parts (e.g. antennas, transponders). Space infrastructure will, however, likely remain under state ownership.

A number of programmes supported by public funds through the NASA or the European Space Agency will support demand for launches as commercial demand for renewal of satellites and related launches is slowly picking up.

Opportunities for the Bank reside in the financing of the manufacturing of rockets or satellites with local manufacturers. In particular, there may be opportunities to support the development of the Soyuz's launches in Kourou as there would be substantial contributions from Russian space enterprises. Other opportunities may arise through the financing of the renewal of the fleet of satellites for CIS countries.

There are, however, a number of transition challenges as rocket manufacturers are state-owned and are traditionally bound by strict secrecy laws which may limit their ability to disclose financial information which would allow financing to be structured on a corporate basis. Rocket financing would be structured initially as an asset-based transaction as it is unlikely that an acceptable level of disclosure could be reached by these companies. Opportunities may arise in the financing of the renewal of space infrastructure, either on a Sovereign basis or through PPP, whereby space infrastructure remains state-owned and the telecommunications' capability is leased on a long-term to private operators.

3.5.3 Aviation infrastructure

Civil aviation infrastructure provides the support for a competitive aviation environment. The Bank has been active in providing long term financing to air navigation services (ANS) and airport projects. The Bank has actively promoted the creation of autonomous air navigation services organisations, benefiting from the charges paid by airlines for the use of ANS facilities. Where possible, the Bank has given first priority to membership in Eurocontrol, the European Organisation for the Safety of Air Navigation, which oversees air traffic control in the upper airspace of member states, so as to guarantee operational integration into a single European network and the centralised and secure collection of air navigation charges.

As a result of this institutional and financial framework, air navigation service providers have gained a fairly wide access to financial markets. The Bank may still play a useful role in partnership with commercial banks to provide the necessary long term maturities and risk guarantees. The Bank will also encourage regional co-operation between air navigation service providers and the implementation of the European Single Sky Initiative. This Initiative aims at addressing airspace fragmentation and at creating “functional blocks of airspace” or zones of control that supersede national boundaries. Where this framework is unavailable, the Bank will continue to support projects that promote safety, airspace rationalisation or regional co-operation, to the extent that those are self-repayable and managed by an air service provider autonomous from the State. To the extent that the Bank has lent on a sovereign basis to finance projects in the sector, further transition impact may be achieved by refinancing on a public sector non-sovereign basis, thereby encouraging the commercialisation and transparent operation of autonomous air service providers.

In the airport sector, the Bank’s countries of operation have inherited a large number of airport facilities, sometimes ex-military. Apart from Moscow, no airport in the region is currently a major connecting hub. Point to point connections will continue to dominate the airport landscape in the years to come, although transit traffic will play an increasing role at the few airports, which are home to the few national airlines that will compete successfully with the major international airlines. With a few exceptions, runway capacity is unlikely to be an issue. The critical problem has been the non-compliance with minimum standards of safety and passenger levels of service. International standards, especially in the field of security, will continue to drive long term investment requirements for rehabilitation and modernisation of airport assets. The Bank has an important role to play in early and intermediate transition countries, where no long-term financing is available. Where vertically integrated entities exist, the legal and managerial separation of activities will be an objective of the Bank’s financing. This is to avoid conflict of interest, create transparency and promote a competitive downstream market with regards to ground-handling and passenger services to airlines. The Bank’s sovereign transactions will seek to move the sector to this structure over time in order to enable more transparent competition.

In intermediate and advanced transition countries, increasing traffic and accelerating liberalisation of airline service make it easier for existing airport companies to access commercial finance. The Bank may be called to co-finance alongside commercial banks or other IFIs for major undertakings. In these countries, the Bank will seek to promote further involvement of private investors and sponsors in airport operations, under the most appropriate structure, ranging from airport operating contract, to Design Build Finance Operate (“DBFO”) concession schemes, Joint Venture agreements, PPP or outright privatisation. In large countries, where the airport fulfils a pre-eminent regional role, the Bank will support the transfer of ownership or involvement of local interests and government.

Opportunities for the Bank could also derive from private initiatives in the provision of ancillary support services to the industry, subject to the financial value of the operation achieving critical mass for the Bank and the prospect of transition impact being of sufficient magnitude to justify the effort undertaken by the Bank. General economic growth, traffic increases and airline liberalisation will also create the conditions for private initiatives in the field of support activities such as ground-handling, in-flight catering, air cargo, aircraft maintenance and repair. The Bank’s countries of operations, with their long tradition of technical excellence and relatively lower staff costs, could derive significant benefits in terms of qualified jobs and wealth generation. In turn, the Bank will endeavour to support the ventures with most demonstration effects, on a commercial basis.

3.6 Municipal Transport

As stated in section 1.1 above, municipal transport falls outside the formal scope of this policy. However for the sake of completeness we set out below a summary of the guiding principles from the municipal and environmental infrastructure operations policy.

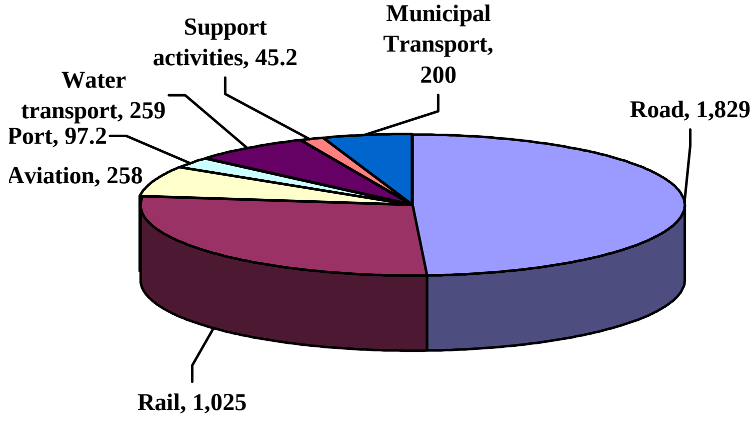
- Transfer of the commercialisation approach pioneered in the water/waste-water sector to operating companies in the urban transport sector, such that:
  - transport companies operate under transparent contractual relationships with their local authority, with clearly defined rights and obligations, and good corporate governance;
  - where a local authority sets fares below full cost recovery levels, the authority makes payments to the operator for services rendered (whether a public or a private operator) under a Public Service Contract (PSC), rather than on the basis of blanket subsidies.
- Support for private sector participation where appropriate and feasible for urban transport services, rolling stock provision, street infrastructure provision and maintenance, and parking infrastructure and management;
- Grounding of urban infrastructure investments (e.g. roads, bridges, track renewal) on the basis of sound economic priorities, taking into account traffic management improvements, and based on sound environmental and public consultation procedures;
- Application of EBRD public procurement rules in a sector which is subject to non-transparent and corrupt practices;
- Support to local authorities and local transport companies to improve regulatory, institutional, operational and financial performance.

The Bank recognises that sustainable solutions to traffic congestion require road investments to be evaluated in the context of a comprehensive urban transport plan.[3]

The Bank recognises the importance of urban public transport as an environmentally sound transport mode, which is in need of significant investment. The Bank has and will continue to increase its efforts and resources for developing viable stand-alone projects within urban transport sector. Further information on the Bank's strategy can be found in its MEI Policy (2004).

If municipal projects are added to the Transport portfolio then the sectoral breakdown of the portfolio is as follows.

Sector breakdown by volume at end December 2004



[3] For full details refer to the Municipal & Environmental Infrastructure Operations Policy 2004-2008

4. CONSEQUENCES FOR EBRD'S ACTIVITIES

4.1 Products

The changes in the means of achieving transition impact, arising from the progress of the Advanced Transition Countries and from the Bank's renewed emphasis on operations in the Early Transition Countries mean that the Bank will have recourse to a diverse array of products in order to tailor the transition impact of an operation to suit the degree of transition of the host country.

4.1.1 Sovereign Lending

There are structural impediments that generally prevent the private sector from being able to monetise the benefits arising from many types of transport infrastructure. This explains the frequent involvement of the state as a provider of transport infrastructure both in the Bank's countries of operation and more broadly. We will therefore continue to expect to see state involvement in the transport sector in our countries of operation and will seek to exert transition impact in restructuring, transparency of process and funding, improved administration and commercialisation of the state sector. As a consequence the Bank expects to continue to undertake sovereign transactions in the transport sector, which for the medium term are expected to continue to represent the largest part of the Bank's transport sector lending by volume, if not by number of projects.

Sovereign lending is frequently undertaken in conjunction with other IFIs, whereby the Bank may achieve additionality and where the likelihood of achieving the anticipated transition impact may be enhanced by the presence of a number of multilateral lenders on one project.

Such transactions are expected mainly to be in the Early and Intermediate Transition Countries. However, in the poorest of our countries of operations, there may be restrictions, usually required by the International Monetary Fund, on further sovereign indebtedness where the Bank will be prevented from lending on a sovereign basis unless it were able to offer lending at concessional rates. Given the restrictions on the Bank providing loans itself at concessional rates, the strategy employed in these circumstances is to co-finance with another entity, typically a bilateral aid agency or another International Financial Institution which does provide concessional funding, such that the blended rate for the whole transaction complies with the overall requirement for concessionality.

The Advanced Transition Countries are relatively more likely to be in a position to use private sector structures to implement public infrastructure projects. In addition, they are likely to have access to cheaper funding than is generally available from the Bank for sovereign transactions in accordance with the sovereign pricing policy of the Bank as approved by the Board (BDS00-6). Consequently, in order to structure a viable sovereign project, the Bank will need to satisfy concerns of the Ministry of Finance that the cost of borrowing is not excessive in terms of the project itself or broader precedents; of course a government will also take account of the value-added which the Bank's involvement brings in terms of transition and other dimensions.

4.1.2 Public Sector Non-Sovereign Lending

Increasingly we may expect public sector non-sovereign projects to arise as a consequence of earlier successful sovereign transactions. The Bank's earlier operations may have assisted in the commercialisation of a public entity, such that it has achieved sufficient autonomy and that credit and management quality have improved to such a point that it is able to raise finance without the need for a sovereign guarantee. Such was the case in the refinancing of the Tallinn Airport Authority, where the re-financing was provided without the state guarantee, replacing a more costly, sovereign-guaranteed transaction. The airport is now being run as a state owned enterprise, but is self-supporting and run on commercial lines, such that if at a future stage a privatisation might be contemplated, the airport would need little restructuring in preparation. Alternatively, the Bank's intervention might help identify a commercially viable part of a larger, less commercially viable entity, which might be set up as a stand alone entity, to which the Bank can lend. The Bank will also consider public sector non-sovereign projects in poorer countries where a particular public sector entity might hold a strong position in the economy, such as the transit and ports sectors in the Caucasus. As before, the Bank will lend to public sector non-sovereign entities where to do so will have transition impact. Most typically transition impact will arise from the encouragement to the Borrower to behave in a commercially sensitive way through the instrument of the financing itself and through seeking clarity in the relations between the public sector non-sovereign entity and the State. Public sector non-sovereign transactions may, in due course, lead further to privatisation operations and the opportunities for pre-privatisation transactions.

4.1.3 Private Sector Lending

While recognising that the major proportion of transport operations is likely to remain in the state sector for the medium term, the Bank has increased the percentage of transactions that fall in the private sector (refer to Section 2.1 above). This policy anticipates a continuation of this trend as the State steps back in our countries of operation from certain transport operations and encourages the development of the private sector to replace it.

In certain of our sectors either governments have seen the advantages of introducing private sector participation, or they have been unable to supply the needs of the market and the private sector has developed to fill the gap; a particular example of this change is the development of commercial container leasing companies, rail-truck operators and freight train operators, particularly in Russia, meeting the needs of the market. The Bank has already discussed leasing transactions in the sector and will continue to pursue such opportunities. There may also be opportunities for smaller size transactions with freight forwarders, intermodal transport bases and road hauliers. Because smaller companies may be higher risk credits, then asset-based finance might also offer an opportunity to mitigate those risks to some extent. Equally both the shipping and air transport sectors continue to be in transition, with a combination of private operators, state owned operators and regionally owned operators and part privatised companies. These too may offer challenging credit profiles and opportunities for innovative financing.

In the port sector, as restructuring of the ports takes place in our countries of operation, opportunities for the private sector arise in stevedoring, storage and vessel handling, whereas in the shipping sector typically the transition is further advanced, owing to the largely international nature of the business of the shipping companies and their already long term exposure to relatively efficient shipping markets. Opportunities relating to restructuring and sound business investment policies will continue to arise in this sector.

4.1.4 Public-Private Partnerships

With the introduction of PPPs to our countries of operation, private sector opportunities are set to increase, in the field of public infrastructure, putting private sector enterprises in cooperation with the public sector. PPP transactions are frequently large in size and offer the Bank the chance to play a catalytic role in increasing the application of private sector efficiencies to the transport infrastructure sector. PPPs are highly visible transactions and can offer a strong demonstration effect and, if well structured, require a transparent concession contract between the concessionaire and the concession letting agency, thereby also adding to transition impact. The Bank’s objectives in financing well-structured PPP’s are to promote private and entrepreneurial initiative in our countries of operation and to enhance the private sector efficiencies that well structured PPPs are able to bring. In addition, because of the requirement for the relationship between central government and the concessionaire to be documented in the concession agreement, PPPs foster a transparency in operation which is frequently absent from state sector transactions.

EBRD-financed PPPs in the transport sector have only to date been implemented in Hungary, namely the M1/M15 and M5 motorways. Until the tender for the M6, also in Hungary, the only variant of PPP successfully tendered and implemented in Hungary was that in which the concessionaire is exposed to market demand; the tender for the M6 introduces the availability payments type PPP. In Poland there is measured progress with the involvement of the private sector in toll roads with further developments in respect of the A1 and ongoing tenders for sections of the A2 and A4 toll motorways. The scope therefore for further transition impact through the implementation of PPP financing throughout the Bank's countries of operation and in different variants, as appropriate for local conditions is substantial. The transition goals include transparency of funding of transport infrastructure, value for money achieved through private-sector efficiencies, the developmental effect of achieving the return from improving transport infrastructure at an earlier date, that otherwise might have had to wait for the allocation of state borrowing capacity, thereby bringing forward the economic benefits of a transaction, demonstration effect of foreign direct investment in PPPs and also of the refinancing of PPPs. The Bank has already had a transitional effect on private sector transactions, such as the Tirana Airport privatisation and maintains policy dialogue with the PPP units, which have been established to develop the use of PPPs in the countries of operation.

Key Opportunities

The key opportunities in PPPs will predominantly occur in those countries of operation that have the following characteristics:

- Political risk acceptable to investors in infrastructure (in particular a government record of honouring contractual commitments and a broad consensus that PPP contracts once entered into will not be abrogated or renegotiated if opposition parties succeed the party incumbent at the time of signing of the concession)
- Adequate legal structure or willingness to enact necessary legislation on the part of the government.
- Transparent bidding procedures and acceptance that PPP tender documentation, negotiation process and risk allocation should be compatible with international best practice.
- A political need to deliver transport infrastructure beyond the means of the host government to borrow on its own account.
- Adequate public sector systems and resources, including appropriately qualified staff, to negotiate, administer and monitor complex PPP projects effectively. The Bank will support the establishment of such public sector capabilities.

Opportunities may arise in the obvious PPP sectors, such as in road construction and operation, road maintenance, or in less apparent ones, such as rail ticketing systems or communications systems, railway station operation or the installation of street lighting or an integrated road traffic management system. Wherever the PPP is implemented, the achievement of transparency through the contract between the public and private-sector can have a substantial transition impact. The Bank will support PPPs which demonstrate that they provide value for money.

As the PPP project market matures in those countries which have a number of PPPs in successful operation, the market in secondary finance of PPPs is developing, enabling initial sponsors and developers to increase the gearing of the PPP companies, reduce the cost of borrowing and recycle some of their equity for further projects. Many PPP investors view such an exit, or partial exit route as being an essential element in the factors that influence them to make the initial investment. By encouraging the development of the refinancing market for PPPs in our countries of operation the Bank can play an important role in encouraging investors to consider initial investments in our countries of operation, thereby enhancing bidding competition. The Bank may also provide subordinated debt to PPPs if the project and market conditions warrant it.

4.1.5 Asset-based financing

Asset-based financing provides a number of opportunities to enterprises operating in the transport sector such as rail operators, airlines or even providers of space transportation as it is a way to asset fund a specific block of assets rather than the general business of a group.

It relies on the established value of the asset and on an efficient legal environment, allowing creditors to seize the asset. The legal framework which enables creditors to register their interest in the asset, and seize it in an event of default, plays a critical role. The Bank should continue to support actively the ratification of the Unidroit convention on mobile equipment, namely the Cape Town Convention.

The Cape Town Convention establishes a commercially-oriented, comprehensive international legal framework relating to the creation, priority and enforcement of security and leasing interests in aircraft equipment. It also contains bankruptcy rules that protect contract rights in the context of insolvency.

Assets covered by the Cape Town Convention include movable transport equipment, e.g., aircraft and engines, railway carriages and space assets (mainly satellites and rockets used for launching commercial satellites) although a specific protocol has yet to be drafted for space assets.

Equally in the aerospace and space sector there is an increasing number of opportunities for asset-based transactions, including opportunities for the Bank to provide support for the export of Russian made, fuel-efficient new aircraft. Further background is set out in Sections 3.2.1 and 3.2.2.

With the increasing involvement of the private sector in the provision of transport services, growth in opportunities for asset-based finance in respect of rolling stock for freight forwarders is anticipated. Currently there is strong demand for new rolling stock in our countries of operation and particularly in respect of freight cars. For further details refer to Section 3.4.2.

Overall, as the involvement of the private sector has increased in our sectors of operation, so has the interest in asset-based finance. It is anticipated that this trend will continue as the involvement of the private sector increases and also as state owned entities take notice of the demonstration effect of existing transactions.

4.1.6 Credit Enhancement and Guarantees

The EBRD has been prepared to issue credit enhancements and guarantees as the need has arisen in individual transactions. The risks proposed to be guaranteed have included refinancing risks and state performance risk under concession contracts. EBRD's guarantee may also be used as a credit enhancement for capital markets issues. To date EBRD has rarely provided guarantees for transport sector operations as they tend to be used as part of highly structured transactions and the larger part of the Transport business has been sovereign backed with little requirement for financial structuring. An example of EBRD providing its guarantee was that provided for the M5 financing in Hungary, where the repayments were structured with a large "ballooning" final repayment, which was not supported by the cash-flows of the project. EBRD guaranteed the repayment of the final repayment to commercial lenders covering the risk that it would not be re-financed before maturity.

As more sophisticated financial structures are required within our countries of operation and as the appetite of investors in the capital markets for assets from our countries of operation increases, so will the appetite for using EBRD's guarantee, in addition to its lending products.

4.1.7 Subordinated Debt and Equity Instruments

In addition to providing senior debt, the EBRD is prepared to consider providing equity and subordinated debt where appropriate. Increasingly the trend in many infrastructure markets has been for sponsors to conserve their equity by using a tranche of subordinated debt in their financial structure, which because of its position behind senior debt helps strengthen the senior lenders' security. In particular, subordinated debt has been used in structured transactions, as it gives comfort against cash flow shortfall risks, possibly arising from construction risks. It is anticipated that as more complex and sophisticated financing structures are adopted, most probably in the Advanced Transition Countries, the Bank is likely to be asked to provide subordinated debt as part of its participation.

The liberalisation of markets, mainly in the shipping, aviation and rail sectors, has lowered the barriers to entry into dynamic sectors with high growth potential (and attendant risks). While the new entrants into these business sectors may not always have the profile for debt finance, they may be attractive candidates for equity investments. This change gives the Bank an opportunity to have a strong demonstration effect by making appropriate equity investments in the newly liberalised markets.

4.1.8 Bespoke Solutions

As the financial markets of the Advanced Transition Countries become increasingly sophisticated, it is likely that the Bank will be asked to take a role in structured financial solutions. The Bank's presence in such transactions will provide commercial lenders with comfort that the legal basis of such financings has been soundly researched and that the host government is less likely to seek to attack a transaction's legal structure. In the Transport sector, typically, the EBRD has not sought to establish standard lending programmes; EBRD adapts its approach to each transaction to suit the circumstances of the transaction. It is anticipated that the volume of bespoke solutions will increase as our countries of operation develop and the increasing demands on EBRD for bespoke solutions may be interpreted as a measure of the development of our countries of operation. In particular opportunities may arise for the EBRD to participate in capital markets transactions, such as bond and equity issues, where the Bank may achieve transition impact by acting as a lead investor and exerting transition impact through its policy dialogue with the government and its investor dialogue with the lead underwriting banks, which will place the bond.

EBRD may also need to adopt an innovative approach to undertaking projects in the Early Transition Countries. It is anticipated that structured, bespoke solutions may need to be found to ensure that the Bank's operations comply with the requirements of local conditions, such as International Monetary Fund restrictions (see 4.2.1 below), in order to implement projects.

For both of the above reasons, it is anticipated that the requirement for more complex, structured transactions in the Transport Sector will tend to increase.

4.2 Regions

4.2.1 Early and Intermediate Transition Countries

The Early Transition Countries Grouping and Action Plan

The early transition countries pose a particular challenge. The Bank has recognised the challenge and has established an Early Transition Countries ("ETC") initiative to address the difficulties of undertaking business in 7 of the poorest of the Bank's countries of operations, namely: **Armenia**, **Azerbaijan**, **Georgia**, **Kyrgyz Republic**, **Moldova**, **Tajikistan** and **Uzbekistan**. This grouping gives rise to a group of countries which differs from those identified as Early Transition Countries in the 1997 Transport Operations Policy, but has been chosen for particular attention under a Specific Action Plan approved by the Board, because of their low level of economic development. In accordance with the Specific Action Plan, the Transport Team will seek to undertake projects within the nominated ETC countries. It is recognised that projects in these countries are likely to be more labour intensive to implement and that the risks to transition may be higher than in other countries of operation, but these difficulties are outweighed by the impact a successful operation can have. Given the stage of development of the countries, it is likely that most transport transactions in these countries will be based upon the sovereign guarantee. However, for those countries under IMF programmes, there may be restrictions as to the incurring of further debt by the sovereign, unless the new debt is at concessional rates. This would preclude any state-sector operations by EBRD unless it were to provide funds in conjunction with a concessional lender, giving rise to a blended rate that is concessional in accordance with the IMF guidelines.

For those projects that do not rely on a sovereign guarantee, the Bank can expect to focus in the Early Transition Countries on projects that can be structured so as not to infringe any negative pledge requirements nor to encumber existing state assets for the finance of new projects and on the basis of security structures that do not rely solely on allocations from the central budget of the state. In practice, this will probably mean a concentration on smaller transactions, rather than larger infrastructure investments. In some cases projects involving transit traffic through a country, such as oil in rail tank wagons, may give rise to suitable opportunities. Viable private sector transactions will also be considered: the private sector oil products terminal at Poti port in Georgia is an example of such an operation. Smaller private sector transactions in the road haulage and freight forwarding sectors may also provide opportunities for the small scale Direct Lending and Direct Investment Facilities under which the EBRD can lend typically €0.5-€4million or invest typically €0.5-€2.5 million.

In addition to the 7 countries mentioned above, **Albania**, **Belarus**, **Serbia and Montenegro**, **Turkmenistan** and **Bosnia and Herzegovina** also fall at the lower end of the transition scoring for the Bank's countries of operation.

Notwithstanding Albania's early transition status, the Bank has been involved in the bidding for a PPP concession to operate, design, develop, build and maintain the Mother Theresa International Airport, serving Tirana. Where practical the Bank will seek to promote beacon projects in the early transition countries, as the demonstration effect that they have is particularly strong, given the early transition status of the host country. Such projects are, however, scarce and frequently it is difficult for private sector projects to provide value for money for the host country, given the relatively higher cost of private sector capital for these countries than in countries where private sector participation in the provision of transport infrastructure is more developed. In order to help develop the market in which such private sector participation may become more economically viable, the Bank will continue to undertake sovereign operations, complete with covenants which promote the development of a commercial market, improve transparency in the funding of state transport activities and assist in the restructuring of state transport institutions, such that they are able to undertake commercial decisions in response to the demands of the market. Those countries located in South-Eastern Europe may also benefit from proximity to the market of the European Union and EU funding for infrastructure initiatives, particularly those with a regional dimension, which help in the development of a greater, integrated economic market.

EBRD cooperates with the EU in its transport development projects in South-Eastern Europe and the Balkans and beyond and continues to seek to enhance its transition impact through cooperation with other institutional lenders in the region.

REBIS is an EU initiative, which covers the 5 countries of South East Europe: Serbia and Montenegro, Bosnia and Herzegovina, Former Yugoslav Republic of Macedonia and Albania. It has defined a core infrastructure network within these countries, together with investment priorities. Its main objective is the promotion of regional integration within south east Europe. The successor to this is TPPF ("Transport Project Preparation Facility") which is presently on-going and is undertaking feasibility studies for selected projects agreed with the IFIs and participating countries. EBRD anticipates providing finance for appropriate projects nominated under the TPPF.

EBRD has also worked on and continues to consider projects within the TRACECA ("the Silk Road") EU programme promoting the East-West link from Central Asia, through the Caucasus to Europe. Considerable grant financing has been provided by the EU in support of this corridor, in terms of both technical assistance and investment financing. EBRD loans in support of projects on the corridor amount to approximately EUR 450 million.

Intermediate Transition Countries

In the Intermediate Transition countries: **Bulgaria**, **Kazakhstan**, **FYR Macedonia**, **Romania** and **Ukraine**, the Bank will continue to pursue business in the sovereign sector, state sector non-sovereign and private sector. Issues continue to be consistent with those set out in the 1997 Transport Operations Policy, namely that in some of these countries substantial business in the sovereign sector has already been undertaken, bringing into play country portfolio ratio issues. Private sector activities continue to develop, but do not yet play a significant role in the provision of transport infrastructure. The Bank will continue to undertake sovereign transactions on a selective basis with some public sector non-sovereign transactions a possibility as state owned entities continue their transition. In addition to these considerations, **Bulgaria** and **Romania** are currently preparing for accession to the European Union in 2007 and the Bank can expect to cooperate closely with the EIB and the European Commission in order to leverage its transition impact in these countries. More complex, structured transactions are difficult to implement in the Intermediate Transition Countries, often because of inadequate or inappropriate legal structures and procedures. The Bank can be instrumental in achieving transition impact by working to implement such projects and using their requirements as a driver for legal and structural reform. As a consequence, the Bank will seek to work on such transactions in the Intermediate Transition Countries when suitable opportunities arise.

In **Kazakhstan** the Bank has financed projects in all the main transport sub-sectors. As a result it has been actively engaged in promoting transition through the conditions attached to its loan facilities; its policy dialogue with the Government; provision of technical cooperation resources; and through the demonstration effect of its projects. As a result of policy dialogue over a period of time there is currently significant reform of Kazakhstan's transport sector under way: notably in the rail sub-sector where a major restructuring programme, which is broadly supported by EBRD, has begun.

In the road sector the Bank is working with the Government to reform sector financing and rationalise the administration of the sector to make it more transparent and effective. The Bank expects also to remain actively involved in the aviation and airports, and the port and shipping sub-sectors.

Future operations will be designed to support the country strategy which calls for improvements to physical infrastructure to ease market access, increase competition, and promote regional trade and co-operation. Significant transport investment will also be needed to support the development of Kazakhstan's oil resources in the Caspian basin, with port-related upgrades and shipping a possibility. The Bank will provide finance for such projects without a sovereign guarantee, where such finance is a practical proposition. The Bank also expects to continue to finance infrastructure projects in Kazakhstan on the basis of sovereign guarantees, for example in the road sector, where such a guarantee will generally be necessary until the conditions for Public-Private Partnerships and economically viable toll roads are present in Kazakhstan.

In **Ukraine** it is anticipated that transactions will largely be sovereign with a view to institution building and the restructuring of state entities to render them economically viable on a stand-alone basis. The particular focus will continue to be to enhance commercialisation of Ukrainian railways, which is the largest and most significant transport entity in the country. In the road sector, the attention of the Bank will be on reconstruction and upgrading of the international transport corridors and improvement in the efficiency of road sector administration and management. Taking into account the significant investment needs of the country and the complexity of the sovereign guarantee approval process, the Bank needs to choose sovereign transactions where the transition objectives are achievable and which represent an acceptable return for the effort required in implementation. In the port sector, the Bank will foster commercialisation of the main ports initially through sovereign guaranteed financing and will also pro-actively explore increasing private sector opportunities, in particular in development of specialised terminals. The Bank will coordinate its transport sector activities in Ukraine with those of the European Investment Bank, which will start some lending operations in the country shortly.

4.2.2 Advanced Transition Countries

The Advanced Transition Countries comprise the eight of the Bank's countries of operation which acceded to the European Union on 1 May 2004 (the "New EU Members"), namely: **Estonia**, **Latvia**, **Lithuania**, **Poland**, **The Czech Republic**, **Slovakia**, **Hungary** and **Slovenia** and in addition to these eight countries, **Croatia**.

The Bank will seek to open up new markets, promote market liberalisation and encourage investment in liberalised markets. There will be opportunities to finance new entrants into the market, possibly on an equity basis, given the relatively high risk profile such an operation is likely to have (e.g. budget airline in Slovakia, PPP Railway Station projects in Czech Republic). With private sector transactions in these markets, the Bank can achieve demonstration effects which encourage other investors or debt providers to replicate such transactions. These transactions may also have a regional demonstration effect for governments, in the event that beneficial government measures or initiatives are involved.

It is expected that PPPs will feature particularly in the Advanced Transition Countries, driven largely by value for money, budget considerations and the need for governments to deliver faster infrastructure improvements in line with economic growth. The Bank's involvement in these projects is especially important given the history of setbacks and delays associated with PPPs in these countries (e.g. D47 in Czech Republic, and M1-M15 in Hungary) and the impact this has had on market confidence.

Notwithstanding the progress made and access to funding and other support for the new EU Member States through their membership of the European Union, the economies of the Advanced Transition Countries continue to be in transition. This is particularly true in the transport sector, where state-owned entities or agencies may benefit from further restructuring or commercialisation (e.g. Croatian railways, Hungarian railways). supported by selected sovereign financing alongside other IFIs The importance of such institutional development and commercialisation has been evidenced in a wide range of sovereign financings in the transport sector (for instance in Romania where it can be argued that transition in some transport sectors is ahead of some advanced countries). The Bank can also assist in the privatisation of such entities or viable activities within the entity which can be separated out.

It should also be noted that a major challenge for the new EU Member States in the immediate future is to ensure the prudent application of EU funding available to them under the Structural and Cohesion Funds. Some of the transition-intensive projects described above may involve financing from these funds. The Bank's presence in cofinancing such projects can help ensure the transition objectives are achieved.

The Bank can work usefully with the EIB in the Advanced Transition Countries, by lending on a complementary basis to cover the proportion of a project that EIB is prevented by its procedures and guidelines from financing (e.g. labour restructuring for railways). EBRD might also consider participating in tranches of financing for projects which would complement the senior debt, such as mezzanine funding for projects. In addition, if the EIB provides finance for strategic projects in accordance with EU transport policy, then EBRD might equally finance projects which are complementary to these projects, such as the rehabilitation of feeder roads leading to the Trans-European Network routes.

The Bank will work closely with other IFIs, commercial banks, and private investors in pursuing these objectives and may be additional in a number of ways, which may include acting as the anchor lender alongside other commercial lenders; leading the market; and by taking project development risks not acceptable to the market:

- *Anchor role:* The Bank can act as an "anchor" lender or investor in debt, quasi debt, or equity issues on a pari passu basis with commercial institutions and encourage commercial parties to take positions that they would not have undertaken without the presence of the Bank, thereby moving the financial market towards those of the 15 established EU

Member States. This may reflect lenders' concerns about untested regulatory or industry structures where the Bank's presence provides comfort that the arrangements are not only well designed but will be preserved. The Bank's presence in PPPs may be particularly welcomed by the commercial lenders, given the close involvement of the host government and the perceived political comfort the participation of a multilateral lender such as the Bank can bring to the transaction. This applies particularly with respect to the implementation of regulatory regimes and any need for structural changes to concession arrangements.

- *Leading the market:* The Bank can provide assistance and continue to be additional to commercial sources of finance by occupying a position further up the risk curve than would be comfortable for commercial lenders in each country (but not further up that curve than commercial lenders are prepared to go in the established economies of the European Union or than is commercially prudent), for instance by offering to provide subordinated debt and quasi-equity where necessary.
- *Project development:* Commercial financial institutions may be deterred from undertaking transactions in the Advanced Transition Economies by the relatively high risk of failure of first-time, complex or structured financial transactions and the risk that the preparation of the transaction will overrun its schedule significantly. The Bank can provide assistance with the structuring of complex transactions where commercial entities may be unwilling to undertake the work, because of the relatively higher transactional risks involved.

The Bank will continue to develop concepts and projects in the Advanced Transition Countries for their demonstration effect regionally, and which could subsequently be applied in more challenging environments.

Any sovereign lending to the Advanced Transition Countries will be conditioned by the circumstances set out in Section 4.1.1, Sovereign Lending, above.

4.2.3 Russia

Because of its size and underdeveloped transportation network, **Russia** presents the single largest challenge and opportunity for the Bank. The Government, cognisant of the sector's pivotal role in the task of doubling the country's GDP in four years, has adopted a broad agenda for the sector ("Transport Strategy"), which aims to contribute to the creation of a single economic space in Russia, as well as to the country's further integration in the world's economy. More specifically, the Strategy recognizes the critical importance of transport infrastructure in the creation of the single economic space and calls for the continuing reform of the railways sector; modernization of sea-ports; renovation of airside assets in airports; and development of concessions and PPPs in the road sector.

The Bank is prepared to work alongside the Government in its objective of creating an efficient economy within the country and to enhance international economic integration, assisting it in the implementation of the Transport Strategy, predominantly on a commercial basis. The Bank will seek to encourage institutional reform, which would create autonomous, revenue-generating entities, acting commercially as bona-fide borrowers (e.g., RZD, Rosmorport, Air-navigation Corporation, and Airport GUP) on a public-sector non-sovereign basis. In some cases sovereign support will be required, and the Bank will proceed with such transactions where the Government is prepared to take such loans.

The Bank anticipates increasing private sector opportunities, including the development of private ports and terminals, land-side airport assets, industrial railways, leasing of rolling stock and other assets.

Transition impact will be achieved by influencing creation of a legal/institutional environment conducive to PPPs and other private-sector solutions in the transport sector; commercial lending to former ministerial entities (e.g., Rosmorport, RZD), which should contribute to their further corporatisation; lobbying for reform of the Road Sector, in particular the introduction of transparency with regard to project selection and allocation of maintenance funding; and support of the purely private initiative (e.g., private ports). In particular, the changes to the legal and regulatory environment that would permit the Russian state to take on contingent liabilities and issue guarantees would have a catalytic effect on the implementation of transport projects, enabling private sector engagement and the state to give limited support to the private sector where necessary.

The EBRD will also cooperate closely with the European Investment Bank in Russia in the implementation of key, transition-positive infrastructure projects.

4.3 Environment and Sustainable Development

Environmental Trends of Transport

In the last 15 years there has been a shift in the transport patterns in Eastern Europe and the former Soviet Union from public to private transport in passenger transport and from rail to road in freight transport. This environmentally adverse trend has been favoured by current market conditions, which are characterised by non-harmonised pricing between transport modes. Rail transport has gradually lost market share to road transport both in passenger and freight transport and both track infrastructure and rolling stock are in need of significant investments to retain/regain its competitiveness. Throughout the region, car ownership has risen sharply, traffic volumes are growing, motorway network has grown significantly and road transport is increasing generally. Expansion of transport infrastructure networks is causing biodiversity concerns through habitat fragmentation. Air transport is growing, contributing to ozone layer depletion and to increase of noise pollution and greenhouse gas emissions. Consequently, the adverse environmental impact of transport is increasing. Technology and environmental policy development are failing to match the pace of economic growth. Policy-makers and regulators tasked with promoting sustainability in transport sector face major challenges.

The aggregate emissions from motor vehicles of some harmful substances, such as nitrogen oxides and SO_2, have fallen due to improvements in engine and emission abatement technology and the use of cleaner fuels. In the most advanced transition countries, these improvements have been faster than the growth in road traffic volumes. However, the emissions of other substances, such as CO_2, ozone precursors and particulates, have again started to rise. Road transport has become a significant source of greenhouse gas emissions. At the same time, traffic is burgeoning in the region’s cities becoming the main source of urban air pollution. In many parts of the region, particularly in the CIS, poor fuel quality aggravates the emissions problems. Noise pollution and accident rates have also increased. Expanding road infrastructure has accelerated land development, putting pressure on green areas and designated nature conservation sites.

In Eastern Europe closer links with the EU have encouraged environmental reforms, both in the transport sector and elsewhere. The region has also been provided access to significant new funds for transport infrastructure investment. Current policy measures in the transport sector, however, have remained insufficient to tackle the growing environmental implications associated with increasing road travel.

The Bank's Response

Environmental Appraisal

The Agreement Establishing the Bank includes the requirement to foster environmentally sound and sustainable development. As a result all transport operations undergo environmental appraisal in line with the Bank's Environmental Policy and Procedures. These ensure that the Bank will structure its projects to meet appropriate standards (national, EU and international good practice), to prevent or mitigate any adverse impacts and to enhance environmental benefits wherever possible. This policy, in line with the Bank's mandate, sets out the framework under which transport projects are implemented with regard to the environment, health and safety, and social implications.

The environmental appraisal takes place within the context of an overall effort to optimise the project's development. This will include economic, financial, and technical viability, as well as the institutional context within which the project is developed. The environmental appraisal is designed to identify and assess two out of three key sustainability dimensions - environmental and social impacts. EBRD's transport projects are always structured to meet national and EU standards in respect both of environmental impact and also health and safety, including road safety, and will take account of other international standards where applicable (e.g., ICAO, IMO, MARPOL, World Bank, regional environmental programmes, etc.). Projects are required not to conflict with specially protected areas and other areas of high biodiversity conservation value, and should include measures to safeguard and, where possible, enhance natural habitats and the biodiversity they support. Any degradation of natural habitats must be appropriately mitigated.

In the scope of social considerations, the Bank will pursue measures to mitigate effectively potential adverse impacts in terms of required land acquisition, resettlement, economic displacement, impact on indigenous peoples, labour issues and/or preservation of cultural property. The Bank's projects will be structured to meet IFC Safeguard Policies on Indigenous Peoples, Involuntary Resettlement and Cultural Property, if they involve potential impacts related to such matters. Labour restructuring programmes will be carried out in accordance with the principles of consultation and non-discrimination. Where possible, the Project design will be enhanced to provide additional safeguards to the most vulnerable parts of the affected population. The appraisal may also look into potential wider indirect impacts, such as the epidemiology associated with more efficient transport options, livelihood issues, and other adverse social impacts on the community.

The worldwide increased ease of transport has, in some cases led, directly or indirectly, to some undesirable effects such as the trafficking of people and goods and the spread of HIV/AIDS. Whilst the EBRD does not have the resources and capacity to address these issues specifically in its transport projects, it will liaise with relevant organisations working on these issues and support relevant governments to implement mitigation measures.

Increasing numbers of transport projects are now being classified in category A in view of the increasing focus, particularly in the roads sector, on upgrading and new construction. The Bank's Environmental Policy requires Category A projects to undergo an Environmental Impact Assessment (EIA), including scoping of key issues through a Scoping Meeting, the preparation of a Public Consultation Disclosure Plan (PCDP) and public consultation. Moreover, in accordance with the revised Environmental Policy (July 2003) category B projects will involve, at a minimum, local disclosure of a summary of environmental issues and mitigation measures and Action Plans. These tasks aiming at ensuring public participation in the decision making may be challenging for some of the Bank's clients and necessary support will be provided through the provision of consultancy services to ensure the Bank's environmental requirements will be met. Particular attention will be paid to the period of consultation to ensure the views of potentially affected people, communities and NGOs are heard and, to the extent possible, reflected in the project scope.

Where the Bank is financing part of a wider development, the sustainability of the whole development will be appraised in the context of the Bank's project due diligence. EBRD acknowledges the importance and benefits of Strategic Environmental Assessment (SEA) as a key tool for sustainable development and for assessing the cumulative impacts of transport plans and programmes on the environment, including SEAs prepared according to the Protocol on Strategic Environmental Assessment (Kiev, 2003) to the Convention on Environmental Impact Assessment (EIA) in a Transboundary Context. Whereas the Bank does not have ownership of such plans and programmes, it will liaise with governments, regional bodies and those multilateral institutions most appropriately placed to use SEAs as a government decision making tool and will structure its transport activities in accordance with the conclusions of relevant SEAs, where available.

Environmentally oriented investment and policy dialogue

An important aspect of the EBRD's additionality is promoting environmental improvements in its projects in the region. The EBRD has and will continue to develop viable stand-alone projects with primarily environmental objectives, including urban transport and sustainable transport solutions.

The EBRD will seek to incorporate a wide range of environmental measures, such as enhanced energy and resource efficiency, waste minimisation and recycling, and cleaner technologies, in its projects to ensure they fulfil sustainable development. Specific activities in transport sector may include the following:

- The EBRD will identify and assist its clients in developing energy efficiency solutions. In transport sector, the Bank has provided financing and support to railway companies, airport facilities for energy saving measures. The Bank is operating non-reimbursable Technical Cooperation funds to carry out energy audits to develop energy saving programmes.
- The Bank will support government initiatives to enhance enforcement of relevant legislation and to encourage the use of cleaner vehicles and projects to increase the use of cleaner fuels and biofuels, where consistent with its transition objectives.

In the context of wider sustainability considerations, the Bank recognises that as income levels and the desire for improved mobility have increased, so have traffic, transport-related pollution, and the consumption of non-renewable resources. At the same time, absence of harmonised price structures has favoured the growth of environmentally damaging transport modes. These concerns relate to the overall concept of "sustainability" of transport systems. EBRD believes that financial and environmental sustainability are inextricably linked. Pricing is one of the key policy instruments able to promote sustainable transport development as it influences overall transport demands. It can also be used to encourage shifts to more environmentally-friendly fuels, vehicles and modes of travel and transport. Road pricing schemes will need to be carefully thought out, to avoid the inadvertent transfer of heavy traffic to minor roads and through urban centres.

EBRD will include the consideration of such issues in its policy dialogue with Governments, recognising each Government's sovereign role in establishing national environmental and transport policy.

4.4 The Changing Means of Achieving Transition Impact

Much of the preceding material has spoken in detail to the transition impact of the Bank's operations. The following review of the changes to the means whereby transition impact is achieved seeks to pull together those individual strands and draw some general conclusions about the changing nature of transition. The first twelve years of EBRD's transport operations have seen great progress with the rebuilding of transport infrastructure and put transport operations on a more sound commercial basis. While the process of transition is far from complete, the nature of the challenge is changing and the role of the Bank must change with it. This is particularly the case for the Bank's future operations in those countries which have acceded or will accede to the European Union.

During the first twelve years of EBRD's operations in the transport sector, the predominant financing instrument was debt, in most cases backed by a sovereign guarantee.

EBRD's additionality in future is expected to come increasingly from arranging structured transactions (cf Section 4.5, below). These will range from state-sector, non-sovereign borrowers to private sector investments. It will broaden the exposure of such borrowers to international institutions, and will be associated with more sophisticated procurement and financing strategies. As a result, through the further development of the finance markets and by exposing borrowers to a broader range of financing products, it will be strongly transitional. It will have the consequence of making EBRD's transport portfolio both more risky in terms of non-sovereign related risks and potentially more profitable, compared to the existing predominance of sovereign lending in the transport portfolio, although the increase in the transaction-related risk is offset by the improvement in the credit quality of the host country.

The central task of a market-oriented transition in the sector is to encourage a more commercial approach to transport service provision. Prior to 1991 transport sector infrastructure and operations in the countries of eastern Europe and the former Soviet Union reflected the priorities of the old regimes. Transport operations were largely unresponsive to underlying economic costs. Priority was given to heavy goods production and massive freight flows were generated by excessive regional specialisation and the location of interdependent facilities often with little regard to economic viability. There was little concern for satisfying consumer preferences.

The transition challenge is to reduce the state's involvement in the supply of transport services and to focus on its role as regulator and as the facilitator of private sector involvement in transport provision[4] The state needs to create the right institutional framework for competition, and in particular, it must determine economically efficient charges for the use of publicly provided infrastructure, paying due regard to the difficulties in monetising the benefits arising from such infrastructure. But a significant level of state involvement in transport infrastructure provision and the regulation of transport operations is unavoidable and desirable because:

- The transport sector has inherently monopolistic tendencies, based on the typically high fixed / low marginal costs of many transport operations, combined with the effects of geographical separation which create local cost advantages.
- Transport provision is typically characterised by significant external costs and benefits, requiring the state to intervene to reach optimal solutions in the transport market.
- A proliferation of competing, commercial transport alternatives can, if unregulated, give rise to environmental damage in excess of that which occurs in a regulated system.
- In addition, for areas, such as the Balkans, relatively small countries may benefit significantly from an integrated regional approach to the provision and maintenance of transport infrastructure, thereby broadening the regional market and easing transit.

[4] In the words of the World Bank, ("Sustainable Transport: A Sector Policy Review, Executive Summary") the state should function as "the enabler of competition and the custodian of environmental and social interests".

The EBRD's ability to engage effectively in policy dialogue often resides primarily in the relationships it is able to build up over a period of years with Governments and public sector transport operators. It will thus often be the case that more than one operation may be required to reap the full transition benefit of the Bank's involvement.

Key transition objectives of the Bank in the transport sector are to:

- Put the provision of transport services on a commercial basis, such that costs to the State are transparently allocated.
- Assist transport enterprises to operate efficiently and to maintain full and transparent accounts.
- Seek financial sustainability through tariff policies aimed at cost recovery.
- Separate the provision of transport services from the legal, policy-making and regulatory functions of the Government and
- Promote the enhanced performance of transport infrastructure that may be achieved through private sector participation.

However in the more Advanced Transition Countries the channels through which the transition objectives are to be achieved are changing as the markets become more sophisticated. Increasingly the emphasis is on demonstration impact, rather than the conditionalities incorporated into the loan, particularly in respect of more structured transactions.

The Bank can achieve these transition objectives through a combination of the direct transition impacts of project investments; associated legal and policy reforms (often reinforced with loan conditionality); and technical co-operation undertaken in parallel with transport investments.

4.5 Portfolio Management

As part of the project evaluation process, consideration is given to existing exposures and the desirability of maintaining a balanced portfolio as to sub-sector and country, in line with sound banking practice. In addition to portfolio balance in respect of credit risk the Transport Team also seeks to maintain a portfolio balance in respect of Transition Risk. Often projects with the highest transition impact also carry the greatest risk to that impact. As a consequence it is sound practice to maintain a portfolio of projects, some offering greater transition impact, but carrying the greater risk that that transition impact might not be achieved, some with lesser potential transition impact, but a greater likelihood that the transition impact will be achieved successfully.

Annex 1

Breakdown of Transport Operations by Sector

General Operational Statistics (€m) - 31 December 2004

	Total Cumulative Project Cost	Net Cumulative Business Volume	Private Sector	Public Sector Non-Sovereign	Sovereign	Cumulative Signed No. of Operations
Transport						
Air Transportation	52.2	46.9	28.6	0.0	18.3	3
Support Activities for Air	333.2	211.1	2.9	7.3	200.9	20
	385.4	*258.0*	*31.5*	*7.3*	*219.2*	*23*
Highway, Street, Bridge	5,526.9	1,828.6	329.0	0.0	1,499.6	33
Ports & Harbours Operations	175.5	97.2	20.6	16	60.6	7
Rail Transportation	2,071.4	781.8	25.9	15.0	740.9	18
Railroad Rolling Stock Equipment	2,075.0	243.0	10.3	0.0	232.7	8
	4,146.4	*1,024.8*	*36.1*	*15.0*	*973.4*	*26*
Ship and Boat Building	23.6	8.4		0.0	8.4	1
Water Transportation	845.8	250.7	250.7	0.0	0.0	14
	869.4	*259.1*	*250.7*	*0.0*	*8.4*	*15*
Support Activities for Transport	152.5	45.2		2.8	42.4	4
Total Transport	**11,256.0**	**3,513.3**	**668.0**	**41.2**	**2,803.9**	**108**

Annex 2

Outline Eurostat Guidelines for the treatment of PPPs

eurostat
news
release

18/2004 -

11 February 2004

New decision of Eurostat on deficit and debt

Treatment of public-private partnerships

Eurostat, the Statistical Office of the European Communities, has taken a decision on the accounting treatment in national accounts of contracts undertaken by government units in the framework of partnerships with non-government units. The decision specifies the impact on government deficit/surplus and debt. It results from work undertaken in 2003 in cooperation with experts from European countries and different international bodies.

The decision is in line with the European System of Accounts (ESA95), and is consistent with the opinion of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), as described in the annex.

Eurostat recommends that the assets involved in a public-private partnership should be classified as non- government assets, and therefore recorded off balance sheet for government, if both of the following conditions are met:

1. the private partner bears the construction risk, and
2. the private partner bears at least one of either availability or demand risk.

If the construction risk is borne by government, or if the private partner bears only the construction risk and no other risks, the assets are classified as government assets. This has important consequences for government finances, both for the deficit and the debt. The initial capital expenditure relating to the assets will be recorded as government fixed capital formation, with a negative impact on government deficit/surplus. As a counterpart of this government expenditure, government debt will increase in the form of an "imputed loan" from the partner, which is part of the "Maastricht debt" concept. The regular payments made by government to the partner will have an impact on government deficit/surplus only for the part relating to purchases of services and "imputed interest".

Why is Eurostat taking this decision now?

Public partnerships with private units have been observed for a long time in **EU** Member States. Such arrangements take various forms, including concessions which normally do not raise difficulties as regards their treatment in national accounts. Recently however, new kinds of arrangements have been made **in** a few Member States, and a significant increase in these arrangements is expected for various reasons such as efforts to increase efficiency of public expenditure and to improve the quality of public services. Moreover, the European Growth Initiative, approved by the European Council in December 2003, sets as one of its objectives to promote the use of such partnerships, notably in order to develop growth-related infrastructures.

As the Statistical Authority of the Commission, Eurostat does not examine the motives, rationale and efficiency of these partnerships, but has to provide clear guidance on their treatment in national accounts, as regards their impact on data for the general

Annex 2

Outline Eurostat Guidelines for the treatment of PPPs

government sector. Furthermore, an important part of Eurostat's mission is to ensure homogeneity of government statistics in all Member States, including the 10 Acceding Countries, under ESA95, such that deficit and debt figures are fully comparable.

Which partnerships does this decision cover?

The decision will a:pply to long-term contracts in areas of activity where government normally has a strong involvement. These contracts often (but not always) correspond to what is referred to as "Public-private partnerships", concluded with one or several partners, directly or through a special entity set up on purpose, and possessing expertise in the content of the contract over its lifetime. An important feature is that the contract mentions both the output of some specifically-designed assets, needing an initial capital expenditure, and the delivery of agreed services, requiring the use of these assets and according to given quality and volume standards.

This decision applies only in cases where government is the main purchaser of the services supplied by the partner, whether the demand originates directly from government itself or from third party users (as seen notably for health and education services, and the use of some transport infrastructures).

What is the key issue relating to public-private partnerships as regards their treatment in national accounts?

The key issue is the advance classification of the assets involved in the partnership contract -either as government assets or recorded in the balance sheet of the partner. In national accounts, the assets involved in a public-private partnership can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risk attached to the specific partnership. Therefore, this analysis of risks borne by the contractual parties is the core element of the assessment of a partnership project, as regards classification of the assets involved in the contract, in order to ensure the correct accounting of the impact on the government deficit of public- private partnerships.

However, this assessment does not consider risks that are not closely related to the asset and can be fully separated from the main contract, as is the case where part of the contract might be periodically renegotiated, and subject to performance and penalty payments that do not significantly depend on the condition of the main assets.

What is the Eurostat analysis of risk in partnerships?

Many risks may be observed in practice in such arrangements. The wording used may be in addition diverse and confusing. This is why, for the purpose of this decision, Eurostat has selected three main categories of "generic" risks. Therefore, "bearing a risk" for one party means that this party bears the majority of the risk.

A first category is "construction risk" covering notably events like late delivery , non-respect of specified standards, additional costs, technical deficiency, and external negative effects. Government's obligation to start making regular payments to a partner without taking into account the effective state of the assets would be evidence that government bears the majority of the construction risks.

A second category is "availabilit~ risk" where the responsibility of the partner is quite obvious. It may not be in a position to deliver the volume that was contractually agreed or to meet safety or public certification standards relating to the provision of services to final users, as specified in the contract. It also applies where the partner does not meet the required quality standards relating to the delivery of the service, as stated in the contract, and resulting from an evident lack of "performance" of the partner. Government will be assumed not to bear such risk if it is entitled to reduce significantly (as a kind of penalty) its periodic payments, like any "normal customer" could require in a commercial contract. Government payments must depend on the effective degree of availability supplied by the partner during a given period of time. Application of the penalties where the partner is defaulting on its service obligations should be automatic and should also have a significant effect on the partner's revenue/profit, and must not be purely "cosmetic" or symbolic.

A third category is "demand risk" covering variability of demand (higher or lower than expected when the contract was signed) irrespective of the behaviour (management) of the private partner. This risk should only cover a shift of demand not resulting from inadequate or low quality of the services provided by the partner or any action that changes the quantity/quality of services provided. Instead, it should result from other factors, such as the business cycle, new market trends, direct competition or technological obsolescence. Government will be assumed to bear the risk where it is obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final user, rendering irrelevant the fluctuations in level of demand on the partner's profitability. However, this statement does not apply where the shift in demand results from an obvious government action, such as decisions of units of general government (and thus not just the unit(s) directly involved in the contract) that represent a significant policy change, or the development of directly competing infrastructure built under government mandate.

How will the decision be implemented in practice?

The analysis of the risks in such partnerships will be carried out in all Member States and Acceding Countries (as this decision is applicable for the next notification on 1 March 2004), under the responsibility of the National Statistical Offices.

Eurostat is of the opinion that information about such risks can easily be obtained by statisticians and that the burden of the different risks is generally identifiable in the contracts. Eurostat is also of the opinion that the assessment of risk according to the process described above would allow for a straightforward classification of the assets either "on" or "off' government balance sheet in most cases.

However, it may happen in some cases that the risk analysis, as mentioned above, might not give clear conclusions (for instance if at least for two categories the share in risk may be estimated as balanced or based on very fragile hypotheses). In these cases, some additional elements in a partnership contract should also be taken into consideration. Apart from an analysis of the nature of the partners (notably in specific cases where the partner is a public corporation), the importance of government financing, the effect of government guarantees or provisions relating to the final allocation of the assets could be in some cases appropriate supplementary criteri a.

In this respect, if the assets remain the property of the partner at the end of the project, and if they still have a significant economic value, then it is normally classified on the partner's balance sheet. This also includes contracts where government has merely an option to buy the asset at the current market value. On the other hand, if government has a firm obligation to acquire the assets at the end of the contract at a pre-determined price that does not reflect the economic value of the assets at that time (such as expected on the basis of conservative hypothesis at the time the contract was signed), or has paid for the right to acquire the assets throughout the contract through regular payments that were higher than they would have been without that right, then there can be a reason to record the assets as government assets if the other tests do not give a clear answer.

Finally, Eurostat considers that this decision is not in contradiction with the usual business approach to such issues. In any case, specific and complex borderline cases should be closely examined according to the agreed procedure, including at a first stage the assistance of Eurostat.

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Annex 2

Outline Eurostat Guidelines for the treatment of PPPs

CMFB

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CMFB opinion on the treatment in national accounts of assets related to "public-private partnerships" contracts

The CMFB Chairman, with the assistance of the Executive Body, invited the CMFB Members on 23 December 2003 to give an opinion on the above-mentioned subject. Fourteen (14) national statistical institutes and thirteen (13) national central banks from the Member States returned the questionnaire. A total of twenty-seven (27) national institutions thus participated in the consultation. The ECB also provided a reply.

The result of the consultation was the following:

On the question: *Do you agree that PPP assets should be considered as non-government assets i/there is strong evidence that the non-government partner bears most of the risk, according to the assessment of risks proposed in the guidance note* ?

Twenty-six (26) national institutions responded Yes, among which three (3) asked for minor corrections to the numerical examples and three (3) requested clarifications on some parts of the guidance note. One (1) national institution answered No.

Accordingly, the CMFB endorses the guidance note of 23 *December* 2003 *relating to the classification of assets in the context of "Public-Private Partnerships". The CMFB recommends that the suggested clarifications should be incorporated in a revised version of the ESA* 95 *M anual on Government Debt and Deficit, in so far as they do not change the substance.*

In addition to this opinion, a document summarising the replies and all the original answers from the CMFB Members have been transmitted to Eurostat and will be kept in the records of the CMFB secretariat.

Jean CORDIER CMFB Chairman

(Signed)

Paris, 30 January 2004

Annex 3

PPP Background Information

Public-Private Partnerships ("PPPs") in the transport sector are a specific form of public sector procurement. They comprise the awarding of a contract by the public to the private sector for the private sector to provide services relating to transport infrastructure for a concession period. Most, but not all, PPPs involve the design, finance, construction, operation, maintenance and handover to the public sector at the end of the concession period of transport-related infrastructure. They may involve no payment from the public sector, with users bearing the cost of the infrastructure at point of use, such as toll roads; they may involve similar structures with public-sector support against certain risks, such as traffic/usage risks; they may be expressly subsidised where the public sector deems the implied toll level for full recovery of cost and return on equity to be socially or politically unacceptable; or they may be paid for in full by payments from the public-sector over the life of the concession, to the concessionaire, provided that it delivers the infrastructure in accordance with the performance criteria set out in the concession agreement.

The principal reasons for using PPPs are:

- To achieve value for money for the public-sector over the life of the concession (this is verified by comparing the net present values of the projected cost to the public-sector of undertaking the project in the public-sector over the concession period (the Public-Sector Comparator ("PSC")) and of the net present value of the cost to the public sector of the private-sector bid for the concession period). In order to demonstrate value for money, the private-sector's costings must demonstrate that the savings are more than sufficient to offset the higher cost of capital for the private-sector compared with that of the public-sector.
- To mobilise private-sector funding in support of the transport sector; if a PPP is correctly structured, with appropriate risk transfer to the private-sector, then the debt raised by the private-sector (and the equity investment made) to fund the implementation of the project may reasonably be considered and reported as private sector obligations, not those of the public sector, thereby conserving public sector borrowing capacity for projects which can only be implemented in the public sector.
- To increase the capacity to implement projects where administrative capacity in the public sector might be limited, by contracting out the burden of implementation, leaving the public sector to act in a less manpower-intensive project monitoring capacity; and
- To increase the transparency in the implementation of projects by documenting the terms of the project in the concession contract between the public and private sector.

EBRD’s PPP precedents

To date the Bank has provided finance for two transport PPPs and has refinanced both of them. The first refinancing was of the M1/M15 motorway in Hungary, in the context of the bankruptcy of the concession company, the effective nationalisation of the project and the restructuring of the debt. The second refinancing, of the M5 motorway in Hungary was contemplated in the original financing structure and was undertaken as an orderly refinancing in the context of the concessionaire as a going concern. Both PPPs were based upon the collection of tolls by the concessionaire, with the concessionaire bearing traffic risk. Both projects suffered from traffic being substantially lower, up to 60% less, than forecast. The crucial difference between the two projects was that the M5 benefited from a subsidy arrangement with the public-sector covering revenue shortfall up to a specified maximum amount, over a limited initial period of operation when the concession company was at its most financially vulnerable. The lesson drawn from this experience is that the prediction of traffic for new-build projects in countries with a high growth potential is generally not sufficiently accurate to allow the Bank to take such risks without supplementary support.

Annex 4

Means of achieving transition impact in transport projects

Initial Situation and Reform Challenges by Stage of Transition	**Project's Transition Impact**
1. Early and intermediate stage of transition:	
Criterion No. 1 **Competition in the project sector: Does the project increase competition in the sector? Does it promote customer orientation, innovation and greater efficiency?**	
- transport enterprises or agencies not commercialised and financially dependent (e.g., *national railway company; roads department; airports*)	- commercialisation of transport enterprises (full financial, operational and managerial autonomy); EBRD seeks to place the provision of transport services on a contractual basis (e.g., *railway performance contracts*) - elimination of preferential treatment to state customers (e.g., *subsidised rail freight tariffs*)
- lack of competitive pressures even in those transport sub-sectors amenable to competition	- EBRD procurement rules and open tendering for works create competition among suppliers (e.g., *road rehabilitation works)*
- large operational inefficiencies; no clear investment plan in existence	- incentives for efficiency improvements through management or service contracts to private contractors (e.g., *railway workshops; airport rehabilitation; urban transport services*) - EBRD focus on priority investments which maximise the yield from existing asset base and promote least-cost solutions (e.g., *railway business plans*)
Criterion No. 4 **Framework for markets: Does the project strengthen public and private institutions that support the market? Does it support government policy formation and improvements in regulatory practises?**	
- tariffs below cost recovery levels, significant cross subsidisation	- tariff reforms as loan covenants; linked to commercialisation programme to ensure simultaneous cost reductions and tariffs increases - reduction of cross-subsidisation through tariff increases and transparent public budget allocations (e.g., *public service obligations transfers to railways*)
- inadequate accounting rules	- change in accounting rules to include bad debt provisioning and adequate depreciation charges - EBRD projects involve external audit of transport company accounts
- institutional and legal framework	- creation of sector agencies, regulatory bodies, legal framework (e.g., *road agency, Railway Law*) - technical assistance in drafting legislation (e.g. *concession laws*)

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Means of achieving transition impact in transport projects

- transport enterprises largely dependent on central budget transfers; local capital and commercial loan markets underdeveloped	- commercialisation and tariff reform reduces fiscal burden on the public budget, which support refocusing of government activities in the transport sector - support for investment programmes assessment; auditing of company's accounts - support for local financial institutions (e.g. *using local bank as co-financier wherever possible*)
Initial Situation and Reform Challenges by Stage of Transition	**Project's Transition Impact**
2. Advanced stage of transition:	
Criterion No. 2 **Market expansion: Does the project contribute to the integration of economic activities into the national or international economy (forward linkages)?**	
- large infrastructure investment needs to meet increased traffic levels (EU accession; border crossings) and network maintenance needs	- private sector involvement to meet financing requirements
- enterprises (in particular SMEs) face large transaction costs due to transport infrastructure bottlenecks	- improvement in the quality of transport services reduces input costs for private businesses (e.g., *inter-modal facilities*) - reduction of cross-subsidisation reduces the burden of financing on freight services - commercialisation improves consumer orientation and reduces the risk of inadequate supply
Criterion No. 2 **Competition and backward linkages: Does the project increase competition in the project sector and among suppliers?**	
- scope for competition limited	EBRD support for private service providers; review of contractual framework to balance interests of public, government and private investor (e.g., *use of local contractors in transport infrastructure works*) In sectors with natural monopolies (e.g. *toll roads, railway infrastructure*): assistance in organising "*competition for the market*" with private participation;
Criterion No. 3 **Private ownership: Does the project increase the share of goods and services provided by the private sector?**	
- public sector divestiture is needed to refocus the activities of the state and initiate/consolidate private ownership and/or operations	- private sector participation in service provision, often building on earlier EBRD involvement in the commercialisation of transport enterprises

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Means of achieving transition impact in transport projects

Criterion No. 4 **Framework for markets: Does the project supports the functioning of regulatory entities and facilitates private sector involvement through the reduction of political risks?**	
- lack of separation of regulatory and operations introduces regulatory risks (e.g., *divestiture of periodic road maintenance*)	- EBRD may assume part of the political and regulatory risk building on a strong relationship with government - EBRD can help provide technical assistance for the establishment of effective (independent, transparent, accountable) regulatory bodies
Initial Situation and Reform Challenges by Stage of Transition	**Project's Transition Impact**
3. General transition impacts:	
Criterion No. 5 **Transfer of technology and skills: Does the project contribute significantly to the upgrading of technical and managerial skills beyond the project itself?**	- competitive tendering ensures that the best technical and commercially viable proposals are chosen (e.g. *railway track maintenance technology*) - institutional development programme with possibility for training by foreign consultant (e.g. *road maintenance and road user charges*)
Criterion No. 6 **Demonstration effects: Does the project create replicable practices and processes which help transfer the impact of EBRD from the project level to the sector as a whole?**	- for example: the first BOT toll road in a country; the first railway privatisation etc.; - demonstration effects are particularly strong when the Bank enters a new sub-sector and pushes the frontier of financing outwards towards increased private sector participation and commercial orientation (e.g. *international airport terminals, railway operations*) - concentration on countries/cities with potentially high demonstration effects (e.g. *urban transport in Poland*
Criterion No. 7 **Corporate governance: Does the project press for visible changes in corporate governance arrangements at the level of transport enterprises and at the level of the government agencies themselves?**	- review of governance arrangements in transport enterprises and improvement as part of loan covenants (e.g. *‘contract plans’*, *IAS*) - asset decentralisation from central to local governments (e.g. *aviation, urban public transport*)

Annex 5

Transition Impact Monitoring

Project	DTM No	Country	Year of Signing	Original Potential	Original Risk	New TI Potential	New TI Risks
Baku Port Development	3686	Azerbaijian	1999	Good	High	Good	High
Budapest Intermodal Logistics Centre - Basic Infrastructure	7486	Hungary	1999	Good	Medium	Good	Medium
KTZ Track Maintenance and Commercialisation Project	2920	Kazakhstan	1999	Good	Medium	Good	**High**
North Western Shipping Company Follow-on Loan	6296	Russian Federation	1999	Good	High	Good	**Medium**
Railway Development Project	4080	Ukraine	1999	Excellent	High	**Good**	High
M06 Highway Rehabilitation	2213	Ukraine	2000	Good	High	Good	High
Ukraine International Airlines	11274	Ukraine	2000	Good	High	**Satisfactory**	**Medium**
Ukrrichflot II	12271	Ukraine	2000	Good	Medium	Good	**Low**
Autocesta Rijeka-Zagreb (ARZ)	20178	Croatia	2001	Good	High	Good	High
Gdansk Urban Transport Project	5956	Poland	2001	Good	High	Good	High
Kazakhstan Atyrau Airport Project	18492	Kazakhstan	2001	Good	Medium	**Satisfactory**	**High**
Lithuania Railways (LG) Corridor IX Project	7654	Lithuania	2001	Excellent	High	Excellent	**Medium**
Locomotive Re-Powering Project	18493	Uzbekistan	2001	Excellent	High	Excellent	**Medium**
Railways Recovery Project	10224	Bosnia & Herzegovina	2001	Excellent	High	Excellent	High
Road sector Restructuring - Pitesti By-Pass	13119	Romania	2001	Excellent	High	Excellent	High
TSA Air Navigation Systems	15857	Tajikistan	2001	Good	High	Good	**Low**
Uljanik Shipyard	18149	Croatia	2001	Good	High	Good	High
Viking River Cruises	6884	Regional	2001	Satisfactory	Medium	Satisfactory	Medium
ZTP Belgrade Reconstruction Project	18659	Serbia & Montenegro	2001	Good	High	Good	High
Albania: Road Rehabilitation Project II	28092	Albania	2002	Satisfactory	Medium	Satisfactory	Medium
Croatia: Area Control Centre Project	25800	Croatia	2002	Satisfactory	High	Satisfactory	**Medium**
JSC Channel Energy Poti Port	11846	Georgia	2002	Good	High	Good	**Medium**
Macedonia: Civil Aviation Upgrading Project	25801	FYR Macedonia	2002	Good	High	Good	High

Annex 5

Transition Impact Monitoring

Project	DTM No	Country	Year of Signing	Original Potential	Original Risk	New TI Potential	New TI Risks
Ostankino Tower Repairs	15898	Russian Federation	2002	Excellent	High	Excellent	High
PKP Second Railway Restructuring & Privatisation Project	9366	Poland	2002	Excellent	High	Excellent	High
Republic of Serbia: Road Recovery Project	22705	Serbia and Montenegro	2002	Good	Medium	Good	**High**
Russia Road Sector Reform 1	17559	Russian Federation	2002	Good	Medium	Good	Medium
Sofia Public Transport Project	17765	Bulgaria	2002	Good	Medium	Good	**High**
Macedonia Regional Roads Project	15314	FYR Macedonia	2003	Satisfactory	Medium	Satisfactory	Medium
Regional Navigation Safety System in the Gulf of Finland	26805	Russian Federation	2003	Satisfactory	Medium	Satisfactory	Medium
Ukrrichflot III (Incl 12271 from 2nd review)	31608	Ukraine	2003	Satisfactory	Medium	Satisfactory	Medium

Of the 31 projects monitored, the risk applying to 8 has decreased and applying to 4 has increased. The transition impact potential has decreased in respect of 3 transactions. These developments are largely as might be expected as in general positive transition steps are achieved thereby tending to reduce risks to transition, but with some less positive developments, typical of a broad portfolio of projects.