

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

Approved by the Board on 7 April 2020¹

CROATIA

Zadar Wastewater Project

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

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

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

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ABBREVIATIONS / CURRENCY CONVERSIONS

CAPEX	Capital Expenditure
CWA	Croatian Water Agency
DSCR	Debt Service Cover Ratio
DSRA	Debt Service Reserve Account
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortisation
EBRD	European Bank for Reconstruction and Development
EIA	Environmental Impact Assessment
ESAP	Environmental and Social Action Plan
ESDD	Environmental and Social Due Diligence
ESMP	Environmental and Social management Plan
EU	European Union
EUR	Euro
FX	Foreign Exchange
HRK	Croatian National Currency (Kuna)
LA	Loan Agreement
LAD	Last Availability Date
LT	Long Term
MSA	Municipal Support Agreement
NFD	Net Financial Debt
OHSAS	Occupational Health and Safety Advisory Services
OPEX	Operating Expenses
PCA	Project Co-financing Agreement
PE	Population Equivalent
PIU	Project Implementation Unit
PP&R	Procurement Policies and Rules
PSC	Public Service Contract
SSF	Shareholder Special Fund
TA	Technical Assistance
TC	Technical Cooperation
TI	Transition Impact
WC	Working Capital
WWTP	Waste Water Treatment Plant

CURRENCY CONVERSION

EUR 1 = HRK 7.44258
(as of 31 December 2019)

PRESIDENT'S RECOMMENDATION

This recommendation and the attached Report concerning a senior loan of up to EUR 4.5 million in favour of Odvodnja d.o.o. Zadar (the “Company”, the “Borrower”), a limited liability company incorporated in Croatia, (the “Loan”, the “Project”) is submitted for no-objection approval by the Board of Directors. The operation will enable the Borrower to complete the reconstruction and upgrade of the wastewater network system in the Zadar region in Croatia. The Bank’s loan will provide co-financing alongside EU grant funds for the Company’s investment programme under the EU Operational Programme for Competitiveness and Cohesion 2014-2020.

The expected transition impact of the Project stems from the Green transition quality of a sustainable market economy. The proposed investment in the wastewater infrastructure will result in more sustainable and efficient wastewater management as well as enhanced resilience to climate change impacts in the wastewater sector. It will also significantly improve the quality of the treated effluent discharged to the Adriatic Sea.

I am satisfied that the operation is consistent with the Bank’s Strategy for Croatia and Municipal and Environmental Infrastructure Sector Strategy, focusing on energy and resource efficiencies, climate change adaptation, as well as corporate governance, operational performance and financial results of municipal enterprises. The Project is also in line with the Green Economy Transition (GET) Approach and with the Agreement Establishing the Bank.

The project requires an exception from EBRD’s Procurement Policies and Rules (“PP&R”), as envisaged by paragraph 2.4 of the PP&R for projects jointly co-financed with EU Cohesion Funds. FOPC issued a general recommendation in favour of exceptions to allow national procurement rules for all projects co-financed with EU Cohesion Funds in Croatia at its meeting on 13 March 2014.

I recommend that the Board approve, on a no-objection basis, the proposed loan substantially on the terms of the attached Report.

Suma Chakrabarti

BOARD DECISION SHEET

Croatia - Zadar Wastewater Project - DTM 50078	
Transaction / Board Decision	Board approval ² is sought for a senior loan of up to EUR 4.5 million (the “Loan”) in favour of Odvodnja d.o.o. Zadar (the “Company” or the “Borrower”), a limited liability company incorporated in Croatia. Proceeds of the loan will be used to co-finance the reconstruction and extension of the wastewater network in the city of Zadar together with the EU Cohesion Funds (the “Project”). The Project is fully in line with GET Mandate of the Bank as it contributes to sustainable wastewater management.
Client	Odvodnja d.o.o. Zadar is a municipal company incorporated in Croatia, providing wastewater services to around 78,000 people in the City of Zadar, the fifth largest Croatian city (the “City”). The Company is 100% owned by the City. [REDACTED] The Company has stable financial position.
Main Elements of the Proposal	<p><u>Transition impact:</u></p> <p><i>Quality – Green</i> (assessed under the GET Direct Track): The proposed investments in the wastewater infrastructure will result in more sustainable and efficient wastewater management as well as enhanced resilience to climate change impacts.</p> <p><u>Additionality:</u></p> <p>The additionality derives from the Bank’s significant experience in the wastewater sector including co-financing of projects with the EU Cohesion funds.</p> <p><u>Sound banking:</u></p> <p>The Company has low leverage and solid operating profitability, whereby the Project implementation is supported by the Croatian Water Agency’s (“CWA”) expert team and experienced consultants. The conducted due diligence confirmed sound banking criteria.</p>
Key Risks	<p><u>Project implementation risk</u> – The Company’s experts, supported by the CWA’s team, have sufficient project preparation and implementation experience. [REDACTED]</p> <p><u>Legal /sector reform risk</u> [REDACTED]</p> <p><u>Tariff risk</u> [REDACTED]</p>
Strategic Fit Summary	The Project is consistent with the Bank’s Strategy for Croatia, Municipal and Environmental Infrastructure Sector Strategy and the Green Economy Transition (GET) Approach focusing on energy and resource efficiencies, climate change adaptation, as well as corporate governance and operational performance of municipal enterprises.

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

ADDITIONAL SUMMARY TERMS FACTSHEET

EBRD Transaction	<p>The EBRD transaction will complement infrastructure financing of the major reconstruction and upgrade of the water & wastewater system in Zadar region, co-financed alongside the EU Cohesion Funds (“Zadar Water & Wastewater Investment Program” or “Investment Program”) via a senior loan of up to EUR 4.5 million to Odvodnja d.o.o. Zadar.</p> <p>The total investments under the Investment Program, estimated at EUR 78.10 million, consist of the two investment components:</p> <p style="margin-left: 40px;">I) <u>Wastewater Investment Programme (EU co-financed) - EUR 60.95 million</u>: rehabilitation, reconstruction and extension of the wastewater infrastructure, and the upgrade of wastewater treatment facility.</p> <p style="margin-left: 40px;">II) <u>Water Investment Programme</u> - parallel investments into water supply system, rainfall drainage system and sidewalks - EUR 17.15 million: construction of storm water drainage system and reconstruction of the water supply system (implemented in parallel with the Wastewater investment program).</p> <p>Both investments will be procured under local law thorough a joint procurement process managed by the Company.³</p>
Existing Exposure	None.
Maturity / Exit / Repayment	Regular repayments up to 12 years [REDACTED]
Use of Proceeds	<p>The Loan of up to EUR 4.5 million will be used to co-finance the following under Wastewater Investment Program:</p> <p style="margin-left: 40px;">(i) Rehabilitation, reconstruction and extension of wastewater network (~91 km) across the city of Zadar and its suburb areas;</p> <p style="margin-left: 40px;">(ii) Upgrade of the existing Wastewater Treatment Plant (“WWTP”) - Zadar Centre, without further increase in capacity.</p> <p>The use of proceeds will be controlled through conditions precedents prior to disbursement, whereas the Borrower will need to confirm the use of proceeds in line with the project description.</p>
Investment Plan	[REDACTED]
Financing Plan	[REDACTED]
Key Parties Involved	<p>Borrower: Odvodnja d.o.o. Zadar</p> <p>Sponsor: City of Zadar</p> <p>Parallel financiers: EU, CWA, Government of Croatia, City, and Water supply company</p>
Conditions to disbursement	<p>All project agreements to be signed, including:</p> <ul style="list-style-type: none"> • Grant Agreement for EU funding [REDACTED] • Project construction agreement

³ The project requires an exception from EBRD’s Procurement Policies and Rules (“PP&R”), as envisaged by paragraph 2.4 of the PP&R for projects jointly co-financed with EU Cohesion Funds.

	<ul style="list-style-type: none"> • Security package in place [REDACTED].
Key Covenants	<ul style="list-style-type: none"> • Ratios to be monitored [REDACTED]
Security / Guarantees	The Loan security will comprise of: [REDACTED] Municipal Support Agreement (“MSA”) between the City of Zadar and EBRD.
Other material agreements	<ul style="list-style-type: none"> • Public Service Contract • Project Co-financing Agreement with City of Zadar and Water supply company
Associated Donor Funded TC and co-investment grants/concessional finance	<p><i>Pre-signing</i></p> <p><u><i>Environmental and Social Impact Assessment</i></u></p>

[REDACTED]

INVESTMENT PROPOSAL SUMMARY

1. STRATEGIC FIT AND KEY ISSUES

1.1 STRATEGIC CONTEXT

The reform of the water supply and wastewater system in Croatia started with the revision of the Law on Water services, which sets the legal framework for the upcoming process of consolidation and reorganisation of the sector (based on the National Reform Programme adopted in April 2018). Through regionalisation, the Government plans to improve the quality and efficiency of its water and wastewater infrastructure and services in order to fulfil the country's environmental targets. Through the creation of larger regional operators, Croatia will ensure the long-term sustainability of these investments and create a greater EU grant absorption capacity.

[REDACTED]Zadar county is rapidly developing as a tourist destination with tourist arrivals of more than 1.4 million in 2018 (vs 1.6 million in 2016 and 1.8 million in 2017) and more than 15 million overnights, which results in substantial demand for water and wastewater services during the summer season. Urgent investments to improve the water and wastewater system as well as to maintain sustainable coastal development are a top priority for the City.

Despite the limited contribution of the Bank's loan to the funding sources under the overall investment programme, the Borrower seeks EBRD's established expertise as a co-investor with the European Structural and Investment Funds. [REDACTED]

The Project is consistent with the Bank's Strategy for Croatia and Municipal and Environmental Infrastructure Sector Strategy, focusing on promotion of energy and resource efficiencies and climate change adaptation, as well as improving corporate governance, operational performance and financial results of municipal enterprises. The Project is also consistent with the Green Economy Transition (GET) Approach by promoting climate change adaptation and "ensuring availability and sustainable management of water and sanitation".

The Project is aligned with the EBRD transition qualities. Under *Green*, it boosts energy efficiency of operations and betters the environment through formalised wastewater treatment.

1.2 PROJECT STRUCTURE

The Bank has been supporting Croatian water supply and wastewater operating companies in meeting the EU Water and Wastewater Directive through long-term loans for priority investment programmes alongside EU Cohesion Funds. The Zadar Water & Wastewater Investment Program is one of such priority programmes delivering major reconstruction and upgrades of the region's wastewater network.

The total investments under the Investment Program, estimated at EUR **78.10 million**, consist of the two investment components:

1) Wastewater investment programme (EU co-financed) - EUR 60.95 million:

Major investments into reconstruction and expansion of the wastewater network including rehabilitation, reconstruction and extension of the wastewater infrastructure in Zadar and surrounding area, and the upgrade of wastewater treatment facility.

The Wastewater investment programme will be implemented by the Company and will be financed predominately from the EU funds (under the EU Operational Programme for Competitiveness and Cohesion 2014 – 2020) [REDACTED].

II) Water investment programme, including parallel investments into water supply system, rainfall drainage system and sidewalks - EUR 17.15 million:

Investments in construction of storm water drainage system and reconstruction of the water supply system with a CAPEX of EUR 17.15 million will be implemented in parallel with the Wastewater investment program. [REDACTED]

The Loan of up to EUR 4.5 million will be used to co-finance the following investments under the Wastewater investment programme:

- Rehabilitation, reconstruction and extension of wastewater network (~91 km) across the city of Zadar, city precinct Bokanjac and suburb areas of Kozino and Petrcane, including pipelines, collectors, pumping stations [REDACTED].
- Upgrade of the existing Wastewater Treatment Plant (“WWTP”) - Zadar Centre, [REDACTED], through construction of equalisation tank, the upgrade of the air purification system and other works and equipment. (The capacity of the WWTP will remain unchanged).

1.3 TRANSITION IMPACT

Obj. No.	Objective	Details
TI Quality: Green (Direct track)		
1.1	The percentage of EBRD use of proceeds allocated to the project that qualifies as GET is 50% or higher.	<p>The Project is expected to be 100% GET eligible as the proposed capital investments will directly result in more sustainable and efficient wastewater management, through improved wastewater quality, including improvement of the wastewater collection network and increased access to wastewater services, as well as enhanced resilience to climate change impacts in the wastewater sector.</p> <p>Key benefits of the Project include:</p> <ul style="list-style-type: none"> (i) improved quality of wastewater services for the citizens with greater number of household connections to the sewerage network, which will reduce the usage of septic tanks and the release of carbon dioxide. [REDACTED] (ii) improved quality of wastewater discharged into the Adriatic Sea, (iii) improved condition and quality of underground waters and soil by connecting more households to the sewage network.

Delivery Risks

The risks to transition impact are mostly related to the successful implementation of planned capital investments to meet GET targets. The related risks will be mitigated by the fact that EU financing has been approved by the relevant authorities prior to Bank’s financing, whereas the Company (with support of the CWA) possesses adequate experience for implementation of the Project.

1.4 ADDITIONALITY

No triggers identified	
Financial structure: EBRD offers financing that is not available in the market from commercial sources on reasonable terms and conditions [REDACTED]	The Bank is able to structure and offer long-term loans [REDACTED] not widely available on the market [REDACTED].
Risk mitigation: EBRD helps the client to mitigate Environmental, Social and Governance (“ESG”) risks through identification of risks related to the depletion of natural capital assets, raw materials and water availability, etc., and to manage these risks.	The Bank’s standards, with respect to project preparation, assistance in project implementation, regular reporting (including through ESAP) and sector reform are more advanced than the national and the sector standards.

1.5 SOUND BANKING - KEY RISKS

Organisational risks	Medium/ Medium	[REDACTED] An MSA is envisaged to be signed with the City, whereby the City undertakes to support the Project and to ensure that the Company performs all of its obligations and fully complies with the terms of the Loan Agreement.
Implementation risk	Medium/ Medium	The Project will be majority financed by EU grants and will be procured in accordance with national rules. [REDACTED]
Legal /sector reform risk	Medium/ Medium	The reform of the water supply and wastewater system started with the revision of the Law on Water services to improve the quality and efficiency of its water and wastewater infrastructure and services [REDACTED]

2. MEASURING / MONITORING SUCCESS

<i>Overall objectives of project</i>	<i>Monitoring benchmarks</i>	<i>Implementation timing</i>
- Good financial and operational performance - On-time project implementation	- Growth in revenues and EBITDA - Completion according to the timeline and within the budget	- [REDACTED]

<i>Transition Impact Monitoring Indicators and Benchmarks</i>						
Quality	Obj. No.	Monitoring Indicator	Details	Baseline	Target	Due date
Green	1.1	Wastewater treated	[REDACTED] additional wastewater volume treated at the secondary level before discharge to the Adriatic Sea	[REDACTED]	[REDACTED]	[REDACTED]
	1.2	New household connections to wastewater system	[REDACTED]new household connections to wastewater system	[REDACTED]	[REDACTED]	[REDACTED]

3. KEY PARTIES

3.1 BORROWER

Odvodnja d.o.o. Zadar is a wastewater utility company incorporated in Croatia, which is wholly owned by the City of Zadar. It provides wastewater services to around 78,000 people in Zadar and manages 185 km of wastewater collection system, 19 pumping stations and 2 WWTPs with a total capacity of 115,000 Population Equivalent (“PE”).

During 2018, the Company collected 5.7 million m³ of wastewater with the same quantity of wastewater treated. Currently, the wastewater connection rate (i.e. percentage of the population connected to wastewater network) is around 75%, with the remainder of population using either septic tanks or, more commonly, drywells / leaching pits. Following the completion of the Project, the wastewater connection rate will increase to around 95%. [REDACTED]

3.2 CITY

Zadar is located on the Adriatic Sea and is the largest city in Zadar County and the wider northern Dalmatian region. The City has around 78,000 inhabitants, while the whole county has 170,000 inhabitants. Zadar county is rapidly developing as a tourist destination with tourist arrivals of more than 1.4 million in 2018 (vs 1.6 million in 2016 and 1.8 million in 2017) and more than 15 million overnights (2017:13.7 million; 2016:11.6 million), which results in substantial demand for water and wastewater services especially during the summer period. [REDACTED]

Given positive economic trends, especially in the tourism sector, further increase of the budget tax collections are expected from 2020 onwards. At the same time, the decrease of the indebtedness in the last few years is notable and with currently low leverage, the City will undertake the new borrowings for the financing of the capital investments in 2020.

The investments are predominately related to upgrade of the infrastructure (e.g. roads and traffic light management) but more and more to educational and social infrastructure (extension of school facilities, nurseries and hospitals).

4. MARKET CONTEXT

The first level of water and wastewater sector management in Croatia is represented by local water companies, followed by the Croatian Water Agency, which represents the second level of management and regulation, whereas the latter reports to the Ministry of Environment and Energy (the “MinEE”) that represents the third layer in the management.

Under the Croatian Municipal Law, municipalities, through municipal companies, are responsible for providing communal services (water, wastewater treatment, solid waste collection, urban transport etc.) and for setting tariffs. Currently, there are around 125 water/wastewater companies operating in Croatia. [REDACTED]

The Government’s strategy (based on the National Reform Programme adopted in April 2018), is focused on lowering total number of providers [REDACTED] through creation of larger regional water and wastewater utilities. This should over the long run significantly improve efficiency in the sector as well as strengthen capacities for preparation and implementation of the EU funded projects.

According to the Croatian Law on Water services and Law on Water Management Financing, tariff mechanism is structured to provide full cost recovery for operating and capital expenses of a water/wastewater company. The tariff level is determined by decision of each individual company, but also needs to be approved by local authorities. [REDACTED]

In addition to water/wastewater service fees, water/wastewater companies also regularly charge Development fee dedicated to (i) development of water/wastewater network, and (ii) repayment of loans for development of water/wastewater network, as per the Law on Water Management Financing (updated in 2019).

5. FINANCIAL / ECONOMIC ANALYSIS

5.1 FINANCIAL PROJECTIONS

[REDACTED]

5.2 SENSITIVITY ANALYSIS

[REDACTED]

5.3 PROJECTED PROFITABILITY FOR THE BANK

[REDACTED]

6. OTHER KEY CONSIDERATIONS

6.1 ENVIRONMENT

Categorised B (2014 ESP). The Project involves investments in the water supply, sewage and wastewater treatment system of the Zadar-Petrcane agglomeration in order to meet the requirements of the Directive 91/271/EEC in the City of Zadar. This will be achieved through the construction and reconstruction of over 100 km of city collectors, 17 pumping stations and increase in connection to the public sewage system from the existing 75% to 95% of the population. The Project will also connect the two existing WWTPs (with a total capacity of 115,000 PE) which are operating in compliance with the EU requirements without further increasing their capacity.

Environmental and social due diligence (“ESDD”) was undertaken by an independent consultant and included an assessment of the Project’s potential Environmental and Social (“E&S”) impacts and a review of the Client’s E&S management systems and capacities to implement the Project in line with Performance Requirements (“PRs”). An Environmental and Social Action Plan (“ESAP”) has been developed and agreed with the Client to address E&S improvements required to bring the Project in line with EBRD PRs.

An Environmental Impact Study in line with national requirements was prepared for the Project in 2017, based on which the Ministry for Environment and Energy issued a Decision in November 2017 that no further Environmental Social Impact Assessment (“ESIA”) is required for the Project and that it will have an overall positive environmental impact.

Currently the Company operates an informal Environmental, health and safety (“EHS”) management system, but is not currently accredited. The Company has in place EHS management plans for the

operation of the Company, further project-specific plans will need to be developed. For construction related impacts, a Framework Environmental and Social Management Plan (F-ESMP) has been prepared by the Consultants and ESAP requires the F-ESMP to be implemented by the Contractors.

The Company operates in line with Croatian Labour Law. To ensure compliance with PR2, the Company will be required to establish a formalised grievance mechanism for its' employees.

As the Project will be implemented in a heavily urbanised area, no impacts are expected to biodiversity assets. Construction works are not expected to affect any cultural heritage sites. The Project does not involve any land acquisition and all works will be carried out on publicly owned land. However, the Project may cause temporary loss of income to the old town businesses due to access-related issues and heavy traffic while the works are being carried out. A Livelihood Restoration Framework ("LRF") has been prepared to ensure compliance with PR 5. A Framework Traffic Management Plan ("F-TMP") has also been developed to mitigate the potential traffic impacts.

There has been public consultation carried out during the development of the Project. A disclosure package that includes an overarching Non-Technical Summary, Land Acquisition Framework and Stakeholder Engagement Plan, including the grievance mechanism for the Project will be disclosed.

The Bank will evaluate the Project's environmental and social performance in accordance with the Bank's PRs through review of reports and monitoring visits as required.

6.2 INTEGRITY

In conjunction with OCCO, internal integrity due diligence was undertaken [in respect of all relevant counterparties [REDACTED]]. [I]t was concluded that these issues are sufficiently mitigated and the project does not present an unacceptable reputational or integrity risk to the Bank. No derogatory information was identified on the Borrower and its management. [REDACTED]

ANNEXES TO OPERATION REPORT

ANNEX 1	Shareholding Structure
ANNEX 2	Historical Financial Statements
ANNEX 3	The Investment Programme
ANNEX 4	Project Implementation
ANNEX 5	Procurement Plan

ANNEX 1 – SHAREHOLDING STRUCTURE

The Company is 100% owned by the City of Zadar.
There are no third jurisdictions. The Republic of Croatia is the only jurisdiction.

ANNEX 2 – HISTORICAL FINANCIAL STATEMENTS

[REDACTED]

ANNEX 3 – THE INVESTMENT PROGRAMME

[REDACTED]

ANNEX 4 – PROJECT IMPLEMENTATION

Procurement classification – *Public sub-sovereign*

[REDACTED] The Client's procurement department employs certified public procurement professionals in accordance with the Croatian Public Procurement Law. The Company operates under Croatian Procurement Law, which is aligned with EU procurement directives. [REDACTED]

The scope of the contracts covered by the project is not technically complex. All envisaged contracts for works, goods and services under this project are familiar and frequently executed by the Company. The project envisages three works contracts for construction of wastewater system, drainage of rainfall and reconstruction of water supply system in (i) neighbourhood Bokanjac (ii) Zadar City (iii) neighbourhood roads between Bokanjac and Petrcane and another works contract for upgrade of the Zadar Wastewater Treatment Plant. In addition, the project includes one goods contract for procurement of equipment and four consultancy contracts for (i) works supervision, (ii) PIU support, (iii) Environmental and Social Impact Assessment and (iv) Regionalisation and Financial and Operational Performance Improvement Programme.

Procurement arrangements:

The project requires an exception from the Bank's PP&R as envisaged by paragraph 2.4 for projects jointly co-financed with EU Cohesion/Structural Funds. [REDACTED] [S]uch requests shall be referred directly to the Board to decide case-by-case on granting the exception.

[REDACTED] For new contracts outside Cohesion Fund programme which will be majority financed by EBRD the procurement shall be carried in accordance with the PP&R and subject to the Bank's prior review and no objection. For the envisaged or new contracts funded within Cohesion Fund programme the exception agreed under paragraph 2.4 of the PP&R shall apply and procurement would be carried out in accordance to Alternative procurement procedures in line with open tendering under the Croatian Public Procurement Law. [REDACTED]

ANNEX 5 – PROCUREMENT PLAN

[REDACTED]