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R2017-0245/1

November 16, 2017

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<p><b>Closing Date: Thursday, December 7, 2017 at 6 p.m.</b></p>
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FROM: Vice President and Corporate Secretary

**Bosnia and Herzegovina**  
**Republika Srpska Railways Restructuring Project**  
**Project Appraisal Document**

Attached is the Project Appraisal Document regarding a proposed loan to Bosnia and Herzegovina for a Republika Srpska Railways Restructuring Project (R2017-0245), which is being processed on an absence-of-objection basis.

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Report No: PAD2359

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EUR 51.3 MILLION  
(US\$ 60.6 MILLION EQUIVALENT)

TO

BOSNIA AND HERZEGOVINA

FOR A

REPUBLIKA SRPSKA RAILWAYS RESTRUCTURING PROJECT

THE SECOND PHASE OF THE  
TRANSPORT SECTOR MODERNIZATION PROGRAM (TSMP)

November 14, 2017

Transport & ICT Global Practice  
Europe And Central Asia Region

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CURRENCY EQUIVALENTS  
(Exchange Rate Effective September 30, 2017)

Currency Unit = EUR  
EUR 0.8466 = US\$1.0000  
EUR 1.0000 = US\$1.18125

Currency Unit = BAM  
BAM 1.6557 = US\$1.0000  
BAM 1.0000 = US\$0.60397

Currency Unit = BAM  
BAM 1.9558 = EUR1.0000  
BAM 1.0000 = EUR0.5113

FISCAL YEAR  
January 1 – December 31

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## ABBREVIATIONS AND ACRONYMS

B40	Bottom forty percent of income distribution	ICB	International Competitive Bidding
BFC	Beneficiary Feedback Commission	IFC	The International Financial Corporation
BHŽJK	Public Railways Corporation	IFI	International Finance Institution
BiH	Bosnia and Herzegovina	IFR	Interim Financial Report
BAM	BiH Convertible Mark	IFRS	International Financial Reporting Standards
BP	World Bank Procedure	INDC	Intended National Determined Contributions
CE	Citizen Engagement	IPA	Instrument for Pre-Accession Assistance
COP21	21st annual Conference of the Parties to the 1992 United Nations Framework Convention on Climate Change (UNFCCC)	IPF	Investment Project Financing
CFD	Central Feedback Desk	IRAP	International Road Assessment Program
CPF	Country Partnership Framework	ISA	International Standards on Auditing
EA	Environmental Assessment	ISP	Implementation Support Plan
EBRD	European Bank for Reconstruction and Development	IT	Information Technology
EEP	Eligible Expenditure Program	km	Kilometer
EIB	European Investment Bank	M&E	Monitoring and Evaluation
EIRR	Economic Internal Rate of Return	MoTC	Ministry of Transport and Communications (entity level)
EIS	Environmental Impact Study	MoCT	Ministry of Communication and Transport Bosnia and Herzegovina (state level)
ESIA	Environmental and Social Impact Assessment	MFT	Ministry of Finance and Treasury Bosnia and Herzegovina
ESMF	Environmental and Social Management Framework	NCB	National Competitive Bidding
ECA	Europe and Central Asia	NPV	Net Present Value
EU	European Union	Ntkm	Net Tonne Kilometer
FBH	Federation of Bosnia and Herzegovina	OP	Operational Policy
FIRR	Financial Internal Rate of Return	PAD	Project Appraisal Document
FM	Financial Management	PDO	Project Development Objective
FMF	FBH Ministry of Finance	PIMT	Project Implementation and Management Team
GDP	Gross Domestic Product		
GHG	Greenhouse Gas		

POM	Project Operation Manual	WB	World Bank
QCBS	Quality and Cost-Based Selection	WBG	World Bank Group
REBIS	Regional Balkans Infrastructure (Transport) Study		
RPF	Resettlement Policy Framework		
RRA	Resettlement Review and Audit		
RRB	(BiH) Railway Regulatory Board		
RS	Republika Srpska		
SAA	Stabilization and Association Agreement		
SC	Steering Committee		
SCD	Systematic Country Diagnostic		
SEE	South East Europe		
SEETO	South East Europe Transport Observatory		
SA	Social Assessment		
SOE	Statement of Expenditure		
SOP	Series of projects		
TA	Technical Assistance		
TEN-T	Trans-European Transport Networks		
TSMP	Transport Sector Modernization Program		
TU	Traffic Units		
UNDP	United Nations Development Program		
UNFCCC	United Nations Framework Convention on Climate Change		
USD	United States Dollar		
VAT	Value-Added Tax		
ŽFBH	Željeznice Federacije Bosne i Hercegovine (Railway Company of the Federation of Bosnia and Herzegovina)		
ŽRS	Željeznice Republike Srpske (Railway Company of Republika Srpska)		



## BASIC INFORMATION

Is this a regionally tagged project? No	Country(ies)	Financing Instrument Investment Project Financing
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- Situations of Urgent Need of Assistance or Capacity Constraints
- Financial Intermediaries
- Series of Projects

Approval Date 07-Dec-2017	Closing Date 31-Dec-2021	Environmental Assessment Category B - Partial Assessment
Bank/IFC Collaboration No		

## Proposed Development Objective(s)

The Overall Development Objective of the Transport Sector Modernization Program (TSMP) is to improve transport connectivity of the country along priority transport links and to support improvements in transport operations and asset management practices. The Program is multi-phased with a First Phase including road sections in the Federation of Bosnia and Herzegovina, and the Second Phase including railways in the Republika Srpska.

The Development Objective of the Second Phase of the TSMP is to improve the operational efficiency and financial sustainability of the railways in Republika Srpska.

## Components

Component Name	Cost (US\$, millions)
Financial restructuring	139.02
Workforce restructuring	4.13
Organizational restructuring	5.90

**Organizations**

Borrower : Bosnia and Herzegovina

Implementing Agency : Republika Srpska  
Republika Srpska Railways

**PROJECT FINANCING DATA (US\$, Millions)**

<input checked="" type="checkbox"/> Counterpart Funding	<input checked="" type="checkbox"/> IBRD	<input type="checkbox"/> IDA Credit	<input type="checkbox"/> IDA Grant	<input type="checkbox"/> Trust Funds	<input type="checkbox"/> Parallel Financing
Total Project Cost: 149.19	Total Financing: 149.19		Financing Gap: 0.00		
	Of Which Bank Financing (IBRD/IDA): 60.60				

**Financing (in US\$, millions)**

Financing Source	Amount
Borrower	88.59
IBRD-88080	60.60
<b>Total</b>	<b>149.19</b>

**Expected Disbursements (in US\$, millions)**

Fiscal Year	2018	2019	2020	2021	2022
Annual	0.00	8.50	23.00	18.00	11.10
Cumulative	0.00	8.50	31.50	49.50	60.60



## INSTITUTIONAL DATA

### Practice Area (Lead)

Transport & ICT

### Contributing Practice Areas

Finance & Markets

Social Protection & Labor

Social, Urban, Rural and Resilience Global Practice

### Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

### Gender Tag

Does the project plan to undertake any of the following?

a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF

Yes

b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment

Yes

c. Include Indicators in results framework to monitor outcomes from actions identified in (b)

Yes

## SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)

Risk Category	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● Substantial
3. Sector Strategies and Policies	● Substantial
4. Technical Design of Project or Program	● Substantial
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Substantial



7. Environment and Social	● Substantial
8. Stakeholders	● Substantial
9. Other	
10. Overall	● Substantial

**COMPLIANCE**

**Policy**

Does the project depart from the CPF in content or in other significant respects?

Yes  No

Does the project require any waivers of Bank policies?

Yes  No

**Safeguard Policies Triggered by the Project**

	Yes	No
Environmental Assessment OP/BP 4.01	✓	
Natural Habitats OP/BP 4.04		✓
Forests OP/BP 4.36		✓
Pest Management OP 4.09		✓
Physical Cultural Resources OP/BP 4.11		✓
Indigenous Peoples OP/BP 4.10		✓
Involuntary Resettlement OP/BP 4.12		✓
Safety of Dams OP/BP 4.37		✓
Projects on International Waterways OP/BP 7.50		✓
Projects in Disputed Areas OP/BP 7.60		✓

**Legal Covenants**

**Conditions**

**PROJECT TEAM****Bank Staff**

<b>Name</b>	<b>Role</b>	<b>Specialization</b>	<b>Unit</b>
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Railway Economic & Financial  
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BOSNIA AND HERZEGOVINA  
RAILWAYS MODERNIZATION PROJECT

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## I. STRATEGIC CONTEXT

### A. Country Context

1. After modest post-crisis recovery, Bosnia and Herzegovina (BiH) continues to struggle with structural problems that undermine economic growth. Following the global financial crisis (2008/2009) and subsequent euro area crisis leading to a double-dip contraction of the economy, the country experienced a moderate economic recovery in 2013 when growth reached 2.4 percent. This was interrupted by the floods of May 2014, which impacted almost all sectors of the economy and slowed growth to 1.1 percent in 2014. Following the floods of 2014, and supported by stronger net external demand, the economy recovered in 2015 achieving growth of 3.1 percent. At the same time, the current account balance narrowed down from -7.2 percent of gross domestic product (GDP) in 2014 to -4.3 percent of GDP in 2016. Although the fiscal deficit is low, the fiscal sector is still characterized by a high tax burden and inefficient patterns of spending. In the medium-term, supported primarily by rising domestic demand, economic growth is projected to strengthen from 3.1 percent in 2016 to 3.5 percent by 2019.
2. Bosnia and Herzegovina (BiH) is a state comprising two entities, each with a high degree of autonomy: the Federation of Bosnia and Herzegovina (FBH) and Republika Srpska (RS). The district of Brčko was added to the state structure in 1999. The country's complex political system poses significant challenges in developing comprehensive sectoral policies and efficiently confronting emerging development priorities but authorities in BiH have been pursuing a jointly-authored reform agenda that centers on the goals of macroeconomic stability, export-led economic growth, employment and social cohesion, and sustainable development. The overarching objective of the reform agenda is EU accession.
3. Progress on poverty reduction remains slow. Latest available figures between 2007 and 2011 the poverty headcount remained stable at the country level. While poverty incidence in 2011 was similar at the entity levels, it was much higher in rural areas, at 19 percent, compared to 9 percent in urban areas. Unlike poverty, for which there is little difference between FBH and RS, the bottom forty percent income group (B40) of BiH is disproportionately represented in RS, partly due to its smaller share of urban population, but also because the urban population in FBH has higher welfare income on average than the urban population in RS.
4. BiH is vulnerable to heat waves, flooding and droughts. These events may become more common in the future with severe negative impacts for people and the economy. For instance, the negative impacts of the heavy floods in May 2014 in BiH were estimated at 15 percent of GDP. A joint EU-UNDP-World Bank led Recovery and Needs Assessment estimated that the cumulative impacts could significantly slow growth, increase poverty and put pressure on public finances.
5. BiH has one of the world's largest public sectors relative to the size of its economy, with general government expenditures at 43.7 percent of GDP in 2016.<sup>1</sup> Enhancing expenditure efficiency can therefore significantly improve economic growth and help reduce poverty. The efficiency of the railway sector, and necessary budgetary support, are issues of major concern to both Entities.

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<sup>1</sup> WB staff estimates based on consolidated BiH 2016 public expenditure data.



**B. Sectoral and Institutional Context**

6. The railway sector is administered and managed at the State level by the Ministry of Communications and Transport (MoCT), and at the entity level, by a separate Ministry of Transport and Communications (MoTC) in each entity. BiH’s legal framework for the railways sector has established a two-railway system. Figure 1 is a functional map broadly describing the ‘de facto’ roles of the main institutions.

**Table 1. Distribution of railway sector functions among institutions in BiH**

Function	Federation of Bosnia and Herzegovina	Republika Srpska
<b>BiH multi-modal transport strategy (preparation in progress)</b>	Council of Ministers (CoM) of BiH in collaboration with the Entities and Brčko District	
<b>International railway economic and safety regulation</b>	BiH Rail Regulatory Board (RRB) reporting to CoM	
<b>Inter-entity technical standards &amp; coordination</b>	BiH Railways Corporation (BHŽJK) reporting to the Entities	
<b>Entities’ transport policies</b>	Government of FBH (MoTC, MoF)	Government of RS (MoTC, MoF)
<b>Intra-entity railway policy, planning and regulation</b>		
<b>Public budgetary support</b>		
<b>Ownership of railway company</b>	Government of FBH and some private shareholders	Government of RS, pension fund and some private shareholders (20%)
<b>Railway network infrastructure management</b>	Željeznice Federacije Bosne i Hercegovine (ŽFBH)	Željeznice Republike Srpske (ŽRS)
<b>Railway transport operations</b>		

7. The ŽRS railway network consists of 426 route-km (of which 353 route-km are in use) making it one of the smallest networks in the Western Balkans. The backbone railway route is the east-west line from the border with Croatia via Novi Grad, Banja Luka to Doboj. There it meets RS’s section of the north-south Pan-European Railway Corridor Vc (which constitutes part of the Indicative Extension to the TEN-T Mediterranean Core Corridor). It also provides a link eastward from Doboj to ŽFBH’s network centered on Tuzla (see map in Annex 8). The operational network is standard gauge (1,435mm), predominantly single track (94 percent), and electrified at 25 kV (88 percent). The maximum rated design speed on the main line is generally 100km/h, and many sections have been rehabilitated to meet this standard. ŽRS freight traffic density of about 1.2 million tonnes/route-km is relatively high compared to neighboring countries and about equal to the EU average. In 2015, it carried around 5 million tonnes of freight and 428 million net tonne-km (ntkm).

8. ŽRS has been generating operating losses on a yearly basis (Annex 6). This is partly due to previous railway employment policies that have led to excessive labor costs, and partly due to underfunded passenger service losses. Over 97 percent of the company’s traffic and revenue are from freight, but nearly half of all the train distance run (49 percent) is for passenger services. During the period 2007-2014, the company’s annual working ratios (operating costs less depreciation and debt repayments, divided by commercial revenue) prior to budgetary contributions ranged from 1.43 to 2.13, indicating substantial (and fluctuating) commercial



deficits. Entity budgetary support, although allocated to infrastructure and passenger services, is used to finance operating deficits bringing the company's total income closer to its operating cost (less depreciation and debt repayments). The annual working ratios (with budgetary support) varied over the period between 0.93 and 1.09.

9. These deficits do not include repayment of debt obligations which have been accumulating and accruing interest and penalties over the years further worsening the financial sustainability of ŽRS. Budgetary contributions are effectively being used to keep the railway sector on 'life-support'. The principle of budgetary support of railways is acceptable under the EU rail acquis, but only for validated contracts for infrastructure investment, maintenance, and public service obligations for passenger transport. However, this is not the case for ŽRS, where budgetary support is essentially used to finance deficits in operating expenditures.

10. Heavy overstaffing in ŽRS has resulted in the lowest labor productivity levels in the region (see component 2 in Section IIIA). As a result, labor costs are a disproportionate share of the cost structure of ŽRS. In 2016, the wage bill was 64 percent of operating costs and 123 percent of commercial revenues (excluding Entity subsidies), and averaged 61 and 125 percent respectively over the 2007-2014 period.

11. Because depreciation is unfunded, ŽRS has no financial resources for systematic investment. Instead ŽRS is wholly dependent on ad-hoc financial support from the Entity government for meeting debt repayment obligations associated with prior investment, as well as for future capital needs. Debt service payments are made on behalf of ŽRS by the Entity government, but charged to the railway account becoming an obligation to the railway companies--an obligation that is difficult to meet. The current outstanding debt including accrued interest related to capital investment in infrastructure and locomotives is estimated at about EUR 75 million.

12. ŽRS does not keep separate sector accounts for its freight and passenger businesses, but the Bank assessed the underlying financial performance of each business (See Annexes 4 and 6). The analysis for 2014, for example, shows that passenger services generate a deficit of BAM 14.2 million after receiving budgetary support for these services of BAM 2.5 million. The budgetary contribution is therefore insufficient to fund the cost of services. In contrast, freight transport generated a surplus of BAM 14.2 million that year that was used to cross subsidize passenger services. To adopt the EU railway acquis, ŽRS will need to phase out such cross-subsidy and replace it with a commercially-based passenger public service contract for those specified passenger services deemed necessary by the government.

13. The RS Government sees the restructuring of its railway sector as a policy priority. Not only is the sector financially unsustainable in its current form, but there is an overarching policy challenge to meet the provisions of EU-Bosnia and Herzegovina Stabilization and Association Agreement (2015) as they apply to the railway sector (the 'EU railway acquis'). Confirming to the acquis requires action by the RS Government in several areas: ŽRS's organizational structure, track access, budgetary support for passenger services, budgetary support for infrastructure, and debt sustainability. The restructuring is backed by a new Railway Law passed in 2016 to harmonize the railway sector with the EU rail acquis, restructure ŽRS to promote its financial stability, and for the railway network to be integrated into the European network.

14. In addition, the BiH Council of Ministers and the entity governments endorsed a medium-term Reform Agenda in July 2015, which serves as a blueprint for structural reforms. The Agenda entails reforming state-



owned enterprises through privatization, restructuring, or bankruptcy. Restructuring ŽRS will be a cornerstone of this process, as it will be the first of its kind to be undertaken in the RS.

15. It is imperative for ŽRS to become more financially sustainable and commercially-focused. In the short-term this is needed to make the railway sector publicly affordable. In the longer-term it is necessary to give the industry a better chance of sound growth and success in an integrated European transport market as well as avoid the erosion of the railways modal share and loss of traffic to roads which would contribute to an increase in Greenhouse Gas (GHG) emissions, road accidents and fatalities. In this context, the World Bank prepared a Railways Policy Note to assist the governments of the Entities in Bosnia and Herzegovina to better understand the current conditions of the railway sector, assess the policy options for modernizing it, and help chart a course ahead. Following the preparation and discussion of the Policy Note, the RS Government prepared a Letter of Sector Policy (Annex 7) establishing the Government’s vision and strategy for the railway sector and requested Bank support in modernizing the sector with a focus on the following two main areas:

(a) Ownership and financial restructuring aimed at repaying employee-related debts, converting government debt into equity, and making ŽRS a one-shareholder government-owned joint-stock company. This would deleverage and recapitalize the company, and relieve it of historical and unsustainable debts in a manner consistent with EU acquis. This would in turn enable the government to buy out minority shareholders under the recently enacted bankruptcy law, prepared with IFC support (see box below), to facilitate complex restructurings of large corporates such as ŽRS while offering (i) protection with respect to a buy-out of minority shareholders (who received free allocations through vouchers in the early 1990’s) and (ii) a higher degree of certainty over the time and costs with such restructuring. The government will use its own resources to buy out the affected shareholders at a fair transparently-determined price.

(b) Organizational transformation of ŽRS to: (i) restructure the workforce to reduce operating costs and raise productivity to acceptable norms; and (ii) bring ŽRS in line with European railways with respect to EU railway acquis, accounting regulations, and commercial management methods while continuing to invest in railway lines and services which the government considers essential to the economy.

16. Sound railway asset management plans are also critical to enhance the resiliency of the transport network and its ability to better cope with extreme weather events. Repairing the damages to the railway network in BiH following the 2014 floods was estimated to cost about 50 million Euros, and the economic losses associated with network disruptions were estimated at about 35 million Euros.



**WBG support to BiH in preparing a Bankruptcy law to be followed in restructuring ZRS**

A Financial Sector Assessment Program (FSAP), undertaken by the World Bank and the IMF in 2014 included a report on *the Observance of Standards and Codes for the Insolvency and Creditor/Debtor Regimes* (ICR ROSC). The ICR ROSC at the time found that the insolvency framework was biased towards piecemeal asset liquidation, in terms of both the law and practice, as the bankruptcy process was protracted and lengthy. Reorganizations or going concern sales were very rare, and insolvency proceedings often started too late, when the business was no longer viable.

FSAP recommendations concluded that the legal framework governing creditor/debtor relationships was comprehensive, however neither debt resolution, businesses reorganization or bankruptcy liquidation work effectively. The report recommended streamlining execution procedures, introduction of tools and incentives to facilitate corporate debt restructurings and resolution, and adoption of out-of-court restructuring guidelines.

In 2015, the IFC provided technical assistance to both entity authorities to improve efficiency of debt resolution in BiH by improving the legal framework and bankruptcy practices. The WBG team worked with both entities to support preparation of the new bankruptcy laws to improve mechanisms for initiating the bankruptcy, improve rules for collection of receivables, setting up out-of-court settlement and introduction of the enterprise restructuring.

The RS Government enacted the Law on Bankruptcy on March 10, 2016. Since then 21 bankruptcy cases were completed successfully with a total value of 21.4mUSD, while around 600 jobs were saved via 3 restructuring processes. ŽRS will carry out its restructuring under the 2016 RS Law on Bankruptcy.

17. While the full benefits of an efficient railway system in BiH will be achieved from the modernization of the railway companies in both Entities, unilateral reforms by ŽRS will generate net benefits regardless of any reforms in ŽFBH. Moreover, the pace of the reforms by ŽFBH will have no bearing on the ability of the RS Government to carry out its own railway reforms as it has the legal powers and responsibility to take all the necessary actions for these reforms.

**C. Higher Level Objectives to which the Project Contributes**

18. The TSMP was approved by the World Bank’s Board in August 2016 to support BiH’s transport modernization in the most effective manner to achieve national economic and social goals. The Federation Road Modernization Project was the first phase of the TSMP aimed at improving road connectivity and safety. The Republika Srpska Railways Restructuring Project, the second phase of TSMP, will support the modernization of the railway sector.

19. The higher-level objectives of the Project stem from the Bank’s Country Partnership Framework (CPF) FY16-20, BiH’s 2015 medium-term Reform Agenda, the BiH TSMP and BiH’s pre-accession aim to harmonize its



transport policies with those of the EU.

20. The Project directly targets Focus Area 1 of the CPF which is to increase public sector efficiency and effectiveness, an objective that includes improving management and efficiency of public finances, strengthening governance, and reducing the fiscal burden of state-owned enterprises. It will also support Focus Area 3 to build resilience to natural shocks through a modern asset management system (see details in para. 38).

21. The Project's objectives are also in line with the Berlin Process that was established by EU member states in 2014 to reinforce a European perspective for the Western Balkans and encourage reform, reconciliation and regional cooperation among countries. Among the main goals for transport connectivity set in the Prime Ministerial Western Balkan Summits in Vienna in 2015 and Paris in 2016 were railway modernization and railway market opening. These goals were further articulated in the "Joint Action Plan for Western Balkans Trade and Transport Facilitation" that was adopted in mid-2016.<sup>2</sup>

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. Program Objective

22. The Overall Development Objective of the Transport Sector Modernization Program is to improve transport connectivity of the country along priority transport links and to support improvements in transport operations and asset management practices. The Program is multi-phased with a first phase including road sections in FBH, and the second phase including railways in the RS.

### B. Project PDO

23. The Project Development Objective is to improve the operational efficiency and financial sustainability of the railways in Republika Srpska.

### C. Project Beneficiaries

24. The main beneficiaries of the Project are the ŽRS freight rail users in the region who are currently the producers and users of iron ore, bauxite, aluminum, hydrated aluminum, alkali and coal and account for 60 percent of the freight (in tonnes) transported in RS by rail. In the absence of sector restructuring ŽRS would continue to deteriorate financially and, even if it continued to receive cash injections from the government to avoid official bankruptcy, would be unable to replace its operational assets, maintain services, or successfully contribute to and compete in the EU's common rail market without significantly and adversely impacting other sectors of the economy. The main railway cargos are commodities that depend on low cost transport and can only be handled by road transport at much higher economic and environmental costs.

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<sup>2</sup> While BiH was the only country out of the 6 Western Balkans countries not to sign the Transport Community Treaty in Trieste on July 12, 2017, the delay in signing is not expected to affect the path or pace of railway modernization in the RS where the Entity Government commissioned the World Bank two years ago to prepare a policy note on reform options for the railway sector and initiated the reform process year ago.



25. The Project will also address the sustainability of passenger services: passengers, who currently account for only around 460 trips/day, will benefit from a properly funded service contract in accordance with the EU rail acquis. In addition, the Project will also identify how to maintain or increase these passenger benefits through a road-coach based alternative contract for rail services that cannot be funded by the RS government.

26. The wider population of the RS will also benefit from improved management of public finances. Relative to the size of its economy, BiH has one of the world's largest public sectors, impacting economic growth and employment. The Project will directly address the institutional governance and efficiency of public expenditures in the railway sector, which has also been identified by IMF as one of the key sectors for reform.

27. In addition, the employees of ŽRS will benefit from the Project in three ways. The Project will fund: (i) repayment of arrears owed to them; (ii) fair and reasonable compensation packages for those subject to the workforce restructuring program; and (iii) organizational restructuring that will provide much more secure employment prospects for railway employees who remain in the sector.

28. Finally, the global community will benefit from the Project. Ensuring the financial sustainability and operational efficiency of the railways will help maintain the railways share of the freight market and avoid a loss of business to roads, thus avoiding an increase in GHG emissions.

#### **D. PDO-Level Results Indicators**

29. Operational efficiency will be measured primarily by improved labor productivity (traffic units per employee). Improved financial sustainability will be measured by the ratio of revenues to operating costs excluding depreciation and interest (the working ratio), and the implementation of Public Service Contracts for passenger services and a Multi Annual Infrastructure Contract. Several supporting intermediate indicators will also be used to monitor PDO achievement. The Results Framework for the project is described in Section VII.

### **III. PROJECT DESCRIPTION**

#### **A. Project Components**

30. The Project will support the restructuring of ŽRS by creating a sound framework for public financing, and supporting a more commercial approach to railway management. The Project has three main components:

***Component 1: Financial restructuring (EUR 117.7 million, IBRD financing of EUR 42.7 million)***

31. ŽRS's debt to the RS Government is EUR 75 million. The RS Government will convert this debt into equity. This will relieve ŽRS of a historical debt burden associated with IFI and bilateral loans for capital investment, a debt it cannot repay and will put the company on the right path to financial sustainability, with infrastructure capital investments clearly and transparently financed by the government through the Multi Annual Infrastructure Contract. This conversion will be financed by the RS Government. ŽRS however, needs to pay existing and accruing debts towards its employees before it can proceed with the conversion.

32. ŽRS currently has about BAM 83.5 million (EUR 42.7 million, USD 50.4 million) in debts and provisions



related to its employees. These include (i) direct debts to employees for benefits and allowances, (ii) employer’s contributions to pensions, health insurance and other social accounts, (iii) employer’s contributions to employee taxes, (iv) interest and expenses related to litigation with respect to outstanding debts, and (v) penalties and interest for late/outstanding tax payments. ŽRS will use proceeds of the Bank’s loan to repay the company’s outstanding debts to employees as well as other arrears and thereafter, under the protection of the RS’s bankruptcy court, the Government will implement the debt-to-equity conversion. The repayment of staff debts prior to a staff retrenchment program is not only an issue of social responsibility, but also an important enabler of financial restructuring. Table 2 below present the breakdown of these arrears.

33. Prior to proceeding with the restructuring, ŽRS will have credible and realistic organizational plans and business plans, including commitments between the RS Government and ŽRS that secure funding for investment and passenger services while holding ŽRS accountable for meeting agreed operational and financial targets. These plans would minimize the risk of ŽRS building up new debts.

**Table 2: List of arrears related to ŽRS employees**

Type/Description	Amount (BAM million)
<b>(i) Direct debts to employees for benefits and allowances</b>	
Reimbursement of transport to work for eligible employees <sup>3</sup>	2.3
Reimbursement of km for locomotive drivers <sup>4</sup>	0.4
Reimbursement for meals and leave allowance <sup>5</sup>	23.7
<b>(ii) Contributions (on salaries, meal allowance and paid leave allowance)<sup>6</sup></b>	29.0
<b>(iii) Employers contribution for employees’ taxes<sup>7</sup></b>	5.9
<b>(iv) Lawsuits on labor disputes</b>	10.6
<b>(v) Penalties and interests</b>	11.6
<b>TOTAL</b>	83.5

**Component 2: Workforce restructuring (EUR 3.5 million, IBRD financing of 100 percent)**

34. This component will include: (i) support for compensation packages for up to 1,000 employees over the period 2018-2021, and (ii) support to retrenched employees in the form of training and counseling to convert to other sectors of the economy.

35. Workforce restructuring is an essential element of Project design as employment and labor costs are at unsustainable levels. Currently, ŽRS has about 3,100 employees and its labor productivity<sup>8</sup> is around 146,000

<sup>3</sup> Eligible employees are those living more than 4 km away from a train station or without a convenient railway connection.

<sup>4</sup> Benefit specific to train drivers (in lieu of meal allowance). Amount not submitted to taxes and contributions.

<sup>5</sup> Leave allowance for all employees; meals for all employees, excepting train drivers

<sup>6</sup> Contributions represent 33 percent of the gross salary, and are split into 18.5 percent to the pension fund, 12 percent to the health system, 1.5 percent to child protection and 1 percent to unemployment, and further split into 20 percent to local authorities and 80 percent to the Entity

<sup>7</sup> Taxes represent 10 percent of the gross salary, and are also split into 20 percent to local government and 80 percent to the Entity government.

<sup>8</sup> Average traffic units per employee, where the total traffic units are the sum of tonne-km and passenger-km.



TU/employee, the lowest in the region (other than Albania) and about a quarter of the EU average. ŽRS has more employees than it had in 2005, due to previous job creation policies rather than commercial needs, and the highest number of employees/route-km of any railway in the region.

36. Labor costs, due to excess employment, are a disproportionate component of the cost structure of ŽRS. In 2016 the wage bill was 64 percent of operating costs<sup>9</sup> and 123 percent of commercial revenues (excluding Entity subsidies). RS MoTC is planning a reduction in the number of ŽRS employees of about 1,000-- 500 in 2018 and another 500 by latest 2021. This would boost the average productivity of labor to a level closer to the mid-point of the regional range. The sooner the labor force is optimized, the sooner ŽRS will have additional resources that would help ensure financial sustainability and avoid the risk of building new arrears.

37. Workforce optimization will take place through retirement, voluntary separation by providing attractive packages and applying involuntary separation for cases when staff do not meet minimum qualifications for the position, and cannot be reassigned elsewhere. Workforce optimization will also be eligible to benefit from the WB funded Employment Support Project (P152347), which will finance targeted wage subsidies, on-the-job training, and self-employment programs. Retrenchment plans will include gender disaggregated information and clear criteria for non-discriminatory processes for identifying redundancies, and corresponding grievance redress mechanisms related to retrenchment.

***Component 3: Organizational restructuring (EUR 5 million, IBRD financing of 100 percent)***

38. The objectives of the organizational restructuring are (i) to equip ŽRS with the appropriate mechanisms to support its long term financial sustainability and (ii) to harmonize its organizational structure with the EU railway acquis while at the same time creating clarity, focus and independence in infrastructure and operating roles. This is intended to improve the commercial management of each function (infrastructure and operations) and enhance their ability to determine their own business strategies in the context of a European railway system in which each will have different opportunities and constraints, and sometimes different interests. This component will include:

- Planning and implementation of a new, more commercial ŽRS organization structure consisting of a corporate core plus two independently managed and separately accounted business divisions, one for infrastructure management and one for transport operations. Within the operating department sector accounts would be kept for freight business and passenger business.
- Specification, procurement and implementation of a modern and effective financial accounting system including core general ledger functionality, accounts, human resources management and payroll, assets and inventory, funds management, etc. Specification and application of such system must be geared to railway businesses and the specific financial and enterprise resource planning, budgeting and management needs of ŽRS's independently managed divisions (sector accounting).
- Specification and implementation of (i) a railway infrastructure asset management system for the Infrastructure Division and (ii) a rail operations asset management system for the Operating Division.

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<sup>9</sup> Defined for this purpose as expenditures related to materials, fuel, electricity, salaries and allowances, outsourcing and other services, and depreciation.



- Development of commercially-driven and financially attainable and sustainable medium-term (2019-2023) Business Plans (including marketing plans), based on good railway practices and experiences, for the constituent divisions and subsidiaries of ŽRS;
- Development, adoption and implementation of a multi-annual Public Passenger Services Contract (PSC) to be agreed between ŽRS (Operating Division) and government of RS together with proposed annual contract prices and payment arrangements consistent with the Operations Division Business Plan for passenger services.
- Development, adoption and implementation of a multi-annual Infrastructure Contract (MAIC) and proposed contract price and payment arrangements to be agreed between ŽRS Infrastructure Division and the RS Government consistent with the Infrastructure Division Business Plan.
- The combination of expected improved commercial performance plus contractually-based government contributions for passenger services and infrastructure operations in accordance with the EU rail acquis, when properly estimated through the new sector accounting, would ensure financial sustainability.
- Capacity building for MoTC and ŽRS management and staff as necessary and other activities supporting organizational change.

39. This component will also finance technical assistance to support ŽRS in the implementation of the Project as necessary and particularly in two areas: support with organizational restructuring, accounting and business systems; and support with business planning and establishing contractual relationships with government. It will also support project monitoring.

40. This inputs needed for this component—procurement of services and goods—will be financed following standard World Bank Group IPF procedures and practices (i.e., financing the cost of inputs). The estimated cost for these inputs is about EUR 3.0 million. The disbursement linked indicators supporting this component will focus on outcomes and key results which underpin the organization restructuring and modernization of ŽRS operations and business practices.

### ***Loan Instrument***

41. While the loan instrument is an IPF, the Project will use a results-based approach (disbursement linked indicators) to incentivize the achievement of the desired outcomes, not only those related to ownership restructuring and resettlement of debts, but also labor force optimization and implementation of key recommendations and plans. The use of the IPF with DLIs is best suited for this project due to the strong need for implementation support on difficult organizational, financial and workforce restructuring during implementation.

42. To incentivize the implementation of the operational efficiency and reforms and organizational restructuring, a larger amount of the loan disbursement is associated with indicators in these areas (see Table A1.4 in Annex 1 for details).

**(i) DLI 1: Implementation of financial and ownership restructuring:** this DLI will be linked to the official

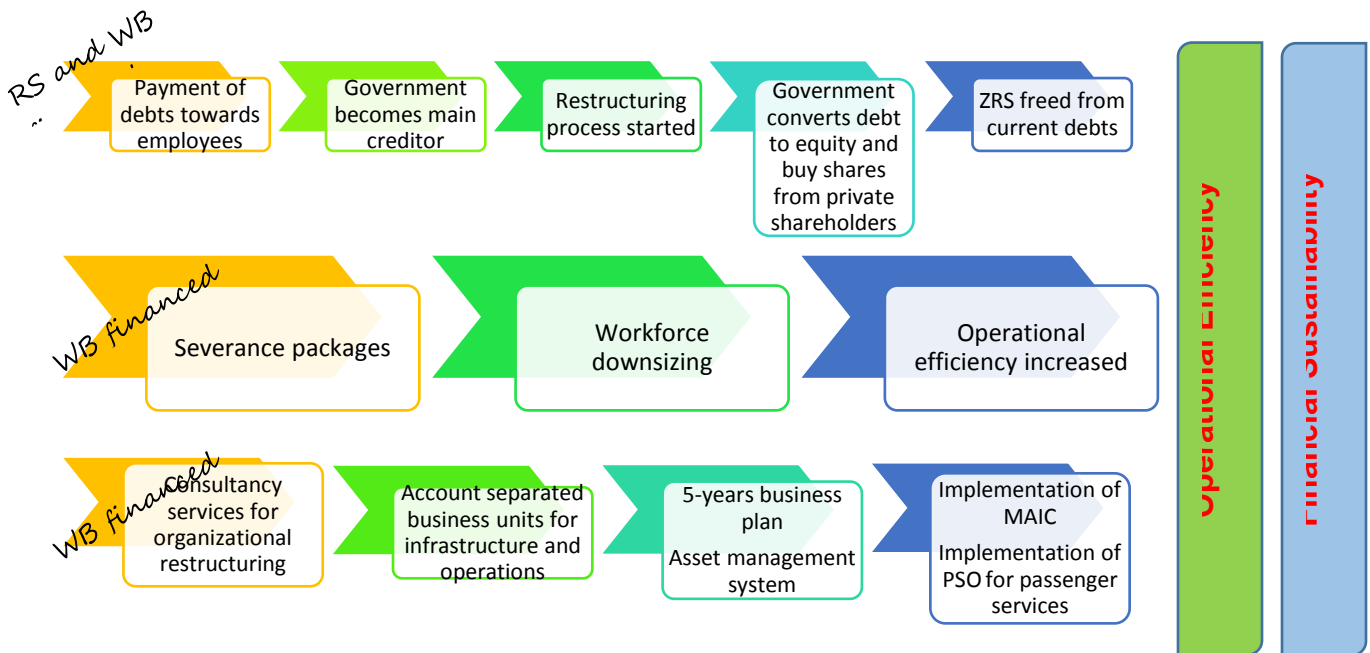


approval and submission of the restructuring plan by the RS Government as agreed with the Bank and the resettlement of arrears.

- (ii) **DLI 2: Implementation of workforce restructuring:** This DLI will track progress on the labor productivity levels and disburse when specified thresholds are reached.
- (iii) **DLI 3: Implementation of organizational restructuring:** This DLI will track progress in the implementation of the new ŽRS organization structure, the PSO, TAC, MAI and performance contracts, asset management plans, business plans and implementation of modern management and financial systems.

43. The rationale for public sector financing lies on the complexity and political difficulty of railways restructuring and reforms, for which private financing is not available. Once the reforms take place, private operators could be interested in service provision, competing either for or in the market.

Figure 1: Project Design



**B. Project Cost and Financing****Table 3. Project costs and financing (including contingencies and Value Added Taxes) in EUR million**

Project Components	Project cost	IBRD Financing	Counterpart Funding
<i>1 Financial restructuring</i>	117.7	42.7	75.0
<i>2. Workforce restructuring</i>	3.5	3.5	0.0
<i>3. Organizational restructuring</i>	5.0	5.0	0.0
<b>Total Costs</b>	126.2	51.2	75.0
Front End Fees (0.25%)		0.13	
<b>Total Financing Required</b>	126.3	51.3	75.0

**C. Lessons Learned and Reflected in the Project Design**

44. The Bank has a long history of assisting governments in the challenging area of railway reform in all regions of operation. Its involvement in BiH builds specifically upon railway policy and operational investigations and action plans in South East Europe including Railway Policy Note for BiH, and similar notes for Serbia and Croatia; a multi-country study “Railway Reform in South East Europe and Turkey: On the Right Track?” reviewing the state of the railway sector in the region; and an update of the Regional Western Balkans Infrastructure Study (REBIS) identifying regional physical and non-physical priorities including in railways.

45. The Bank’s sector and regional knowledge is therefore built into the Project in four ways:

- (a) Because railway restructuring is complex and multi-faceted, the Project will support all elements of the Restructuring Plan including financial restructuring, workforce rationalization, and organizational reform.
- (b) The EU railway framework of directives and regulations is structural and not of itself sufficient to improve the day to day management of railways. The organizational reform component has therefore been designed not just to seek structural compliance with EU requirements but also to seek improvement in the business management and processes of the railways as it engages with markets and customers and manages its resources.



- (c) Workforce downsizing is essential to raise productivity towards that of peers and potential competitors. The World Bank's Labor Toolkit notes that the desired outcomes of labor restructuring may be short-term and urgent (for example, reducing operating costs), medium-term (improved services to consumers and business), or long-term (improved international competitiveness in the sector). In the case of ŽRS all three aims are relevant but cooperation by unions can only be anticipated if the program is seen to be fair and reasonable and compensation packages sufficient to induce a high degree of voluntary application prior to any involuntary separation. This has been learnt from previous labor restructuring operations in Polish Railways, Croatian Railways and Serbian Railways in which the Bank was involved as well as in other economic sectors. The Bank team is deploying one of its own specialists in labor retrenchment and associated issues to monitor and advise the Borrower.
- (d) The restructuring of transport state-owned enterprises is nearly always contentious and a matter of keen public interest. Bank specialists in project communications are supporting ŽRS and MoTC in developing a communications strategy for the Project. Part of the funds allocated to organizational restructuring will be used to implement and maintain this strategy.

46. The WB Independent Evaluation Group (IEG) highlights the need to prioritize investments in railways as it is considered as more energy-efficient, more economically and environmentally sustainable mode compared to roads, particularly with regard to freight. IEG also highlights weak asset management systems in the sector as an issue.<sup>10</sup> The Project will directly address this concern by supporting institutional and organizational capacity, and the preparation of railway asset management systems.

47. Railway sector reform remains a complex, ambitious and time consuming activity. The use of DLI's provides the right incentives to achieve the desired reforms and ensure RS Government ownership and leadership.

## IV. IMPLEMENTATION

### A. Institutional and Implementation Arrangements

48. The Project will be implemented by ŽRS under the administrative responsibility of RS MoTC.

49. ŽRS established a Project Implementation and Management Team (PIMT). The PIMT will be based in the city of Dobož, headquarters of ŽRS. ŽRS staff have been identified and will form the core team of the PIMT. The PIMT includes a Head, a Deputy Head, a Financial Management Specialist, a Procurement Specialist, a Human Resources Specialist, and a Transport Operations Specialist. Capacity building has been provided on the WB's new procurement framework.

50. A Project Steering Committee, chaired by MoTC and consisting of representatives of RS MoTC, ŽRS, RS MoF and other relevant institutions will be created to provide guidance and direction to ensure timely implementation of the project.

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<sup>10</sup> Improving Institutional Capability and Financial Viability to Sustain Transport, March 2013.



51. The PIMT will be supported by two project-financed consultancies: one for assisting with organizational restructuring, accounting and business systems; the second for assisting with business planning and establishing contractual relationships with government.

## **B. Results Monitoring and Evaluation**

52. The Project includes a set of monitoring indicators at the Project level focusing on the financial, operational and organization restructuring targets. The indicators and the monitoring and evaluation arrangements are detailed in Section VII of this document.

53. Overall responsibility for monitoring and evaluation (M&E) of the outcomes of this Project lies with ŽRS. During preparation, the team confirmed the strong capacity of the Project Implementation and Management Team (PIMT) to collect and report on the results framework indicators. The PIMT will prepare progress reports, based on data available from the financial and human resources management system, with support from the consultants to be appointed to support the organizational restructuring.

54. A communication strategy on the sector reform and the project's achievements will be elaborated during the first semester after the Project's start and will be followed as part of the Project's monitoring and evaluation. Its implementation will also be an opportunity for future citizen engagement.

55. A DLI audit consultant will be procured to monitor and verify the implementation of the Project's DLIs.

## **C. Sustainability**

56. The Project is designed to create a more financially sustainable railway sector that will in due course become a participant in the single EU railway market. Financial sustainability is taken to mean that ŽRS can expect, on a yearly basis, to receive sufficient revenue to cover its operating and maintenance costs and to sustain the productive value of its asset base. This is planned to be achieved by the combination of improved commercial performance plus contractually-based government contributions for passenger services and infrastructure operations in accordance with the EU rail acquis. Budget support of the railway will thereby be converted from the existing (partial) cash deficit funding to separately targeted funding of (a) specific passenger services (to the train operating division) and (b) an agreed multi-year infrastructure operations and maintenance program (to the infrastructure division). Both payments will in the future be properly estimated through the new divisional accounting functionality (known as sector accounting). The Project contains no investments in rail network infrastructure or rolling stock, though by improving railway efficiency and implementing an asset management system it will make future system investments more productive.

57. The main threat to the financial sustainability of ŽRS under the EU railway funding framework is the current RS Government policy to require ŽRS to offer costly passenger services without providing the commensurate financial support. However, this risk is mitigated by the fact that the government has specifically requested Bank support in implementing EU-compliant reforms, a centerpiece of which is an adequate and targeted passenger subsidy based on complete cost transparency. At this stage, the RS Government has stated its intention to retain passenger services but only until Component 3 is implemented, and the first PSC is formulated, costed and negotiated. Component 3 will formulate and cost a range of



possible service specifications, including in some cases, possible replacement of train passenger services with equivalent bus services.

58. The implications of BiH joining the EU at some point in the future creates some longer-term uncertainties for railway industry sustainability though they differ for railway infrastructure and train operations. For the ŽRS infrastructure division, the outlook under the EU rail acquis is secure: the RS railway network would continue to exist as part of an EU-wide network to serve any train operating company licensed in the EU. Moreover, the substantial on-going upgrading in FBH of railway infrastructure in the north-south rail Corridor Vc, which is complementary to the RS east-west line, will also be beneficial to ŽRS infrastructure division by encouraging more rail traffic to BiH. However, in a single EU rail market, the train operating division of ŽRS would be confronted with competition from other train operators. The restructuring plans, commercialization and improved management are intended to enhance the likelihood that the operating division can compete successfully, but as in any competitive market, this cannot be assured. Since the freight part of the operation is profitable it is possible that it might eventually become part a larger EU railway operator as has occurred with a number of rail freight operations in the EU.

59. The extent to which the environmental benefits of railways may be sustained depends on railways retaining or increasing the volumes carried, but not any particular operator winning the competition for carrying that freight. As the Project is aimed at making the sector as a whole in RS more efficient and effective (infrastructure and operations), any competitive outcome will help protect the environmental benefits of rail use over roads.

#### **D. Role of Partners**

60. Other development partners have interest in the outcome of the Project and have been consulted during preparation, and will continue to be consulted during implementation. The EU is concerned with progress towards the implementation of the rail acquis. EBRD is interested in financing physical investments in ŽRS in the context of a restructuring plan that ensures the financial sustainability of the sector. The Bank will consult all partners including the Swedish International Development Cooperation Agency (SIDA) which funded the Bank's Policy Note, as appropriate to continue to build consensus among development partners on the reforms.

### **V. KEY RISKS**

#### **A. Overall Risk Rating and Explanation of Key Risks**

61. The overall risk for the project is rated as Substantial. While there will be no adverse environmental impacts, social risks are rated Substantial. Social risks are associated with inadequate implementation of the workforce restructuring program and with inadequate client handling of the review of passenger services that could negatively adverse staff and/or railway passengers. The Bank team will work closely with ŽRS and a consultant to be procured to monitor and mitigate these risks. Stakeholders risks are associated with the same two issues, workforce restructuring and passenger services planning and the possibility that workers, unions and/or passengers would oppose the railway reforms. The Bank team will support RS MoTC and ŽRS in the development of a Communications Strategy for stakeholder engagement.



62. Macroeconomic risks are rated Substantial. A slower than projected pace of recovery in the Euro area could lead to lower than expected output growth and revenue collection and more sluggish fiscal consolidation. A prudent macro-fiscal medium term framework combined with growth-enhancing structural reforms, including the ones supported by the World Bank, the IMF and the EU are likely to mitigate the macroeconomic risks. This medium-term framework would be anchored by the agreed three-year Extended Fund Facility IMF program, approved in September 2016.

63. Political and governance risks are Substantial. Fragmentation of political structures exists in both entities. For example, recent disputes over the census results publication show the potential for political developments to hamper the reform agenda. Sustained efforts are required to tackle governance issues, such as a weak rule of law. A mitigating factor is that the different levels of governments have achieved a broad-based unprecedented level of agreement behind the broad-based Reform Agenda document. Society at large has been supportive of the content of key reforms. Recent reforms related to labor, pensions and bankruptcies are encouraging. The RS Government's new Railway Law adopted in 2016 is evidence of commitment to change in this sector. Support of the RS reform efforts from the international community is another important mitigating factor of these risks.

64. Sector Strategies and Policies risks are considered Substantial. The restructuring of ŽRS will pioneer the use of the new law on bankruptcy in the public sector, will require strong Government commitment along the way and will serve as a spearhead for other SOE reforms in the future. The Letter of Sector Policy provided by MoTC describing the desired outcomes of the reforms and demonstrating the Government's commitment to implement them, helps mitigating these risks.

65. Technical Design risks are considered Substantial, in particular, those related to the retrenchment process which will require consultation and dialogue with unions and other stakeholders. The Bank team will continue working closely with ŽRS providing feedback following the previous experiences in the region and elsewhere and ensuring that the retrenchment process adopted minimizes social risks. An additional technical design risk relates to the court approval of the restructuring process which falls outside of the control of the Government or ŽRS. To minimize this risk ŽRS recruited a specialized consultant to prepare a high-quality restructuring document following the requirements of the law.

66. Institutional Capacity for Implementation and Sustainability and Fiduciary risks are considered Substantial, due to the limited experience of RS MoTC and ŽRS in implementing IFI financed projects. However, a six-person PIMT has been appointed containing most of the skills required and with relevant Bank training, planned consultant support and the oversight of an Inter-Ministerial Steering Committee these risks can be mitigated.

## VI. APPRAISAL SUMMARY

### A. Economic and Financial Analysis

#### ***Project Development Impact***

67. The Project is motivated by the need to make ŽRS more financially sustainable while ensuring the economic viability of the sector and the Project's interventions. The appraisal therefore first estimated the



financial returns to the Project from the corporate perspective of ŽRS, following which the Project’s economic impacts were assessed. In summary, the Project is expected to yield a real financial internal rate of return (FIRR) to ŽRS of 15 percent and a real financial net present value (FNPV) to the company (discounted to 2017 at a rate of 10 percent) of BAM 40 million (USD 22 million).

68. Financial benefits to ŽRS arise from (i) the reduction in the wage bill, (ii) the elimination of interest payments on the continuously accruing debt on its labor-related obligations, and (iii) efficiency gains expected as a result of the restructuring. In the absence of the labor restructuring component, ŽRS would expect to reduce its labor force by about 1,000 employees using natural attrition by about 2040. By comparison, under the Project this level would be targeted to be reached by 2020 if not earlier. The organizational restructuring component should streamline maintenance planning and implementation, help increase volume and revenue, especially by improving service levels and so maintaining yields. While some of the current bulk ŽRS traffic (such as iron ore) would be relatively unaffected, general and inter-modal traffic is expected to be more responsive (assumed to increase at 2 percent annually) especially on Pan-European Corridor Vc.

69. The sensitivity of the FIRR was tested against changes in four main variables as shown in Table 3 below. The Project’s financial returns are robust to changes in these variables. The greatest sensitivity is to the reduction Project’s estimated benefits, 90 percent of which are related to labor costs, which is unlikely to happen if the planned labor retrenchment program is implemented as designed.

**Table 3. Sensitivity of FIRR estimate**

Test		FIRR (%)	FNPV BAM (mill)
1	Base	14	61
2	Arrears +15%	12	49
3	Severance costs +50%	14	58
4	Restructuring cost +50%	14	57
5	Benefits -20%	13	30

70. The repayment of the staff related arrears is not, in economic terms, a resource costs because the labor resource has already been expended in previous years and thus does represent creation or use of any economic resources. Similarly, the redundancy payments to surplus employees are, in economic terms, a transfer payment from the community at large to a specific group within it: the overall value of society’s real resources consumed is not directly affected by such transfers. Therefore, these two financial components were excluded from the economic appraisal which is intended to capture the overall resource impacts of the Project. The resource cost is captured by Component 3, the costs of consultant services and accounting and information systems to improve the performance of the company.

71. Significant economic benefits are anticipated in addition to the reduced operating costs of railways. Some of the staff who are not productively employed at ŽRS will, after taking the severance payments, find alternative employment in productive jobs outside the railway, the marginal value of which is approximated by anticipated average remuneration package obtained. In addition, the increment of freight traffic which is expected to be attained with improved management, operating efficiency and marketing plans will also generate economic benefits through reduced resource costs of transport of the incremental traffic compared to the alternative of road transport. Such rail traffic increment will also lead to reduced external



social/environmental costs of road traffic accidents and greenhouse gases (GHG). Taking into account only the resource costs of the Project (Component 3), but including the reduced railway operating costs and external benefits, the EIRR of the project is estimated to be about 480 percent (Annex 6).

72. The reduction in GHG emissions resulting from the project were estimated, using the WB's methodology, at about 8-10,000 tonnes per year during the 2020s.

### ***Rationale for public sector financing***

73. The railways play an important role in the economic development of Bosnia and Herzegovina carrying close to 60 percent of all goods by weight. The rail modal shares are similar in both RS and FBH.<sup>11</sup> About 30 percent of the freight carried by rail is import and export traffic. The main commodities carried by rail include iron ore, bauxite, aluminum, alkali and metals. About 40 percent of the freight carried by the RS railways is iron ore for steel producer, Arcelor Mittal Zenica, one of the largest foreign investors in BiH.

74. At the regional level, the importance of integrating the railways of BiH and the Western Balkans into the Trans European Transport Network (TEN-T) has been recognized at the Prime Ministerial Summits of 2014-2017, with targets set for railway modernization and market opening (see paragraph 21). In addition, IMF has identified the railways in BiH as a key sector for reform to enhance the efficiency of public expenditures.

75. The project will enable future private sector participation on the railways sector. In the short to medium term, the business plans to be prepared for the ŽRS workshops will identify possibilities to convert these workshops into profitable business providing services to other railways in the country and the region. In the medium to long term, the open market will be implemented according to the EU acquis on railways, this will create incentives for ŽRS to attract private capital into the company and for private railways to develop, as it is happening in Croatia.

### ***World Bank value added***

76. The Bank has significant experience in advising and supporting railways reforms, particularly in the region. Recent examples include Serbia, Croatia, Poland and Romania. The Bank has recently completed the Railways Policy Note providing a series of recommendations to improving railways effectiveness in BiH while harmonizing with European Union requirements, which provided the conceptual framework for the technical and institutional components of this proposed Project.

77. The Client's trust in the Bank as a partner to proceed with politically difficult reforms. Through the previous involvement in the transport sector and the preparation of the Policy Note, the Bank has built a high level of dialogue and trust on key reform issues, which has led to increased collaboration and partnership with RS Government in the sector.

## **B. Technical**

78. The Project has been designed to restructure the railway sector to make it financially sustainable and meet the requirements of the new Railway Law (2016) which requires, inter alia, that the sector be

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<sup>11</sup> Transport and Communications, thematic statistical bulletin, Statistical Yearbook of Republika Srpska 2016 ([http://www.rzs.rs.ba/static/uploads/bilteni/godisnjak/2016/23sao\\_2016.pdf](http://www.rzs.rs.ba/static/uploads/bilteni/godisnjak/2016/23sao_2016.pdf)); and Institute for Statistics of FBiH, Statistical Year Book, Sarajevo 2016 (<http://fzs.ba/index.php/publikacije/statisticki-godisnjaciljetopisi/>)



harmonized with the EU rail acquis. Table 4 below indicates how the technical design of the Project meets the key elements of the EU railway acquis and the actions necessary to attain financial sustainability.

***Component 1: Financial restructuring***

79. ŽRS is currently able to provide precise estimates of the arrears related to employees for all those who did not appeal to court, or who did appeal and the court provided the decision. There is however a small number of employees (about 200) whose appeal is still ongoing and the final amount cannot be estimated yet with certainty, and for which the average was applied. Other than this issues, there are no unresolved technical issues for this component.

***Component 2: Workforce restructuring***

80. The procedures to implement the workforce restructuring will be determined based on an agreement between the RS Ministry of Labor, RS MoTC, and ŽRS in consultation with the Trade Unions. Regardless of its specific structure, the process will include the following steps:

1. Based on the new job systematization conducted by the company, ŽRS will select which business units/sections have higher or lower needs or demand for workers;
2. ŽRS will consider various methods of retrenchment to reduce adverse impacts of labor restructuring;
3. In order to ensure impartiality and non-discrimination when redeploying workers pursuant to the provisions in the new Rulebook on Organization and Organizational Chart, the company has established a Working Group within ŽRS. This group consists of qualified and experienced lawyers employed ŽRS who are responsible for determining relevant rules and criteria for redeploying employees.



**Table 4: Key technical elements of restructuring project design**

<b>Key elements of EU rail acquis and financial sustainability</b>	<b>Relevant technical design elements of Project</b>
Mechanisms to reduce historic indebtedness of rail incumbents	<i>Proceeds of Bank loan will be used to facilitate financial restructuring ŽRS through settling long-term labor-related debts</i>
Railways to be managed on a commercial basis, driven by market	<i>Bank loan will finance ŽRS workforce restructuring to improve labor productivity and produce 5-year Market and Business Plans for Infrastructure and Operations</i>
Separation of Infrastructure Manager and Rail Undertaking (Operator)	<i>Project will create separately managed rail infrastructure and operating directorates with own allocated assets, staff and financial accounts</i>
Government contracts for loss-making passenger Public Service Obligations	<i>Project will undertake social survey of passenger needs, assess losses, explore alternatives and prepare a contract for negotiation between ŽRS Operations and RS government</i>
Government contracts for support of infrastructure O&M costs	<i>Project will create maintenance/development plan and prepare a Multi-Annual Infrastructure Contract for negotiation between ŽRS Infrastructure and RS government</i>
Track access regime and charges for third-party rail operators	<i>Project will develop a plan for track access policy and regime, including track access charge recommendations for future integration into European railway market</i>

81. The methods of retrenchment will include:

- Retirement of employees (natural attrition)
- Voluntary leave with severance pay
- Technological redundancies (involuntary separation)

82. A Social Assessment has been prepared and disclosed per WB requirements. The SA analyzed the workforce profile, legal framework for retrenchment including requirement for consultations with unions, and proposed mitigation measures. The retrenchment plan is currently under preparation and will be subject to approval by the World Bank.

**Component 3: Organizational restructuring**

83. This component has several key technical elements that can be categorized into three groups of activities: (a) organization and accounting systems; (b) business planning, processes and contracts and (c) project implementation support and capacity building.

84. Terms of Reference for consultant services are being finalized so that the consultants would be available to support the implementation of the operational restructuring as soon as the proposed Bank Loan is effective.



### C. Financial Management

85. An assessment of the financial management capacity was carried out by the World Bank in July 2017. The assessment concluded that the financial management arrangements within PIMT established under the ŽRS is acceptable to the Bank, and the overall financial management risk is moderate after the application of the mitigation measures.

86. The PIMT will maintain a financial management system acceptable to the World Bank. The Project financial statements and ŽRS Financial Statements will be audited by independent auditors acceptable to the Bank under terms of reference acceptable to the Bank. The annual audited financial statements and the audit reports will be provided to the World Bank within six months for the project audit and 9 months for the ŽRS audit of the end of each fiscal year, respectively. The audits of the Financial Statements of the Project will be procured by the Ministry of Finance and Treasury and financed from the loan, whereas the audits of the Financial Statements of the ŽRS will be procured by the ŽRS and funded from the ŽRS own sources of funding. The interim audit of the arrears and retrenchment payments (voluntary leave and involuntary leave) may also be requested by the Bank.

87. The PIMT shall also prepare and furnish to the World Bank not later than forty-five (45) days after the end of each calendar semester, interim unaudited financial reports for the project covering the semester, in form and substance satisfactory to the Bank. However, in order to improve the existing financial management arrangements, an action plan had been agreed to draft FM sections of the Project Operational Manual and to actively work towards resolving the issues that have led to qualified audit opinion for FY 2015 during the project implementation.

88. The Project has been designed to utilize the model of results-based disbursement. The verification protocols are defined in Annex 1. The planning and budgeting function will play a key role in this Project as the design of Bank financing is based on accurate rolling cash flow forecasts in support of project implementation. Therefore, advances and disbursements will be based on Interim Financial Reports (IFRs) and will include a rolling cash-flow forecast report for the following twelve months.

89. Eligible expenditures programs (EEPs) directly relate to payments for arrears stemming from employment contracts, payments of retrenchments as well as any payments of operating expenses relating to component 3 of the Project. As result the EEPs consist of payment of employee arrears, retrenchment payments and operating expenses that are explained as follows:

- a) **Arrears.** The overdue and unpaid liabilities, arrears, that are subject to financing and form part of the EEPs are the payables that relate to employees' salaries and earnings. As such they include the following expenditures: employee net salary, social contributions paid on and from salary, personal income taxes and other taxes that are paid from salaries, allowance for hot meals, allowance for transport to and from work, allowance for annual leave, other allowances related to employment, penalty interest charged by courts for the overdue amounts outstanding to the RS authorities and employees. However, expenses for court awards in favor of ŽRS' workers related to labor disputes for which the proceedings started after August 31, 2017 will not eligible to be financed with EEPs.



- b) **Retrenchment.** Retrenchment payments can include one off voluntary severance payments, one off involuntary severance payments etc.
- c) **Operating expenses that relate to the implementation of:** (a) recommendations of key regulatory and financial reviews; (b) new ŽRS organization structure: (C) PSO, TAC, MAIC and Performance Contracts; (d) asset management plans; (e) business plans; and (f) acquisition of management and financial systems but also any other operating expenses of the ŽRS that support DLIs related to Component 3 of the Project.

90. EEPs, arrears, and retrenchments can be used when reporting EEPs for each DLI and DLR. The first set of DLIs (financial restructuring) will mostly rely on the arrears as the EEPs, while the second set of DLIs (workforce restructuring) will rely on both arrears and retrenchment EEPs. The third set of DLIs (organizational restructuring) will use operating expenses, in addition to arrears and retrenchment, as EEPs.

#### D. Procurement

91. Components 1 and 2 of the Project do not finance physical assets and so do not require procurement in the traditional sense and special procedures will be applied. Component 3, representing the non-DLI portion of the project, will be subject to application of Procurement regulations for Borrowers dated July 1, 2016 and preparation by the Borrower of Project Procurement Strategy for Development (PPSD). Latest Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants shall apply.

92. Component 3 - Support for organizational restructuring - will finance both consultancy services and purchase of accounting and business systems. They shall be procured in accordance with the Bank's Procurement Framework and Regulations for Borrowers for projects with PCN after July 1, 2016. Project Procurement Strategy for Development will result in preparation of Procurement Plan by the Borrower which will be approved by the Bank. The Procurement Plan will be aimed at obtaining the best overall value for money, taking into account quality, cost, and other relevant factors. General Procurement Notice (GPN) will be published in the UN Development Business on-line, on the Bank's external website and in local newspapers distributed throughout BiH.

93. The capacity of the entity to implement technical assistance activities will be reflected in respective Procurement Risk Assessment and Management System, taking into account existing capacities at the time of assessment. The team assessed the risks that may negatively affect the ability of the Implementing Agency – ŽRS - to carry out Goods procurement and Technical Assistance selection processes. ŽRS will be responsible for implementation of the project and will report to the Bank. PIMT will require support from individual consultants as necessary, providing fiduciary support for procurement of goods such as accounting and business systems, selection of consultants' services and management of contracts. It is expected that goods, non-consultant services, and consultants' services will be procured. Considering the risks identified, their mitigation measures and the proposed implementation arrangements, the overall risk for procurement is considered Substantial.



## **E. Social (including Safeguards)**

94. The Project will create positive benefits for the customers of the railways transport services. They will have access to more efficient and better quality railways transport services. The employees of ŽRS will benefit in terms of: i) receiving monies which the company owes them; and ii) more secure future employment prospects for railway employees who remain in the sector following the reorganization.

95. The Project will not finance any physical investments, therefore OP4.12 was not triggered. The most significant social risk associated with the Project is the workforce restructuring under Component 2. The process of workforce restructuring will lead to retrenchment – the reduction of the total number of workers using different socially responsible methods.

96. OP 4.01 applies to the social risks and impacts of the Project associated with retrenchment. As of April 2017, ŽRS employed 3,098 workers (462 women). It is estimated that the workforce will be reduced by 500 employees during the first year of project implementation, as a result of the new company organization and technological improvements. It is estimated that the workforce will be reduced by an additional 500 workers by 2020. The retrenchment will be carried out in compliance with applicable labor, employment and social protection laws and good international practice.

97. The Borrower prepared a social assessment (SA) focusing on workforce reduction. The SA assesses the workforce profile, applicable legal framework for different methods of retrenchment and available mitigation support for retrenched workers. The retrenchment process is governed by a robust set of labor regulations, which offer protections to workers affected by retrenchment. ŽRS expressed a preference to carry out the workforce reduction on a voluntary basis through retirement packages or incentive severance compensation. The Bank loan will finance severance payments, outstanding debts to employees for social contributions, re-training and prequalification of employees, and workers counseling and advisory support.

98. Prior to carrying out the workforce reduction, ŽRS will prepare the retrenchment plan, which will be reviewed and approved by the Bank, as an instrument to manage, implement and monitor retrenchment. ŽRS has a legal and human resources department with prior experience in workforce restructuring that took place in 2003 - 2005, under EBRD financing. The retrenchment shall be carried out in collaboration with the railways trade unions. The trade unions would be extensively consulted on the severance packages and selection criteria. In instances of involuntary retrenchment, the Entity Labor Law requires that the company prepare a social plan and to carry out consultations with trade unions and the Entity employment service. Consultations with trade unions and employment service will be documented. The labor law also provides for the formula for calculation of the minimum severance payment, and includes provisions for the protection of vulnerable groups.

99. The workers affected by workforce restructuring will have access to multiple mitigation compensatory measures such as: incentive severance package, unemployment benefits (for workers affected by involuntary separation), employment mediation services offered by the Employment Service, additional training and counselling support by specialized providers. In addition, as a part of the BiH Employment Support Program, the Bank provided support to the RS Ministry of Labor to implement active labor market programs and improve job intermediation services offered by the Employment Service. It is assumed that a percentage of the ŽRS workers affected by workforce restructuring would be able to benefit from this support.



100. The final Social Assessment in local language was disclosed in the country and the English language version was published in the World Bank.

101. The RS Government has decided to retain current passenger rail services. As part of the Project the government will be presented with a strategy for improvements and development, which can be considered for funding through a passenger public services contract (PSC) in accordance with the EU rail acquis. An assessment was carried out to assess the needs and profile of passengers so that if the government decides to discontinue an unprofitable rail passenger service, the profile and preferences of passengers are better understood. The analysis confirmed a decreasing trend in passenger volume on all routes, with a 75 percent decline in rail passenger trips over the last ten years. Most rail passenger services are operated parallel to roads that have bus services along them, some of which are being improved substantially by investment such as in the motorway being built between Banja Luka and Dobož. Data for 2012 showed that ŽRS carried only around 0.009 percent of passenger trips. This negligible modal share has declined even further since then. In instances of any proposed changes of rail services, the strategy will ensure that high quality and affordable replacement bus coach services operating the same routes are provided.

102. **Gender:** The social assessment on workforce restructuring is gender informed. Male employees account for 85% of the workforce (2,636), while female employees are only 15% of the total number (462). The gender difference is mainly explained by the fact that most positions in ŽRS are composed of operations positions that involve physical activities that have been historically and occupied by males. Customarily, physical activities are more likely to be performed by a male labor force. Female employees are generally employed in administrative positions or in other sections of the company where no physical work is needed (finance, accounting, legal). It is expected that men will be more affected by workforce restructuring as they represent the majority of employees in the company and occupy majority of positions in the operations. The restructuring process will seek at least to maintain the current share of women employees in the current workforce. The retrenchment plans will include gender disaggregated information and clear criteria for non-discriminatory processes for identifying redundancies, and corresponding grievance redress mechanisms related to retrenchment. The monitoring and evaluation processes associated with the implementation of the retrenchment plans will also include gender-specific indicators.

103. **Citizen Engagement:** ŽRS has two operating grievance redress mechanisms: (i) book of complaints for railways services users, and (ii) grievance commission responsible for handling workers' grievances including grievances related to retrenchment. Citizen engagement will be monitored through two specific indicators, reviewing (i) the Percent of workers' grievances resolved percentage of workers' grievances resolved and (ii) the percentage of responses to users' complaints and remarks. The process of consultations and engagement with workers related to workforce restructuring is described in section on safeguards.

## **F. Environment (including Safeguards)**

104. The Project will not have direct environmental impact, and does not therefore trigger directly a Bank safeguards policies with regard to environment. It does trigger however OP4.01 to cover social risks, as discussed in section E. Although no activities with associated environmental impacts are expected, a precautionary EMP Checklist has been disclosed by the Client and World Bank and will be completed and followed for all, if any, activities that may involve small-scale reconstruction, in particular reconstruction



related to server rooms and IT equipment within ŽRS. The team will follow closely the project and assist the Client in preparing the Checklist, when and if needed.

105. However, the Project may have indirect impacts because the development objective of improving railway operational efficiency and financial sustainability means that the restructured railways will be better positioned to retain freight, rather than shifting such freight to road transport.

106. **Climate Co-benefits:** The project activities are expected to generate climate change mitigation and adaptation co-benefits. First, the project activities aimed at the financial, workforce and organizational restructuring of ŽRS, will prevent a shift of traffic from rail to road and will therefore prevent associated increase in greenhouse gas emissions (in the amount of 8 to 10 thousand tonnes of CO<sub>2</sub> annually). Second, through the preparation of railway asset management plans, the project activities will support improvement of climate resilience of the transport network and its ability to better cope with extreme weather events.

### **G. Other Safeguard Policies (if applicable)**

Not applicable

### **H. World Bank Grievance Redress**

107. Communities and individuals who believe that they are adversely affected by a Bank supported project may submit complaints to existing project-level grievance redress mechanisms or the Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address project-related concerns. Project affected communities and individuals may submit their complaint to the Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of non-compliance with Bank policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service>. For information on how to submit complaints to the World Bank Inspection Panel, visit [www.inspectionpanel.org](http://www.inspectionpanel.org).



## VII. RESULTS FRAMEWORK AND MONITORING

### Results Framework

COUNTRY : Bosnia and Herzegovina

Republika Srpska Railways Restructuring Project

#### Project Development Objectives

The Overall Development Objective of the Transport Sector Modernization Program (TSMP) is to improve transport connectivity of the country along priority transport links and to support improvements in transport operations and asset management practices. The Program is multi-phased with a First Phase including road sections in the Federation of Bosnia and Herzegovina, and the Second Phase including railways in the Republika Srpska.

The Development Objective of the Second Phase of the TSMP is to improve the operational efficiency and financial sustainability of the railways in Republika Srpska.

#### Project Development Objective Indicators

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Name: ZRS Working Ratio		Number	1.70	1.00	Annual	ZRS annual financial statement	ZRS

Description: The indicator measures the capacity of ZRS to cover operating and maintenance costs, it includes market revenues as well as revenues from Public Service Obligation Contract (PSO) and excludes other subsidies. It is estimated as the ratio between the operating expenses (without depreciation) and the operating revenues.



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> ZRS labor productivity		Number (Thousand)	146.00	215.00	Biannual	ZRS payroll system and annual reports	ZRS
Description: Measures the operational efficiency in thousands of traffic unit per employee, where a traffic unit is a sum of tonne-km and passenger-km.							
<b>Name:</b> Public Service Obligations Contract for passenger services		Text	No	Implemented and fully covering passenger operations deficit.	Annual	RS MoTC / ZRS	RS MoTC / ZRS
Description: Measures the implementation of Public Service Obligations Contract for passenger services.							
<b>Name:</b> Multi-annual infrastructure contract (MAIC)		Text	None	Contract implemented, fully covering infrastructure investments	annual	RS MoTC / ZRS	RS MoTC / ZRS
Description: This indicator will track the implementation of the Multi-annual Infrastructure Contract (MAIC)							

**Intermediate Results Indicators**

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Arrears related to employees benefits and social contributions		Amount(USD)	42700000.00	0.00	Annual	ZRS Human resources and financial departments.	ZRS
Description: The indicator measures the amount of arrears related benefits and contributions for ZRS employees, as per Component 1.							
<b>Name:</b> Size of ZRS workforce		Number	3098.00	2098.00	Quarterly	ZRS Human Resources Department	ZRS
Description: The indicator will measure the number of ZRS employees, tracking the implementation of the workforce restructuring plan.							
<b>Name:</b> Accounting separation for infrastructure and operations		Text	No	Accounting separation implemented	Annual	ZRS financial reports	ZRS
Description: This indicator will measure the implementation of the accounting separation between business units, according to the EU directives.							
<b>Name:</b> 5-year Business Plans		Text	No	Business Plans updated annually as	annual	ZRS	ZRS



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
				standard management/governance tool			

Description: This indicator will track the preparation of a five years business plan covering (i) freight, (ii) passengers, and (iii) maintenance depots.

<b>Name:</b> Railways asset management system		Text	No	Railways asset management system used as basis for maintenance and capital investment plans	annual	ZRS	ZRS
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Description: This indicator will track the implementation of a railway asset management system, covering infrastructure and rolling stock.

<b>Name:</b> Share of female employees of ZRS		Percentage	15.00	15.00		ZRS Human Resources department.	
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Description: Female employees represent currently 15 percent of ZRS labor force. The restructuring process will seek at least to maintain the current share of women employees in the current workforce.



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Percent of workers' grievances resolved		Percentage	0.00	100.00	annual	ZRS working group on retrenchment	ZRS
Description: This indicator tracks citizen engagement through the responsiveness of ZRS to resolve grievance issues.							
<b>Name:</b> Number of customers' complaints (percent change)		Percentage	0.00	-40.00			
Passenger customers complaints (percent change)		Percentage	0.00	-40.00	annual	ZRS customer feedback	ZRS
Freight customers complaints (percent change)		Percentage	0.00	-40.00			
Description:							



**Target Values**

**Project Development Objective Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	YR4	End Target
ZRS Working Ratio	1.70					1.00
ZRS labor productivity	146.00					215.00
Public Service Obligations Contract for passenger services	No	Contract drafted	Contract principles and indicative budget agreed between ZRS and RS Government	Contract signed, fully covering passenger operations deficit.	Contract signed, fully covering passenger operations deficit.	Implemented and fully covering passenger operations deficit.
Multi-annual infrastructure contract (MAIC)	None	Contract drafted	Contract principles and indicative budget agreed between ZRS and RS Government	Contract signed, fully covering infrastructure investments	Contract signed, fully covering infrastructure investments	Contract implemented, fully covering infrastructure investments

**Intermediate Results Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	YR4	End Target
Arrears related to employees benefits and social contributions	42700000.00	17000000.00	8000000.00	0.00		0.00
Size of ZRS workforce	3098.00	2800.00	2400.00	2200.00	2098.00	2098.00



Indicator Name	Baseline	YR1	YR2	YR3	YR4	End Target
Accounting separation for infrastructure and operations	No	No	Specification and procurement of new financial management system	New financial management system completed	Accounting separation implemented	Accounting separation implemented
5-year Business Plans	No	Development of business planning framework and the first draft Plan	Business Plans approved by Board and MoTC and implemented by ŽRS	Updated	Updated	Business Plans updated annually as standard management/governance tool
Railways asset management system	No	Asset management system prepared	Asset management system implemented	Asset management system used for maintenance prioritization	Railways asset management system used as basis for maintenance and capital investment plans	Railways asset management system used as basis for maintenance and capital investment plans
Share of female employees of ZRS	15.00	15.00	15.00	15.00	15.00	15.00
Percent of workers' grievances resolved	0.00	100.00	100.00	100.00	100.00	100.00
Number of customers' complaints (percent change)	0.00					-40.00
Passenger customers complaints (percent change)	0.00					-40.00
Freight customers complaints (percent change)	0.00					-40.00



## ANNEX 1: DETAILED PROJECT DESCRIPTION

### COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project

#### Project Design overview

The Project has been specifically designed to tackle the urgent financial problems facing the entity's railway sector, create a proper framework of public financing, restructure its management and support a more commercial approach to running the railway businesses.

The railway network in the Republika Srpska consists of 426 route-km (of which 353 route-km are in use) being one of the smallest networks in the Western Balkans region. ŽRS freight traffic density of about one million tonnes/route-km is high compared to neighboring countries and about 80 percent of the EU average. In 2015, it carried around 5 million tonnes for 428 million net tonne-km (ntkm). Despite a weak overall financial status, ŽRS earns a healthy surplus on freight operations relative to its operating costs. By contrast, there are substantial losses on passenger services, after allowing for some (but not adequate) revenue support from the budget. Even with RS budget support, passenger unit revenues cover around a third of direct expenses of passenger services and 16 percent of total operating costs. ŽRS is not financially sustainable in its current role and form.

The Republika Srpska government has therefore made the restructuring of its railway sector a policy priority. Not only is the sector financially unsustainable in its current form but there is an overarching policy challenge to meet the provisions of EU-Bosnia and Herzegovina Stabilization and Association Agreement (2015) as they apply to the railway sector. The obligation is to harmonize sector policies with the EU railway framework of directives and regulations (the 'EU railway acquis'). The framework needs action in several areas to become compliant. The areas that most immediately bear on responsibilities currently exercised by the Republika Srpska are those related to debt sustainability, organizational structure, budgetary support for passenger services; budgetary support for infrastructure; and track access. These requirements have been built into the detailed Project design. The restructuring is backed by a new Railway Law passed in 2016 to harmonize the railway sector with the EU rail acquis, restructure ŽRS to promote its financial stability, and for the railway network to be integrated into the European network. The Project therefore has legislative backing.

The Project would support the restructuring of ŽRS through the following Project-financed components:

- *Component 1: Financial restructuring*
- *Component 2: Workforce restructuring*
- *Component 3: Organizational restructuring*

#### **Component 1: Financial restructuring**



ŽRS would use proceeds of the Bank's loan to repay the company's outstanding arrears to employees and related contributions and taxes, and thereafter convert the company's long-term debt liabilities to government into equity, relieving it of historic and unsustainable debts in accordance with the EU acquis. The government would use its own resources to buy the shares of the small residual proportion of non-government shareholders, who received free allocations through vouchers in the early 1990's, at a fair and reasonable price.

Under the protection of the Republika Srpska bankruptcy court the Republika Srpska Government aims to recapitalize and deleverage the company via a debt-to-equity conversion which will relieve ŽRS of this historical debt burden in accordance with the EU rail acquis. This will inevitably dilute the equity share of the small shareholders (the shares were the result of a voucher program in the 1990's). These shareholders will be made an offer of acquisition such that Republika Srpska would become sole shareholder. The recently enacted bankruptcy law was designed to facilitate complex restructurings of large corporates such as ŽRS while offering protection with respect to a buy-out of minority shareholders (compensation is set at the higher of accounting value or fair value determined independently).

RS Government has estimated the benefits of this approach as follows: (i) a well-defined process whereby the implementation of a comprehensive Restructuring Plan is under bankruptcy court protection, (ii) a controllable timeline for approval of restructuring plan by the court and settling claims of non-consenting creditors, (iii) lower costs of restructuring process (relative to alternative options), and (iv) any planned activities aimed to improve ŽRS operations (such as organizational transformation and workforce reorganization) can be implemented whilst ŽRS is under bankruptcy protection.

ŽRS currently has about BAM 83.5 million (USD 50.4 million) in arrears related to its employees. These include direct debts to employees for benefits and allowances, arrears to tax contributions related to such benefits, and expenses related to litigation with respect to these amounts. Penalties and interests related to these debts represent almost USD 5 million. The repayment of staff debts prior to a staff retrenchment program is not only an issue of social responsibility but also an important enabler of financial restructuring because, if they were to remain creditors of ŽRS, the staff could seriously hinder restructuring proposals in the bankruptcy court. Table 1 below describes these arrears as estimates to December 31, 2017.



**Table A1.1: List of arrears related to ŽRS employees**

Type/Description	Amount (BAM million)
<b>(ii) Direct debts to employees for benefits and allowances</b>	
Reimbursement of transport to work for eligible employees <sup>12</sup>	2.3
Reimbursement of km for locomotive drivers <sup>13</sup>	0.4
Reimbursement for meals and leave allowance <sup>14</sup>	23.7
<b>(ii) Contributions (on salaries, meal allowance and paid leave allowance)<sup>15</sup></b>	29.0
<b>(iii) Employers contribution for employees' taxes<sup>16</sup></b>	5.9
<b>(iv) Lawsuits on labor disputes</b>	10.6
<b>(v) Penalties and interests</b>	11.6
<b>TOTAL</b>	<b>83.5</b>

**DLI 1: Implementation of financial and ownership restructuring**

The DLI will include the approval, by RS Government, of the restructuring plan and all needed documentation needed to (i) recapitalize and deleverage the company via a debt-to-equity conversion which will change the ownership structure (~91% RS Government, ~9% small shareholders) and then (ii) buy-out the minority shareholders (through an offer for acquisition) such that RS Government would become sole shareholder (100%). The DLI will also include the actual debt-to-equity conversion.

The appropriate documentation shall be submitted to the Bank who will verify the achievement of the targets.

**Component 2: Workforce restructuring**

Workforce restructuring is an essential element of Project design as employment and labour costs are currently at unsustainable levels., ŽRS has about 3,100 employees and its labor productivity (average traffic units per total employee) is around 146,000, the lowest in the region (other than Albania) and about a quarter of the EU average. ŽRS has more employees than it had in 2005, as result of previous job creation policies rather than commercial needs, and the highest number of employees/route-km of any railway in the region (Table 1).

<sup>12</sup> Eligible employees are those living more than 4km away from a train station or without convenient railway offer.

<sup>13</sup> Benefit specific to train drivers (since they do not receive meal allowance). Amount not submitted to taxes and contributions.

<sup>14</sup> Leave allowance for all employees; meals for all employees, excepting train drivers

<sup>15</sup> Contributions represent 33 percent of the gross salary, and are split into split into 18.5 percent to the pension fund, 12 percent to the health system, 1.5 percent to child protection and 1 percent to unemployment, and further split into 20 percent to local authorities and 80 percent to the Entity

<sup>16</sup> Taxes represent 10 percent of the gross salary, and are also split into 20 percent to local authorities and 80 percent to the Entity.



**Table A1.2. Railway labor productivity by country (2014, unless otherwise indicated)**

COMPARATOR RAILWAYS	Total employees (000)	Staff productivity (000 traffic units/employee)	Number of employees per km of line
EU average	1069.0	613	5.1
Poland	90.0	490	4.7
Romania	45.1	318	4.2
Bosnia	7.0	193	6.8
ŽFBH	3.6	253	5.9
<b>ŽRS (2015)</b>	<b>3.2</b>	<b>146</b>	<b>8.7</b>
Croatia	9.3	329	3.6
FYR Macedonia	2.6	188	3.7
Montenegro (2009)	1.0 (est)	178	4.0
Serbia	17.1	188	4.5
Albania (2009)	1.1	42	2.7

Labor costs are, as a consequence of excess employment, a disproportionate component of the cost structure of ŽRS. In 2016, the wage bill was 64 percent of operating expenses<sup>17</sup> and 123 percent of commercial revenues (excluding Entity subsidies). The Project workforce restructuring would involve a reduction of approximately 1,000 ŽRS employees (just under a third of the total). The MoTC expects that the reduction of number of ŽRS employees in the near-term will be about 1,000 (including the 500 in 2017) with a further reduction of about 500 by latest 2021. This would boost the average productivity of labour to a level closer to the mid-point of the regional range.

The program would seek to provide attractive voluntary packages to meet the targets. The Bank’s social experts in this field will monitor and assess the workforce restructuring program, eligibility criteria and compensation.

**DLI 2: Operational efficiency improved**

The DLI will be directly linked to improvements in operational efficiency. The Borrower shall prepare a detailed schedule (or schedules) of compensation due to each member of staff to be retrenched calculated in accordance with the eligibility and entitlement criteria. Such schedule (or schedules) shall be submitted with appropriate documentation to the Bank who shall check the eligibility and estimation of the payments to be made.

The Bank will disburse to ŽRS the proportion of the total Schedule sum verified to be eligible and properly estimated on meeting the staffing targets.

**DLI 3: Component 3: Organizational restructuring**

<sup>17</sup> Defined for this purpose as expenditures related to materials, fuel, electricity, salaries and allowances, outsourcing and other services, and depreciation.



The organizational restructuring component of the Project has two sub-components:

- (a) **Sub-component 1** involves company reorganization into a corporate core and two main independently managed and separately accounted departments, one for infrastructure management and one for transport operations. The reorganization will be matched by implementation of a modern financial accounting system, human resources management and payroll, and railway asset management systems for infrastructure and operational assets. The Project includes the following activities:
- i. Planning and implementation of a new, more commercial ŽRS organization structure consisting of a corporate core plus two independently managed and separately accounted business divisions, one for infrastructure management and one for transport operations. Within the operating department sector accounts would be kept for freight business and passenger business. Three rolling stock maintenance workshops at Prijedor, Banja Luka and Dobož will be established as separately accounted profit centers under the provisional supervision of the new operating division. It is generally intended by MoTC that the corporate core should be a small and strategic unit with possibly diminishing functions over time and that the operations and infrastructure divisions should be responsible for the day-to-day management of their sectors of the railway business.
  - ii. Specification, procurement and implementation of a modern and effective financial accounting system including core *general ledger functionality*, accounts, payroll, assets and inventory, funds management etc. Specification and application of such system must be geared to railway businesses and the specific financial and enterprise resource planning, budgeting and management needs of ŽRS's independently managed divisions. It must provide transparent separation of infrastructure and operations accounts (balance sheet, income statement and cash flow) and generate all accounting information necessary to meet corporate, auditing and legal reporting obligations.
  - iii. Specification and implementation of (i) a railway infrastructure asset management system for the Infrastructure Division and (ii) a rail operations asset management system for the Operating Division.
- (b) **Sub-component 2** involves preparation of medium term business and marketing plans segmented for infrastructure, transport operations freight and passenger sectors) and railway workshops, and formulation of corresponding contracts with government for passenger services and infrastructure management and development in accordance with the EU railway acquis. The Project includes the following activities.
- i. Development of commercially-driven and financially attainable and sustainable medium-term (2019-2023) Business Plans (including marketing plans), based on good railway practices and experiences, for the constituent divisions and subsidiaries of ŽRS.
  - ii. Formulation and drafting of a detailed multi-annual Public Passenger Services Contract (PSC) to be agreed between ŽRS (Operating Division) and government of RS together with



- proposed annual contract prices and payment arrangements consistent with the Operations Division Business Plan for passenger services.
- iii. Formulation and drafting of a detailed multi-annual Infrastructure Contract (MAIC) and proposed contract price and payment arrangements to be agreed between ŽRS Infrastructure Division and government of Republika Srpska consistent with the Infrastructure Division Business Plan for passenger services.
- iv. Capacity building for MoTC and ŽRS management and staff as necessary and other activities supporting organizational change.
- v. This component will also finance technical assistance to support ŽRS in the implementation of the Project as necessary and particularly in two areas: support with organizational restructuring, accounting and business systems; and support with business planning and establishing contractual relationships with government. In addition, and if considered necessary a DLI audit consultant will be hired to verify the implementation of the DLIs as a basis for disbursement.

**(c) Sub-Component 3** involves implementation support and capacity building activities. Specifically, it comprises:

- i. Capacity building for MoTC and ŽRS management and staff as necessary and other activities supporting organizational change.
- ii. Technical assistance to support ŽRS in the implementation of the Project.
- iii. If necessary, a DLI audit consultant will be hired to verify the eligible expenditures as a basis for disbursement.

This component will follow standard procurement for services. Terms of Reference for consultant services are being finalized so that the consultants would be available to support the implementation of the operational restructuring as soon as the proposed Bank Loan would be effective.

The overall railway restructuring plan would be implemented over the period 2018-2021 with Bank loan proceeds supporting all three areas of restructuring, with allocation of loan proceeds and estimated timing as shown in Table 2.



**Table A1.4. List of Disbursement-Linked Indicators (DLIs) with annual Disbursement-Linked Results (DLRs) – Estimated values**

DLIs	BiH RS Railway Restructuring Project: Disbursement-Linked Results (DLRs) <sup>18</sup>			
	July 31, 2018	July 31, 2019	July 31, 2020	July 31 2021
DLI 1: Implementation of financial restructuring	<b>DLR 1.1A: EUR 1.00 million</b> Restructuring plan approved by RS Government.  <b>DLR 1.1B: EUR 2.00 million<sup>19</sup></b> Settlement of worker-related arrears (under Component 1) for 500 workers	<b>DLR 1.2: EUR 12.00 million</b> Settlement of all remaining arrears (under Component 1): Worker-related arrears for the remaining workers ŽRS's employee tax withholding for all workers. Penalties and interest related arrears for all workers.	<b>DLR 1.3: EUR 3.00 million</b> Debt-to-equity conversion (RS Government hold more than 90% of ŽRS capital)	
DLI 2: Implementation of workforce restructuring <sup>20</sup>	<b>DLR 2.1: EUR 2.00 million</b> Implementation of Retrenchment Plans for 500 ŽRS workers (from 3098).	<b>DLR 2.2: EUR 5.00 million</b> Implementation of Retrenchment Plans for an additional 200 ŽRS workers (700 workers in total)	<b>DLR 2.3: EUR 6.00 million</b> Implementation of Retrenchment Plans for an additional 300 workers (1000 workers in total)	
DLI 3: Implementation of organizational restructuring	<b>DLR 3.1: EUR 2.00 million</b> Consultants selected for the following two consultancies: Regulatory and functional review of the railways, ŽRS reorganization, modern management and financial systems, and asset management systems. Business plans, contracts for Public Service Obligation (PSO), track access charge (TAC), multiannual infrastructure (MAI), and management performance.	<b>DLR 3.2 EUR 3.00 million</b> Draft reports completed for the consultancies referred to in DLR 3.1	<b>DLR 3.3 EUR 6.00 million</b> Implementation of: Recommendations of key regulatory and financial reviews. New ŽRS organization structure. PSO, TAC, MAI and performance contracts Asset management plans Business plans Acquisition of management and financial systems	<b>DLR 3.4: EUR 9.17 million</b> Management and financial systems fully functional. PSO and MAIC fully funded Contracts reviewed and updated Business plans reviewed and updated
<b>DLI related disburs.(EUR mil)</b>	<b>7.00</b>	<b>20.00</b>	<b>15.00</b>	<b>9.17</b>

<sup>18</sup> Dates included in this table are approximate



**Table A1.5. DLI verification protocol**

No	DLI	DLI Definition and Scalability	Draft Protocol to Evaluate Compliance of the DLI
1.1A	<b>Restructuring plan approved by RS Government</b>	This DLI will be met when the RS Government approves a restructuring plan following the provisions of the law on bankruptcy and acceptable to the Bank.	<p><b>Data Source:</b> RS Government</p> <p><b>Procedure:</b> The restructuring plan will to follow the Law on Bankruptcy and include the following elements:</p> <ul style="list-style-type: none"> <li>- The change in capital structure</li> <li>- The procedures for share acquisition</li> <li>- The timeline for implementation</li> </ul> <p>The Bank will receive an Official Government Decision approving the agreed Plan.</p>
1.1B 1.2	<b>Settlement of arrears under component 1</b>	<ul style="list-style-type: none"> <li>• Worker-related arrears for the remaining workers</li> <li>• ŽRS's employee tax withholding for all workers. Penalties and interest related arrears for all workers.</li> </ul>	<p><b>Data Source:</b> ŽRS, RS Government</p> <p><b>Procedure:</b> The documentation will include the accounting reports showing the structure and status of all debts towards the workers. Final clearance will be supported by a RS Government letter to the WB.</p>
1.3	<b>Debt-to-equity conversion (RS Government hold more than 90% of ŽRS capital)</b>	This DLI will be met when the RS Government holds more than 90% of the capital of ŽRS.	<p><b>Data Source:</b> RS Government</p> <p><b>Procedure:</b> The documentation will include the shareholding structure according to the Banja Luka Stock Exchange.</p>
2	<b>Operational efficiency improved</b>	This DLI will measure the net reduction in ŽRS workforce.	<p><b>Data Source:</b> ŽRS, RS Ministry of Transport and Communication.</p> <p><b>Procedure:</b> Staff retrenchment will be carried out accordance with the law and procedures. Bank to receive all the official documentation including confirmation from the Minister of Transport and Communications that the target has bene met.</p>
3.1	<b>Implementation of organizational restructuring: selection of consultants</b>	<p>Consultants selected for the following two consultancies:</p> <ul style="list-style-type: none"> <li>• Regulatory and functional review of the railways, ŽRS reorganization, modern management and financial systems, and asset management systems.</li> <li>• Business plans, contracts for Public Service Obligation (PSO), track access charge (TAC),</li> </ul>	<p><b>Data Source:</b> ŽRS</p> <p><b>Procedure:</b> ŽRS will submit to the WB the bidding evaluation reports and the contracts for the selected companies.</p>



No	DLI	DLI Definition and Scalability	Draft Protocol to Evaluate Compliance of the DLI
		multiannual infrastructure (MAI), performance. Management	
3.2	<b>Implementation of organizational restructuring: draft final reports</b>	<p>This DLI will be met when ŽRS prepares draft final reports are completed for:</p> <ul style="list-style-type: none"> <li>• Regulatory &amp; functional review &amp; recommendations</li> <li>• ŽRS Organization structure</li> <li>• PSO, TAC, MAI and performance contracts</li> <li>• Asset management plans</li> <li>• Business plans</li> <li>• Specifications for management &amp; financial systems.</li> </ul>	<p><b>Data Source:</b> ŽRS, RS Ministry of Transport and Communication</p> <p><b>Procedure:</b> Reports will be submitted to the WB for validation.</p>
3.3	<b>Implementation of organizational restructuring: first implementation</b>	<p>Implementation of:</p> <ul style="list-style-type: none"> <li>• Acquisition of management and financial systems</li> <li>• New ŽRS organization structure.</li> <li>• PSO, TAC, MAI and performance contracts</li> <li>• Asset management plans</li> <li>• Business plans</li> </ul>	<p><b>Data Source:</b> ŽRS, RS Ministry of Transport and Communication</p> <p><b>Procedure:</b> <i>Acquisition of management and financial systems:</i> proof of procurement submitted to the WB</p> <p><i>New ŽRS organization structure:</i> new structure including separate management and accounting of operations and infrastructure, supported by MoTC letter to the WB.</p> <p><i>PSO, TAC, MAIC and performance contracts:</i> contracts signed by RS Government and ŽRS to be submitted to the WB.</p> <p><i>Asset management plans:</i> implementation will be verified by dynamic databases of infrastructure and operating division assets containing comprehensive register of significant assets with the capability to record condition, operational and maintenance histories and costs of assets and similar data, such system(s). to be submitted to the WB.</p> <p><i>Business plans:</i> decision of business plan approval by ŽRS management board to be submitted to the WB.</p>



No	DLI	DLI Definition and Scalability	Draft Protocol to Evaluate Compliance of the DLI
3.4	<b>Implementation of organizational restructuring: full implementation</b>	<ul style="list-style-type: none"><li>• Management and financial systems fully functional.</li><li>• PSO and MAIC fully funded</li><li>• Contracts reviewed and updated</li><li>• Business plans reviewed and updated</li></ul>	<p><b>Data Source:</b> ŽRS, RS Ministry of Transport and Communication</p> <p><b>Procedure:</b> <i>Management and financial systems fully functional:</i> annual financial report prepared through the system, and submitted to the WB.</p> <p><i>PSO and MAIC fully funded:</i> confirmation from MoTC that the financial commitments of the PSO and MAIC have been fulfilled.</p> <p><i>Contracts reviewed and updated:</i> Updated PSO and MAIC submitted to the WB by MoTC.</p> <p><i>Business plans reviewed and updated:</i> Updated 5-years business plan approval by ŽRS management board to be submitted to the WB.</p>



## ANNEX 2: IMPLEMENTATION ARRANGEMENTS

### COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project

#### Project Institutional and Implementation Arrangements

This Project consists of the second project under a series of projects (SOP) supporting a borrower's long-term development program. The series approach allows that not both entities would need to start at the same time, but rather each would begin when ready, through a series of sequential phases.

The first project under the SOP, the Federation Road Sector Modernization Project, was approved by the Board of Directors in August 2, 2016 and effectiveness is expected to take place soon. The objectives of the Federation Road Sector Modernization Project are to improve road connectivity and safety for road users along project roads and to strengthen capacity for sustainable management of the main road network in the Federation of Bosnia and Herzegovina.

The implementing agency (IA) will be the Republika Srpska Railways (ŽRS), which already has the core members of the PIMT. Capacity in management, planning, monitoring and program administration has been assessed and strengthened during the project preparation. RS Entity through ŽRS will have the overall responsibility for coordination, planning, procurement, disbursement, project level monitoring and evaluation, progress implementation reporting, and use of Project funds. These will be detailed in the Project Operational Manual (POM).

A Project Steering Committee, chaired by MoTC and consisting of representatives of RS MoTC, ŽRS, RS MoF and other relevant institutions will be created to provide guidance and direction to ensure timely implementation of the project.

#### Financial Management

The overall financial management (FM) risk for the Project is substantial before mitigation measures, and with adequate mitigation measures agreed, the financial management residual risk is moderate. The Inherent Risk of the Project is rated as moderate, while the controls risk is rated as substantial before the mitigation measures. After the introduction of mitigation measures such as adequate financial management staffing and planning arrangements, as well as a private audit firm to audit the entire Project and ŽRS, the overall FM risk is moderate. The POM will include, among other topics, the main aspects of Project Financial Management.

**Budgeting and Counterpart Funding Arrangements:** The PIMT has acceptable planning and budgeting capacity. Budgeting and planning for the Project will be based on annual ŽRS business plans as well on the project procurement plan and approved by company management board. Variances of actual versus budgeted figures will be reported, monitored and explained.



The RS government will take over the repayment of funds related to the first project component (repayment of arrears towards employers). In addition, RS government will take over ŽRS's debt to IFIs converting it into equity, which is treated as government counterpart funding. The current balance of the outstanding loans that the RS intends takeover is about €75 million.

**Staffing:** The staffing of the PIMT is appropriate and there is skilled staff within ŽRS engaged with some prior experience in implementing IFIs' (EIB, EBRD) funded projects. The Finance and Accounting department will be providing all the details related to project related payments. The project will rely on financial management staff already employed in ŽRS and the key staff will be head of accounting department and the financial manager for the project. The terms of references for the FM staff will be appended to the Project Operational Manual (POM).

**Accounting and Maintenance of Accounting Records:** Accounting policies and procedures are adequate. For Project accounting, simple cash accounting method will be used. There will be a POM describing detailed project accounting procedures and policies. Accounting system used for company's accounting and reporting is assessed to be adequate and is assessed to provide accurate and reliable accounting information. Accounting data is backed up on weekly basis on external drives and on servers. The accounting system will be further improved during the project implementation under the component 3 of the project. Accounting policies and procedures to be applied for Project accounting include the following major assumptions and principles:

- (a) cash accounting as the basis for recording transactions;
- (b) appropriate analytical accounting records exist by DLRs, contracts and payments;
- (c) reporting done in currency of the loan (reporting currency);

ŽRS entity financial statements will be prepared in accordance with prevailing local legislation which prescribes application of International Financial Reporting Standards (IFRS).

**Internal Controls and Internal Audit:** ŽRS and specifically PIMT has adequate internal controls for the Project, including regular reconciliation of bank accounts, adequate segregation of duties, proper accounting policies and procedures and monthly reconciliation of disbursement summaries of the World Bank with Project accounting records will be performed.

- (a) are reconciled with the excel Project data for every withdrawal application, client connection figures are reconciled monthly with the Project accounting records. PIMT maintains a list with all the payments made out of the Designated Account, which is used for reconciliation.
- (b) The access to the accounting software are password protected; there is only accounting staff access to the systems. The journal entries cannot be altered once they are made. Any changes can be done only with reversal of the initial journal and posting the correct one.
- (c) Internal controls for repayment of arrears related to employment contracts, adequacy of hiring and dismissing procedures.

Currently the internal controls surrounding employee payments is ensuring sufficient segregation of duties and relevant authorization procedures are followed, however there were instances when ŽRS departed from the hiring procedures that are implied by the law and their internal regulations. It is understood also that some employees were assigned to the job positions for which they were not sufficiently qualified. ŽRS will need to review its hiring procedures in order to ensure that all potential applicants are treated equally and in



the way that all job positions are assigned transparently and based on selection of the best candidates.

No reliance will be put on the internal audit in ŽRS, since these is in its inception stage with limited capacity.

**Periodic Financial Reporting:** The PIMT shall prepare and furnish to the Bank not later than forty-five (45) days after the end of each calendar semester, interim unaudited financial reports for the Project covering the quarter, in form and substance satisfactory to the Bank.

The IFRs will include the following reports stated in the currency of the loan:

- (a) Statement of Sources and Uses of Funds;
- (b) Report on DLIs, DLRs and EEPs
- (c) Uses of funds by category;
- (d) Uses of funds by component
- (e) Statement of Designated Account; and
- (f) Cash Flow Forecast for the following 2 semesters

**External Independent Audit of ŽRS:** ŽRS is subject to annual external independent audit by private audit firm. Also, the RS audit office (equivalent to suprema audit) is normally auditing ŽRS every second year. The auditor for the year ended 31 December 2015 was Backer Tilly doo Sarajevo and they had issued a qualified audit opinion. Also, the RS Audit Office issued a qualified opinion on the financial statement for the year ended 31 December 2014. In their audit reports both the private audit as well as RS Audit office identified number of material issues that ŽTRS need to resolve. Such issues included the following:

- Unrecorded liabilities for periods FY 2013 to FY 2015 stemming from unpaid fees for meal allowances and vacation allowance in the amount of BAM 21,014 thousand without penalty interest and the result for the year FY 2015 is understated by BAM 6,124 thousand and accumulated loss is understated by BAM 14,890.
- No impairment test for obsolete inventories (raw materials and spare parts) of carrying value in amount of BAM 11,991 thousand, for which there is a very low turnover ratio, the net realizable value has decreased significantly and estimated useful life has expired
- Inconsistencies and departure from the accounting policy relating to revaluations, as at 31 December 2015 the Company recorded effects of the land valuation in total amount of BAM 77,900 thousand which resulted with decrease in value of land. Additionally, the Company recorded income from surplus for the land recorded for the first time in the amount of BAM 876 thousand thereby overstating the result for the year understating the revaluation reserves. The Company failed to record effects of the valuation effects for other classes of property, plant and equipment. In 2014 the Company recorded impairment losses on inventories and property, plant and equipment damaged in the natural disaster caused by floods in amount of BAM 1,406 thousand and BAM 11,462 thousand. The impairment losses on property, plant and equipment has been recognized in the Statement of comprehensive income for the year ended 31 December 2014. Company has not charged existing revaluation reserves in this respect due to lack of their analytical records.
- The Company did not perform consistently an impairment test on assets under construction which date from earlier periods in the amount of BAM 4,042 thousand, although there are strong indicators of their significant value decrease. In addition, the Company did not perform impairment test on equipment which is recorded in assets under construction and which were damaged in the natural disaster caused by floods, in the amount of BAM 2,087 thousand. Furthermore, the assets under construction that represent



expenses amount to BAM 902 thousand and the assets under construction that should have been activated in previous periods amount to BAM 1,636 thousand.

- In 2014 the Company decided to remove deferred tax liabilities referring this decision to the SIC21: "Income tax - compensation of revalued assets that are not subject to depreciation. Accordingly, deferred tax liabilities are understated and revaluation reserves are overstated by BAM15,742 thousand;
- The Company has not disclosed segment reporting in accordance with International Financial Reporting Standards 8: 'Operating Segments'

ŽRS management is working on eliminating the issues that have led to qualified audit opinions. In addition, special attention will be paid to the financial difficulties of the company and issues that may jeopardize the company’s going concern principle.

**External independent audit of the Project and ŽRS.** The Ministry of Finance and Treasury shall be responsible for appointing Project audit services, while ŽRS is in-charge of contracting its company-wide audit services. The terms of reference for the both audits, and the auditor(s) will be acceptable to the Bank. The PIMT will be responsible for enabling timely compilation of the annual Project and ŽRS financial statements (FS) for the independent external audit. Project financial statements (FSs) will be audited by an independent auditor acceptable to the Bank.

The annual audited financial statements and the audit reports will be provided to the World Bank within, six months for the project financial statements audit and 9 months for the ŽRS financial statements audit respectively, as of the end of each fiscal year. The audits of the Financial Statements of the Project will be procured by the Ministry of Finance and Treasury and financed from the loan whereas the audits of the Financial Statements of the ŽRS will be procured by the ŽRS and funded from the ŽRS own sources of funding.

The project will finance retrenchment expenditures paid by the ŽRS prior and/or after the project signing as well as settlement of arrears related to employee expenses. Retrenchment payments can include one off voluntary severance payments, one off involuntary severance payments etc. As such payments include high volume of payments the Bank may require specific interim audit of such payments. The audit will include agreed upon procedures to obtain reasonable assurance on inter alia: the eligibility of payments, existence, correct amounts of paid employee arrears and retrenchments.

**Table A2.1. Audit reporting**

<b>Audit report</b>	<b>Due date</b>
Financial/operational audit (agreed upon procedures) for the retrenchment expenditures and settlement of arrears related to employee expenses.	Upon request by the Bank, within six months of the end of each fiscal year
Project financial statements (PFS) that include formats agreed for IFRs as well as any notes to such financial statements.	Within six months of the end of each fiscal year and also at the closing of the project
Entity financial statements The financial statements will include the full set of financial statements as per the applicable International Financial Reporting Standards (IFRS)	Within nine months of the end of each fiscal year



The audited Project and ŽRS audit Financial Statements will be made publicly available in a timely fashion, and in a manner acceptable to the World Bank. Such reports will be published on a web site one month after the Bank has sent official audit acknowledgement letter accepting such reports.

There are no overdue or due audit reports for the projects in BiH.

## **Disbursements**

### ***Eligible expenditure programs (EEPs)***

**Arrears.** The overdue and unpaid liabilities, arrears, that are subject to financing and form part of the EEPs are the payables that relate to employees' salaries and earnings. As such they include the following expenditures: employee net salary, social contributions paid on and from salary, personal income taxes and other taxes that are paid from salaries, allowance for hot meals, allowance for transport to and from work, allowance for annual leave, other allowances related to employment, penalty interest charged by courts for the overdue amounts outstanding to the RS authorities and employees. However, expenses for court awards in favor of ŽRS' workers related to labor disputes for which the proceedings started after August 31, 2017 will not be eligible to be financed with the EEPs.

In order to be able to validate the EEPs stemming from arrears the Bank will require the following information: list of employees for which arrears exist, list and amounts of all allowances and benefits as well as tax obligations for which payment is outstanding, summary of all payments to employees, bank statements proving that all payments of the relevant arrears have been made and any other documents that the Bank may be reasonably requesting as evidence for incurring and paying the EEPs.

### ***Retrenchment***

Retrenchment payments can include one off voluntary severance payments, one off involuntary severance payments etc. The following evidence will be used for documenting EEPs: the contract termination signed by both employee and ŽRS management, bank statement proving that the retrenchment payment had been made to the dismissed employee, evidence that the employee had become a retiree, or evidence that the employee had become unemployed or self-employed.

All the documents that support the EEPs will be kept in ŽRS and be available for review by the World Bank, independent external auditors and other authorized persons.

***Operating expenses relating to Component 3 of the project.*** Namely this expenses will relate to the following: Implementation of: (a) recommendations of key regulatory and financial reviews; (b) new ŽRS organization structure: (c) PSO, TAC, MAIC and Performance Contracts; (d) asset management plans; (e) business plans; and (f) acquisition of management and financial systems but also any other operating expenses of the ŽRS.

## **Disbursements and flow of funds**

To support implementation of activities under all Components, the following disbursement methods will be used:



**Disbursements under the DLR-linked components will use advances and reimbursements as the relevant disbursement methods.**

A designated account will be opened by the Ministry of Finance and Treasury, in a commercial bank acceptable to the World Bank. The designated account will be denominated in EUR currency.

**Reimbursements** in order to meet the DLIs for the first year (July 31, 2018), the RS Government will provide funding that will be retroactively refinanced upon achievement of the relevant DLRs and upon project effectiveness. For any reimbursements under the retroactive funding, the funds will flow from the World Bank to the RS Government that provided/paid the funds for such eligible expenditure. Achievement of the DLRs will be confirmed to the WB according to the Compliance Protocols established for each DLR agreed with the government and ŽRS. In addition, in cases when ŽRS decide to finance the EEPs from own funds, as soon as a DLR is met in line with predetermined protocol and the underlying EEPs are reported, the ŽRS will be reimbursed for the amounts of eligible expenditure achieved. Such transfer of funds will be done directly from the loan account to the ŽRS bank account, or another account from which the relevant payment was made.

**Advances.** When using advances as disbursement method the funds will flow from the World Bank to the designated account opened by the Ministry of Finance and Treasury.

No advances will be used to meet the DLIs of July 31, 2018, as the financing needed to meet these DLIs will be retroactively financed out of the loan. An advance of EUR 20 million is expected to be made in early August 2018 which will be used to retire arrears. About EUR 12 million of this amount will be converted into disbursement once the verification of the DLRs are done. This is expected to happen within a month. An advance of about EUR 18 million is expected to be provided the second half of August. This will enable the resettlement of all arrears by August/September 2018. This would bring the outstanding advances to about EUR 26 million. Smaller advances will be required to meet the DLIs for July 2019, July 2020 and July 2012. The total advances at any point will not exceed EUR 26.5 million. The remaining balance of the advances will be converted into disbursement in years 2019, 2020 and 2021 when the DLIs for these years are met and sufficient EEPs are provided to cover the underlying DLR value. If certain DLIs are not met by the end of the Project, advances associated with these DLIs will be returned by the ŽRS to the Bank.

**Nature of the DLRs**

- I. DLRs 1 and 2 (except for DLRs 1.3) are scalable. Disbursements will be based on the proportional achievement of the DLIs. ŽRS
- II. For DLRs 3, the disbursement is directly linked to the number of results. For example, DLR 3.3 has a value of EUR 6.0 million is linked to the preparation of 6 reports. The preparation of each report will result in a disbursement of EUR 1.0 million.

The eligible expenditure will be documented using the Interim Unaudited Financial Reports (IFRs) for all components. With respect to each DLR, there has to be evidence satisfactory to the Bank that the specific results have been attained, as per Schedule 2, Section IV.B.2.(a), of the Loan Agreement.



**Table A2.2. Eligible expenditures**

Category	Amount of the loan allocated (expressed in EUR)	Percentage of expenditures to be financed (inclusive of taxes)
(1) ŽRS eligible expenditure program	51,171,750	100%
(2) Front-end fee	128,250	[Amount payable pursuant to Section 2.03 of this Agreement in accordance with Section 2.07 (b) of the General Conditions]
(3) Interest rate cap or interest rate collar premium		[Amount due pursuant to Section 2.08(c) of this Agreement]
<b>TOTAL AMOUNT</b>	<b>51,300,000</b>	

**Retroactive financing**

No withdrawal shall be made for payments made prior to the date of the Loan Agreement, except for withdrawals up to an aggregate amount not to exceed \$10,000,000 may be made for payments made for Components 1 and 2 made prior to the date of the loan signing but on or after twelve months prior to such date, for Eligible Expenditures.

**Financial Management Covenants.** It will be required that the following covenants for the project are complied with:

- (a) Appropriate financial management system is maintained by the client throughout implementation.
- (b) Delivery of financial reports as indicated in financial reporting section.
- (c) Delivery of annual audits as indicated in external audit section.

**Table A2.3. Financial Management Action plan**

Action	Deadline	Responsible
To draft FM sections of the Project Operational Manual	Prior to project implementation	ŽRS
ŽRS needs to actively work towards resolving the issues that have led to qualified audit opinion for FY 2015	During project implementation	ŽRS

**Implementation Support and Supervision Plan:** The Bank will apply a risk based approach in undertaking Project supervision activities that will include reviews of periodic reports, review of audited annual financial statements together with auditors’ management recommendation letters; monitoring implementation of agreed remedial actions; and addressing emerging issues in collaboration with implementing units.



**Contract management:** The PIMT will maintain technical and financial database of all Project contracts. The technical database shall be updated by procurement staff on a regular basis. Such database will have available all information on contracts, any annexes which were concluded as well as any payments made up to date. The FM manager maintains an overview of all Project-related payments and thus controls and is able to avoid any overpayments.

**Use of country systems:** The Project will use elements of country systems such as: staffing, planning and partially internal controls.

## Procurement

Procurement under the proposed project shall be carried out in accordance with the WB Procurement Framework dated July 2016 and application of Regulations for Borrowers dated July 2016.

**The capacity of each entity to implement procurement and contract management needs to be strengthened.** The team assessed the risks that may negatively affect the ability of the Implementing Agency – ŽRS - to carry out procurement of Goods and Technical Assistance.

**Summary of the Risks and Mitigation Measures.** ŽRS has no previous experience with DLIs, which might result in delays in the implementation process. However, the counterpart and the WB team made sure that the DLI matrix includes realistic indicators and targets in line with capacity constraints and control span of the implementing institutions.

Currently, it is planned that there will be no procurement of works, only IT related goods and consultants' services. It is estimated that for component 3 equivalent of EUR 2 million for accounting and business systems and EUR 3 million for technical assistance and incremental costs under category (2) will be procured following Regulations for Borrowers.

Given such project design and the risks identified, the overall risk for procurement is considered as Substantial.

### **Procurement Arrangements**

- 1. Procurement of works.** Currently not envisaged.
- 2. Procurement of IT goods and non-consulting services.** Goods may be procured using procedures and methods as described in the Project Procurement Strategy for Development and as specified in more detail in the Procurement Plan.
- 3. Procurement of consulting services.** Consulting services under the project may potentially be of various size and complexity. Selection of consulting firms will be done using the World Bank standard procurement documents, such as Request for Proposal. The employment of technical experts will be conducted through the selection of individual consultants in accordance with the Regulations for Borrowers. In case the service is required from a consultancy firm, the Quality- and Cost-Based Selection method will be



applied and other methods such as Least Cost Selection, Fixed Budget Selection, or Quality Based Selection may also be used following provisions of Regulations for Borrowers. For contracts below USD 300,000 equivalent, the Selection Based on Consultants' Qualification (CQS) method may be used. The short list can entirely comprise national consultants if the contracts with the firms are below USD 300,000 equivalent.

**4. Procurement under the DLI component.** The major part of the project financing will be disbursed against eligible expenditures upon meeting DLIs. At this stage, it is not envisaged that there will be any procurement under the DLI component. However, if during project implementation there is a need to procure under this component, this procurement should be consistent with the key principles of the Regulations for Borrowers and should be undertaken as follows:

- **Goods, Works, non-consulting service.** "For the procurement of those contracts for goods, works, and non-consulting services not financed in whole or in part from the Bank loan, but included in the project scope of the loan agreement, the Borrower may adopt other rules and procedures. In such cases, the Bank shall be satisfied that the procedures to be used will fulfill the Borrower's obligations to cause the project to be carried out diligently and efficiently, and that the goods, works, and non-consulting services to be procured: (a) are of satisfactory quality and are compatible with the balance of the project; (b) will be delivered or completed in timely fashion; and (c) are priced so as not to affect adversely the economic and financial viability of the project."
- **Consultant Services.** "In procuring consulting services not financed in whole or in part from Bank loans but included in the project scope of the loan agreement, the Borrower may adopt other rules and procedures. In such cases, the Bank shall satisfy itself that: (a) the obligations to diligently and efficiently implement the project, and will result in the selection of consultants who have the required qualifications; (b) the selected consultant will carry out the assignment in accordance with the agreed schedule; and (c) the scope of services is consistent with the needs of the project."

**5. General Procurement Notice.** It will be prepared and submitted to the World Bank after negotiations. The World Bank will arrange for its publication in United Nations Development Business online and on the World Bank's external website. The General Procurement Notice will contain information concerning the borrower, amount, and purpose of the loan; scope of procurement reflecting the procurement plan; the name, telephone (or fax) number, and address(es) of the borrower's agencies responsible for procurement; and the address of a widely used electronic portal with free national and international access or website where the subsequent Specific Procurement Notices will be posted.

**6. Procurement Plan.** IA will develop an initial procurement plan for the entire project scope consistent with the implementation plan, which will provide information on the IT goods procurement and technical assistance packages and potential selection processes with methods, and the WB review requirements. Since this will cover the entire project completion period, it will be tentative. However, procurement plan for 18 months of the project should be prepared in more detail. The procurement plan will be updated in agreement with the WB project team at least annually or as required to reflect the actual project implementation needs and improvements in the IA's institutional capacity.

**7. Procurement supervision.** Routine procurement reviews and supervision will be conducted by the procurement specialist. In addition, one supervision visit is expected to take place per year when ex post reviews will be conducted. The WB project team recommends a post review of at least 20 percent of contracts



subject to post review (i.e. 1 in 5 contracts shall be post reviewed). Procurement documents will be kept readily available for the WB’s ex post review during supervision missions or at any other point in time. A post review report will be prepared annually and shared with the IAs.

**8. Procurement/selection method and prior review thresholds.** Considering the risk assessment rating as Substantial, it is proposed that the thresholds for procurement activities financed under the project are set in accordance with the latest Europe and Central Asia regional procurement thresholds. The thresholds will be specified in the procurement plan.

**Table A2.4. Estimated IT goods and technical assistance packages for non DLI component 3**

Description	Type	Cost Estimate (EUR)	Selection Method	Review	Planned Date (Tender Launch)	IA
IT goods packages - multiple packages (TBD)	Goods	2,000,000	TBD per PPSD	Post	March 2019	ŽRS
Consultants services - multiple packages (to be determined (TBD))	CS	2,000,000	CQS (or QCBS, QBS,FBS,LCS) TBD	Post	March 2019	ŽRS
Selection of individual consultants (PIT) - multiple packages TBD	CS	1,000,000	IC	Post	March 2019	ŽRS
<b>Subtotal</b>	<b>Goods</b>	<b>2,000,000</b>	<b>Multiple packages</b>			
<b>Subtotal</b>	<b>CS</b>	<b>3,000,000</b>	<b>Multiple packages</b>			
<b>TOTAL</b>		<b>5,000,000</b>				

Note: CS = consultants services; IC=Individual Consultant; CQS= Consultants Qualifications Selection; QCBS= Quality and Cost-based Selection; QBS=Quality Based Selection; FBS= Fixed Budget Selection; LCS=Least-Cost Selection.

**Environmental and Social (including safeguards)**

The Borrower prepared social assessment related to the workforce restructuring. The assessment identified that more than fifty percent of the ŽRS workforce is aged over 50, many of them have worked for ŽRS for over 20 years. Some employees in this group no longer meet the physical and health requirements specified as necessary to perform specific tasks, but due to the nature and specificity of particular railway jobs, and the



general overemployment in the company, it is not easy to re-assign these workers to other positions or hire younger workers to fill them. These workers have a similar profile to Republika Srpska's unemployed persons. It would be expected that this category of workers can face difficult re-employment circumstances. Conversely, the share of new, younger ŽRS workers to replace workers retiring in the next few years is relatively small: only 7 percent of employees are under 30 and not all have the skills and experience readily to replace the retiring workers. Women account for some 15 percent of the workforce, mainly employed in finance, accounting and legal departments. Workforce restructuring will make all reasonable efforts to avoid disproportionate impact on them.

ŽRS has also many employees with physical disabilities (partly as a result of previous policies to employ war-wounded) and workers with reduced ability to work (about 8 percent of total employees). This category of workers cannot be easily re-assigned to other jobs within ŽRS, and would be disadvantaged in obtaining other employment opportunities in the market. The situation of workers who are war veterans (around 200 workers) or surviving family members of soldiers killed (around 80 workers) is also particularly sensitive. Labor Law does not grant them any special rights but any disproportionate impact on this group is likely to create opposition in the broader community.

Unemployment in Republika Srpska is high and may affect the ability of workers leaving the railway sector to find alternative jobs. Official data provide estimates of unemployment of between 21.5 percent and 35 percent of the working-age population. More than half are long-term unemployed (unemployed for at least three years). Moreover, the profile of the unemployed is similar to that of ŽRS employees in terms of age, education and qualifications. More than 90 percent are categorized as low-skilled or semi-skilled many of whom have completed education at vocational schools or secondary schools. It can be expected that ŽRS employees affected by workforce restructuring may have challenges in seeking new jobs.

Given the social complexities, even though severance is planned to be as far as possible voluntary, it is important that the employees leaving are offered a range of supportive initiatives relevant to their age, gender and skills profile and needs. These initiatives should go beyond just the assistance currently provided by the entity's Employment Service and could encompass: re-training; part-time work; training on on-line job search tools; employment counselling; and other technical training and preparation for employment. Other alternatives being considered include capacity-building and entrepreneurship courses focusing on developing income-earning opportunities, which may to some leaving employees be an attractive use of the lump-sums received through payments of benefit arrears and a severance package.

Although no activities with associated environmental impacts are foreseen at this time, a precautionary Checklist EMP has been disclosed by the Client and will be completed and filled in for all, if any, activities that may involve small-scale reconstruction, in particular reconstruction related to server rooms and IT equipment within ŽRS. The team will follow closely the project and assist the Client in preparing the Checklist, when and if needed.

## **Monitoring and Evaluation**

The Project includes a set of monitoring indicators at the Project level focusing on the financial, operational and organization restructuring targets as well as corporate indicators on gender and citizen engagement. The indicators and the monitoring and evaluation arrangements are detailed in section VII of this document.



Overall responsibility for monitoring and evaluation (M&E) of the outcomes of this Project lies with the Republika Srpska Railways (ŽRS). During preparation, the team confirmed the strong capacity of the Project Implementation and Management Team (PIMT) to collect and report on the results framework indicators. The PIMT will prepare progress reports, based on data available from the financial and human resources management system, as well as inputs from the consultants to be appointed to support the organizational restructuring.

A communication strategy on the sector reform and the project's achievements will be elaborated during the first semester after the project start and will be followed as part of the project's monitoring and evaluation. Its implementation will also be an opportunity for future citizen engagement.



## ANNEX 3: IMPLEMENTATION SUPPORT PLAN

### COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project

#### Strategy and Approach for Implementation Support

The strategy for implementation support has been developed based on the nature of the Project and its risk profile. The main objective of the implementation support is to ensure appropriate technical support to implement the required reforms. Supervision will also focus on monitoring compliance with the Bank fiduciary and social safeguards requirements. Emphasis will be placed on upstream reporting, auditing and accountability, and technical compliance measures to ensure early detection and remedy of problems.

The project implementation support will also put a specific emphasis on the workforce restructuring related activities (Component 2), and the timely implementation the institutional activities under Component 3.

#### Implementation Support Plan and Resource Requirements

The Bank project team will provide timely and effective implementation support through combination of day-to-day supervision and semi-annual implementation support missions. Key members of the Bank's team, including the task team leader, railways specialists and financial management specialist are based in the region and the country office in Bosnia and Herzegovina. This will enable the task team to provide more effective supervision and daily implementation support to the Railways Modernization Project. In addition, it will allow early detection and remedy of any issues that arise during implementation.

- (a) *Project Management*: The TTL and co-TTL will conduct the quarterly supervision of the project, liaise with the client on a day-to-day basis, and will coordinate with project team members based in the region and HQ to ensure timely guidance and support to the client.
- (b) *Technical Inputs*: The railways specialists will provide technical support in supervising the timely implementation of the reforms.
- (c) *Financial Management*: FM support will be provided during project preparation and implementation and will consist of the following: review of periodic reports, review of audited annual financial statements together with auditors' management recommendation letters; monitoring implementation of agreed remedial actions; and addressing emerging issues in collaboration with implementing units.
- (d) *Procurement*: The procurement-related implementation support will include: (a) timely advice on various procurement related issues, (b) guidance on the Bank's Procurement Rules and Guidelines; and (c) monitoring of procurement progress against the procurement plan. One supervision visit is expected to take place per year during which ex-post reviews will be conducted.



- (e) *Environmental and Social Safeguards*: The social specialist will support relevant counterpart staff and provide any necessary training. Particular focus will be given to the implementation of the workforce restructuring aspects. The Environmental specialist will supervise the respect of the environment safeguards. Field visits will be made on a semi-annual basis.

Time	Focus	Skills Needed	Resource Estimate (Staff Weeks/year)	
First twelve months	Team Leadership	Management, supervision, coordination, dialogue with government and other stakeholders	Task Team Leader, co-TTL	18
	Project Support	Coordination	Program Assistant in-country	6
	Technical	Technical support to implementation of reforms	Railways Specialists	8
	Social	Social safeguards, workforce restructuring	Social Specialist	4
	Environment	Environmental safeguards	Environmental Specialist	1
	Procurement	Procurement experience, Banks procurement norms knowledge, procurement reviews and supervision	Procurement Specialist	4
	Financial Management	FM experience, knowledge of Bank FM norms, financial management and disbursements	FM Specialist	4
12-48 months	Team Leadership	Management, supervision, coordination, dialogue with government and other stakeholders	Task Team Leader, co-TTL	12
	Project Support	Coordination	Program Assistant in-country	6
	Technical	Technical support to implementation of reforms	Railways Specialists	8
	Social	Social safeguards, land acquisition and resettlement, gender and poverty	Social Specialist	4
	Environment	Environmental safeguards	Environmental Specialist	1
	Procurement	Procurement reviews and supervision, training as needed	Procurement Specialist	2
	Financial Management	FM reviews and supervision, training and monitoring	FM Specialist	2



Skills Mix Required

Skills Needed	Number of Staff Weeks	Number of Trips	Comments
Task Team Leader (TTL)	36	Field trips as required	Region-based
Co-TTL	18	Eight	HQ-based
Railways Specialists	32	Field trips as required	Region-based
Social Specialist	16	Eight	HQ-based
Environmental Specialist	4	Field trips as required	Country-based
Procurement Specialist	10	Field trips as required	HQ-based
Financial Management Specialist	10	Field trips as required	Country-based
Program Assistant	24	Field trips as required	Country-based



## **ANNEX 4: FINANCIAL AND ECONOMIC APPRAISAL**

### **COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project**

#### **Introduction**

ŽRS is a railway facing severe financial difficulties. Total operating expenses of ŽRS exceeded total revenues for each year during 2007-2014. The amount of total revenues, including budget support, was just about sufficient to cover operating costs (less depreciation and interest). Labour costs are a disproportionate component of the cost structure of ŽRS, not surprisingly given the very high levels of staff for a railway of this length and traffic profile. In 2014, the wage bill was 64 percent of operating costs (less depreciation and interest) and 108 percent of commercial revenues. Depreciation is the second largest cost item, but ŽRS has had no commercial revenue or budget support to fund depreciation provisions as a source of finance for annual renewals or investment. Basically, all infrastructure O&M costs are funded from the budget on an ad hoc basis. A more detailed analysis of ŽRS's financial deterioration and status is provided in Annex 6 which demonstrates that the company is not sustainable financially without restructuring and reforms.

However, the restructuring program has some financial preconditions. ŽRS's workforce has not received many of the allowances due to it (such as meal and transport benefits) for some years and the total arrears to staff and government for wage-related payments are expected to total about 83.5 million BAM (EUR 42.7 million) including penalties and interests at end-July 2018. ŽRS will continue to decline financially and in its competitiveness until the labor force is reduced and productivity improved. However, this cannot be done until the existing wage-related arrears are cleared.

The proposed strategy, of which this Project is an integral part, is thus to settle the arrears and then reduce the labor force to a more efficient level, while at the same time modernizing the administrative and managerial processes of the company. The financial impact and benefit of the project to ŽRS is therefore the main driver of the project design. In this regard, the Project is expected to yield a financial internal rate of return (FIRR) of 17 percent and a financial net present value (FNPV) during 30 years of operation of BAM 52 billion (2017 prices discounted at 10% to 2017). The estimation is described in the sections below, following which the broader economic appraisal is addressed.

#### **Assessment methodology**

The World Bank team used and extended a financial model of ŽRS previously constructed during the production of its BiH Railways Policy Note (2016) designed to evaluate the financial impact of alternative commercial strategies. This section describes the structure of the financial model, the inputs used for the analysis and the sources from which they have been derived. The model generates consolidated financial statements of ŽRS and profit and loss statements for its three main sector components (passenger, freight and infrastructure).



The inputs fall into five groups:

- (i) general economic data
- (ii) traffic data and growth rates
- (iii) operating data
- (iv) financial data (operating costs and opening balance sheet)
- (v) investment and funding data

#### ***(i) Economic Data***

This data consists of forecasts of inflation, growth in annual real wages and changes in the exchange rate between 2015 and 2020.

**Inflation:** The model presents results in nominal terms.

**Real wages:** Growth in real wages is a major factor driving the operating cost projections, which combine changes in unit labor costs with assumptions on changes in physical productivity.

**Exchange rate:** The exchange rate between the Euro and BAM affects both the cost of any project and the cost of servicing any Euro-denominated debt.

#### ***(ii) Traffic Data and Growth Rates***

The base traffic data consists of the 2016 volume, task and revenue for each of the passenger and freight sectors, together with annual growth rates. The projections were made following discussions with ŽRS.

**Passengers:** The ŽRS forecasts are based on the train patterns for 2015 and assume no growth unless there is major investment to improve service levels.

**Freight:** The ŽRS projections also assume no growth. If dangerous goods are legally required to be not use roads, there could be some growth in freight movements.

**Infrastructure revenue:** This includes a number of items which are associated with infrastructure management, such as rents, sale of scrap etc. These are assumed to remain a constant proportion of transport revenue. Infrastructure revenue also includes track access charges paid by the passenger and freight businesses to the infrastructure company. These have been set at rates comparable with other railways in the region.

**Government compensation:** ŽRS is assumed to continue to receive direct Government public service contract (PSC) payments for passenger services and contractual payments for infrastructure maintenance and servicing of historic debt to international financial institutions. The PSC payments are calculated from the cash deficit on the passenger and infrastructure businesses (excluding debt service).

#### ***(iii) Operating Data***

Operating data includes the main parameters which enable traffic projections to be converted into the operating resources (passenger car-km, train-km etc.) which drive the operating costs. These have been derived from ŽRS operating statistics.

#### ***(iv) Financial Data***

The financial data consists of three components:

- Current annual operating costs, which form the basis of projected expenditure
- projections of changes in operating costs.
- opening balance sheets for ŽRS as a whole and for the three sectors: freight, passengers and infrastructure.



**Current operating costs:** Current operating costs were derived from the management accounts for 2014, updated and supplemented by special analyses of rolling stock maintenance costs.

**Future operating costs:** The projected changes in operating costs have two elements:

- changes in the unit cost of performing particular activities e.g. unit fuel costs, unit labor maintenance costs, etc.
- changes in the number of units of work required due to changes in the traffic task or operating plan, which affect operating costs through the assumed cost driver relationships.

**Opening balance sheet:** The model includes a balance sheet for the consolidated accounts of ŽRS, based on the closing balance sheet for 2014, together with notional balance sheets for the passenger, freight and infrastructure businesses derived by splitting the consolidated balance sheet and ignoring inter-business payables and receivables.

### ***(v) Investment and Funding***

The projections allow for investment in both rolling stock and infrastructure. This is assumed to be funded entirely by government grants, although the model also has the facility to assume loans, in which case it calculates interest and debt service payments.

Table 1 summarizes the input assumptions used for the ŽRS financial model. For some variables, only a single set of assumptions was used while for others, such as labor productivity and freight volume and revenue, separate assumptions were made for the ‘with-Project’ and ‘without-Project’ cases.



<b>Table A4.1. ŽRS Financial Model: Summary input assumptions</b>		
	2017-2020	2021-2025
<b>General</b>		
Real wages	0 per cent pa	0 per cent pa
Exchange rate	Depreciate against Euro by 0.8 per cent p.a. in 2017 decreasing to 0.6 per cent p.a. in 2020.	Depreciate by 0.6 per cent p.a. against Euro.
Euro inflation	1.5 per cent in 2017, increasing to 1.9 percent in 2020	1.9 per cent p.a.
RS Inflation	2.5 per cent p.a.	2.5 per cent p.a.
<b>Traffic and revenue</b>		
<b>Passenger traffic</b>		
Demand	0 per cent pa growth	0 per cent p.a.
Average trip length	Constant	Constant
Average real yield	Constant	Constant
<b>Freight traffic</b>		
Without project	Demand reduces by 2% p.a.	Demand continues to reduce at 2% p.a.
With project	Demand reduces by 2% p.a. to 2019, then recovers at 2% p.a.	Demand recovers by 2% p.a. in 2021, then remains constant
Average freight haul	Constant	Constant
Average freight real yield	Reduces at -1 percent p.a. for without-project; general freight revenue constant for with-project	Reduces at -1 percent p.a. for without project; general freight revenue constant for with-project
Infrastructure revenues	Constant proportion of transport revenue Non-cash revenues omitted	As for 2017-2020
Government payments	Calculated in model as amount needed to cover deficit in working expenses	As for 2017-2020
<b>Operations data</b>		
Train operations	Derived from operating statistics for 2014; passenger load factors and rolling stock utilisations kept constant	As for 2017-2020
Track –km	Constant	Constant
<b>Financial data</b>		
Costs by activity	Derived from 2014 management accounts, with some estimation and disaggregation for detailed cost items. Reduction in unit labour costs according to productivity scenarios.	
<b>Labour productivity</b>		
Without project	1.6% reduction p.a.	As for 2017-2020
With project	Staff reduce to 2000 by 2020	Reduce by 2% p.a.
Access charges	Train-working and usage-related track costs charged to both passenger and freight. Passenger Euro 1.50 per train-km +0.50/000 gtkm Freight Euro 2.00 per train-km+1.00/000 gtkm	As 2017-2020
Third-party access	None	None
<b>Investment</b>		
Passenger	BAM 3 million p.a.- based on current level. ROI 0% (i.e. maintains current operating costs)	As 2017-2020
Freight	BAM 4.5 million p.a.- based on current level. ROI 0% (i.e. maintains current operating costs)	As 2017-2020
Infrastructure	BAM 5 million p.a.- based on current level. ROI 0% (i.e. maintains current operating costs)	As 2017-2020



### Project Cost

The cost of the three components as applied to the appraisal are:

Component 1 (wage-related arrears) – **EUR 42.7 million**

Component 2 (labor restructuring) – **EUR 3.5 million.**

Component 3 (administrative and management restructuring) – **EUR 5.0 million**

### Benefits to ŽRS

The benefits of the Project are that ŽRS will be able to accelerate its restructuring and reduce its operating losses. In the absence of the Project, it expects to reduce its staff by 1.7% p.a., resulting in the workforce reducing from its current 3098 to about 2000 by about 2040. By comparison, under the Project this level would be reached by 2020, of which 1000 would be redundancies and 100 the net loss of staff by attrition<sup>21</sup>.

The organizational restructuring, including business and marketing strategies to be financed under Component 3, are planned to improve ŽRS operations and financial outturn:

- (a) the proposed creation of new divisions focused on infrastructure and commercial train operations, combined with modern accounting and resource management (including asset management) systems should greatly improve management focus, information and accountability, and maintenance planning and implementation
- (b) the application of Business Plans containing formal marketing plans would help increase both volume and revenue, especially by improving service levels. Whilst some of the current bulk ŽRS traffics (such as the iron ore) would be relatively unaffected, general and inter-modal traffic should be more responsive, especially on Corridor Vc. While this corridor is difficult operationally, requiring co-ordination between five railways for freight between Ploče and Hungary, development will also be helped by the implementation of the Corridor Monitoring Plan currently under preparation.

The financial impact of these improvements has been estimated using the financial model of ŽRS described above. This model has been used to compare two sets of assumptions related to the ‘with-Project’ and ‘without-Project’ cases. For the purposes of the evaluation most of them are common to both cases; Table 2 summarizes the assumed differences. Table 3 summarizes the financial impacts of the Project on ŽRS.

**Table A4.2. Comparison of with and without-Project cases**

Assumption	Without-Project	With-Project
<b>Labor productivity</b>		
2017-2020	1.7% reduction p.a.	Staff nos. reduce to 2000 by the year 2020
2020 onwards	As for 2017-20	Reduce by 2% p.a.
<b>General freight volume</b>		
2017-2020	Demand constant,	Demand constant to 2020
2020 onwards	Demand constant.	Increases at 2 percent p.a.
<b>General freight yield</b>		
2017-2020	Reduces at -1 percent p.a.	Constant
2020 onwards	Reduces at -1 percent p.a.	Constant

<sup>21</sup> This allows for a small number of new recruits in specialized areas.

**Table A4.3. Comparison of ŽRS Revenue\* and Working Expenses (BAM million current)**

	Without project		With project		Benefit
	Revenue	WE	Revenue	WE	
	1	2	3	4	(3-4)-(1-2)
2018	37	68	37	65	3
2019	37	68	37	61	7
2020	37	69	37	57	12
2021	37	69	38	54	17
2022	36	70	39	54	19
2023	36	70	40	55	20
2024	36	71	41	55	21
2025	36	72	42	56	22
2026	36	72	43	57	23
2027	36	73	44	58	24
2028	35	74	45	59	25

\*excluding Entity subsidy

**Financial Rate of Return and Sensitivity Analyses**

The appraisal period begins in 2017, with benefits calculated for the 20-year period following project completion, from 2021 to 2040 and the estimated FIRR derived and FNPV calculated using a real discount rate of 10%. The estimated FIRR in real prices is 14% and the FNPV, discounted to 2017, is about BAM 61 million (Table 4). The FIRR in nominal prices is 17%.

**Table A4.4. Financial evaluation (BAM million current)**

	Wage arrears	Severance	Admin/mgt	Benefits	Net benefit
2017	83.5	1.7		0	-85
2018		1.7	4.9	3	-4
2019		1.7	4.9	7	1
2020		1.7		12	10
2021				17	17
2022				19	19
2023				20	20
2024				21	21
2025				22	22
2026				23	23
2027				24	24
2028				25	25
2040				25	25



The sensitivity of these results was tested against changes in four base case assumptions (Table 5):

- an increase in wage arrears of 15%
- an increase in severance costs of 25%
- an increase in the cost of the administrative and management restructuring of 25%
- a reduction in benefits of 20%

**Table A4.5. Sensitivity of project evaluation**

	Test	Real FIRR (%)	FNPV BAM (mill)
1	Base	14	61
2	Arrears +15%	12	49
3	Severance costs +50%	14	58
4	Restructuring cost +50%	14	57
5	Benefits -20%	13	30

The Project financial performance is robust to changes in the assumptions. The greatest sensitivity is to the estimated benefits but as these are largely (90 percent) related to the reductions in the workforce rather than increased traffic and revenue they are reasonably certain, as long as the severance program is implemented as planned.

**Economic Analysis**

The repayment of the staff arrears is not, in economic terms, a resource cost because the labor resource associated with the activity has already been expended in previous years. So, this is a mere transfer of funds with no impact on the opportunity cost of labor.,. Similarly, the redundancy payments to surplus employees are, in economic terms, a transfer payment from the community at large to a specific group within it: the overall value of society’s real resources consumed is not directly affected by such transfers. Therefore, these two financial components should be excluded from the economic appraisal which is intended to capture the resource costs of the Project rather than its financial costs. The resource cost is captured by Component 3, the costs of consultant services and accounting and information systems to improve the performance of the company.

However, the Project will yield additional resource benefits in addition to the reduced operating costs of railways. Some of the staff who are not productively employed at ŽRS will, after taking the severance payments, find alternative employment in productive jobs outside the railway, the marginal value of which is approximated by anticipated average remuneration package obtained. Given the current significant unemployment rate in Republika Srpska, it is clear this re-absorption of surplus railway labor will not happen immediately. For the purposes of this evaluation, it is conservatively assumed that 20% of the separated workers will be employed within 1 year, 30% within 2 years, 35% within 3 years up to a maximum of 40% after 4 years. About 30% - 40% of the separations will happen through retirement. The benefits associated with the re-employed workers are referred to as re-employment benefits.



In addition, the increment of freight traffic which is expected to be attained with improved management, operating efficiency and marketing plans will also generate economic benefits through reduced resource costs of transport of the incremental traffic compared to the alternative of road transport (referred to as transport savings). Such rail traffic increment will also lead to reduced external social/environmental costs of road traffic accidents and greenhouse gases (GHG). Taking into account only the resource costs of the Project (Component 3) but including the reduced railway operating costs and external benefits, the EIRR of the project is about 480 percent (Table 6).

**Table A4.6. Economic evaluation (BAM million constant)**

	Economic costs	Rail opex savings	Re-employment	Transport Savings	Road Accidents	GHG savings	Net benefit
2017		0.00	0.00				0.00
2018	4.9	2.69	0.80				-1.41
2019	4.9	6.99	2.00				4.04
2020		11.08	3.40	2.66	0.85	0.13	18.12
2021		14.01	5.00	5.33	1.73	0.26	26.33
2022		14.32	5.80	6.85	2.27	0.35	29.59
2023		13.98	6.20	8.36	2.82	0.43	31.79
2024		13.63	6.40	9.84	3.39	0.53	33.79
2025		13.29	6.40	11.31	3.97	0.62	35.59
2026		12.94	6.40	12.75	4.57	0.72	37.39
2027		12.60	6.40	14.18	5.19	0.82	39.19
2040		9.74	6.40	14.18	6.71	1.19	38.21

The impact of reductions in greenhouse gas (GHG) emissions and road accidents is significant but small in value compared to the railway and wider transport cost savings. Nevertheless, the saving in GHG emissions is estimated to be about 8-10,000 tonnes p.a. during the 2020s.



## ANNEX 5: KEY OPTIONS FOR RESTRUCTURING THE RAILWAYS SECTOR

### COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project

A Policy Note was prepared by the World Bank (with SIDA financial support) to assist the governments of the Entities in Bosnia and Herzegovina to better understand the current conditions of the railway sector, assess the policy options for modernizing it and help chart a course ahead. Railway performance was benchmarked against a number of regional comparator countries and against the EU average. The financial performance of each railway was examined by main business sectors (freight, passenger and network infrastructure) using a railway cost allocation model developed by the Bank. Sector policies were also assessed in terms of budget impact.

Public policy decisions on the railway sector are the prerogative of the governments of the Entities. To help inform their decisions a range of structural and policy options were presented, their key features delineated and relative merits discussed. The Policy Note presented the Bank team's opinions on certain of the options where this seems warranted but this was not intended to be prescriptive.

#### **The institutional framework**

Bosnia's legal framework<sup>22</sup> for the sector has established a two-railway system with two centers of governance, one railways corporation and one BiH regulator. In the Federation of Bosnia and Herzegovina (FBH) the railway is managed by *Željeznice Federacije Bosne i Hercegovine* (ŽFBH) and in Republika Srpska by *Željeznice Republike Srpske* (ŽRS). The Entity governments are majority (though not exclusive) owners of the railways located within their territory. They are responsible for its policy framework, performance oversight, and budgetary support as well as for the inter-entity coordination through the Railways Corporation (BHŽJK). At the BiH level, the Railway Regulatory Board (RRB) is responsible for international regulation. Figure 1 is a functional map broadly describing the 'de facto' roles of the main institutions. The sector faces three critical policy challenges relating to international obligations, sector strategy and company performance.

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<sup>22</sup> The Dayton Agreement and the Constitution are the main legislative framework of Bosnia and Herzegovina.



**Figure A5.1. Distribution of railway sector functions among institutions in BiH**

Function	territory of Federation of Bosnia and Herzegovina	territory of Republika Srpska
<b>BiH multi-modal transport strategy</b> (preparation in progress)	Council of Ministers (CoM) of BiH in collaboration with the Entities and Brčko District	
<b>International railway economic and safety regulation</b>	BiH Rail Regulatory Board (RRB) reporting to CoM	
<b>Inter-entity technical standards &amp; coordination</b>	BiH Railways Corporation (BHŽJK) reporting to the Entities	
<b>Entities multi-modal transport policies</b>	Government of FBH (MoTC, MoF)	Government of RS (MoTC, MoF)
<b>Intra-entity railway policy, planning and regulation</b>		
<b>Public budgetary support</b>		
<b>Ownership of railway company</b>	Government of FBH and some private shareholders	Government of RS, pension fund and some private shareholders
<b>Railway network infrastructure management</b>	ŽFBH	ŽRS
<b>Railway transport operations</b>		

The Law on Railways of Bosnia and Herzegovina of 2005 was intended broadly to reflect European Union directives for railways. The law provided for a degree of separation between railway transport services and infrastructure management, introduced License and a Safety Certificate for train operators, the establishment of a Railway Regulatory Board, and introduction of the concept of a track access fee. The law indicates that its purposes are to ensure the development of a sound railway transport system with effective competition among train operators and with other transport modes, to ensure non-discriminatory access to railway infrastructure, to encourage efficient and transparent management of the railway sector, to follow prevailing international practices and applicable directives of the European Union, to promote a safe and efficient railway transport system, and to ensure fair and efficient regulatory decisions.



The Law on Railways of Federation of Bosnia and Herzegovina makes the ŽFBH the manager of railway infrastructure in FBH and adopts some similar articles to the BiH law in terms of vertical separation and competition. FBH is the owner of the railway infrastructure<sup>23</sup>. The law was established in 2001 and amended in 2012<sup>24</sup>. According to the law, competition in the railway market through entry of a new company is possible as ŽFBH shall allow approved operators access to railway infrastructure without discrimination if operators accept designated railway routes and pay an adequate infrastructure fee to ŽFBH. The law mandates accounting separation (but no other degree of separation) between infrastructure management and transport operations. The law provides a basis of compensation by the Entity government and Cantons to reimburse ŽFBH for loss-making railway passenger services. However, there is no specification of contract form, scale of compensation or how to calculate the amount.

A new Railways Law in Republika Srpska was under preparation at the time of the Policy Note (and since enacted in 2016). The law proposes to restructure ŽRS to promote its financial stability, and for the railway network to be integrated into the European network. The draft law divides roles of the entity government, the infrastructure manager and the train operator, introducing vertical separation in railway transport with the possibility for third party operators to enter the market. The draft law in its current form does not establish the principles for calculating the infrastructure access fees. Also, the draft law does not provide the basis for estimating and contracting for payment of Public Obligation Services for non-profitable passenger lines.

Although the institutional arrangements in BiH are particular to the country, the two railways themselves are relatively straightforward and share many of the features and problems of state-owned railways worldwide. The Policy Note benchmarks performance at the Entities' levels and first considers the options within the current framework of roles and responsibilities, taking the current arrangements as the starting point. The similarities in the role, structure and transport functions of each railway means that the policy issues and options are similar.

### **Railway performance**

FBH's network has about 600km and is the most intensely-used freight railway in the region with about 1.4 million tonnes per route-km, nearly 20 percent higher than the EU average. In 2014, ŽFBH carried 8.5 million tonnes for 885 million net tonne-km. ŽFBH achieves good locomotive and wagon productivity though an already old fleet continues to age. Despite low labor productivity and the poor overall financial results, the freight sector earns a creditable surplus above operating costs. Passenger rail services however make a near-negligible contribution to FBH's overall personal mobility needs. In 2014, ŽFBH carried 355,000 passengers (fewer than 1,000 passengers/day). With an estimated total passenger operating costs of about BAM 23 million, the financial results for the passenger sector represent a poor use of operating resources and a financial drain on the surplus from freight operations. Because there is a heavy implicit subsidy from the freight to the passenger sector, the ability of freight to contribute to infrastructure costs is correspondingly low.

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<sup>23</sup> Although the law specifies that FBH is the owner of the railway infrastructure, currently 8.2% of ŽFBH belong to private shareholders.

<sup>24</sup> Amendment published in the Official Gazette of FBH, issue No. 25/12 whose objective was for the FBH Railways to continue their operations as a limited liability company. The amendments reduced the number of members of the Supervisory Board (Management Board) from 11 to 7, and a new article was added, Article 21a, according to which the company is under obligation to act in compliance with the decisions of the Regulatory Board as determined in the Law on Railways of BiH.



The railway network in the Republika Srpska consists of 426 route-km (of which 353 route-km are in use) being one of the smallest networks in the Western Balkans region. ŽRS freight traffic density of about one million tonnes/route-km is high compared to neighboring countries and about 80 percent of the EU average<sup>25</sup>. In 2015, it carried around 5 million tonnes for 428 million net tonne-km (ntkm). Despite a weak overall financial status, ŽRS actually earns a healthy surplus on freight operations relative to its operating costs. By contrast, there are substantial losses on passenger services, even allowing for revenue support from the budget. Passenger rail transport is marginal to the RS's overall transport system, carrying only about 460 passengers/day. Passengers have declined in recent years and train occupancy (based on ŽRS data) now averages only about 16 passengers/train equivalent to less than half a bus-load. Even with RS budget support, passenger unit revenues cover around a third of direct expenses of passenger services and 16 percent of total operating costs. ŽRS is not financially sustainable in its current role and form. The amount of total revenues, including budget support, was just about sufficient to cover cash operating expenses, with labor costs representing a disproportionate component of the cost structure of ŽRS.

### **The policy challenges**

#### ***Restructuring for compliance with the EU railway acquis***

A specific policy challenge is to meet the terms of EU-Bosnia and Herzegovina Stabilization and Association Agreement (2015) as they apply to the railway sector. The obligation is to harmonize sector policies with the EU railway framework of directives and regulations (the 'EU railway acquis'). The framework needs action in a number of areas to become compliant. The areas that most immediately bear on responsibilities currently exercised by the Entity governments are those related to institutional structure, track access, budgetary support for passenger services; budgetary support for infrastructure; and debt sustainability. Compliance requires both structural and process changes in the railway sector.

#### ***Implementation of an affordable sector strategy***

A second and more long-standing policy challenge is the need for both Entities to settle on a financially sustainable railway sector strategy. Annual deficits recur year after year, even after receiving budget support from the respective Entity governments. This is partly due to railway employment policies and partly due to underfunded passenger losses. Over 97 percent of the traffic of both railways is freight, and both earn a creditable surplus on freight transport relative to operating costs. But nearly half of all the train distance run (42 percent in FBH and 49 percent in RS) comprises passenger trains. They carry few passengers but are a huge cost burden which consumes most of the freight surplus, which is therefore not available to re-invest in the freight rail business or contribute more to the upkeep of the infrastructure networks.

To illustrate the scale of this problem if, in compliance with the EU rail acquis, passenger services had been adequately reimbursed through Public Services Contracts (PSC) in 2014, the average subsidy per return trip would have been about BAM 108 in FBH, and BAM 168 in RS. While providing subsidies for non-profitable passenger lines through PSC is allowed, cross-subsidizing passenger trips from freight earnings is contrary to the EU rail acquis, but more crucially is a poor use of resources. Moreover, cross-subsidizing passenger services by freight increases the cost of doing business for firms relying on the railway freight, reflected in a high

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<sup>25</sup> Considering only the network length currently in use, this number is 1.2 million tonnes/route-km and equals the EU average.



average freight rate compared to neighboring countries. New sector policies are essential to make the railway system more cost-effective and sustainable.

### ***Adoption of a commercial management culture***

The third challenge is an extension of the previous two and is the imperative for railways to become, and be allowed by their owners to become, more commercially-focused. Both geopolitical and structural economic changes in the region mean that traffic levels can never reach historic levels experienced as part of the former Yugoslavia nor justify the levels of employment and assets that those high traffic levels supported. It is important that railway managements be allowed and encouraged to adopt a more commercial 'zero-based'<sup>26</sup> approach to the assets, human resources, operating and maintenance standards, workshop requirements, work practices and business processes they need to be successful in the future. In the short-term this is needed to make the railway sector affordable. In the longer-term it is necessary to give the industry a better chance of being successful in an integrated European transport market.

### ***Strengths of the sector***

In contemplating options, BiH starts with some strong and positive features - it has the two busiest railway networks in the Western Balkans region. The overall traffic density per route-km in BiH is the highest in the region. The density of freight traffic is comparable with the EU (some 80 percent of the EU average in RS<sup>27</sup> and 119 percent of the EU average in the FBH). Moreover, most of BiH's network is main-line and it does not have a large sub-network of underutilized branch lines which have been a formidable and enduring financial burden in most other countries in South East Europe. The basic infrastructure and rolling stock allow the companies to provide a reasonable freight service for most traffic realistically available. These fundamentals would allow substantial improvement in cost-effectiveness if railway sector policies were matched to the country's markets, scarce budget resources more productively used than they are now, and railway managements permitted and encouraged to run the railways as commercial transport businesses.

### **The structural options**

The Entity governments have various structural options in the way they configure the railways they own which could each be consistent with the EU railway acquis. Among the alternatives considered in the Policy Note are: whether to adopt a group company structure or separate companies; the institutional arrangements for delivery of passenger services; whether the ministry performing the policy functions of the sector should also administer the government's share ownership in public railway companies; and whether to privatize the freight transport operations (Figure 2).

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<sup>26</sup> Zero-based approach is a budgeting process that asks managers to build a budget from the ground up, starting from zero and allocates funding based on program efficiency and necessity rather than budget history.

<sup>27</sup> Considering only the network length currently in use, this number equals the EU average.



Figure A5.2. Railway Industry Structure: The Main Options

Key issue	Structural Alternatives		
Basic organizational form of state-owned railway enterprises	Group structure with holding company		Separate Infrastructure Management and Transport Operating companies
Location of a passenger rail management	Subsidiary in holding company structure	Independent freight and passenger companies	Subsidiary or Business Division of Transport Operating Company
Exercise of Entity share-owning functions	Line Ministry (MOTC)	Shared 'ownership' between ministries	A specialized central agency or department
Private participation in the state railway operator	Retain public ownership		Transfer to private owners/investors

**Holding company structure or separate companies (without a holding company)**

The most pressing structural issue is the institutional form of what are currently vertically integrated companies. The EU railway acquis allows a group structure with a holding company. Four EU countries use such model, the nature and merits of which are discussed in the Note. In the case of small railways similar to the ones in BiH, such a structure seems too 'top-heavy' and bureaucratic. The Bank team's view is that the simplest and most straightforward approach in each Entity is to create two separate companies: an Infrastructure Manager and a Transport Operating Company (13 EU countries have opted for such separation). Synthesized structures including a number of specific arrangements are found in other EU countries. Institutional separation would avoid the ambiguity and potential conflict of interest inherent in a group structure. The preference for separation is reinforced by the added weight the team gives to two factors in the evaluation criteria: first, there is the expectation under separation that clarity and focus in roles would lead to better management of the individual infrastructure and transport operating companies; and second it would enhance their ability to determine their own business strategies in the context of a European railway system in which each will have different opportunities and constraints, and sometimes different interests.

**Passenger rail services management**

The Bank team's favored approach is that passenger service management be established as a separately-accounted division or subsidiary of the Operating Companies. The EU rail acquis would require separate accounts be kept for the passenger division activities in order to verify and agree on the costs of the passenger Public Service Contract. Alternatively, the passenger company could be a specialist subsidiary of the Operating



Company, buying in most of its services (e.g. crew, rolling stock maintenance) from the main company at properly verified transfer prices.

### ***Vesting of government's share ownership***

Following the changes in company structures, it is considered better under EU framework to vest the ownership of the government's shares in new companies in a central agency or ministry of government other than the line transport ministry. There are potential conflicts of interest when a line ministry is both railway policy-maker and railway owner. Moreover, under the EU model the relationship between a line ministry as 'customer' and a railway enterprise should be governed by contractual arrangements that embody public policy aims. The owner and customer roles should clearly be kept separate. At the time of formation, it is considered better, if the option is available, to vest the ownership of the government's shares in the two rail enterprises in a central agency or ministry that will not be responsible for negotiating the PSC and MAIC contracts. Given that a minor proportion of shares in each existing railway company are already privately owned, it would also seem appropriate to encourage or incentivize such shareholders to swap their shares in the current integrated company for shares in the Operating Company. This would leave the Infrastructure Manager as a fully publicly-owned company while the Operating Company would be part-private, with the possibility of increasing the private participation later.

### ***Private participation in the Operating Company***

The Entity governments<sup>28</sup> currently hold majority ownership of existing companies but further privatization of the new Operating Companies is an option worthy of consideration. International experience and envisaged participation in a competitive European railway market suggest the government could benefit from considering the option of privatization before the market is opened. When the railway freight market becomes contestable each Entity's Operating Company will be vulnerable to competition for the best of their few markets. While the EU acquis does not favor either public or private ownership as a principle, the Bank's international experience is that under public ownership, freight railway operators are less likely to grow into the high-efficiency, high-performing enterprises necessary to compete successfully both with the predominantly private road transport industry and the other operators in the emerging European rail freight industry. Privatization should be seriously considered while the Operating Company still has dominant freight market positions and before the market becomes contestable because the value of the companies will deteriorate once it is.

### ***Structural options: implementation issues***

Irrespective of whether a holding company is established or not, the creation of separate operating and infrastructure companies needs to be well-planned and implemented and not just be a process of dividing existing assets, liabilities and human resources. The intention of restructuring is not just to harmonize with EU structures but to create a more effective and sustainable railway industry. Separation of the current railway companies in the two Entities into infrastructure and operating companies appears likely to require a new Railway Law in each Entity with legal obligations on companies to implement those parts of the EU rail acquis

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<sup>28</sup> In case of ŽRS, shares of state owned capital are managed by owners of shares: the Share Management Fund and the restitution Fund, which are within the structure of the RS IDB.



that fall to them (for example, in the case of the Infrastructure Manager, the preparation and publication of the Network Statement and access terms and conditions).

The new companies should be established with a clear commercial mandate to operate their businesses in the most efficient and effective manner. Their opening balance sheets should carry only the assets they need and any obsolete or surplus assets disposed of as soon as possible. They should not be burdened with the transfer of unsustainable loan obligations which they are unable to service and repay and which are in practice funded from the budget. The new companies should ideally only take over the staff they need to run the companies efficiently. Unless these issues are addressed prior to separation and a robust implementation plan adhered to, the new companies will simply inherit and share between them the current problems and inefficiencies rather than having the opportunity to make a clean start.

**The policy options**

The Entity governments have policy options in four main areas of railway development policy: railway jobs policy, the future of passenger services, the future of freight services and the level of investment in infrastructure. The options evaluated are shown in Figure 3. The World Bank team evaluated the policies using purpose-built financial models of each railway to estimate for the next 10 years (2016-2025) the total amount that each Entity budget would need to pay to sustain the railway financially through a combination of capital outlays and net operating deficit.

**Employment and productivity**

At the present employment levels, BiH’s railways will retain the lowest levels of labor productivity in the region and a cost to Entity budgets that past experience suggests is unaffordable. In both railways, labor costs constitute around two-thirds of operating costs. Employment levels have been heavily influenced by government job protection influences that in the ‘business-as-usual’ option would continue to amplify operating costs, reduce the funding available for equipment, works and services, and perpetuate labor-intensive operational practices that impede train operations. A second option of a sustained program of natural attrition of employee numbers would offer gradual improvements in productivity and budget affordability over a ten-year period compared to doing nothing. In this case the net operating deficit prior to budget support over ten years could be cut by around half in FBH and by about 40 percent in RS.

The adoption of railway labor restructuring programs in line with market demand and reasonable levels of labor productivity in each Entity would offer much greater efficiency and long-term competitive benefits in a single European railway market. The target in this third option would be to achieve regional best productivity by 2025, which should be facilitated by BiH’s relatively high traffic density and freight predominance (though the 2025 labor productivity levels would still be below EU average levels). In this case the net operating deficit prior to budget support could be cut by around 25 percent in FBH and by more than 90 percent in RS.

**Figure A5.3. Railway Industry Policy: The Main Options**

Key issue	Policy Choices		
Employment and productivity	Maintain current	Reduce employment	Adopt an early labor



	employment levels	through natural attrition	restructuring policy
Rail passenger public services	Current service level	Invest in improved passenger services	Discontinue rail passenger services
Contestability of freight market	No competition in foreseeable future		Third-party freight competition from 2020 <sup>29</sup>
Investment in railway network infrastructure	Current investment levels	Prioritize train control and associated improvements	Train control plus increased line speeds

**Rail passenger services**

Passenger rail services cost far more than the Entities’ budgets have shown willingness to fund but make a near-negligible contribution to BiH’s overall personal mobility needs. Passenger traffic density per network-km in both Entities is less than 2 percent of the EU average. In 2014 ŽFBH carried fewer than 1000 passengers/day (around 21 passengers/train) and ŽRS around 450 passengers/day (16 passengers/train). Improving labor productivity would help cut cost, but the basic problem is that trains are being run to serve passenger markets for which the use of railway technology is wholly uneconomic. Doing business as usual is an inherently unattractive option as it involves the Entities paying much more money than they do now (to avoid cross-subsidy) for a low-quality service performing a minimal transport role. A range of options for passenger services, ranging from rail services to be discontinued and public transport provided by good replacement bus services, to the rail services to be improved to attract a bigger market and perform a more significant role, is available.

Withdrawal of obligations to operate passenger rail services would beneficially transform the economics of each railway company and the budget support they require. In concert with higher labor productivity, this option would just about eliminate the need for net operating cost support from the budgets of the Entities. The Operating Companies would then be capable of operating profitably in their freight markets and, depending on their track access charges paid to the Infrastructure Manager, network infrastructure might nearly recover its operation and maintenance costs so requiring capital support only.

The option of reinvigorating passenger services by investing in modern rolling stock and providing better services on the main passenger routes could generate more passengers but its budget impact would be severe. The indicative policies tested in the Policy Note could increase passenger numbers by about 60- 65 percent. More efficient rolling stock would also provide some unit operating cost savings although these would be more than consumed by increasing service frequency to more attractive levels. This would result in an increase in the 10-year budgetary impact compared to discontinuing services would be about BAM 580 million in FBH and about BAM 91 million in RS (considering productivity improvement by labor restructuring).

<sup>29</sup> If the EU railway acquis is adopted this is not a strategic choice but will depend on the market. However, the two alternatives are included to illustrate what impact significant competition could have on sector finances.



While discontinuing passenger services is politically problematic, and reinvigorating may be unaffordable, there is a need for an informed assessment and implementation plan. An intermediate option would consist in identifying the services that should be kept and that Governments can afford to subsidize through Public Service Contracts. This would require a wider potential catchment survey of passenger transport demand that might be attracted to an improved railway service as well as detailed economic, social and environmental appraisal of the investments required. A much more explicit Public Service Contract would also need to be developed with a verifiable costing procedure that meets EU approaches.

### ***Rail freight services***

The strategic imperative is to try to hold onto the freight already carried and minimize vulnerability to envisaged third-party competition through efficiency improvements and customer service. In accordance with the EU rail acquis, freight rail services should be competitive and financially self-sustaining without budget support for the train operations so that business strategy decisions and rolling stock investment would be essentially matters for the operating company management rather than governments. It has not been possible to discern any substantial new commodity flows that railways could realistically target in RS. In FBH, there are potential traffic movements to/from the Port of Ploče that may be transferable to rail. Other things being equal (and without third-party competition) if railway freight in FBH could be increased by about 30 percent, the net operating results of the company could be improved over the ten-year period by about BAM 100 million.

With track access, the concentrated market of a few large bulk customers could be attractive to third-party competitors in both Entities. Infrastructure access rights would tend to pressure freight rates downward (which is the aim of competition) and probably reduce the volume of traffic carried by the Entity-owned Operating Companies. Naturally, if new operators were to win part of the freight market they would still pay track access charges for infrastructure and so the income of infrastructure management companies would not be diminished. Competitive markets are never predictable, but noting the competitive vulnerabilities, an indicative scenario was tested in which by 2025 the Company's markets would be reduced by 50 percent. This would increase the operating support required in FBH by BAM 77 million and in RS by BAM 45 million over the 10-year period because the increased track access income from third-party operators would not compensate for the anticipated reduction in net operating surplus from freight by the Entity-owned Operating Companies. In practice, sufficiently entrepreneurial managements might preserve more of their pre-existing freight markets but it is also possible that the impact could be greater.

### ***Rail infrastructure investment policies***

The Policy Note considers three development policies for the infrastructure sector depending on the level of investment that government wishes to make in the railway network. One policy is to sustain investments at the current level but this would perpetuate a number of operational problems. A second policy is to increase investment levels giving priority to the creation of an improved train control system which would include overcoming the numerous delays currently associated with train operations at level crossings. A third policy is to add to the train control system improvements yet higher investment to achieve higher line speeds. In the view of the Bank Team, investment in train dispatching and control (including level crossing control) to reduce operational delays and labor costs is the highest priority capital investment in both Entities. There is also an



additional case for rehabilitation of tracks on the more problematic track sections of Corridor Vc connecting Bosnia to the port of Ploče in the south and to Central and Western Europe in the north.



### ***Policy options: implementation issues***

The Policy Note assessed the financial consequences of various combinations of structural and policy options. All of the main elements of the policy options require more detailed evaluation and planning prior to decision and implementation. A labor restructuring program should have a sound basis in future business needs of the companies. Their managements would undertake a fundamental re-evaluation of their ways of working to identify the most efficient labor force capable of meeting the traffic commitments they can reasonably foresee. A labor restructuring program would also need to be able to demonstrate that it is fair and transparent, that full consultation with the workforce and trade unions has taken place, and that funding is available for satisfactory compensation packages and supporting social/retraining programs.

Deciding the future of passenger rail services requires a more detailed review of the public passenger transport market in the Entity corridors where passenger rail services currently run. More detailed passenger surveys could define the precise existing and potential markets for passenger rail service by origin-destination, journey purpose, age and gender, amongst other attributes. The option of withdrawing passenger rail services could then be accompanied by public transport policies to ensure adequate bus replacement services. Conversely, the passenger improvement policy option would require a more detailed economic, social and environmental appraisal of the investments required and a solid estimate of the costs of the Public Service Contract implied. (The financial model estimates suggest the budget support for such contract would need to be at many multiples of what government now pays for passenger rail services).

Third-party access will become obligatory if the EU acquis is to be adopted, but many of the details of implementation and timing need to be determined. Good practice Network Statements are available from other EU Infrastructure Managers.<sup>30</sup> Track Access charges should be structured in accordance with evolving EU guidance. When freight traffic no longer subsidizes passenger traffic it could in principle make a significant contribution to network infrastructure costs relative to many European countries or rates could come down increasing the attractiveness of rail. There is a strong case to implement only after labor restructuring, the proper separation of the infrastructure management from operating companies, and when the latter have been given the opportunity to re-organize themselves for commercial effectiveness. The implementation of track access in 2020 that was assumed in the financial model may be a reasonable target to aim for.

The final network investment programs would be developed by the management of the Infrastructure Management Companies in each Entity. The programs would need to be within a budget envelope agreed with Entity governments who will ultimately need to fund them. The program should cover a duration of at least five years and be renewable. The Note has concluded at a strategic level that greater centralization of train dispatching and control and better (and safer) control of level crossings is the main priority but there are track sections in both Entities where, if sufficient funds are available, a combined train control and track rehabilitation program could be a justified priority. A fuller investment appraisal could be used to optimize the projects which will provide highest returns.

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<sup>30</sup> A template according to EU rules is available at [www.rne.eu/network-statement](http://www.rne.eu/network-statement).



## **Implications for the railway sector at BiH level**

### ***Coordination between the railway companies in RS and FBH***

The adoption of new structural arrangements to comply with the EU railway acquis will present Entity governments and railways an opportunity to consider how best to cooperate for mutual advantage in a European railway market. At present, each railway enjoys de facto exclusivity in transport operations within its territorial boundaries. The most critical impact of the new structure will be the effective dismantling of both Entity and international boundaries so far as rail transport operations are concerned in accordance with the EU acquis. When the EU railway competition model is implemented, any train operating company licensed in the EU (including those of the two Entities) will be able to cross between the tracks of the FBH and RS Infrastructure Management Companies, and across those of neighboring countries, as already happens daily throughout the European Union. The Entities should consider how they might productively cooperate in such circumstances.

### ***Cooperation between transport Operating Companies***

It is likely to be in the mutual interest of the Operating Companies to partner to undertake marketing and operations on a co-operative basis. Cooperation to provide 'seamless' inter-entity and international freight services would tend to strengthen the operating companies combined competitive position relative to new entrants. Cooperation also has advantages in regional markets in that 'going it alone' from the relatively small resource base of each Operating Company may well be to the advantage of other, larger European operators.

### ***Co-operation between Infrastructure Managers***

The EU railway framework means the physical interface between the two infrastructure management companies will become less important than the economic interface. The challenge will be to ensure mutually advantageous coordination of network statements, train control performance standards and track access charges. When the two infrastructure management companies are in place, BHŽJK could provide the technical resource and institutional forum for the entities infrastructure managers to agree to harmonize key aspects of their Network Statements (or to publish a combined Network Statement). This would lower the cost of doing business for firms using the railways.

### ***The role of the Railway Regulatory Board to meet the EU acquis***

A good regulatory capacity and effectiveness is imperative to meet the EU acquis and provide for market access. According to RRB, it is sufficiently empowered under the BiH Railway Law (2005) to perform licensing, economic regulation, safety regulation and other functions compatible with the EU railway acquis. It already performs a range of BiH-wide licensing, regulatory and safety functions under its legislation. But when the railway market in BiH is opened, the actual economic regulatory tasks will include the access to the network and track access charges. Although the BiH railway sector is smaller than many in the EU, it also has a bigger freight market than many, plus two international SEETO Comprehensive Network freight routes of wider regional significance (north-south Corridor Vc and east-west route 9a). Moreover, RRB will effectively be regulator of two entity rail markets, two infrastructure managers and access administration and pricing issues pertaining to two separately-owned and managed networks.



### ***Railway infrastructure funding***

Implementation of a multimodal planning policy in Bosnia could lead to an alternative allocation of network infrastructure development funds between roads and railways. A multimodal approach in planning and financing transport infrastructure could put in perspective the comparative advantage of the railways, their important role in Bosnia's freight movements, the detrimental impact of overloaded trucks on roads and the environmental benefits of the railways. They could lead to an increase in the capital allocation for railways.

An alternative or complementary policy consists in raising additional funds to be allocated to the railways. Such approach can either be applied under the current sector planning approach as dedicated funds for the railways or under a multimodal planning approach discussed earlier raising additional funds to be invested in all transport modes, but leading to higher investment resources for railways.

There are a number of possible options for raising additional funds for transport investments. Traditional approaches include fuel taxes, classic road tolls, electronic distance-based tolling, vehicle registration and licensing fees, and freight related fees. In particular, fuel levies and electronic distance-based tolling have been successfully applied in Europe to raise additional funds for transport investments. However, each mechanism has its advantages and disadvantages and must be studied in detail before any attempt of implementation.





## **ANNEX 6: FINANCIAL PERFORMANCE OF ŽRS**

### **COUNTRY: Bosnia and Herzegovina Republika Srpska Railways Restructuring Project**

This Annex provides more detail of the financial performance of ŽRS in terms of both a time-series of results 2007-2014 (results since 2014 show some deterioration) and a cross-section of results by business sector (freight, passengers, network infrastructure) in 2014.

The company has been earning operating losses year-by-year (Table 1). Commercial revenue is dominated by income from freight with passenger fare income only 2 percent of operating revenues by 2014. Total operating expenses of ŽRS exceeded total revenues for each year during 2007-2016. Without budgetary support the working ratio (cash expenses divided by revenue) ranged from 1.43 to 2.13, representing a substantial and fluctuating commercial deficit. With budgetary support revenue became broadly sufficient to cover just cash operating expenses varying between 0.93 and 1.09. Budgetary support just about keeps the railway sector on 'life-support' but is not provided on the validated contractual basis as required by the EU railway acquis nor covers depreciation of assets.

Heavy overstaffing means that labour costs are a disproportionate share of the cost structure of ŽRS. In 2016, the wage bill was 64 percent of operating costs and 123 percent of commercial revenues (excluding Entity subsidies), growing in absolute terms by 35 percent by 2016. Depreciation is the second largest cost item, but since ŽRS had no commercial revenue or budget support actually to fund depreciation provisions the sector is also wholly dependent on the Entity government for meeting debt repayment obligations and future capital needs.

During 2009-2013 ŽRS invested on average 20 million BAM annually on rail infrastructure and rolling stock. Infrastructure investments included mainly overhaul and rehabilitation of track and modernization of signalling and telecom system on some sections. Rolling stock investments were slightly less and financed purchase of new and rehabilitation and overhaul of the existing rolling stock. The financing was made available to ŽRS through foreign and domestic loans.

Persistent financial losses prevented ŽRS from funding a material share of its capital expenditure and also servicing fully its debt obligations. As a result, International financiers, including IFIs and bilateral government financing – with total outstanding debt close to EUR 75 million – have been paid by the government (but charged to the railway account) and in addition the company is unable to cover the obligations towards its employees, which reached approximately EUR 38 million (excluding interests). In addition to the loans, ŽRS received annual subsidies for infrastructure however this amount declined over the years from over BAM 28 million in 2008 to BAM 17 million in 2014.



**Table A6.1.2. ŽRS Financial Performance 2007-2014 (BAM millions)**

	YEAR									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>Total Revenue</b>	65.12	72.14	66.51	72.06	77.08	71.39	69.77	71.38	64.40	71.17
Passenger	1.87	2.13	1.87	2.09	1.58	2.24	1.79	0.85	(N/A)	(N/A)
Freight	32.65	33.81	27.74	35.04	38.84	41.51	40.91	41.44	(N/A)	(N/A)
Other	3.11	3.71	4.42	2.94	4.26	2.64	2.07	4.09	(N/A)	(N/A)
<b>Total operating re</b>	<b>37.63</b>	<b>39.65</b>	<b>34.02</b>	<b>40.06</b>	<b>44.68</b>	<b>46.39</b>	<b>44.77</b>	<b>46.38</b>	<b>38.09</b>	<b>44.99</b>
State operating contribution	27.49	32.49	32.49	32.00	32.40	25.00	25.00	25.00	26.31	26.17
Passenger	6.93	3.93	3.93	3.78	3.65	2.81	7.04	7.89	(N/A)	(N/A)
Freight	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	(N/A)	(N/A)
Infrastructure	20.55	28.55	28.55	28.22	28.76	22.19	17.96	17.11	(N/A)	(N/A)
<b>Total expenditure</b>	<b>79.52</b>	<b>87.82</b>	<b>94.13</b>	<b>96.07</b>	<b>101.13</b>	<b>98.85</b>	<b>96.78</b>	<b>110.53</b>	<b>96.72</b>	<b>112.79</b>
Materials	7.23	7.86	8.00	5.57	4.91	5.20	5.28	5.58	8.36	8.82
Fuel, electricity	4.88	5.06	4.33	4.89	5.91	6.01	4.84	4.38	3.31	4.16
Salaries and allow	41.07	47.13	52.57	55.49	59.35	54.04	53.47	50.02	50.76	55.28
Outsourcing and services	9.70	7.15	7.45	9.89	6.57	8.13	6.10	6.51	2.26	1.97
Depreciation	13.37	14.63	14.34	12.51	11.59	12.11	12.00	15.68	15.94	16.18
Total operating expenditures	76.25	81.83	86.70	88.36	88.33	85.49	81.69	82.17	80.62	86.41
Non-operating expenditures	3.27	5.99	7.43	7.72	12.79	13.36	15.08	28.37	16.10	26.39
<b>Net income</b>										
With Entity contr	(13.79)	(14.57)	(26.51)	(20.33)	(18.51)	(21.37)	(23.06)	(33.80)	(32.32)	(41.63)
Without Entity contribution	(41.21)	(47.06)	(58.99)	(52.33)	(50.91)	(47.37)	(48.06)	(58.80)	-58.63	-67.80
<b>Working ratio</b>										
With Entity contr	0.97	0.93	1.09	1.05	1.00	1.03	1.00	0.93	1.00	0.99
Without Entity contribution	1.67	1.69	2.13	1.89	1.72	1.58	1.56	1.43	1.70	1.56

ŽRS does not keep separate sector accounts for its freight and passenger businesses but the Bank team has synthesised the underlying patterns through use of an activity-based sector costing model (described in Annex 4). The analysis shows that within the overall financial outturn, ŽRS earns a surplus on freight operations but made substantial losses on their passenger operations. For example, Table A6.2 provides sector results (passenger, freight and network infrastructure) for FY2014. The estimates suggest a passenger services loss of BAM 14.2 million after receiving budgetary support of BAM 2.5 million. The budgetary contribution is therefore wholly insufficient to fund the cost of services.

By contrast, there was a surplus earned on freight transport in an amount that was also (coincidentally) BAM 14.2 billion. The results indicate clearly the cross-subsidy from freight income to passenger services occurring within the company. In the infrastructure sector, income from track access charges for passenger and freight trains was about BAM 1.7 million compared to infrastructure operating costs of BAM 18.8 million, and the



modest overall operating surplus, due to budgetary support for infrastructure operating and maintenance costs of BAM 22.5 billion.

**Table A6.2: ŽRS estimated financial performance by sector, BAM millions (2014)**

Income and expenditure summary	Passengers	Freight	Network	Total
<b>Direct expenses</b>				
Labor	7.5	10.5	12.5	30.5
Materials	1.3	3.2	2.4	6.9
Fuel/energy	0.6	1.9	0.2	2.8
Other	0.4	4.3	0.8	5.5
<b>sub-total direct expenses</b>	<b>9.9</b>	<b>19.8</b>	<b>16.0</b>	<b>45.7</b>
Train control	5.6	6.4	0.7	12.7
Corporate	2.0	3.5	2.2	7.7
<b>Total operating costs</b>	<b>17.5</b>	<b>29.7</b>	<b>18.8</b>	<b>66.0</b>
Revenue	0.9	43.9	1.7	46.4
Budget support	2.5		22.5	25.0
Amortization				16.1
<b>Deficit/surplus</b>	<b>-14.2</b>	<b>14.2</b>	<b>5.3</b>	<b>-10.8</b>
Financial income				0.4
Financial expenses				13.9
Other revenue				4.3
Other expenditure				13.8
<b>Total Loss</b>				<b>-33.8</b>

Source: ŽRS financial statements and operational data and World Bank activity-based cost analysis. Total revenue, expenditure and loss of BAM 33.8 million reconciles to ŽRS financial statements. Note that both train control and corporate costs in the above table include significant labor components.

Adopting the EU railway acquis means the cross-subsidy from freight to passenger services would need to be phased out, with a service contract to be agreed with government for those loss-making passenger services specified by the Entity government to be socially necessary. Since all passenger services in Republika Srpska are heavily loss-making the contract would need to specify the full operating timetable and compensate ŽRS for the specific losses earned on each route or service-group. The Project provides not only for the development of such a ‘priced’ contract but also investigation of alternative and more efficient ways of providing the specified public transport services by more cost-effective railway operations or by contracting with road coach operators to provide replacement services of at least equal or better levels of service.



**ANNEX 7: LETTER OF SECTOR POLICY**

**COUNTRY: Bosnia and Herzegovina  
Railways Modernization Project**

Republika Srpska

Ministry of Transport and Communications

Trg Republike Srpske 1, tel. 051/339603, Fax:051339649, www.vladars.net; E-mail: msv@msv.vladars.net

Number: 13.04/340-971/17

Date, 15.05.2017

WORLD BANK

Fra Anđela Zvizdovića 1/B/17

71000 Sarajevo

**SUBJECT: Restructuring Policy of “Željeznice Republike Srpske” a.d. Doboj**

The management of the company “Željeznice Republike Srpske” a.d. Doboj, at the 107. Government session held on 12.01.2017, presented the document the Analysis of the status of the company ŽRS and the proposal for restructuring. The Government of Republika Srpska accepted it in the Conclusion number 04/1-012-2-18/17.

The main objective of the project of restructuring of Željeznice Republike Srpske a.d. is to improve the operational efficiency and to achieve financial sustainability of the Company, as well as to harmonize it with the European Union railway transport policy. The restructuring project should be realized through three components: ownership, financial and organizational restructuring. These three components are mutually closely connected, and the realization of each depends on the successful realization of the other two restructuring components.

In 2017, the Government of Republika Srpska adopted a new Law on Railways of Republika Srpska in order to underpin these objectives and create a legal basis for the restructuring of the railway company “Željeznice Republike Srpske” a.d. which is in majority owned by Republika Srpska.

The Government has requested financial support and technical assistance from the World Bank (WB) for the implementation of these policies.



### **The need to restructure Željeznice Republike Srpske**

In the document the Analysis of the status and the proposal for the restructuring of Željeznice Republike Srpske a.d., which was presented at the Government session and which was supported by the Government in its conclusion, a detailed analysis was performed of the assets, revenues and finances of the Company, showing a poor situation concerning the operations of Željeznice Republike Srpske a.d. The Analysis includes the five-year period 2011-2015 and shows that in every year of the analyzed period the operating costs largely exceed the revenues, and the total expenditures largely exceed the total revenues. The most prominent portion of expenditures are the expenditures related to gross salaries, compensation for salaries and other wages, followed by expenditures related to depreciation and those related to interest rates. Also, there is a noticeable growth of payables, as well as of accumulated loss. Of the total payables to creditors, Željeznice Republike Srpske a.d. is especially burdened by foreign credits, which it cannot service on its own, so it is done by the Government of Republika Srpska on its behalf. On account of this, the Government calculates legal interest on arrears, obligations towards Tax Administration, which threaten to block the bank accounts of the Company, and the obligations towards the employees for meal allowances, travel allowances and recourse for the period 2011-2016. With such difficulties in the daily operations, Željeznice Republike Srpske a.d. is not in a position to make significant investments in infrastructure and operations, which, as estimated, require around 800. 000. 000 KM worth of investment (600. 000. 000 KM in infrastructure and 200. 000. 000 KM in operations).

Republika Srpska also wants to harmonize its sector policy with the European Union railway directives and regulations framework, which assumes restructuring of debt of ŽRS to a sustainable level, separating the roles of management of infrastructures and transport services, with transparency of expenditures and properly-based budget support for passenger transport services and infrastructure and the preparation of railways for the possibility of access to a wider railway market of the European Union in the future. It is necessary for Željeznice Republike Srpske to become commercially more efficient in order to be competitive.

#### **The Government policy includes:**

- Ownership restructuring with the aim to make ŽRS a joint stock company fully owned by Republika Srpska.

Financial restructuring with the aim to improve liquidity, financial stability, reduce the debt level, and improve the overall business image of the Company.

- Organizational restructuring of ŽRS, (a) to perform restructuring of workforce to the level which will reduce operating costs and bring the productivity up to the level of regional norms, and (b) harmonize railways with the European railway framework, accounting regulations and commercial managing methods, while continuing to invest in railways, which is necessary for the economy.

#### **Measures of ownership and financial restructuring**

ŽRS are planning to use part of the funds from the credit of the World Bank for paying the company's debt to the employees. After the payment of debt to the workers, they cease to be creditors of the company, which increases the chances for adopting the Restructuring Plan by the Assembly of creditors, once the restructuring process formally begins before the relevant court, in accordance with the Law on Bankruptcy. Also, in



accordance with the Law on Bankruptcy of Republika Srpska, the debt owed by the Company to the Government of Republika Srpska on account of foreign credits that the Government is servicing on behalf of the Company, shall be turned into capital, which will make the debt of the Company sustainable. This will lead to the increase in the number of shares in circulation and reduce the value per share, which will decrease the purchase value of shares from small shareholders. Once the RS Government settles the debt of ŽRS to the workers and converts the debt owed to the Government of Republika Srpska into capital, it will be in a position to begin with the realization of the plans concerning the organizational transformation, including the restructuring of workforce.

### **Measures for organizational restructuring**

ŽRS started with the reduction of workforce through voluntary retirement. At the end of 2016, ŽRS had 3078 employees. The plan for the period of four years is to reduce the number of employees by approximately 1000 employees, so that the number of employees is reduced to circa two thirds of the current number, and compensations for workers will partly be financed from the loan of the World Bank. This will bring the average productivity rate of ŽRS closer to the regional norms. The Railway Unions have been consulted with regards to criteria and compensations for the termination of employment status and it has been requested that the World Bank specialist in this field helps ŽRS to ensure that the program is fair and transparent. The intention is to make the program voluntary, as much as possible. As for the majority of employees who will stay in the company, they will be required to raise the level of competence and knowledge through training, professional development and recruitment selection.

Also, it is necessary to perform the reorganization of ŽRS, where the experience and the support of the World Bank will be of great importance. According to the plan, the reorganized company will consist of a corporate core and two business units, which will have independent management and separate accounts, one for managing infrastructure and the other for operations. Within the operations unit, accounting will be done for freight and passenger transport. Three workshops for maintaining the rollingstock will be established as profit centers with separate accounting, but as an integral part of the corporation, and not as separate companies.

As for the organization of management and executive positions, executives should be authorized to make decisions that affect their business results. The new structure should be supported by the introduction of modern accounting and managing system, which ensures financial results and measures efficiency for every sector of the company. The Government may, in the future, decide to separate railway infrastructure and railway transport into two separate companies.

It will be important that, in the new organization, the outdated equipment and assets are gradually upgraded to a higher level of functionality, which assumes new investment in infrastructure and rollingstock.

The Government has decided to keep the passenger transport and to sign a contract with the operator on public transport with mandatory investment in the renewal of assets.

### **Timeframe of the implementation**



Should the funds of the World Bank become available to Republika Srpska by the end of 2017 to help financing this program, the intention is to implement the policies in the following time frame:

- Ownership and financial restructuring: to be completed in 2018
- Organizational restructuring: to be completed by 2021.

Sincerely,

Minister

Neđo Trninić



ANNEX 8: PROJECT MAP

