

Subotica Water Upgrade Project

State Sector Project Assessment

Prepared in line with the EBRD's Access to Information Policy¹

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| Sector | Municipal and Environmental Infrastructure |
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Operation Description

The Subotica Water Upgrade Project was signed with the City of Subotica (the “City” or “Subotica”) on 4th May 2012 in an amount of EUR 11 million. In 2014, the City and the Subotica Water and Sewerage Company (the “Company”) entered into a Subsidiary Loan and Grant Agreement. The Project was co-financed by a European Western Balkan Joint Fund (“EWBJF”) investment grant in an amount of EUR 1.3 million.

The primary objective of the project was to enable the City to upgrade its water and wastewater system. The transaction increased the quality of water supply, wastewater disposal and treatment services in Subotica. The total funding financed priority investments including: construction of a second water treatment plant; extension of the wastewater collector II and wastewater collector VII; construction of the main water distribution aqueduct with accompanying pipes; and the construction of four water wells. The EWBJF grant was utilised for the construction of wastewater collector VII. By the end of 2017, four of the five works contracts related to the Project were complete. The savings achieved in the first four works contracts were reallocated to the final works contract related to the construction of a second water treatment plant. The water treatment plant was completed in December 2020.

The City of Subotica is Serbia's fifth largest city with a population of 140,000 inhabitants. It is located about 10 km south from the Hungarian border in the prosperous region of Vojvodina. The City is the administrative centre of the North Backa District, and home to the general and agricultural industries. The Company is the municipal water and wastewater utility of the

¹ As required by Section IV paragraph 1.4.8 of EBRD's Directive on Access to Information (2019), the Bank shall disclose information (excluding Confidential information) contained in Operational Performance Assessment (OPA) reports for State Sector Projects selected for extended review, within 60 calendar days after completion of the relevant OPA report.

City of Subotica, fully owned by the City. The City on-lent the proceeds of the loan to the Company under a subsidiary loan agreement. The loan is sovereign guaranteed.

The loan is not the first facility with the City. A EUR 9 million sovereign guaranteed loan was provided to the City for the Municipal Infrastructure Reconstruction Programme (OpID 26807) in December 2004. The proceeds were used for modernisation of the wastewater treatment plant and construction of a sludge line.

Relevance

The Project is consistent with the Bank's Strategy for Serbia, the Bank's Municipal and Environmental Infrastructure Operations Policy and with the Agreement Establishing the Bank.

The Project design and structure was important at achieving the targeted results.

Given the Company was repaying an existing EBRD loan (OpID 26807) at the time of signing, the Project structure was adjusted accordingly. The City and the Company entered into a Subsidiary Loan and Grant Agreement (the "SLGA"). This structure allowed the Company to meet its investment objectives while not being burdened by excessive debt service obligations.

To achieve the objectives of the Project, donor funded activities and policy dialogue were integrated into the Project design. In advance of signing, the Austrian Fund for Municipal Infrastructure provided funding of EUR 196,200 to finance a feasibility study and review of the technical designs commissioned by the City and the Company; technical and financial due diligence; and development of incentive-based contracts for management of the city-owned utility companies.

Post-signing, the European Western Balkan Joint Fund (EWBJF) provided a grant of EUR 1.3 million to finance the extension of the wastewater collector VII, and EUR 0.74 million for technical assistance. The technical assistance included: 1) a Project Implementation Unit support consultant which assisted the Company with project implementation, and 2) consultants which prepared a feasibility study for wastewater sludge management and identify the potential for commercialisation of sludge.

To ensure Project objectives were achieved and donor funded activities monitored, TIMS benchmarks were incorporated to measure results. The TIMS benchmarks were concerned with 1) incentive based contracts for management and public utility reform, 2) benchmarking and a public service contract, and 3) commercialisation of wastewater sludge.

1. Incentive based contracts for management and public utility reform

The draft incentive-based contract developed with the assistance of Austrian Fund for Municipal Infrastructure during the preparation of the feasibility study, served as the basis for this TIMS benchmark. Post-signing it was intended that the incentive-based contract would be implemented within the Company. However, the contract was not signed as a result of legal obstacles.

In addition to incentive-based contracts, this TIMS benchmark was concerned with reform of public utility companies (“PUC”). The Chamber of Commerce and Industry of Serbia organized a panel discussion on 18 June 2014 to discuss the concept of the proposed PUC reform based on a draft reform strategy. However, the adoption of the strategy has been delayed as the Serbian government shifted their focus to a comprehensive strategy and implementation measures for wider public sector reforms in the country, which will encompass all PUCs. In 2020, EBRD provided a technical assistance with the aim of strengthening the Serbian corporate governance regulatory framework by assisting the Ministry of Economy (and more broadly the Government) in developing a State Ownership Strategy and strengthening corporate governance of SOEs, in line with international standards and best practice. The Government adopted the Strategy (2021-2027) in April 2021.

2. Benchmarking and a public service contract

The second group of TIMS benchmarks relates to benchmarking and a public service contract. The Company participated in several local and regional benchmarking programmes, including the International Association of Water Supply Companies in the Danube River (IAWD), based in Vienna. These benchmarking exercises include indicators which allow them to show a positive demonstration effect, and which could be applicable to other water companies in Serbia in the future. Furthermore, the Company managed to adopt a public service contract with the City and a new tariff system. The success of achieving the targets laid out in the benchmark demonstrate the adequacy of the benchmark in achieving a portion of the Project objectives.

3. Commercialisation of wastewater sludge

The final TIMS benchmark grouping relates to commercialisation of wastewater sludge. A consultant analysed the potential for

commercialisation and determined it was not feasible, therefore, no further action was taken. Though no commercialisation of sludge was achieved, the benchmark was adequate in supporting the commercialisation investigation.

The EBRD was additional to the Project. The EBRD's additionality relates to terms, EBRD attributes and conditionalities.

Firstly, the terms dimension was achieved at signing. The Bank's assistance in structuring resulted in financing for a maturity longer than was available from commercial banks in Serbia. The City, despite significant investment needs, was not able to obtain long term financing from commercial banks. The tenor was tailored to the needs of the Project.

Secondly, EBRD attributes relate to the Bank assisting the City in the mobilisation of significant donor grant funds to support project implementation and commercialisation. Donor funds financed PIU consultant support and feasibility assessment including investigating the potential of sludge commercialisation.

Finally, conditionalities include financial control through maintenance of financial ratios, compliance with local and the Bank's environmental and social standards (including the ESAP and SEP). These conditions were consistently in compliance and supported the financial sustainability of the City and Company.

Effectiveness

The Company and the City successfully implemented all five planned works contracts of the intended Project. Therefore all project works objectives have been achieved, however with a slight delay.

In addition to Project works, the Project included TIMS benchmarks to facilitate the achievement of policy and institutional objectives. These benchmarks were partially achieved. The TIMS benchmarks were concerned with 1) incentive based contracts for management and public utility reform, 2) benchmarking and a public service contract, and 3) commercialisation of wastewater sludge. The second and third benchmarks were achieved albeit after delays. The first benchmark has not been achieved.

Regarding the first TIMS benchmarks a draft incentive-based contract was developed with the assistance of a bank-funded consultant during the preparation of the feasibility study. Ultimately, the contract was not signed as a result of legal

obstacles. The Chamber of Commerce and Industry of Serbia organized a panel discussion on 18 June 2014 to discuss the concept of the proposed PUC/SOEs reform strategy that has been drafted. However, the adoption of the strategy has been delayed as the Serbian government shifted focus to a comprehensive strategy and implementation measures for public sector reforms in the country, which will encompass PUCs. The State Ownership and SOE Management Strategy was developed with EBRD's technical assistance (as part of separate initiative not directly related to this Project) and adopted in April 2021.

The second group of TIMS benchmarks relates to benchmarking and a public service contract. The Company participated in several local and regional benchmarking programmes, including the International Association of Water Supply Companies in the Danube River (IAWD), based in Vienna. These benchmarking exercises include indicators which allow them to show a positive demonstration effect, and which could be applicable to other water companies in Serbia in the future. Furthermore, the Company managed to adopt a public service contract with the City and a new tariff system.

The final TIMS benchmark grouping relates to commercialisation of wastewater sludge. A consultant analysed the potential for commercialisation and determined it was not feasible, therefore, now further action was taken

The City and the Company achieved their intended project objectives. All water infrastructure related to the Project was implemented successfully while the Company maintained strong financials. The new infrastructure makes Subotica one of the first cities in Serbia with modern water and wastewater infrastructure in line with EU standards. Project funds were used to finance the construction of a second water treatment plant, two wastewater collectors, four water wells, a main water distribution aqueduct and sewage extensions. The new network improved the quality of water supply, wastewater disposal and treatment services in the City. It also allowed the City to connect around 12,000 more citizens to the sewerage network, bringing coverage up to 60 per cent of the population. The improved wastewater treatment system also prevents the pollution of Lake Palić, one of the top five tourist destinations in Serbia. In addition, the new system has the technological capacity to produce energy from waste and currently produces 25 to 40 per cent of its total energy needs.

Throughout the period from 2012, the Company maintained a positive EBITDA. The Company was annually in compliance with the covenanted financial ratios, as per the loan agreement.

The City also maintained strong financials, with a current surplus being maintained since signing in 2012.

The Project contains policy dialogue and other activities funded by two donors which partially helped to achieve operational objectives and larger outcomes.

The Austrian Fund for Municipal Infrastructure provided funding of EUR 196,200 to finance a feasibility study and review of the technical designs commissioned by the City and the Company; technical and financial due diligence; and development of incentive-based contracts for management of the city-owned utility companies. All funded items except for the incentive-based contract workstream were completed in advance of signing. Overall, the funding from the Austrian Fund for Municipal Infrastructure provided the key due diligence documents required to achieve signing, and also helped to facilitate policy discussions related to incentive-based contracts for management.

The European Western Balkan Joint Fund (EWBJF) provided a grant of EUR 0.74 million for technical assistance. The technical assistance included: 1) a Project Implementation Unit (PIU) support consultant which assisted the Company with project implementation, and 2) consultants which prepared a feasibility study for wastewater sludge management and identification of the potential for commercialisation of sludge. The PIU support consultant was pivotal in project implementation and the achievement of operational objectives. The second element of EWBJF technical assistance funding concluded that sludge commercialisation was not possible. The result of the sludge management study helped to support the Company in investigating new revenue streams.

Efficiency

The Project has achieved significant results in improving water and wastewater in the City. The new infrastructure makes Subotica one of the first cities in Serbia with modern water and wastewater infrastructure in line with EU standards. EBRD's support and commitment to the implementation process was crucial in keeping the Project on right track despite implementation challenges and related delays.

Due diligence financed by donor funding was pivotal in supporting the EBRD in signing and execution.

The financials of the Company and City remained strong since signing, and debt has been repaid in a timely manner. The strong financials have been demonstrated with compliance with the financial ratios as per the loan agreement. The EBRD has maintained a strong relationship with the client by being closely involved in the implementation process, coordinating with the donors, facilitating extensions to the last availability date, and allowing savings from one element of the Project to be used for another element that was over budget.

The results achieved through the Project are financially, environmentally and socially sustainable.

The Company and City have managed to achieve sustainable financials, with a constant positive EBITDA and current surplus being achieved respectively. The financial outlook for the Company and City is positive.

The Project has associated significant environmental and social benefits to Subotica, its population and surrounding environment. Helping to solve decades long problems of insufficient water supply, sewage coverage, associated health risks and environmental hazards. Prime examples of these environmental and social benefits include the increase in households and businesses connected to the water supply network, and the reduction in phosphorus and nitrogen in the nearby Lake Palic.

Implementation Summary

The Project supported the improvement in the water infrastructure of the City of Subotica. Project funds were used to finance the construction of a second water treatment plant, two wastewater collectors, four water wells, a main water distribution aqueduct and sewage extensions. All items have been implemented successfully.

As result of the Project's investments, Subotica, its population and surrounding environment have benefitted from improved water infrastructure. Helping to solve problems of insufficient water supply, sewage coverage, associated health risks and environmental hazards. Prime examples of these environmental and social benefits include the increase in households and businesses connected to the water supply network, and the reduction in phosphorus and nitrogen in the nearby Lake Palic.

In addition to water infrastructure works, the Project supported Public Utility Company Waterworks and Sewerage Subotica (the “Company”) in setting standards for corporate governance and business conduct by participating in benchmarking programmes. The Company participated in several local and regional benchmarking programmes, including the International Association of Water Supply Companies in the Danube River (IAWD), based in Vienna. These benchmarking exercises include indicators which allow them to show a positive demonstration effect. In addition, the Project supported the adaptation of a public service contract between the Company and City, and a new tariff system. This has and will support the financial sustainability of the Company.