



EUROPEAN COURT OF AUDITORS

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EUROPEAN UNION DIRECT FINANCIAL SUPPORT
TO THE **PALESTINIAN AUTHORITY**

EN



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REPLY OF THE COMMISSION AND THE EEAS

ACRONYMS AND ABBREVIATIONS

AHLC: Ad Hoc Liaison Committee

AIDCO: EuropeAid Cooperation Office

AUPs: agreed upon procedures

CSP: support for civil servants and pensioners

CSDP: common security and defence policy

DFS: direct financial support

EEAS: European External Action Service

ENP: European neighbourhood policy

ENPI: European neighbourhood and partnership instrument

EUREP: Office of the EU Representative (Jerusalem) (also *ECTAO*)

NIS: New Israeli Shekel

oPt: occupied Palestinian territory

PA: Palestinian Authority

PEFA: public expenditure and financial accountability

Pegase: Mécanisme Palestino–Européen de Gestion et d’Aide Socio–Économique

PLO: Palestinian Liberation Organisation

PFM: public finance management

PRDP: Palestinian reform and development plan

PSRG: private sector reconstruction in Gaza

SEPS: support for essential public services

TIM: temporary international mechanism

UNDP: United Nations Development Programme

UNRWA: United Nations Relief and Works Agency for Palestine

VPF: support for vulnerable Palestinian families

EXECUTIVE SUMMARY

I.

The European Union has provided more than 5,6 billion euro in assistance to the Palestinian people since 1994 to support its overall objective of helping bring about a two-state solution to end the Israeli–Palestinian conflict. Since 2008, its largest programme in the occupied Palestinian territory (oPt) has been Pegase direct financial support (DFS), which provided approximately 1 billion euro in funding from 2008 to 2012. Pegase DFS seeks to help the Palestinian Authority (PA) to meet its obligations to civil servants, pensioners and vulnerable families, maintain essential public services and improve public finances.

II.

The audit examined if the Commission and the European External Action Service (EEAS) had managed Pegase DFS well. It was carried out from July to December 2012 and included a 2-week visit to the West Bank, including East Jerusalem, and Gaza in October 2012.

III.

The audit concluded that the Commission and the EEAS had succeeded in implementing direct financial support to the PA in difficult circumstances, but that a number of aspects of the current approach are increasingly in need of an overhaul. While some important results have been achieved, their sustainability is in doubt without major revisions to the current approach. As part of these revisions, the PA also has to be encouraged to undertake more reforms, notably in relation to its civil service. At the same time, a way needs to be found to bring Israel to take the necessary steps to help ensure that Pegase DFS is effective.

IV.

The audit found that several aspects of the programming of funding for Pegase DFS need to be strengthened. In addition, while the verification procedures established by the Commission are generally robust, there is scope for it to obtain savings by making more use of competitive tendering and simplifying the complex management system. The Commission and the EEAS have not made sufficient use of the large-scale funding from Pegase DFS to help leverage reforms from the PA, particularly in the field of civil service reform.

V.

Pegase DFS has reached the eligible beneficiaries and thereby made a significant contribution to covering the PA's salary bill. However, with the number of beneficiaries increasing and funding through Pegase DFS from other donors declining, there were serious delays in the payment of salaries by the PA in 2012 which led to unrest amongst the Palestinian population.

VI.

Pegase DFS has contributed to essential public services, but the audit found that in Gaza a considerable number of civil servants were being paid without going to work and providing a public service due to the political situation in Gaza. The Commission and the EEAS have not sufficiently addressed this problem.

VII.

Despite the large Pegase DFS funding, the PA was facing a severe budget deficit in 2012 which was also threatening to erode public finance management (PFM) reforms. Ultimately, however, the threat to the financial sustainability of the PA can to a considerable degree be traced to the manifold obstacles imposed by the Government of Israel to the economic development of the oPt. These obstacles also undermine the effectiveness of Pegase DFS.

VIII.

The report sets out a number of recommendations which the Commission and the EEAS should address when undertaking the necessary review of Pegase DFS.

INTRODUCTION

1. This audit report assesses the European External Action Service's (EEAS) and the European Commission's management of the direct financial support (DFS) provided through the Pegase mechanism to the Palestinian Authority (PA).

BACKGROUND

2. The European Union, in common with most of the international community, supports a two-state solution to the Israeli–Palestinian conflict. This envisages the creation of a viable, contiguous and democratic Palestinian state, living side by side with the state of Israel in peace and security.
3. The Israeli–Palestinian peace process began with the Oslo accords of 1993 and 1995. Israel granted some autonomy to the Palestinians while, in return, the Palestinian leadership, under the Palestinian Liberation Organisation (PLO), recognised Israel's right to exist. Both sides gave commitments that they would start talks regarding final status by May 1996 and conclude them by May 1999.
4. In the meantime, the West Bank was divided into three areas: Area A, which basically comprised urban settlements to be run by the PA; Area B, where the PA became responsible for civilian affairs but Israel remained for the time being in charge of security; and Area C, comprising 61 % of the territory of the West Bank, where both security and civilian affairs continued under Israeli control pending a final status agreement (see the *Map*). Israeli forces were to withdraw from the Gaza Strip over this period. East Jerusalem was not covered by the agreements.

MAP

WEST BANK AND GAZA



Note: Israel transferred control of the Gaza Strip to the Palestinian National Authority in 2005. Palestinian-controlled cities on the West Bank have been repeatedly re-occupied by Israeli forces.

Source: European Court of Auditors.

- 5.** In 2002, in view of the lack of progress in the Oslo process, the United States, Russia, the EU and the United Nations came together to form 'the Quartet on the Middle East'. The quartet established a 'Roadmap for peace' designed to lead to a two-state solution through the setting up of an independent Palestinian state alongside Israel over a period of 3 years. The most concrete initial progress was the appointment in 2003 of the first-ever Palestinian prime minister, but the key benchmarks of the roadmap were not fulfilled by either party.
- 6.** The peace process suffered a further setback in January 2006, when Hamas, which unlike the PLO does not recognise Israel's right to exist and is classified by the EU as a terrorist organisation, won the Palestinian parliamentary elections by defeating the Fatah party¹. In 2007, fighting broke out between Fatah and Hamas which led to a de facto division of the Palestinian territories in June 2007. Hamas took control of the Gaza Strip while the PA under Fatah continued to administer the parts of the West Bank under its jurisdiction. The EU has had a no-contact policy with Hamas throughout the period while aiming to maintain its assistance to the local population.
- 7.** As a result of the Hamas takeover, Israel imposed an even more stringent closure of Gaza in 2007 which led to a significant deterioration of the humanitarian situation there. At the end of 2008, Israel launched a 1-month military campaign in Gaza (Operation Cast Lead) targeting Hamas, which caused considerable loss of life and destruction of property. However, after a period of relative calm, a renewed rise in tensions led to Israel launching another military campaign in Gaza in November 2012 (see paragraph 73).
- 8.** In May 2011, Hamas and Fatah formally reached a reconciliation agreement, although no new general elections have been held and the two sides have still to agree on the conditions for the establishment of a unity government. With the UN General Assembly's adoption of Resolution 67/19 on 29 November 2012, Palestine, represented by PA President Mahmoud Abbas, obtained the status of 'non-member observer state' in the United Nations.

¹ Fatah, which was founded and headed by Yasser Arafat until his death in 2004, is the largest political faction within the PLO.

9. However, 2012 also witnessed a significant deterioration in the PA's already weak fiscal situation. Its overall fiscal difficulties are to a considerable degree due to the continuing restrictions placed on it by Israel. It is widely considered that these restrictions undermine the viability of an independent Palestinian state.
10. The EU has an association agreement with Israel which includes provisions for political dialogue, economic cooperation and trade liberalisation. Israel is also a European neighbourhood policy (ENP) beneficiary country. It is the only non-European country that benefits from an associated country status in the EU's framework programmes for research and development and the EU is Israel's largest source of public research funding².

² As of December 2012, the EU's seventh framework programme for research and development (2007–13) was funding over 1 200 projects involving nearly 1 500 Israeli participants.

³ The ENPI covers 16 beneficiary countries: Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Libya, Moldova, Morocco, Palestine, Syria, Tunisia and Ukraine.

EU FINANCIAL ASSISTANCE

11. Following the signing of the Oslo I agreement, the EU considerably increased its cooperation with the occupied Palestinian territory (oPt). An 'interim association agreement on trade and cooperation' was established between the European Community and the PLO on behalf of the PA in 1997. The primary objective of the very significant financial assistance was, and continues to be, to support progress towards the two-state solution. During the period 1994–2006, more than 2,7 billion euro was allocated to Palestine from the EU's general budget.
12. Under the EU's new ENP launched in 2004, an EU–Palestinian authority action plan was agreed in 2005 to support the PA's political and economic reform agenda over the next 3 to 5 years. A new action plan to replace the first one was being finalised at the time of the audit. After the introduction of the European neighbourhood policy instrument (ENPI) in 2007, funding was further significantly increased: between 2007 and 2012 some 2,9 billion euro in assistance was committed from the EU general budget (see **Table 1**). Indeed, approximately 20 % of the ENPI budget for all beneficiary countries is allocated to the oPt³.

13. As **Table 1** shows, the main focus of EU assistance has been on ENPI-funded direct financial support (DFS), which accounted for 47,4 % of the overall assistance in the period 2007–12. A significant share of allocations has also been made to UNRWA⁴, humanitarian and food aid and support for the rule of law (including two EU common security and defence policy (CSDP) missions).

⁴ The United Nations Relief and Works Agency for Palestine refugees in the Near East, which provides basic public services such as primary schooling and healthcare to some 5 million Palestinian refugees from the 1948 and 1967 wars and their descendants. UNRWA provides facilities in 59 camps located in Lebanon, Syria, Jordan, the West Bank and Gaza.

TABLE 1

TOTAL AID ALLOCATIONS TO PALESTINE FROM THE EU GENERAL BUDGET 2007–12 (MILLION EURO)

Priority areas	2007	2008	2009	2010	2011	2012	Total
Total from EU general budget	563,3	501,5	525,2	446,8	452,7	451,7	2 941,1
— of which ENPI	456,1	392,0	357,5	380,2	323,3	356,1	2 265,2
DFS ¹	370,0	258,0	219,1	237,7	145,0	166,0	1 395,8
Support for UNRWA ²	100,6	120,0	175,9	104,6	142,9	146,0	789,9
— of which ENPI	73,4	76,0	81,5	88,0	96,7	117,8	533,3
Other support (humanitarian and food aid, infrastructure, rule of law) ³	92,7	123,5	130,2	104,6	164,8	139,6	755,4
— of which ENPI	12,7	58,0	57,0	54,5	81,7	72,3	336,1

¹ All from the ENPI budget line for Palestine: 19.08.01.02. From 1.1.2007 to 29.2.2008 disbursements were made under TIM. From 2010 the total includes the support provided through the PSRG component.

² Mainly from the ENPI budget line 19.08.01.02.

³ From budget lines 19.08.01.01, 19.08.01.02, 19.08.01.04, 19.03.01/19.03.07/ 19.04.01/19.04.03 (Rule of Law, human rights and CSDP missions), 21.02.01/21.02.02/21.02.04 (Food aid), 21.05.01 (Investing in people) and 23.02.01/23.02.02 (humanitarian aid (ECHO) and emergency food aid).

Source: European Commission and European Court of Auditors.

- 14.** Direct financial support (DFS) was the EU's response to the political, fiscal and humanitarian crisis that followed the temporary suspension of most aid to the PA following Hamas' January 2006 election victory (see paragraph 6). The quartet agreed to a proposal by the EU in May 2006 to establish a 'temporary international mechanism' (TIM) that aimed to ensure the direct delivery of assistance to the Palestinian population while bypassing a Hamas-led government. The TIM, initially set up for 3 months, operated between June 2006 and February 2008. It was then replaced by the current Pegase mechanism, which is largely based on TIM (see **Annex I** for details).
- 15.** Pegase DFS has had the broad objective of helping the PA continue to function until the overall political objective of a two-state solution is achieved. The more specific objectives of Pegase DFS are:
- (a) to help the PA to meet its obligations towards civil employees, pensioners and vulnerable Palestinian families;
 - (b) to maintain the functioning of the administration and the provision of essential public services to the population;
 - (c) to implement public finance management (PFM) reforms and reduce the budget deficit (including reducing net lending and arrears due to the private sector).
- 16.** Between February 2008 and December 2012, Pegase DFS was provided through the five different components described in **Box 1**.
- 17.** **Table 2** gives an overview of the amounts committed to the individual Pegase DFS components up until December 2012. It shows that the support for civil servants and pensioners (CSP) was the most important component (72,5 % of total funding). A breakdown of all Pegase DFS disbursements to final beneficiaries for each month between February 2008 and December 2012 is provided in **Annex III**⁵.

⁵ This breakdown includes all Pegase DFS funds pooled in the sub-account of the PA single treasury account and not only EU general budget funds.

TABLE 2

PEGASE DFS CONTRIBUTIONS FROM THE EU GENERAL BUDGET PAID TO THE PA PER COMPONENT (2008–12) (MILLION EURO)

Donor	CSP	VPF	SEPS	Arrears	PSRG	Total
From EU general budget	726,9	137,5	106,6	10,0	22,0	1 003,01 ¹
Share of EU general budget contribution total	72,5 %	13,7 %	10,6 %	1,0 %	2,2 %	100 %

¹ Excluding the amount of 22,8 million euro in assigned revenues (From Austria: 1 million euro in 2008; 0,5 million euro in 2009; 1,5 million euro in 2010 and 1 million euro in 2011. From Japan: 4,78 million euro in 2011. From Belgium: 9 million euro in 2012 and 5 million euro dedicated to the World Bank programme 'ESSP' under the financing agreement ENPI/2008/019-776 (EC)).

Source: European Commission and European Court of Auditors.

BOX 1

PEGASE DFS COMPONENTS

- (a) **PA civil servants and pensioners (CSP)** (ongoing): civil servants and pensioners on the PA's payroll who are considered to be eligible are paid directly from a sub-account of the PA's single treasury account where all donor contributions to Pegase are pooled.
- (b) **Vulnerable Palestinian families (VPF)** (ongoing): Pegase DFS is given to support the PA in providing cash assistance to individuals living in extreme poverty in the West Bank and Gaza.
- (c) **Support for essential public services (SEPS) — provision of fuel to the Gaza power plant** (suspended at the end of 2010): the SEPS provided fuel to ensure the continued provision of electricity to people living in Gaza. The component was suspended at the end of 2010 and replaced by a development project in the electricity sector.
- (d) **Private sector arrears** (ongoing): through this scheme, the Commission pays unpaid bills accumulated by the PA towards private businesses.
- (e) **Private sector reconstruction in Gaza (PSRG)** (since December 2009): this component provides financial support for businesses destroyed or damaged during the Israeli 'Operation Cast Lead' offensive of 2008. It typically pays for items such as machinery, office furniture and equipment and buildings.

- 18.** The Pegase mechanism has been set up in such a way as to ensure that funds can be transferred directly to individual beneficiaries from a sub-account of the PA single treasury account. Before disbursements are authorised, all beneficiaries are screened in accordance with agreed upon procedures (AUPs) for the individual components by audit firms contracted by the Commission (for details see **Annex I**). These arrangements were designed to mitigate the risk of funding ineligible beneficiaries and terrorist activities. An international organisation has been contracted since the start of the programme to assist the Commission in its management.
- 19.** Since 2011, the European External Action Service (EEAS) and the European Commission's DG Development and Cooperation (EuropeAid) have been jointly responsible for the annual programming of Pegase DFS. The Office of the EU Representative⁶ (EUREP) in East Jerusalem is responsible for managing the implementation of the assistance through direct centralised management under EuropeAid's supervision.

⁶ The EU representative is appointed by the EEAS and functions as head of the EU delegation in East Jerusalem. In addition to the EU representative, there is a Council-appointed EU Special Representative to the Middle East Peace Process who acts as the EU envoy to the Middle East quartet (see paragraph 5).

AUDIT SCOPE AND APPROACH

20. The Court's audit addressed the overall question:
21. 'Have the EEAS and the Commission managed the Pegase direct financial support (DFS) to the Palestinian Authority well?' To answer this question, the audit focused on:
- (a) the design and implementation arrangements for Pegase DFS;
 - (b) the results of Pegase DFS and their sustainability.
22. The audit examined Pegase DFS from 2008 to 2012. It also examined related technical assistance contracts, notably in the area of public finance management, signed during this period. The Pegase DFS financing agreements covered by the audit totalled 1 025,8 million euro, while the TA contracts audited amounted to 36,9 million euro. The complete list of financing agreements and contracts covered is given in **Annex II**.
23. The audit was carried out between 1 July and 31 December 2012 and gathered evidence for its assessment through documentary review and interviews. It included work in the West Bank, including East Jerusalem, and Gaza, from 30 September to 12 October 2012 (see the **Map**, paragraph 4).
24. The audit relied as far as possible on the work of auditors contracted by the Commission for the Pegase DFS for the period February 2008–December 2011 (see **Annex I** for more details). To test the reliability of the work carried out by other auditors, the audit conducted walk-through tests of the AUPs for a sample of payments as well as on-site checks and interviews of 20 beneficiaries employed by two schools and two hospitals in the West Bank and Gaza⁷. The audit also included on-site checks and interviews of 10 VPF beneficiaries in the West Bank and Gaza and two beneficiaries of the private sector arrears and PSRG components.
25. A PFM expert with considerable experience in the region assisted in assessing the state of the PA's public finances and the progress it had made in PFM reform.

⁷ Rafidia hospital (Nablus) and Aziz Shahin school (Ramallah) in the West Bank and Al Shifa hospital and Al Zahra school in Gaza City.

OBSERVATIONS

DESIGN AND IMPLEMENTATION ARRANGEMENTS: THERE IS A NEED TO REVISE A NUMBER OF ASPECTS

- 26.** In assessing the design and implementation arrangements for Pegase DFS, the audit examined whether:
- (a) a strategic framework and objectives relevant to the strategy had been clearly defined and regularly reviewed;
 - (b) allocations to DFS reflected needs;
 - (c) performance indicators were established;
 - (d) Pegase DFS was adequately coordinated with other donors;
 - (e) the risks to sound financial management had been comprehensively assessed and mitigation measures put in place;
 - (f) the controls established were economical;
 - (g) conditionality and a process of policy dialogue had been established.

PROGRAMMING FRAMEWORK IN NEED OF STRENGTHENING

- 27.** The 2005 EU–PA ENP action plan represented the overall basis for EU–PA cooperation. However, there was no specific linkage between priorities set out in the action plan and the Pegase DFS support, although the latter was the EU’s most important funding instrument.
- 28.** When developing the Pegase DFS programme, the Commission sought to target the priorities set out in the 3-year national development programmes of the PA: first the 2008–10 Palestinian reform and development plan and then the 2011–13 Palestinian national development plan. However, Pegase DFS funding was only provided on an annual basis rather than in line with the 3-year cycle of these national development plans, although the latter would have facilitated the planning of the assistance.

- 29.** The budget for Pegase DFS funding is decided on each year under considerable time pressure. The Commission does not apply its standard internal quality review procedures to the annual Pegase DFS programme and consults the ENPI committee over the programme only through a written procedure. This has made it more difficult for the Commission to carry out detailed reviews of the mechanism. Since the launch of Pegase DFS in February 2008, few substantial changes have been made to the main CSP component (see **Box 1**). This is in spite of changes in the operational environment, including the increasing number of beneficiaries, the rise in the number of civil servants not attending work after public sector strikes in Gaza in August–September 2008 and the growing need for civil service reform (see paragraph 46).
- 30.** The Pegase DFS mechanism was intended to facilitate donor coordination, and hence improve the efficiency of aid delivery, by also allowing both EU Member States and other donors to channel funding through this single instrument. However, this has become less and less the case as **Table 3** indicates: the proportion of the main DFS component financed from sources other than the EU budget dropped from 32,6 % in 2008 to 14,8 % in 2012. This in part reflects a general decline in donor funding. Furthermore, some EU Member States also use other mechanisms such as the World Bank Palestinian reform and development plan (PRDP) Multi-Donor Trust Fund as well as bilateral funding. At the same time, the Commission has attracted little funding from non-EU countries.
- 31.** No performance indicators were included in the financing agreements for Pegase DFS, which makes it harder for the EEAS, the Commission and the Member States to assess the concrete results of the support (see also paragraph 53). The lack of performance indicators also makes it more difficult to demonstrate results in order to attract new funding. Moreover, this does not comply with the ENPI regulation's explicit requirement that performance indicators be established for monitoring purposes for all forms of ENPI assistance⁸.
- 32.** The Commission and the EEAS have not developed a clear strategy on how to reduce the PA's dependency on Pegase DFS support over time. While the uncertain political situation makes it unrealistic to establish a definitive exit strategy, it would nevertheless have been desirable to develop a clear approach, in conjunction with other donors, the PA and Israel, to gradually reduce the need for donor funding.

⁸ Article 13 of Regulation (EC) No 1638/2006 of the European Parliament and of the Council of 24 October 2006 laying down general provisions establishing a European Neighbourhood and Partnership Instrument (OJ L 310, 9.11.2006, p. 1).

TABLE 3

DONOR CONTRIBUTIONS TO PEGASE DFS CSP 2008–12¹ (MILLION EURO)

Donor	2008	2009	2010	2011	2012	Total
Denmark					6,03	6,03
Ireland	1,50	1,50	0,50	1	1	5,50
Spain	20	25	30	20	4	99
Luxembourg	0,50	0,50	0,50	0,50		2
Hungary	0,20					0,20
Malta	0,15					0,15
Netherlands	19,85 ²	8,92 ³	5,07 ³		6,50	40,34
Slovenia	0,15					0,15
Finland	3	2		1		6
Sweden	10,62	4,60	5,20	6,60	5,13	32,15
United Kingdom	20,80					20,80
Member States subtotal	76,77	42,52	41,27	29,10	22,66	212,32
% of total	32,6 %	22,0 %	19,4 %	20,1 %	14,8 %	22,6 %
EU general budget	159	150,50	171,40	116	130	726,90
% of total	67,4 %	78,0 %	80,6 %	79,9 %	85,2 %	77,4 %
Total	235,77	193,02	212,67	145,10	152,66⁴	939,22

¹ The table includes payments to PA salaries and pensions under the TIM in January and February 2008.

² Amounts include 6 million euro for the payment of salaries to the civil police/defence (CPD) of the PA, made on 17.2.2009.

³ Earmarked for the payment of salaries to the CPD of the PA.

⁴ The amount includes 26,2 million euro for the payment of December 2011 PA salaries/pensions, made on 5.1.2012.

Source: European Commission.

ROBUST ELIGIBILITY VERIFICATION PROCEDURES BUT SCOPE FOR SAVINGS

- 33.** The Commission established specific verification procedures for the Pegase DFS which are well designed to ensure that funds are only used to pay beneficiaries which meet the specified eligibility criteria (see *Annex I*, Boxes 1 to 3). This is in contrast to traditional budget support programmes where funds cannot be tracked to the final beneficiary after the Commission has transferred them to the beneficiary country's treasury account.
- 34.** However, the Commission has not prepared a risk assessment addressing other Pegase DFS-related risks, such as the specific risks of corruption in Gaza, funds not being used for supporting public service delivery or the destruction of EU-funded infrastructure by the Israeli military.
- 35.** At the same time, the lack of a detailed risk assessment has also meant that the costs and benefits of detailed individual controls have not been assessed. Such an assessment could be used to identify controls which are not cost-effective.
- 36.** All contracts with audit firms and the international organisation⁹ for the AUPs were signed following direct negotiated procedures. The Commission justified its use of such flexible procedures by reference to the crisis situation in the oPt¹⁰. However, even in countries and territories considered to be in crisis, the Commission may still apply competitive tendering procedures where feasible. The Court considers that competitive tendering would have been feasible for contracts for management services and audit.
- 37.** The continuous use of the same international organisation as a contractor to assist in the management of Pegase DFS has put EUREP in a position of increasing dependency on the international organisation over time. This dependency is problematic due to the critical and sensitive nature of the international organisation's tasks, particularly in relation to its management of the Pegase information system database on payments to individual beneficiaries. The Commission's contracting of these management services tends to start late in the year and this is then used as a reason for applying direct negotiations to speed up procurement.

⁹ The organisation is specialised in post-conflict reconstruction interventions, including damage assessments.

¹⁰ Notes from the Director-General of AIDCO, Koos Richelle, of 1.12.2006, 3.7.2007, 20.6.2008 and 15.7.2010 — extension of acknowledgement of the crisis situation; note of 26.6.2011 of Mr Fotiadis, DG Development and Cooperation — EuropeAid. Prior approvals for using flexible procedures were formally granted by the Head of EUREP in accordance with Article 190(2) of the implementing rules of the financial regulation.

- 38.** Although the eligibility verification checks are robust, there is scope to reduce the number of procedural steps¹¹. Similarly, the Pegase database management procedures are complex: the verification of the data in the database requires the involvement of an outside contractor, an audit company and the Commission, both before and after disbursements (see **Annex I**, paragraphs 8 to 13). In recognition of the need to simplify the Pegase DFS system, the Commission has launched a study in three phases of which two were completed as of May 2012¹².
- 39.** The daily fee rate of 1 642 euro paid by the Commission for the team leader of one of the contracted audit firms is substantially higher than rates paid to other 'Big 4'¹³ firms working in the region. The rate of 1 000 euro for a team leader applied by another audit firm, which is contracted to carry out most of the AUPs, is more in line with the rates paid to other 'Big 4' audit firms. However, if the Commission had used competent local audit firms, it could potentially have achieved further savings in fee rates for this contract of 25 %¹⁴. As the AUPs did not require expertise in applying internationally recognised accounting and auditing standards, any additional expertise a 'Big 4' audit firm might offer was not required.

POTENTIAL LEVERAGE REDUCED DUE TO ABSENCE OF CONDITIONALITY

- 40.** Pegase DFS is provided to the PA without conditionality. The only basic requirement for the disbursement of funds is that the individual beneficiaries meet the eligibility criteria set by the EU (see **Annex I**). The EEAS and the Commission have followed this approach to ensure that the PA benefits from a predictable flow of funds without the risk of funding being blocked by the Commission because conditions are not met. However, this approach also reduces the potential leverage its considerable funding could give it to push for more reforms from the PA. While the EEAS and the Commission's 2011 review of the European neighbourhood policy envisaged more funding for countries which made more progress with reforms (the so-called 'more for more' principle), such an approach has not yet been introduced for the oPt¹⁵.

¹¹ For the CSP and VPF components, the 'activity flows' describing the checks to be performed by the EUREP, audit firms, PA and banks consist of more than 50 actions. Excluding the PA staff involved, the Pegase DFS checks require the involvement of 16 full-time equivalent employees.

¹² Two of the three simplification scenarios proposed in the Phase 2 report propose that a part of the work now carried out by audit firms, such as the IT-based checks, be taken over by the EUREP and the PA. They also propose that the function currently carried out by the international organisation be fully or partly insourced to the EUREP. The report estimates the potential savings of choosing the most economical scenario at 472 200 euro per year or just over 1 million euro after 3 years.

¹³ Deloitte, KPMG, Ernst & Young and PriceWaterhouseCoopers.

¹⁴ The Court compared the fees paid with the fees of 'Big 4' and other international audit firms contracted by the Commission for other audits in the West Bank, Lebanon, Jordan, Syria and Egypt. For these, the daily fee rates for team leaders varied between 1 100 euro and 1 250 euro. A competent West Bank-based audit firm visited by the audit team who was contracted by other donors, including USAID, charged 750 euro per day for a team leader.

¹⁵ A new response to a changing Neighbourhood', COM(2011) 303 final, 25.5.2011.

41. Even without conditionality, the large scale of Pegase DFS provides an opportunity for the EEAS and the Commission, in conjunction with the wider donor community, to have a structured dialogue with the PA on key reform issues in areas benefiting from the funding, notably civil service management reform (see paragraph 46) and achieving better value for money in the education and health sectors. However, only limited progress has been made in these areas through dialogue with the PA.

- (a) Dialogue within the framework of implementing the CSP component has largely been limited to practical issues related to individual, recurrent payrolls.
- (b) Little progress has been made through the dialogue in the donor-PA sector working group on public administration and the civil service, which did not meet at all between February 2011 and October 2012. The health sector working group has also not functioned satisfactorily.
- (c) The subject of civil service reform was raised by the Commission in the 2008 annual meeting of the ENP sub-committee dealing with the governance reforms contained in the action plan. However, it was not until 2012 that a civil service law was selected by the sub-committee as a 'deliverable' from the PA.

42. Pegase DFS financing agreements have systematically included a special condition requiring Israel not to impose additional restrictions on the oPt. While fulfilment of this condition could have a significant impact on improving the effectiveness of DFS, the EEAS and the Commission, despite increased efforts since 2012, have not been able to secure Israel's agreement to comply with it. This is notwithstanding the fact that Israel is ultimately also a beneficiary of Pegase DFS, at least to the extent that Pegase DFS contributes to relative stability in the neighbouring oPt¹⁶.

¹⁶ It could be considered from the perspective of the Fourth Geneva Convention relative to the Protection of Civilian Persons in Time of War that Israel benefits from the fact that Pegase DFS contributes to basic public services in the oPt, the cost of which would otherwise have to be met by the occupying power.

RESULTS AND SUSTAINABILITY: PEGASE DFS HAS ACHIEVED SOME RESULTS BUT THEIR SUSTAINABILITY IS INCREASINGLY AT RISK

- 43.** The audit examined for each of the three key objectives (see paragraph 15) whether:
- (a) Pegase DFS was used for the intended purpose;
 - (b) amounts paid to individual beneficiaries were justified;
 - (c) objectives, expected outputs and results were achieved;
 - (d) appropriate steps were taken to ensure sustainability.

¹⁷ The spike for the December 2011 payroll shows that the entire annual contribution from Spain was used to contribute to that payroll (see also **Table 3** and data in **Annex IV**).

PEGASE DFS IS REACHING THE ELIGIBLE BENEFICIARIES BUT TRANSFERS ARE BECOMING DELAYED

CSP COMPONENT

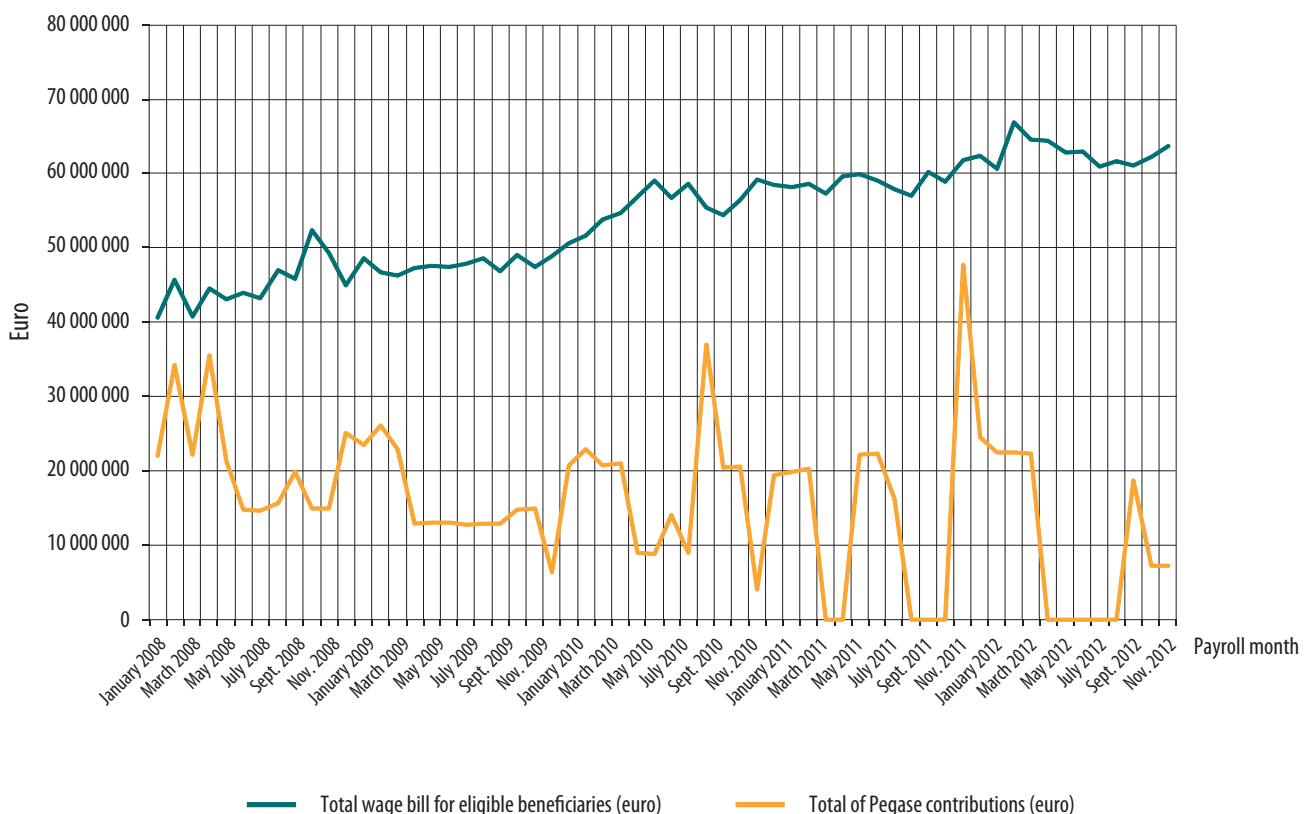
- 44.** The audit confirmed that Pegase DFS funds were paid to and reached the eligible beneficiaries. From 2008 to 2012, the average number of civil servants and pensioners that regularly had part of their salary paid by contributions from the CSP component rose from 75 502 to 84 320. This represents approximately half of the PA's 170 000 civil servants and pensioners.
- 45.** During this period, the average monthly PA wage bill for beneficiaries eligible for Pegase support rose from 45,1 million euro to 62,9 million euro, an increase of some 39 %. However, at the same time, contributions from Pegase DFS for the CSP fell from 21,3 million euro (47 % of total pay to eligible beneficiaries) in 2008 to 10,4 million euro (16 %) in 2012, mainly due to reductions in contributions to Pegase DFS from other donors. This is putting increasing strains on Pegase DFS's capacity to effectively support this component. As **Figure 1** shows, contributions from Pegase CSP were made to every PA payroll up to the March 2011 payroll. Since then, contributions have been less regular and assistance has been increasingly frontloaded to the first quarter of the year as the PA's revenues are particularly under pressure during this period¹⁷.

46. After rapid expansion between 2000 and 2007, since 2008 the PA has tried to limit the growth in public sector employment to 3 000 employees per year. However, this level of growth still represents a significant additional burden on the overstretched budget. At the same time, the PA has made little progress on civil service and pension reforms to reduce the fiscal impact of the increasing numbers of staff and pensioners, for example, by reducing the number of PA staff or amending the rules regulating entitlements¹⁸. The EEAS and the Commission, along with the wider donor community, have not succeeded in developing a reform agenda to tackle these issues.

¹⁸ While a decision to freeze public hiring and promotions could be an appropriate measure in the short term, a more comprehensive long-term agenda should focus on structural reforms for the civil service system. This could include a review of public service grades and pay scales, including allowance categories, which are currently prescribed in the 'Civil service law' (World Bank economic monitoring reports to the Ad Hoc Liaison Committee (AHLIC), dated 18.9.2011 and 23.9.2012).

FIGURE 1

TOTAL PA WAGE BILL FOR CSP-ELIGIBLE BENEFICIARIES COMPARED WITH THE PEGASE DFS CONTRIBUTIONS PAID TO BENEFICIARIES (2008–12)



Source: European Commission.

- 47.** The EEAS and the Commission have focused on ensuring Pegase DFS reaches eligible beneficiaries, but have not paid sufficient attention to the fungibility of the funding provided. Pegase DFS support to the CSP component has freed up the PA's own budget for funding personnel which are not eligible for Pegase DFS, including the PA's security apparatus.
- 48.** A clear sign of the challenges to the sustainability of the present system, in the absence of civil service and pension reform, is the increasing difficulty the PA has had in paying salaries and pensions on time. From February 2008 up until June 2012, of the 52 monthly PA payrolls, 47 were made within 7 days of the end of the payroll month. However, for all PA payrolls between June and December 2012, salaries and pensions were paid with more than 10 days' delay, and in up to three instalments, due to the lack of funds. These delays led to demonstrations and strikes among civil servants from September 2012¹⁹. The unpredictability of funding and resultant social unrest threatens to undermine the previous achievements of Pegase DFS.

VPF COMPONENT

- 49.** The audit also confirmed that the VPF component had been paid to the eligible beneficiaries as listed in the Ministry of Social Affairs' database. The average quarterly contribution to the VPF component was 9,7 million euro. Until 2011, Pegase DFS provided 100 % of the funding for the VPF, since then it has provided approximately 74 % while the PA has provided 26 % to beneficiaries eligible for Pegase VPF support. In addition, since 2011 the PA has supported another 30 000 to 40 000 beneficiaries not eligible for Pegase DFS support. In total, the EU provides 47 % of the total cost of the social allowance payments, while the remaining 53 % are covered by the PA (50 %) and the World Bank (3 %) (see **Annex V**).
- 50.** In contrast with the CSP component, the PA and donors, including the EU, worked closely together to reform social assistance leading to a significant overhaul of the system in 2010. The reform has produced a more rational system for targeting VPF through the use of proxy means testing. Technical assistance from the Commission contributed to the reform process.

¹⁹ There were strikes in September 2012 (*Palestinian Economic Bulletin*, Issue 72, The Portland Trust, September 2012, p. 1) and most recently in February 2013 (*Palestinian Economic Bulletin*, Issue 77, The Portland Trust, February 2013, p. 2).

- 51.** Despite the progress made on reforms, the social protection system is also stretched by a growing number of beneficiaries. The average number of beneficiaries supported by the quarterly contributions from VPF increased from 44 035 in 2008 to 59 915 in 2012²⁰. Because of the pressure on the system, the current level of support provided to beneficiaries is low: it is estimated to cover only 19 % of a typical household's consumption, due to the large size of many of the households dependent on the support.
- 52.** The difficulties the PA has in funding the system are reflected in recent payment delays. While the quarterly payments under the VPF component were made on time up to the third quarter of 2011, since then three of the payments (October 2011, April and October 2012) have been made with delays of between 1 and 3 months (see **Annex V** for data). As for the CSP component, these delays in VPF payments in 2012 reflect the PA's mounting fiscal crisis.

²⁰ This is despite the freezing of the caseload of beneficiaries in Gaza since October 2009.

PEGASE DFS HAS CONTRIBUTED TO ESSENTIAL PUBLIC SERVICES BUT HAS ALSO PAID CIVIL SERVANTS WHO ARE NOT WORKING DUE TO THE POLITICAL SITUATION IN GAZA

SUPPORT TO THE DELIVERY OF PUBLIC SERVICES

- 53.** Approximately 53 % of the Pegase funding for salaries from the CSP 2008–12 went to the education sector and 17 % to the health sector. Thus Pegase DFS has also made significant inputs to the delivery of essential public services. In the absence of performance indicators linked to Pegase DFS (see paragraph 31), it is more difficult to assess how far the sectors supported by Pegase DFS have obtained value for money from the inputs provided.

- 54.** However, the audit found indications that in Gaza a considerable number of civil servants were receiving salaries, partly funded by Pegase DFS, because they were eligible for support by virtue of being on the PA payroll but who were not going to work due to the political situation in Gaza (see paragraph 6)²¹. Out of 10 Gaza beneficiaries selected by the audit for interviews, three stated that they were not working, while one was absent. The audit also found that the State Audit and Administrative Control Bureau was obliged, in accordance with PA regulations, to pay salaries for its 90 staff members in Gaza, all of whom are unable to work. These findings are consistent with estimates based on data from interviews provided in a 2010 evaluation of Pegase contracted by the Commission which indicated that 22 % and 24 % respectively of the staff employed by the PA Ministries of Health and Education in Gaza were not working at the time²².
- 55.** The Commission and the EEAS, while aware of this problem, have not taken adequate steps to address it and were unable to provide clear information on the extent of this practice. Given the amount of money which the EU is providing through Pegase DFS, it would have been expected that they could obtain such information from the PA. The audits contracted by the Commission were not designed to find out whether personnel being paid by Pegase DFS were actually working, only that they were eligible for funding.
- 56.** Despite the importance of this issue, there was no transparent reference to Pegase DFS being used to pay non-performing workers in any of the Commission's financing documentation for the annual programmes.
- 57.** The audit also found that Gaza beneficiaries of the Pegase DFS CSP component have to rely on PA contact persons in their workplaces to communicate with the PA on changes in their situation affecting pay and allowances. However, these contact persons in some cases cannot operate openly towards the Hamas-led administration. The informal nature of these communication channels between Gaza civil servants and the PA in Ramallah makes the payroll system prone to corruption by actors at all levels. The EEAS and the Commission have not addressed these risks.

²¹ Some civil servants were dismissed after the Hamas takeover because they supported the PA, while others were demoted or locked out following the PA trade union strikes of August–September 2008.

²² Interviews conducted in January 2010 (interim Pegase evaluation 2010, pp. 23–24).

58. While Pegase is intended to support public services for the benefit of the Palestinian population, the payment of non-performing civil servants does not serve this objective.

PROVISION OF FUEL TO THE GAZA POWER PLANT

59. Pegase DFS also provided fuel for the Gaza power plant from 2008 to 2010 at a cost of 183,8 million euro, including 106,6 million euro from the EU general budget²³. The use of industrial fuel rather than gas, which the plant was originally designed for, was neither an economical nor a sustainable solution. Whilst this support did help provide electricity, power cuts continued²⁴. The ending of donor funding towards the end of 2010 and the ongoing Israeli blockade of Gaza has led to a deterioration of the situation.

60. Approximately half (some 90 million euro) of the Pegase DFS funding for fuel purchases was spent on VAT and excise duties. The Commission was unable to establish how far this amount was refunded to the PA by the Government of Israel through the agreed clearance mechanism (see also paragraph 70). It was also unable to establish whether the PA actually used reimbursed amounts for the intended purpose of providing essential public services. This represents a shortcoming in the Commission's management of Pegase DFS²⁵, especially when the PA is struggling to meet even its most basic obligations.

THE FINANCIAL SUSTAINABILITY OF THE PA IS AT RISK DESPITE THE LARGE-SCALE FUNDING FROM PEGASE DFS

PUBLIC FINANCE MANAGEMENT REFORMS

61. A public expenditure and financial accountability (PEFA) assessment included in a 2007 World Bank public expenditure review provided a robust baseline for measuring improvements in PFM. However, a follow-up exercise has not yet been carried out despite improvements in PFM being a key objective of Pegase DFS and it being standard practice to have follow-up PEFA exercises every 3 to 5 years. Only in 2012²⁶ did the Commission recommend to the PA that such a follow-up should be carried out.

²³ Some 65,3 million euro was funded by Germany.

²⁴ Scheduled electricity cuts in Gaza since July 2006: Saturdays, 8.00–16.00; Sundays, 16.00–23.00; Tuesdays, 8.00–16.00; Wednesdays, 16.00–23.00; Fridays (alternating weeks), 8.00–16.00 and 16.00–23.00.

²⁵ The Court of Auditors drew the Commission's attention to the problem in connection with its work on the *Declaration d'Assurance* 2008. EuropeAid's Internal Audit Capability highlighted it in connection with its 2009 audit of Pegase.

²⁶ Recommendation in 'Implementation of the European Neighbourhood Policy in the occupied Palestinian territory — Progress in 2011 and recommendations for action', SWD(2012) 120 final, 15.5.2012, p. 3.

- 62.** The most recent PFM assessments of the PA²⁷ suggest that while there have been some improvements in PFM, there are still significant shortcomings. Among the weaknesses identified is the inadequate legislative scrutiny of the budget and the external audit reports. Weaknesses were also noted in government procurement and commitment controls and in the availability of information on resources received by service delivery units.
- 63.** DFS and related technical assistance has contributed to some of the improvements in the PA's PFM.
- (a) Technical assistance has been provided to help develop the internal audit function. For the main completed project, the outputs had mostly been achieved although the internal control component suffered from shortcomings. The activities of another, still ongoing, internal audit project were broadly on track.
 - (b) Technical assistance is also being provided to the national audit body, the SAACB, although it is subject to some delays. More fundamentally, the SAACB's independence and effectiveness is threatened by the continued absence of an active and effective parliament for it to report to.
 - (c) The project 'Palestinian National Authority's financial institutions' provided training and equipment to the Ministry of Finance. Most deliverables were achieved as planned.
- 64.** However, the mounting economic crisis faced by the PA means that gains in institution building, especially in the area of public financial management, risk being eroded²⁸.

THE OBJECTIVE OF REDUCING THE BUDGET DEFICIT

- 65.** Pegase DFS has provided more than 1 billion euro to the PA, or an average of some 200 million euro each year, between 2008 and 2012. This corresponds to more than 10 % of the PA's annual revenues and, as such, has played a key part in keeping the PA's budget deficit down.

²⁷ Including the International Monetary Fund's (IMF) regular reports to the Ad Hoc Liaison Committee (AHLC) in September 2012 and March 2013 and its PFM progress review of January 2012.

²⁸ This issue is highlighted in the World Bank's economic monitoring report and the IMF staff report to the AHLC (both dated 19.3.2013).

- 66.** Pegase DFS included a specific component to which the EU general budget contributed 10 million euro to address private sector arrears²⁹. It covered goods and services and VAT refunds to 416 beneficiary companies in the West Bank and Gaza over a wide range of sectors³⁰, although the Commission did not set clear selection criteria for which companies and sectors should receive funds (see also **Box 2**). The component helped the PA pay a significant share of the arrears owed to the private sector in 2008³¹. However, this boost to reducing the arrears problem has been short-lived.
- 67.** While the provision of fuel to the Gaza power plant was also intended to reduce net lending by the PA by reducing Gaza's electricity bills, it also only brought a short-term improvement. Nevertheless, a new EU technical assistance project launched in 2011 with a budget of 2 million euro to restructure the electricity sector in the West Bank and Gaza has good prospects in the medium term of bringing more sustainable results.

²⁹ A total of 27,8 million euro was disbursed from the private sector arrears component, which included contributions transferred from the TIM programme and other donors (see **Annex III**).

³⁰ Hotels, medical supplies, printing, motor trade, car rental, computers, electronics, textiles, tourism, agricultural supplies, engineering and insurance.

³¹ In 2008, the PA paid some 48 million euro (70 million US dollars) out of 86 million euro (PRDP 2008–10 estimate) of outstanding arrears.

BOX 2

REIMBURSEMENT OF VAT TO A LUXURY HOTEL IN GAZA

The selection criteria for the largest beneficiary of the private sector arrears component were open to question. A luxury hotel in Gaza received a VAT refund of 2 586 266 euro, which represented 9 % of the total amount disbursed from Pegase DFS, towards the payment of arrears and 23 % of the total arrears paid to suppliers in Gaza. In contrast, the average payment to companies was 59 864 euro and 88 % of companies received an amount below 100 000 euro. In addition, whereas in general companies benefiting from the Pegase DFS support were providing inputs to support public services, at the time of the audit visit in October 2012 the hotel was barely operating.

- 68.** Overall, the PA's already fragile financial situation deteriorated significantly in 2012. The overall budget deficit is estimated at 1,7 billion US dollars (1,3 billion euro) (17,1 % of GDP). In particular, the PA faces a liquidity crisis with a large build-up in net arrears (see **Table 4**). The level of PA loans from the Palestinian banking sector has also been rising since 2008 and in 2012 stood at 1,4 billion US dollars (1,1 billion euro equivalent to 112 % of banks' equity). This risks undermining the stability of the banking sector. At the same time, donor funding, on which the PA is heavily dependent, dropped substantially from 1 146 million US dollars (858 million euro) in 2010 to 774 million US dollars (587 million euro) in 2012 (see also paragraph 45). In 2012, donor support to finance the recurrent budget deficit was 214 million US dollars (166,6 million euro) less than anticipated³².
- 69.** The PA itself can take some measures to address the crisis. These include key structural reforms, notably in the areas of civil service reform and pension reform (see paragraph 46). The deteriorating fiscal situation increases the need for the EEAS and the Commission, in cooperation with other donors, to effectively engage with the PA in addressing these issues.
- 70.** However, both the financial sustainability of the PA and the economic development of the oPt, which is essential for financial sustainability, continue to be fundamentally undermined by a series of constraints imposed by the Government of Israel (see below). These constraints also undermine the effectiveness of Pegase DFS as well as other donor assistance. Despite significant efforts, the current approach by the EEAS and the Commission, in conjunction with EU Member States, has not been effective in bringing Israel to adopt a more cooperative approach.

³² *Fiscal Challenges and Long Term Economic Costs*, Economic Monitoring Report to the Ad Hoc Liaison Committee, 19.3.2013, World Bank, p. 6.

TABLE 4

NET ARREARS ACCUMULATION 2009–12 (MILLION EURO)

	2009	2010	2011	2012
Total	190,7	83,3	392,1	451,9

Source: IMF staff report for the meeting of the AHLC, 19.3.2013, p. 14.

- (a) Although approximately 70 % of the PA's revenues come from so-called clearance revenues which are indirect taxes collected by Israel on behalf of the PA from imported goods, this system is affected by Israel's sporadic suspension of these transfers as well as the lack of transparency concerning the amount of fees deducted by Israel for goods and services it charges to the PA. Both of these elements undermine the predictability of the PA's revenues.
- (b) Israel continues to control all of the West Bank's Area C, which is the largest part of the oPt and the one with the most potential for economic development. Israeli planning regulations and travel restrictions on Palestinians currently in effect in Area C, as well as continuing encroachments into the most fertile areas by new Israeli settlements, have largely prevented Palestinians from developing Area C. Resolving the Area C issue is essential to the long-term sustainability of the PA. The issue was addressed in a critical July 2011 internal report by the EU heads of mission.
- (c) Restrictions on imports and exports from the oPt as well as movement and access into Israel and between the West Bank and Gaza. Restrictions on Gaza are particularly severe.

³³ Figures based on study contracted by the Commission.

³⁴ The total value of PRSG-funded assets was estimated at 150 000 US dollars.

- 71.** The Pegase DFS funded one component, the PSRG, to support the rehabilitation of the private sector in Gaza after Israel's 2008 'Operation Cast Lead' destroyed many local enterprises. Damage specifically to the private sector was estimated at 108,7 million euro³³. The PSRG component has provided funding of 22 million euro to 915 companies.
- 72.** The engineers supervising the implementation of PSRG estimated that the funds paid by the PSRG programme replaced only approximately 20 % of the previous capacity of the businesses. More fundamentally, companies continued to suffer from the weight of Israeli restrictions, as was directly observed during an audit visit to one of the beneficiaries in October 2012 (see **Box 3**).
- 73.** Sustainability of the PSRG results depends more on the political context than on further donor financial assistance. This was clearly demonstrated when a new Israeli military operation in Gaza in November 2012 resulted in further damage, including limited damage to 22 of the PSRG beneficiaries³⁴.

BOX 3

PSRG SUPPORT FOR AN ELECTRICAL COMPONENTS COMPANY IN GAZA

The company was established in 1986 in the vicinity of an industrial-free zone. It produces electric outlets, switches and lights. Before 'Operation Cast Lead', it had 90 employees and occupied a 3-storey building of 900 m² which was completely destroyed during the bombing. The company has received a grant of 641 180 euro from the PSRG.

At the time of the audit, the company had 25 employees and was operating at 30 % of its previous capacity with a reduced product range. It faced several problems:

- (a) four items bought by the company in the framework of the PSRG component for 71 300 US dollars had been held in the harbour of Ashdod since 8 September 2011 following the Israeli Ministry of Defence's orders of June and July 2010; in total at least 400 000 euro worth of equipment purchased by different companies as part of the PRSG component was estimated to be blocked by the Israeli authorities at the time of the audit;
- (b) the Israeli closure of Gaza, which meant that there was no physical access to the West Bank and other markets;
- (c) a lack of capital and access to loans. The fact that the PRSG component had not reimbursed the company for equipment it had purchased, as it was still held by the Israeli authorities, clearly contributed to this problem.

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

- 74.** The audit concluded that the Commission and the EEAS had succeeded in implementing direct financial support to the PA in difficult circumstances, but that a number of aspects of the current approach are increasingly in need of an overhaul. While some important results have been achieved, their sustainability is in doubt without major revisions to the current approach. As part of these revisions, the PA also has to be encouraged to undertake more reforms, notably in relation to its civil service. At the same time, a way needs to be found to bring Israel to take the necessary steps to help ensure that Pegase DFS is effective.
- 75.** Pegase DFS has typically been funded on a year-to-year basis using accelerated approval procedures and with few changes to its main component — the payment of civil servants and pensioners — despite the changing operational environment. Despite the requirements of the ENPI regulation, there is a lack of performance indicators which makes it difficult for the EEAS and the Commission to assess and demonstrate results. Although Pegase DFS is intended to serve as a mechanism for other donors to also channel funding, their contributions are declining.
- 76.** The Commission has established a robust verification system for ensuring that funding reaches the eligible beneficiaries. However, the system is in need of simplification. At the same time, the Commission has procured the contractors without competitive tendering because of the crisis situation in the oPt, whereas it would have been feasible to carry out tendering and obtain their services more economically.
- 77.** Pegase funds reached the intended beneficiaries and the funding has played an important part in supporting vulnerable families (and encouraged useful reforms in this area) and contributed to maintaining health and education services. However, the Commission and the EEAS have not sufficiently used the very large-scale funding from Pegase DFS to civil servants' salaries as leverage with the PA to push forward much-needed civil service reforms. The increasing numbers of beneficiaries and the reduced funding from donors is increasingly placing the current approach under stress. In the second half of 2012, there were significant delays in the payment of salaries by the PA, leading to widespread unrest. Support for social assistance is also under strain. The increasing number of beneficiaries, recent delays in the quarterly transfers to beneficiaries and the low level of allowances all raise concerns about the sustainability of the system. Urgent action is needed to address these problems.

- 78.** In Gaza, the audit found that salaries were being paid to large numbers of beneficiaries who were not working due to the political situation. The situation in Gaza made it difficult for the Commission to carry out on-the-spot controls and ensure that rent-seeking was not taking place. The EEAS and the Commission did not have clear information on the extent of this problem nor do they refer to the issue in their documentation on financing Pegase DFS. The payment of civil servants who are not working does not meet one of the main objectives of Pegase: to provide public services for the benefit of the Palestinian people. The Commission was also unable to establish how Israel and the PA had used approximately 90 million euro which Pegase DFS paid for VAT and excise duties on fuel to enable the production of electricity at the Gaza power plant.
- 79.** Some progress has been made in PFM reforms with support from technical assistance provided by the Commission. However, the extent of progress is difficult to assess as the Commission and the EEAS have not yet agreed with the PA to carry out a follow-up of the 2007 PEFA assessment. Progress made in improving the PA's public finance management risks being eroded by the increasingly severe budget deficit and liquidity crisis. Despite large-scale funding support from Pegase DFS since 2008, the fiscal situation of the PA deteriorated markedly in 2012. Ultimately, the effectiveness of Pegase DFS — in terms of building up a financially viable PA — is being undermined by the numerous economic restrictions imposed by Israel. The EEAS and the Commission, despite their efforts, have not yet been able to ensure that Israel engages positively to help make Pegase DFS effective.

RECOMMENDATIONS

- 80.** Based on the above conclusions and given the opportunities provided by the new 2014–20 programming period and a new EU–PA action plan, the Court recommends that the EEAS and the European Commission undertake a major review of Pegase. The review should take the recommendations listed below into account.

- 81.** The EEAS and the Commission should strengthen the programming of the future Pegase DFS, specifically by:
- (a) linking it more closely to the new EU–PA action plan;
 - (b) planning allocations on a multiannual basis;
 - (c) developing performance indicators, particularly in the areas of health, education and PFM, to better assess and demonstrate its results.
- 82.** The Commission should reduce the costs of administering Pegase DFS by:
- (a) using competitive tendering for contracts relating to the management and control of Pegase DFS whenever feasible;
 - (b) simplifying the Pegase DFS management system by making the EU representation in Palestine responsible for administering the Pegase database and taking over some of the checks currently outsourced.
- 83.** The EEAS and the Commission should apply conditionality to the future Pegase DFS, specifically by linking it to concrete progress by the PA on civil service reform and PFM reform.
- 84.** The EEAS and the Commission should reach an agreement with the PA for the funding of salaries and pensions from Pegase DFS for civil servants in Gaza to be discontinued and redirected to the West Bank.
- 85.** The EEAS and the Commission, in conjunction with the broader donor community, should further engage with Israel, within the framework of broader EU–Israeli cooperation, in order to determine what steps Israel needs to take to ensure Pegase DFS is more effective.

This Report was adopted by Chamber III, headed by Mr Karel PINXTEN, Member of the Court of Auditors, in Luxembourg at its meeting of 22 October 2013.

For the Court of Auditors

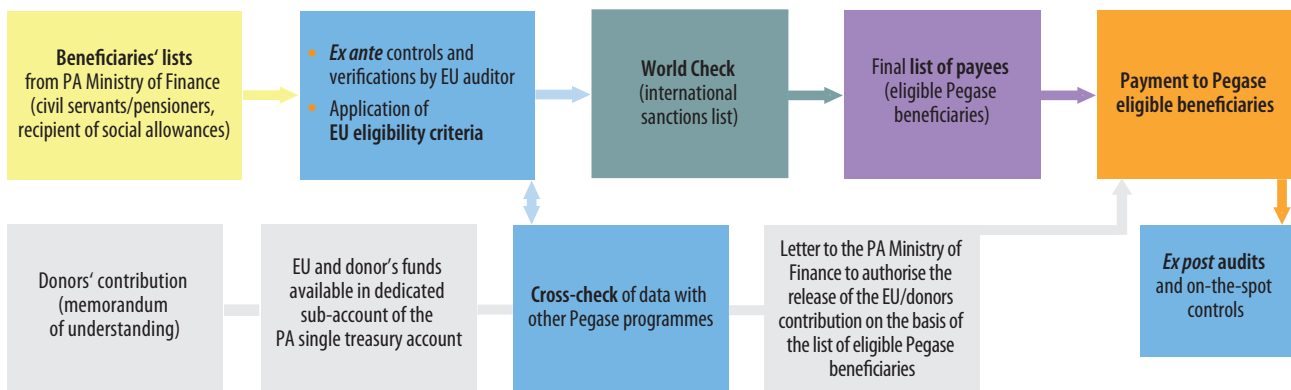


Vítor Manuel da SILVA CALDEIRA
President

THE PEGASE MECHANISM

1. The Pegase mechanism is aimed at ensuring that support is provided directly to the intended beneficiaries and that funds are disbursed in a transparent and accountable manner. An overview of the payment and verification system established by the Commission is provided in **Figure 1**.

FIGURE 1 — OVERVIEW OF THE PEGASE PAYMENT AND VERIFICATION SYSTEM



Source: European Commission.

2. To ensure the reliable verification of individual recipients of funds, as well as to mitigate the risk of misuse of funds, all beneficiaries of Pegase funds under the different components are screened against international sanctions lists and other ad hoc lists via the use of the 'World Check' software. An international organisation is contracted (through a contribution agreement) to host, manage and perform basic IT checks on beneficiary data (see paragraph 8 for details).

ANNEX I

3. All Pegase DFS components are managed with the support of contracted 'Big 4' audit firms. The contracted auditors are responsible for identifying Pegase eligible populations and proposing the level of payments to them on the basis of criteria defined by the Commission and a set of agreed upon procedures (AUPs). The eligibility criteria for three of the components verified through AUPs are set out in **Box 1**.

BOX 1 — PEGASE ELIGIBILITY CRITERIA FOR CSP, VPF AND ARREARS COMPONENTS

Civil servants and pensioners (CSP)	Vulnerable Palestinian families (VPF)	PA arrears to the private sector
<p>Employees on the PA's payroll with the following positions and statutes are <i>ineligible</i> for Pegase DFS contributions under the CSP programme:</p> <ul style="list-style-type: none"> (i) ministers and deputy ministers; (ii) workers identified as 'daily paid' employees; (iii) employees/pensioners of the security forces and the civil police; (iv) employees who work at non-governmental organisations supported by the PA, labour and trade unions supported by the PA and various political parties supported by the PA; (v) exclusions from the international and ad hoc sanctions lists (i.e. 'World Check'). 	<p>Households registered in the PA Ministry of Social Affairs' cash transfer programme (CTP) are eligible to receive a monthly allowance of minimum NIS 250 and maximum NIS 600 from Pegase under the VPF programme if:</p> <ul style="list-style-type: none"> (i) they are eligible to receive cash assistance at the cut-off date of the applicable CTP database (i.e. beneficiaries registered to receive <i>exclusively</i> the following type of assistance are ineligible: medical insurance, food assistance, referral to institutions, care, youth shelter or other); (ii) they have been identified as 'extremely poor' as per the application of proxy-means testing; (iii) they have a valid, complete and correct bank account through which the payment of the allowances can be made, <i>for West Bank beneficiaries</i>; they do not receive direct payments under other Pegase schemes (i.e. PCSP). 	<p>To be eligible, arrears to the private sector must fulfil the following criteria:</p> <ul style="list-style-type: none"> (i) they must be outstanding for more than 45 days from the invoice date, have been approved by the PA Ministry of Finance in accordance with its internal procedures and have still not been paid; (ii) where applicable, the legal status of the beneficiary is in compliance with all legal requirements of the PA regulations for the private sector; (iii) claims must be accompanied by all the necessary supporting documents; (iv) they must not have been already covered by other EC payments under other programmes; (v) the beneficiaries and/or their representatives must not appear on any list of companies/ individuals that have been engaged in illegal or terrorist activities; (vi) they must not be related to goods supplied or services provided for the direct or indirect benefit of the PA security and military services.

Source: European Commission.

4. In addition to the *ex ante* verifications of eligibility carried out, *ex post* verifications are done to confirm that disbursements to individuals (mainly through bank accounts) were properly executed.
5. For the CSP component, detailed checks (but not on-site inspections) are carried out on 5 % of all new beneficiaries with 6-month intervals.
6. For the SEPS component, the beneficiary was the Gaza power plant. For each fuel delivery, the verifications described in **Box 2** were carried out.

BOX 2 — SEPS VERIFICATIONS

The contracted auditor verifies that invoices submitted by the fuel supplier to the Ministry of Finance (MoF) are accurate, valid and eligible for payment, and relate to the goods and services actually rendered.

An audit team attends the fuel deliveries on a daily basis and also prepares an *ex ante* verification report on the eligibility of the requests for payment submitted by the MoF.

An international organisation prepares and maintains a database with information regarding all aspects of fuel provision and related services.

7. The eligibility criteria for the PSRG are presented in **Box 3**.

BOX 3 — PSRG ELIGIBILITY CRITERIA

The PA set the basic criteria for which companies were eligible for the programme.

- (a) Registered commercial and manufacturing firms; firms that lost core production equipment or infrastructure; firms that are able to prove damage.
- (b) The applicant should be the owner of the damaged property or a legal agent.
- (c) The scope of the programmes was limited to the following operating assets: production machinery, office furniture, office equipment and physically damaged buildings, facilities and other business premises.

The EU set additional eligibility criteria.

- (i) The value of the claim is to be equal to or above 1 000 US dollars.
- (ii) Registration of the legal entity allowing it to operate in accordance with the PA requirements, including VAT registration, if applicable; and including registration of the legal entity's ownership and representatives.
- (iii) In order to be eligible for financing, potential beneficiaries were required to have been registered with the PA by 26 December 2008 at the latest.

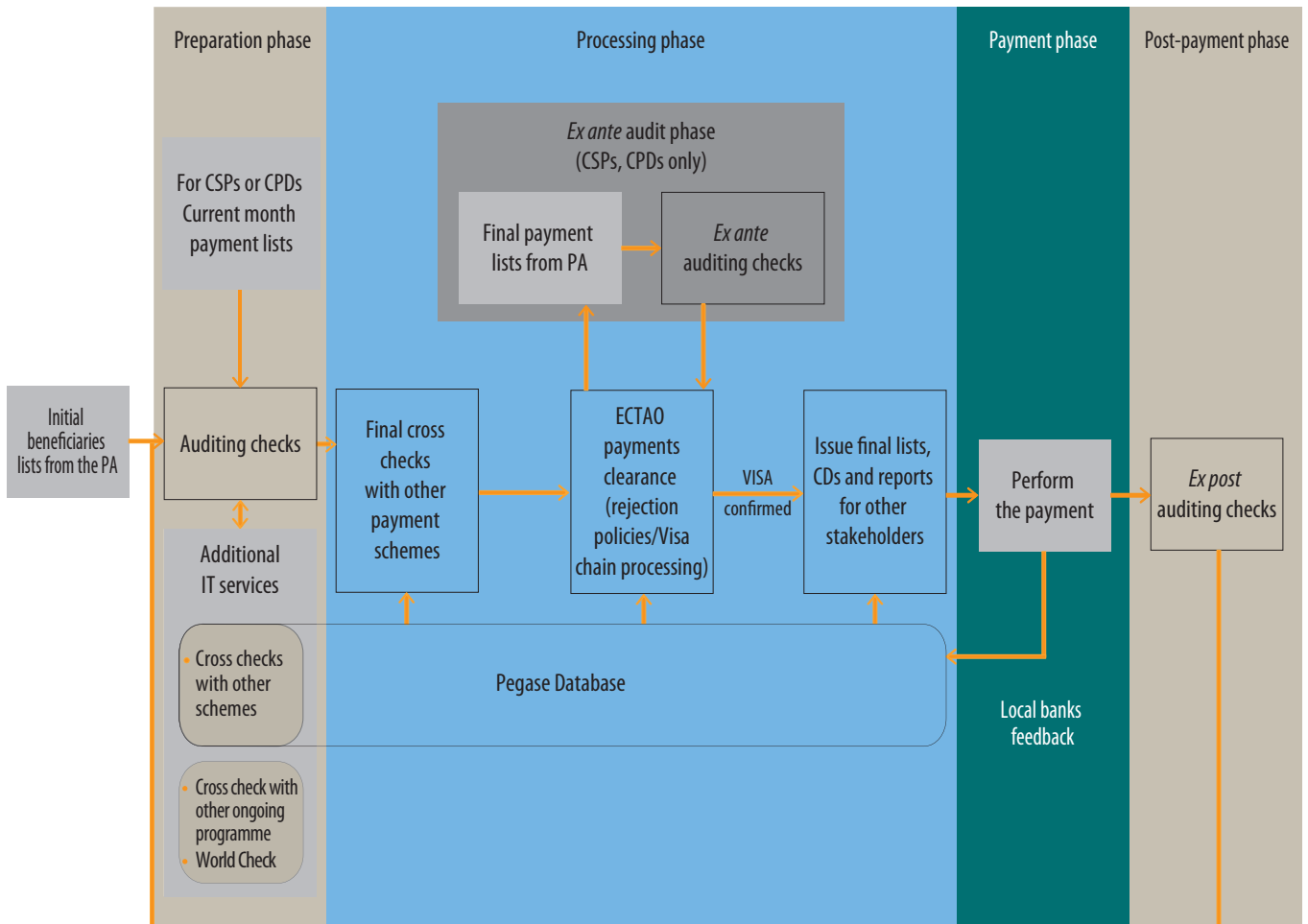
Considering the large number of businesses registered by entities other than the ministry, such as the Chamber of Commerce, various ministries and associations (for licensing doctors, pharmacists, etc.), EUREP felt obliged to relax the criteria. The financing agreement with the PA was amended accordingly to replace the wording 'registered' with 'allowed to do business in Gaza'.

8. The Pegase mechanism depends on the safe handling of large quantities of electronically stored data about thousands of individual beneficiaries. The international organisation provides IT and technical support for the payment process and performs maintenance of the system including hardware and system software, network infrastructure and developed software (user interfaces, databases, reporting and notification services) and technical support regarding integration of other software (e.g. the 'World Check').
9. Data in the Pegase information system is received from external sources (channelled to the international organisation by EUREP), transformed into the proper format, validated for completeness, loaded into the database and processed according to a set of rules. Data is also exported from the system and forwarded to relevant parties at appropriate points in the payment process.

10. The system stores payment and beneficiary information, including approval of beneficiaries, payment confirmation, exclusions, results from *ex ante* verifications and bank rejections. EUREP can currently review and update the data, which can be uploaded to the system by EUREP or the international organisation's IT staff.
11. Access to the system is restricted in accordance with different authorisation levels related to staff functions, tasks to be performed and levels of responsibility. The system supports payments for the benefit of all five Pegase DFS components.
12. The Pegase information system supports the following four verification phases:
 - preparation phase;
 - processing phase;
 - payment phase;
 - post-payment phase.
13. **Figure 2** shows the data flows and verifications carried out in each of the four phases and how they are interconnected.
14. For additional independent assurance, financial audits of Pegase DFS as a whole are carried out periodically. Financial audits for the periods February 2008–June 2009 and July 2009–December 2010 have been carried out, while the financial audit for 2011 was still ongoing as at 31 March 2013.

FIGURE 2

VERIFICATIONS IN THE PEGASE INFORMATION SYSTEM



Source: European Commission ('Assessment of the Simplification of Procedures/Enhancement, Cost-Effectiveness and Efficiency of the Pegase DFS Mechanism', Inception and Phase 1 Report, November 2011).

ANNEX II

OVERVIEW OF PEGASE DFS-RELATED FINANCING AGREEMENTS AND CONTRACTS

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
Direct financial support — recurrent expenditure¹					
ENPI/2008/019-776 (EC)	Pegase support to recurrent expenditures of PA	19.3.2008	176 000 000	176 000 000	176 000 000
ENPI/2008/154-854 (CL)	Supporting the provision of essential public services	8.4.2008	56 000 000		56 000 000
ENPI/2008/155-591 (EC)	Individual commitment for regularisation of payments under Pegase imprest account, VPF, bank fees	14.4.2008	500 000		500 000
ENPI/2008/155-637 (EC)	Individual commitment for regularisation of payments made through Pegase imprest account, VPF	14.4.2008	9 500 000		9 500 000
ENPI/2008/155-640 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project	14.4.2008	95 000 000		95 000 000
ENPI/2008/159-007 (EC)	Individual commitment for payment of arrears under DEC 19776	22.5.2008	10 000 000		10 000 000
ENPI/2008/166-130 (EC)	Additional contribution to the ESSP Phase III TF 070598- MDTF 'the World Bank Group'	14.12.2008	5 000 000		5 000 000
ENPI/2008/020-254 (EC)	Pegase support to recurrent expenditures of the PA (Part II)	8.8.2008	40 000 000	40 000 000	40 000 000
ENPI/2008/163-882 (EC)	Payment of allowances to CSPs — Pegase support to recurrent expenditure Part II	20.8.2008	34 000 000		34 000 000
ENPI/2008/164-449 (EC)	Payment of allowances to VPFs — Pegase support to recurrent expenditure Part II (imprest account)	20.8.2008	5 946 765,17		5 946 765,17
ENPI/2008/164-456 (EC)	Payment of bank fees — allowances to VPFs — Pegase support to recurrent expenditure Part II (imprest account)	20.8.2008	53 234,83		53 234,83
ENPI/2008/020-425 (EC)	Pegase support to recurrent expenditures of the PA (Part III)	5.11.2008	42 000 000	42 000 000	42 000 000
ENPI/2008/169-663 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project III	17.11.2008	30 000 000		30 000 000
ENPI/2008/169-666 (EC)	Individual commitment for regularisation of payments made through Pegase imprest account, VPF	17.11.2008	1 000 000		1 000 000
ENPI/2008/169-667 (CL)	Supporting the provision of essential public services	1.12.2008	11 000 000		11 000 000
Sub-total 2008			258 000 000	258 000 000	258 000 000

¹ The committed amounts include assigned revenues from Austria: 1 million euro in 2008; 0,5 million euro in 2009; 1,5 million euro in 2010 and 1 million euro in 2011; from Japan: 4,78 million euro in 2011; and from Belgium: 9 million euro in 2012. Assigned revenues came to a total of 17,88 million euro.

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
ENPI/2008/020-577 (EC)	2009 Pegase: support to recurrent expenditures of the PA	17.12.2008	168 000 000	168 000 000	168 000 000
ENPI/2008/172-720 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2009: supporting Palestinian administration and services	31.12.2008	108 000 000		108 000 000
ENPI/2008/172-721 (EC)	Individual commitment for regularisation of payments made through Pegase imprest account VPF	31.12.2008	20 795 000		20 795 000
ENPI/2008/172-722 (EC)	Supporting the provision of essential public services	31.12.2008	38 930 000		38 930 000
ENPI/2009/214-989 (EC)	Individual commitment for regularisation of bank fees for VPF payments made through Pegase imprest account	31.12.2008	275 000		275 000
ENPI/2009/021-634 (EC)	2009 Pegase (II): additional support to recurrent exp of the PA	13.7.2009	39 000 000	39 000 000	39 000 000
ENPI/2009/215-912 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2009 (Part II): supporting Palestinian administration and services	22.7.2009	39 000 000		39 000 000
ENPI/2009/021-840 (EC)	2009 Pegase: support to recurrent exp of the PA (Part III)	30.11.2009	12 100 000	12 100 000	12 100 000
ENPI/2009/226-722 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2009 — Part III: supporting Palestinian administration and services	2.12.2009	3 500 000		3 500 000
ENPI/2009/226-733 (EC)	Pegase 2009 — Part III — Component 2 of recurrent expenditures: individual commitment for regularisation of payments made through Pegase imprest account VPF	2.12.2009	7 744 000		7 744 000
ENPI/2009/226-734 (EC)	Pegase 2009 — Part III — Component 3 of recurrent expenditures: supporting the provision of essential public services	2.12.2009	700 000		700 000
ENPI/2009/227-317 (EC)	Individual commitment for regularisation of bank fees for VPF payments made through Pegase imprest account	2.12.2009	156 000		156 000
Sub-total 2009			219 100 000	219 100 000	219 100 000

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
ENPI/2010/021-955 (EC)	Pegase 2010: support to recurrent expenditures of the PA	16.12.2009	169 500 000	169 500 000	169 455 197,80
ENPI/2010/230-426 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2010: supporting Palestinian administration and services	31.12.2009	127 000 000		127 000 000
ENPI/2010/230-836 (EC)	Individual commitment for regularisation of bank fees for VPF payments made through Pegase imprest account	31.12.2009	557 060,22		542 160,22
ENPI/2010/230-838 (CL)	Individual commitment for regularisation of VPF payments made through Pegase imprest account	31.12.2009	30 872 388,14		30 872 388,14
ENPI/2010/256-540 (EC)	Technical addendum to existing individual commitment for regularisation of VPF payments made through Pegase imprest account ENPI.2010/ 230-838	1.12.2010	8 070 551,64		8 038 649,45
ENPI/2010/256-579 (EC)	Technical addendum individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2010: supporting Palestinian administration and services ENPI/2010/ 230-426	1.12.2010	3 000 000		3 000 000
ENPI/2010/022-594 (EC)	Pegase 2010: additional support to recurrent expenditures of the PA (Part III)	5.10.2010	41 400 000	41 400 000	41 400 000
ENPI/2010/253-282 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2010: supporting Palestinian administration and services	22.10.2011	41 400 000		41 400 000
ENPI/2009/021-839 (EC)	Private sector reconstruction in Gaza (PSRG)	23.12.2009	26 781 281,79 ²	26 752 630,25	23 346 684,70
ENPI/2010/241-786 (EC)	Individual commitment for financial assistance to beneficiaries of the private sector reconstruction programme in Gaza	23.5.2010		25 781 281,79	21 010 876,69
ENPI/2010/235-337	Technical assistance to support ECTAO in implementing the Pegase programmes in the occupied Palestinian territory.	31.3.2010		686 943,46	686 943,46
ENPI/2010/236-718	Technical assistance to support ECTAO in implementing the Pegase programmes of 'Support to the settling of PA arrears to the private sector' and 'Private sector reconstruction in Gaza' (PSRG)	19.4.2010		284 405	90 000
Sub-total 2010			237 681 281,80	237 652 630,30	232 643 018

² Financing agreement ENPI/2009/021-839 of 22 million euro plus Japanese contribution of 4,78 million euro.

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
ENPI/2010/022-829 (EC)	Pegase 2011: support to recurrent expenditures of the PA — Part I	MULTI	77 000 000	77 000 000	77 000 000
ENPI/2011/261-044 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2011 — Part II: supporting Palestinian administration and services	18.1.2011	77 000 000 ³		77 000 000
ENPI/2011/023-095 (EC)	Pegase 2011: additional support for recurrent exp of the PA	MULTI	94 200 000	94 200 000	94 200 000
ENPI/2011/266-987 (EC)	Individual commitment for regularisation of VPF payments made through Pegase — single treasury account of the PA	30.5.2011	29 000 000		29 000 000
ENPI/2011/266-991 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2011: supporting Palestinian administration and services — Part II	30.5.2011	65 200 000 ⁴		65 200 000
ENPI/2011/023-376 (EC)	Pegase: support for recurrent exp of the PA 2011/2012 ⁵	19.12.2011	46 000 000	46 000 000	46 000 000
ENPI/2012/284-110 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2011/12: supporting Palestinian administration and services — frontloading 2012	25.1.2012	45 000 000 ⁶		45 000 000
ENPI/2012/284-113 (EC)	Individual commitment for regularisation of VPF payments made through Pegase — single treasury account of the PA	25.1.2012	1 000 000 ⁷		1 000 000
Sub-total 2011			217 200 000⁸	217 200 000	217 200 000

³ Out of this amount, 17 million euro was allocated to pay for December 2011 salaries and pensions and was paid in January 2012.

⁴ Out of this amount, 9,2 million euro was allocated to pay for December 2011 salaries and pensions and was paid in January 2012.

⁵ Encoded in parallel with ENPI/ 2011/023-610 being an integral part of the same financing agreement.

⁶ This amount was allocated to PA salaries and pensions for the first quarter of 2012. The overall amount of 90 million euro under the individual commitment ENPI/2012/284-110 has been encoded in parallel with ENPI/2011/023-376 and ENPI/2011/023-610 being an integral part of the same financing agreement.

⁷ This amount was allocated to PA salaries and pensions for the first quarter of 2012.

⁸ 26,2 million euro was added at the end of 2011 for December salaries and 46 million euro committed on 2011 credits are for frontloading to the first quarter of 2012, including 1 million euro in assigned credits from Austria. The total of 72,2 million euro should therefore be considered part of the budget for 2012. The total allocated budget for 2011 is therefore 145 million euro.

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
ENPI/2011/023-610 (EC)	Pegase: support for recurrent exp of the PA 2012 — Part II	19.12.2011	69 000 000	69 000 000	69 000 000
ENPI/2012/284-110 (EC)	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2011/12: supporting Palestinian administration and services — frontloading 2012	25.1.2012	45 000 000		45 000 000
ENPI/2012/284-113 (EC)	Individual commitment for regularisation of VPF payments made through Pegase — single treasury account of the PA	24.1.2012	24 000 000		24 000 000
ENPI/2012/023-843	Pegase 2012: support to the recurrent expenditures of the PA — Part II	18.10.2012	24 800 000	24 800 000	24 800 000
ENPI/2012/305-379	Individual commitment for payments of allowances to CSP Component 1 of recurrent expenditures project 2012 Part II: supporting Palestinian administration and services	25.10.2012	13 800 000		13 800 000
ENPI/2012/305-390	Individual commitment for payments of allowances to VPF Component 2 of recurrent expenditures project 2012 Part II: supporting Palestinian social protection system	25.10.2012	11 000 000		11 000 000
Sub-total 2012			93 800 000⁹	93 800 000	93 800 000
Total Pegase DFS			1 025 781 282	1 025 752 630	1 020 743 018

⁹ 72,2 million euro had already been committed for frontloading on 2011 credit, which brings the total to 166 million euro for the 2012 budget allocations.

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
Major TA contracts related to DFS implementation support¹⁰					
MED/2007/145-324	TA for finance facility II — arrears	29.10.2007	659 136,50		659 136,50
ENPI/2007/145-484	TA action in the West Bank and Gaza to support the TIM	1.11.2007	545 000		545 000
ENPI/2007/146-120	Further EC emergency support to the Palestinian people in the West Bank and Gaza Strip (TIM windows 2 and 3)	26.11.2007	1 210 496,84		1 210 496,84
MED/2008/153-790	Support to the PDFS unit of the Pegase mechanism	20.3.2008	2 550 722,85		2 550 722,85
ENPI/2009/200-563	Pegase needs assessment mission in Gaza and identification of priority areas for donor financial support	16.2.2009	694 465,20		694 465,20
ENPI/2009/201-712	EC emergency support to the Palestinian people in the West Bank and Gaza Strip (Pegase — support to recurrent expenditures of the PA)	27.2.2009	1 190 399,72		1 190 399,72
ENPI/2009/207-600	TA for the identification, implementation and monitoring of development projects in West Bank, Gaza Strip and East Jerusalem as well as support to Pegase direct financial support	29.4.2009	3 896 917		3 896 917
ENPI/2010/246-160	Technical assistance — TA for the identification, implementation and monitoring of development projects in West Bank, Gaza Strip and East Jerusalem as well as support to Pegase Direct Financial Support	25.8.2010	1 983 662,05		1 983 662,05
ENPI/2011/264-701	2011 Technical assistance action for the identification, implementation and monitoring of development projects in West Bank, the Gaza Strip and East Jerusalem as well as support to Pegase direct financial support (PDFS)	29.4.2011	2 500 000		2 434 252,84
ENPI/2011/262-520	Technical assistance to support EUREP in implementing the Pegase programmes in the West Bank and Gaza Strip	30.3.2011	1 235 600		975 785,75
ENPI/2012/284-005	2012 TA for the identification, implementation and monitoring of development projects in the West Bank, Gaza Strip and East Jerusalem as well as support to Pegase direct financial support	29.2.2012	2 500 000		2 370 000
Sub-total			18 966 400,16		18 510 838,75

¹⁰ The contracts were selected on the basis of materiality (contracts above 275 000 euro).

ANNEX II

Financing agreement/ contract number	Title	Financing agreement/ contract date	Committed (euro)	Contracted (euro)	Paid (euro)
Major TA contracts related to institution and capacity building					
ENPI/2009/209-464	Support to the PNA's financial institutions	11.6.2009	310 366,80		279 330
ENPI/2010/231-390	Technical assistance to the Ministry of Social Affairs (MoSA) in the occupied Palestinian territory	9.3.2010	2 198 379		1 946 509,42
ENPI/2010/231-065	Technical assistance (Phase III) to reinforce PA internal audit and internal control departments	22.3.2010	800 000		794 115,88
ENPI/2010/243-559	Improving health and well-being among people affected by mental illness in Gaza: building local capacity for service provision and support	15.7.2010	2 329 848		1 612 911
ENPI/2010/248-920	Institutional strengthening of the State Audit and Administrative Control Bureau	8.10.2010	3 722 300		1 940 379,71
ENPI/2011/248-905	TA support EUREP in implementing the 'Institutional development and electricity sector reform' project in the framework of the implementation of Pegase PDFS programmes in the West Bank and Gaza Strip	27.1.2011	1 995 105		1 984 242,85
ENPI/2011/261-041	Technical assistance to enhance the PA's capacities in aid effectiveness and good governance (GSG coordinator)	24.2.2011	432 027		341 289,30
ENPI/2011/270-253	EU support to TVET development in the oPt	17.8.2011	4 000 000		1 500 000
ENPI/2011/279-345	TA to reinforce PFM and internal auditing	1.12.2011	2 184 400		826 506,45
Sub-total			17 972 425,8		11 225 284,61
Total			1 062 720 108		1 050 479 141

ANNEX III

SUMMARY OF FUNDS DISBURSED THROUGH PEGASE

Year	Month of disbursement	Civil servants and pensioners (CSP)	Civil police and civil defence (CPD)	Vulnerable Palestinian families	Support for essential public services	Private sector arrears	Private sector reconstruction in Gaza	Total
		Amount (euro)						
2008	February	22 061 275			8 283 749			30 345 024
	March	34 284 281		7 512 910	4 748 826	5 872 358		52 418 376
	April	22 190 184			12 170 064	5 443 951		39 804 199
	May	35 530 287			6 424 669			41 954 957
	June	21 326 546		7 475 092	9 896 548	3 722 310		42 420 495
	July	14 763 600			11 233 844	4 685 347		30 682 790
	August	14 654 950			12 644 495			27 299 445
	September	35 403 365		8 873 487	9 059 387	4 559 654		57 895 892
	October				12 784 641			12 784 641
	November	14 956 569			5 320 646			20 277 216
	December	14 849 556		9 363 890	3 266 549			27 479 995
	Total 2008		230 020 614		33 225 378	95 833 417	24 283 619	
2009	January	25 019 151			914 999			25 934 150
	February	23 535 916	5 957 387		365 837			29 859 141
	March	26 042 684		9 166 509	7 935 189			43 144 382
	April	22 934 571			6 582 430			29 517 001
	May	12 928 927			10 461 756	2 999 875		26 390 558
	June	12 973 571		13 483 031	7 204 661			33 661 264
	July	12 983 581			7 562 712			20 546 293
	August	12 746 538			8 450 202			21 196 740
	September	25 726 437		9 288 785	8 480 912			43 496 134
	October				4 080 359	200 000		4 280 359
	November	29 789 693			10 619 722			40 409 415
	December			9 219 962	6 670 249			15 890 211
Total 2009		204 681 069	5 957 387	41 158 287	79 329 028	3 199 875		334 325 647
2010	January	6 290 363	7 171 680					13 462 043
	February	20 676 363	1 964 134		1 353 402			23 993 900
	March	22 852 534		10 137 710		149 875		33 140 118
	April	20 773 605						20 773 605
	May	20 950 191			4 363 234			25 313 425
	June	8 959 311		10 223 374	1 991 637			21 174 322
	July	8 893 244			3 067 502		4 782 616	16 743 362
	August	14 036 739		9 701 649	1 625 455			25 363 843
	September	8 930 184			1 989 776		3 582 649	14 502 608
	October	37 056 283			4 011 936			41 068 219
	November	20 389 247			2 123 295			22 512 542
	December	20 590 940		6 856 359	1 133 941			28 581 240
Total 2010		210 399 003	9 135 815	36 919 092	21 660 178	149 875	8 365 265	286 629 228

ANNEX III

Year	Month of disbursement	Civil servants and pensioners (CSP)	Civil police and civil defence (CPD)	Vulnerable Palestinian families	Support for essential public services	Private sector arrears	Private sector reconstruction in Gaza	Total
		Amount (euro)						
2011	January	3 981 591					1 231 765	5 213 356
	February	19 471 331	4 915 131					24 386 462
	March	19 796 636		9 406 668		146 134		29 349 438
	April	20 226 656						20 226 656
	May						2 566 615	2 566 615
	June			9 765 125		3 866		9 768 990
	July	22 153 357						22 153 357
	August	22 383 281					2 830 515	25 213 796
	September	16 246 382						16 246 382
	October			10 042 543				10 042 543
	December			12 051 842			3 456 350	15 508 192
	Total 2011		124 259 235	4 915 131	41 266 178		150 000	10 085 245
2012	January	47 668 179					1 050 485	48 718 664
	February	24 510 502						24 510 502
	March	22 405 955						22 405 955
	April	22 420 524		9 990 238				32 410 762
	May	22 315 959						22 315 959
	June			9 875 815				9 875 815
	October			9 759 786			1 620 414	11 380 200
	November	18 677 130						18 677 130
	December	6 715 634		10 882 801				17 598 435
	Total 2012		164 713 884		40 508 640			2 670 899
Grand total		934 073 804	20 008 333	193 077 575	196 822 624	27 783 369	21 121 409	1 392 887 114
Total CSP and CPD		954 082 137						

Source: European Commission.

ANNEX IV

TOTAL PA WAGE BILL DISBURSEMENTS FOR ELIGIBLE CSP AND TOTAL PEGASE CSP PAYMENTS 2008–12 MONTH BY MONTH IN EURO AND NUMBER OF ELIGIBLE BENEFICIARIES

Payroll month	Salary/pension paid (<i>bold italics</i> = late) ¹	Pegase contribution ² to beneficiaries (euro)	Total PA pay for eligible beneficiaries (euro)	Total number of eligible beneficiaries ³
Jan-08	5.2.2008	22 061 275	40 648 607	73 826
Feb-08	6.3.2008	34 284 281	45 693 175	74 014
Mar-08	6.4.2008	22 190 184	40 719 893	74 063
Apr-08	6.5.2008	35 530 287	44 557 242	74 160
May-08	10.6.2008	21 326 546	43 033 758	73 761
Jun-08	7.7.2008	14 763 600	43 881 800	73 818
Jul-08	7.8.2008	14 654 950	43 158 255	73 947
Aug-08	4.9.2008	15 617 485	46 932 662	78 493
Sep-08	25.9.2008	19 785 879	45 824 002	78 340
Oct-08	5.11.2008	14 956 569	52 360 648	78 153
Nov-08	3.12.2008	14 849 556	49 363 160	77 951
Dec-08	6.1.2009	25 019 151	45 037 410	78 162
2008 average		21 253 314	45 100 884	75 724
Jan-09	17.2.2009	23 535 916	48 610 399	78 038
Feb-09	5.3.2009	26 042 684	46 754 502	78 049
Mar-09	6.4.2009	22 934 571	46 285 785	77 994
Apr-09	7.5.2009	12 928 927	47 323 840	78 063
May-09	7.6.2009	12 973 571	47 607 723	78 298
Jun-09	6.7.2009	12 983 581	47 433 886	80 580
Jul-09	4.8.2009	12 746 538	47 882 970	80 620
Aug-09	3.9.2009	12 831 501	48 555 553	78 696
Sep-09	16.9.2009	12 894 936	46 839 660	78 996
Oct-09	4.11.2009	14 835 798	49 017 979	79 916
Nov-09	24.11.2009	14 953 895	47 421 969	80 163
Dec-09	6.1.2010	6 290 363	48 820 026	80 021
2009 average		15 496 023	47 712 858	79 120
Jan-10	4.2.2010	20 676 363	50 577 131	80 551
Feb-10	3.3.2010	22 852 534	51 708 439	80 608
Mar-10	6.4.2010	20 773 605	53 766 495	80 585
Apr-10	5.5.2010	20 950 191	54 692 448	80 576
May-10	7.6.2010	8 959 311	56 814 476	81 032
Jun-10	5.7.2010	8 893 244	59 043 295	80 988
Jul-10	5.8.2010	14 036 739	56 735 240	81 133
Aug-10	6.9.2010	8 930 184	58 631 942	84 628
Sep-10	6.10.2010	37 056 283	55 454 559	84 981
Oct-10	4.11.2010	20 389 247	54 457 318	85 026
Nov-10	6.12.2010	20 590 940	56 492 298	84 948
Dec-10	5.1.2011	3 981 591	59 150 450	84 808
2010 average		17 340 853	55 627 007	82 035

ANNEX IV

Payroll month	Salary/pension paid (<i>bold italics = late</i>) ¹	Pegase contribution ² to beneficiaries (euro)	Total PA pay for eligible beneficiaries (euro)	Total number of eligible beneficiaries ³
Jan-11	6.2.2011	19 471 331	58 409 452	84 465
Feb-11	6.3.2011	19 796 636	58 218 925	84 544
Mar-11	5.4.2011	20 226 656	58 590 035	84 444
Apr-11	5.5.2011	0	57 359 539	-
May-11	5.6.2011	0	59 599 729	-
Jun-11	6.7.2011	22 153 357	59 859 246	84 274
Jul-11	2.8.2011	22 383 281	58 999 587	82 864
Aug-11	14.9.2011	16 246 382	57 855 264	83 070
Sep-11	3.10.2011	0	57 009 951	-
Oct-11	5.11.2011	0	60 178 790	-
Nov-11	6.12.2012	0	58 874 557	-
Dec-11	5.1.2012	47 668 179	61 866 492	84 581
2011 average		13 995 485	58 901 797	84 035
Jan-12	7.2.2012	24 510 502	62 406 634	84 569
Feb-12	7.3.2012	22 405 955	60 706 774	84 278
Mar-12	11.4.2012	22 420 524	66 930 548	83 937
Apr-12	9.5.2012	22 315 959	64 595 271	83 987
May-12	7.6.2012	0	64 354 004	-
Jun-12	11 and 18.7.2012	0	62 891 548	-
Jul-12	12 and 29.8.2012	0	63 029 985	-
Aug-12	11 and 16.9.2012	0	60 889 140	-
Sep-12	18 and 21.10.2012	0	61 593 991	-
Oct-12	11, 21 and 23.11.2012	18 677 130	61 055 815	84 168
Nov-12	23.12.2012 and 14.1.2013	7 277 887	62 298 382	84 064
Dec-12	20.1.2013	7 192 124	63 683 828	83 820
2012 average		10 400 007	62 869 660	84 174
Total		941 828 181	3 242 546 483	

¹ Beneficiaries paid more than 7 days after the last day of the payroll month.

² Contributions in January and February 2008 were made under the TIM.

³ Averages include only the months where there were contributions from Pegase.

ANNEX V

TOTAL PEGASE CONTRIBUTION TO VPF BENEFICIARIES COMPARED WITH PA SOCIAL ALLOWANCE PAYMENTS TO ELIGIBLE VPF BENEFICIARIES 2008–12

Payroll month	Total Pegase pay to beneficiaries (euro)	Number of Pegase beneficiaries	Average Pegase payment (euro)	PA contribution (euro)	Total PA pay to Pegase beneficiaries (euro)	Total PA pay to additional beneficiaries (euro)	Number of PA additional beneficiaries	Average PA pay to add. beneficiaries (euro)
Mar-08	7 512 910	41 321	182	0	0	0	0	0
Jun-08	7 475 092	41 113	182	0	0	0	0	0
Sep-08	8 873 487	46 025	193	0	0	0	0	0
Dec-08	9 363 892	47 680	196	0	0	0	0	0
2008 average	8 306 345	44 035	188	0	0	0	0	0
Mar-09	9 166 509	48 798	188	0	0	0	0	0
Jun-09	13 483 031	49 645	272	0	0	0	0	0
Sep-09	9 288 785	50 531	184	0	0	0	0	0
Dec-09	9 219 962	52 114	177	0	0	0	0	0
2009 average	10 289 573	50 272	205	0	0	0	0	0
Mar-10	10 137 710	51 826	196	0	0	0	0	0
Jun-10	10 223 374	49 672	206	0	0	0	0	0
Aug-10	9 701 649	49 754	194	0	0	0	0	0
Dec-10	6 856 359	33 134	207	0	0	0	0	0
2010 average	9 229 773	46 097	201	0	0	0	0	0
Mar-11	9 406 668	57 912	162	0	0	0	0	0
Jun-11	9 765 125	49 578	197	0	0	0	0	0
Oct-11 ¹	10 042 543	50 556	199	0	0	0	0	0
Dec-11	12 051 842	66 626	181	45	4 834 134	2 986 118	27 339	109
2011 average	10 316 545	56 168	185	45	4 834 134	2 986 118	27 339	109
Apr-12 ¹	9 990 238	64 743	154	79	5 663 659	5 116 698	30 704	167
Jun-12	9 875 815	64 417	153	86	6 043 567	5 569 566	31 952	174
Oct-12 ¹	9 759 786	55 599	176	58	7 975 634	3 242 195	40 219	81
Dec-12	10 882 801	54 900	198	40	8 501 210	2 169 995	42 372	51
2012 average	10 312 201	59 915	170	66	6 603 641	4 024 613	34 517	118

¹ Payments delayed due to the non-availability of cash/liquidity in banks in Gaza and of the budget as a result of the recurrent PA financial crisis.

Source: PA Ministry of Finance data with EU/donor and PA breakdown plus Pegase database records.

REPLY OF THE COMMISSION AND THE EEAS

EXECUTIVE SUMMARY

III.

At the end of 2011, the Commission launched a project to assess the needs and identify feasible projects in the area of civil service reform (CSR) in Palestine (this designation is without prejudice to positions on the recognition of Palestine as a state). On this basis, and starting in the second half of 2013, a comprehensive support to the PA will be provided for CSR funded by the EU. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

It should be noted that the Commission and the EEAS have actively sought to ensure Israeli cooperation. Numerous meetings have been held with the Israeli Ministry of Defence (COGAT) and various Israeli government officials in a number of contexts and fora. When necessary, the EU delegation in Tel Aviv has also been involved. The effectiveness of such demarches could be enhanced by a more consistent and robust approach on the matter from Member States.

IV.

In 2011, the need for increased competition was taken into consideration and is being addressed, with the launch of an international tender process to contract *ex ante* and *ex post* audit services related to the implementation of all Pegase DFS programmes. The forecast notice was published in August 2012 and the new contracts are expected to be signed by the end of 2013.

For CSR, see response to paragraph III (Executive Summary) above.

The leverage of the policy dialogue at PA level through the substantive DFS should not be underestimated.

V.

It should be noted that, during several months in 2012, Israel did not transfer the clearance revenues to the PA. This was a key factor in the delays in the payment of PA salaries. Nevertheless, since the start of 2013, WAFA, PBS and Ministry of Religious Affairs employees have been removed from the list of eligible beneficiaries, returning the number to around 75 000 (down from 84 000).

VI.

The issues surrounding the civil servants who are not able to work in Gaza (e.g. PA-support strike, its duration, its extent and its effects, Hamas' reactions) are complex in the circumstances of the Gaza Strip where objective verification is difficult. DFS is a PA-driven programme. The Commission and the EEAS stand by their decision to support politically the PA (core of the future Palestinian state), which decided to continue to pay all eligible workers in both the West Bank and the Gaza Strip regardless of their working status, which is, in any event, very difficult to clarify. Some civil servants do not work in Gaza simply because they are locked out by the de facto authorities. Others, although actually working, would still officially say that they are not working due to political reasons.

Any decision to stop contributing to salaries in Gaza is expected to be politically very sensitive.

The Commission and the EEAS consider that they have sufficiently addressed this problem. This issue has been raised with the PA on a number of occasions at the highest political level and will continue to be the focus of future discussions.

VII.

For engagement with the Government of Israel, see response to paragraph III (Executive Summary) above.

REPLY OF THE COMMISSION AND THE EEAS

OBSERVATIONS

27.

EU action plans set priority objectives which have been jointly agreed by both the EU and the PA and do not include an indicative financial framework. A new EU–PA action plan (AP) was approved by the Council in March 2013. This new AP is more closely aligned to development assistance needs (and vice versa) than its predecessor, which was concluded before the setting-up of Pegase.

28.

As from 2014, the EU will embark on a 2-year programming cycle for the development part of its financial assistance. Palestine is one of the most sensitive points in the overall budget for external financial assistance and the budgetary authority has, in recent years, frequently increased the initial Commission proposal. The annual amounts available for Palestine are only known with any degree of confidence very late in the budgetary process. The volatile political situation also requires the Commission and the EEAS to be vigilant and to be able to reassess the situation whenever needed.

Very few Member States have programmed assistance to Palestine on a multiannual basis, for precisely the same reasons.

The EU local strategy for development has recently been revised in cooperation with Member States and local representatives.

29.

The Commission and the EEAS consider that submitting measures to Member States by written procedure does not make it more difficult to carry out a detailed review of the mechanism. On a number of occasions, Palestine programmes (Pegase in particular) have been presented to the ENPI committee as an information point on the agenda. Member States have generally indicated their satisfaction with the procedures used and did not refrain from asking for further clarifications whenever they deemed it necessary.

The Commission and the EEAS consider that the establishment of the PSRG programme, which was implemented after ‘Operation Cast Lead’, as well as the use of the SEPS and arrears component demonstrate the ability of the programme to adapt to changes in the operational environment.

The Commission and the EEAS are, however, aware that this situation is unsustainable in the long run and that it is time to make adjustments now that the situation in Gaza has remained unresolved for the past 7 years. In fact, this issue has been raised with the PA on a number of occasions in the past.

Discussions have already started with the PA aimed at finding a solution that would take account of the concerns raised by the Court, while allowing the PA to continue supporting its employees in Gaza.

The Commission and the EEAS stand by their political view that the PA must continue supporting its workers in Gaza as a key element of maintaining the unity of a future Palestinian state and allowing the PA to retain a foothold in Gaza. Due consideration should be given to the fact that the Commission and the EEAS took and implemented this decision in view of political considerations and that most of the workers who are not working in Gaza are in fact prevented from working.

REPLY OF THE COMMISSION AND THE EEAS

30.

It should be noted that, except for the United Kingdom, which only contributed to Pegase in 2008, no other donor to Pegase DFS has moved from Pegase DFS to the World Bank Trust Fund. Furthermore, Pegase also attracted funding from non-member countries such as Japan and Switzerland.

The decline in funding can be attributed primarily to the decline in the fiscal situation of Member States as well as to a certain degree of donor fatigue. Some Member States and other donors prefer to support development projects (rather than DFS) as it gives them more visibility.

31.

The Commission acknowledges that the current situation of Pegase does not include performance indicators.

The EEAS and the Commission are guided in this respect by the indicators contained in the Palestinian reform and development plan and the Palestinian national development plan, on whose priorities Pegase was and remains based. This is also a measure of conditionality.

The Commission also accepts to introduce performance indicators for Pegase, which will take into account the specific situation of the PA and the particularity of the Pegase programme.

The aim of providing DFS through Pegase is to enable the PA to meet its existing commitments to its population, insofar as this is possible. It is not realistic to expect a significant qualitative improvement of these in the current financial situation.

The factors on which the achievement of the objectives depend are mainly external and beyond the PA's control. Pegase DFS is a political instrument whose ultimate objective is to maintain the viability of the two-state solution by sustaining the basic living conditions of the Palestinian people. Palestine is not an independent country whose government can mobilise a wide range of resources in support of a particular target.

DFS is not a classic project which can be evaluated in terms of PCM. It is designed to assist the PA to deal with a long-term problem in the expectation that, by keeping the authority in being, the EU will contribute to the two-state solution of the Middle East peace process.

32.

In line with the PA's 2-year state-building plan of 2009, which envisaged a reduction on dependence on external aid, the EEAS (and previously DG RELEX) sought in each programming to decrease the proportion of DFS; but it has simply not been possible to reduce this drastically because of the threats to the PA's survival. These issues have also been raised in the framework of Ad Hoc Liaison Committee (AHLC) meetings.

In the present circumstances and given the political situation, the possibility to reduce funding is not in line with the current EU policy.

34.

The beneficiaries are known and subject to *ex ante* and *ex post* verifications. Funds are paid upon application by the PA and the provision of the necessary supporting documentation.

These funds essentially only transit through the central treasury sub-account, which operates a 'double key' system for the release of payments, i.e. both the EU and the PA have to authorise this. The risk of corruption is therefore minimal. Insofar as the risk of destruction of EU-funded infrastructure under the Gaza private sector programme is concerned, this risk was known and, although the Commission attempts to minimise the risk through regular dialogue with the Israeli Ministry of Defence (COGAT), this risk has to be accepted.

REPLY OF THE COMMISSION AND THE EEAS

35.

The Commission and the EEAS are prepared to critically examine the cost-effectiveness of controls and weigh these against the risks involved.

36.

In 2011, the need for increased competition was taken into consideration and is being addressed, with the launch of an international tender process to contract *ex ante* and *ex post* audit services related to the implementation of all Pegase DFS programmes. The forecast notice was published in August 2012 and the new contracts are expected to be signed before the end of 2013.

A direct negotiated procedure was requested and approved as per Article 168(2) of the implementing rules of the financial regulation and was duly justified at the time.

37.

Direct award was justified under the implementing rules of the financial regulation.

Following a specific EUREP request, all agreements with an international organisation have been subject to additional requirements (exceptions from the general conditions applying to international organisations), particularly in relation to additional reporting requirements, auditing and the transfer of equipment.

EUREP has completed the transition from a contribution agreement to a 1-year service contract with the international organisation. All equipment under the previous agreements has been transferred to the PA (excluding the DFS database). These services will be subject to an international restricted tender in 2014.

38.

It should be noted that the verification and management procedures applying to the PDFS programmes are being reviewed.

Arrangements for insourcing the Pegase database and its management are being made.

39.

Taking into consideration the size of the project and the political sensitivity related to the implementation of the programme, EUREP deliberately made the choice not to give the contract to a local firm at the time.

Further to the exercise to review the verification and management procedures of Pegase, an international call for tender has been launched for the contracting of *ex ante* and *ex post* audit services related to the implementation of all Pegase DFS programmes.

While the absence of formal conditionality is due to the unique circumstances, this does not imply the absence of leverage vis-à-vis the PA (see paragraph 40).

40.

Pegase DFS is provided to the PA without explicit conditionality: a deliberate choice by the Commission, the EEAS and Member States in line with their political objectives in the Middle East peace process.

However, the EEAS and the Commission are guided by the indicators contained in the Palestinian reform and development plan and the Palestinian national development plan, on whose priorities Pegase was and remains based. This is a measure of conditionality.

Leverage does exist thanks to this reliable and consistent contribution from the EU. EUREP is currently working on improving leverage through policy dialogue, in coordination with interested Member States, through the recently established EU Pegase Informal Group.

41. (a)

At the end of 2011, the Commission launched a project to assess the needs and identify feasible projects in the area of CSR in Palestine. On this basis, and starting in the second half of 2013, support to the PA will be provided for CSR funded by the EU. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

REPLY OF THE COMMISSION AND THE EEAS

42.

It should be noted that the Commission and the EEAS have actively sought to ensure Israeli cooperation. Numerous meetings have been held with the Israeli Ministry of Defence. Various other meetings are held with Israel in the framework of EU–Israel bilateral relations and these issues have been raised in the Association Committee, Association Council and in the political dialogue with Israel. When necessary, the EU delegation in Tel Aviv has also been involved. The effectiveness of such demarches could be enhanced by a more consistent and robust approach on the matter from Member States. Nonetheless, the Council itself has moved from Council conclusions of a more broad nature to much more concrete ones (particularly May 2012 and December 2012).

46.

The Commission launched a project to assess the needs and identify feasible projects in the area of CSR in Palestine at the end of 2011. On this basis, and starting in the second half of 2013, support to the PA will be provided for CSR funded by the EU. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

47.

Pegase is a specific instrument created to ascertain that the funds are traceable to the end beneficiary. The funding is only made available upon agreement on the final list of end beneficiaries by both the EU and the PA. This instrument has been installed to avoid any possible de-routing of EU funding. Therefore, the Commission and the EEAS are of the opinion that the Pegase funds are not fungible in budgetary terms.

Concerning the argument that Pegase has allowed the PA to save some of its resources and redirect them to other uses, the Commission and the EEAS contest this finding which cannot be demonstrated in practice. The Commission and the EEAS consider that there is no evidence that Pegase has resulted in funding being redirected to the recruitment of security forces, which in any case receive support from other sources.

48.

Beyond reforms, sustainability is closely linked to political progress on reconciliation and on ending the occupation.

A key element in the 'increasing difficulty the PA has had in paying salaries and pensions on time' in recent times has been Israel's suspension of the 'clearance revenues'. This sudden drop in income was not accounted for by the PA. The fiscal situation of Member States as well as a certain degree of donor fatigue has certainly played a role in the capacity and willingness of donors to react to this crisis. At the same time, the PA was hoping to attract more funding from Arab donors.

51.

It should be noted that the caseload of beneficiaries of cash assistance has increased from 2010 onwards due to various factors, including the introduction of the cash transfer programme (CTP) in 2010 (consisting of the merger of the SSNRP and SHC programmes and the certification of households on the waiting list) and its subsequent roll-out in Gaza in 2011. The target of the PA is 120 000 households enrolled in the programme — corresponding to the estimated number of households living in extreme poverty in Palestine. On the level of assistance: the basis for calculating the amount of financial benefit for eligible households is the '50 % bridging the gap' policy. The gap is the difference between the welfare rate (consumption) and the household extreme poverty line. The cash component of the CTP provides financial assistance to meet 50 % of this gap and this makes up the base cash benefit rate. Beneficiary households usually have access to additional sources of income (remittances) as well as additional/complementary assistance (i.e. health insurance and in-kind assistance) which complement the cash component.

REPLY OF THE COMMISSION AND THE EEAS

52.

Delays in payment are the result of various factors that are out of the control of the Ministry of Social Affairs/Ministry of Finance, including: (1) the availability of cash/liquidity in banks in Gaza; and (2) the availability of budget as a result of the recurrent PA financial crisis (including transfers of clearance revenues from Israel).

It should be noted that: (i) the September 2011 and September 2012 payments were processed on 3 October 2011 and 6 October 2012 respectively, i.e. with a delay of 1 week only compared to the initial target date (usually the last weekend of September);

(ii) the first quarterly payment in 2012 was made in late April 2012, due to a shortage of cash, mainly Israeli Shekels (ILS) and US dollars, at the local banks in Gaza (as a result of Israeli restrictions on liquidity). Although this did not concern the West Bank, the PA opted for political reasons not to process the payment in the West Bank without assurance that the payment would take place in Gaza at the same time or soon afterwards.

53.

See paragraph 31 above.

54.

The issues surrounding the civil servants who are not able to work in Gaza (e.g. PA-support strike, its duration, its extent and its effects, Hamas' reactions) are complex in the circumstances of the Gaza Strip where objective verification is difficult. DFS is a PA-driven programme. The Commission supports politically the PA (core of the future Palestinian state), which decided to continue paying all eligible workers in both the West Bank and the Gaza Strip regardless of their working status, which is, in any event, very difficult to clarify. It is perhaps worth recalling that amongst those civil servants not working in Gaza, many are effectively locked out by the de facto authorities.

Any decision to stop contributing to salaries in Gaza is expected to be politically very sensitive.

55.

See comment on paragraph 54.

57.

The beneficiaries are known and subject to *ex ante* and *ex post* verifications. Funds are paid upon application by the PA and the provision of the necessary supporting documentation.

These funds essentially only transit through the central treasury sub-account, which operates a 'double key' system for the release of payments, i.e. both the EU and the PA have to authorise this.

58.

See reply to observation 54.

59.

With regards to the use of fuel instead of gas, it should be noted that external factors decided this issue. Neither Israel nor Egypt would allow the export of gas to Gaza, therefore the use of diesel fuel was the only possible option.

60.

The issue of VAT and other taxes on fuel delivery with Israel extends much further than Pegase and is part of an overall issue in relations between the EU and Israel. Efforts had been made by the Commission to get an exemption from paying VAT on the fuel deliveries, but the discussions were not successful. It was apparent that the issue could only be resolved at the highest political levels.

The Commission considers that it cannot be criticised for not being able to establish how VAT and excise duties which it pays are used by the authorities, whether Israeli or Palestinian, under the Paris protocol of the Oslo agreements which establishes conditions for transfers of certain tax revenue from Israel to the PA, but to which the Commission/EU is not a party.

This was one of a number of factors which led to the Commission ceasing to finance fuel deliveries.

REPLY OF THE COMMISSION AND THE EEAS

61.

The Commission did advise the PA to consider the possibility of carrying out a PEFA assessment before 2012.

In November 2011, the PA Ministry of Finance agreed at technical level on the principle of carrying out a PEFA exercise. The EU was planning to finance part of the assessment. However, the PA subsequently decided to delay the assessment.

A PEFA assessment was launched in March 2013 and the PEFA report was formally sent to the Ministry of Finance in June 2013 and was accepted by the ministry in the same month. It was published on 2 September 2013. The EU contributed to this World Bank-led assessment through the financing of one expert.

There have been other assessments of the PA public financial management systems than the PEFA assessments. The IMF carried out PA public financial management progress reviews in April 2008, April 2009, December 2009, October 2010, January 2012 and January 2013. In addition, the IMF staff reports to the meetings of the AHLIC (which take place twice a year) include assessments of the PA public financial management reforms.

62.

The Commission continues to work on this issue regarding PFM: a World Bank-led PEFA assessment was launched in March 2013 and the report was formally sent to the Ministry of Finance in June 2013.

Any form of legislative scrutiny is difficult in the absence of a functioning Palestinian legislative council. It was accepted by the ministry in the same month and published on 2 September 2013.

63. (b)

In September 2012, a result-oriented monitoring report pointed out that: 'the project suffered delays during its first half of implementation for several reasons (long assessment needs studies, reshaping of activities, a low level of knowledge of English for trainees and a lack of translators). Most of these problems have been solved during the first part of 2012.' At the time, the overall efficiency and effectiveness of the project implementation were considered 'good' by the monitor.

66.

The refunds were carried out in accordance with the rules. The major concern was to boost the economy by injecting long-due arrears into the private sector. The outstanding arrears were subject to the obligatory audit controls before the payments were done.

Box 2

The refund was carried out in accordance with the rules. It should be noted that the arrears reimbursed to this company had been accumulated over a period of more than 7 years from December 2000 until January 2008. The fact that the hotel was barely operating in October 2012 is due to the situation in Gaza and the continued blockade.

67.

Support to the Gaza power plant was intended to meet a particular emergency, rather than to be sustainable. When another approach was proposed by the PA, this component of Pegase was no longer funded.

68.

A key element in the 'increasing difficulty the PA has had in paying salaries and pensions on time' in recent times has been Israel's suspension of clearance revenues. In addition, the fiscal situation of Member States as well as a certain degree of donor fatigue has played a role in the capacity of donors to react to this crisis. At the same time, the PA was hoping to attract more funding from Arab donors.

70.

It should be noted that the Commission and the EEAS have actively sought to ensure Israeli cooperation. Numerous meetings have been held with the Israeli Ministry of Defence. When necessary, the EU delegation in Tel Aviv has also been involved. The effectiveness of such demarches could be enhanced by a more consistent and robust approach on the matter from Member States.

REPLY OF THE COMMISSION AND THE EEAS

70. (b)

Substantial sums have been allocated to Area C from the 2012 allocation (7 million euro) in addition to approximately 3.5 million euro from the food security programme. Pegase will also make funds available in Area C through an extension of the Gaza private sector recovery programme to the West Bank, with special emphasis on farmers and communities affected by the separation wall, Israeli army demolitions and settler violence.

The issue of Area C is high on the political agenda. It has been discussed various times at the PSC and an EU demarche was already carried out by the EU delegation in Tel Aviv in December 2011. Area C is also a priority objective of the new action plan.

CONCLUSIONS AND RECOMMENDATIONS

74.

Sustainability can only be ensured through political progress on reconciliation and the ending of occupation.

However, the two issues of reform and Israeli measures are important and the Commission and the EEAS are addressing these issues as follows.

At the end of 2011, the Commission launched a project to assess the needs and identify feasible projects in the area of CSR in Palestine. On this basis, and starting in the second half of 2013, a comprehensive support to the PA will be provided for CSR funded by the EU. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

The Commission and the EEAS have actively sought to ensure Israeli cooperation. Numerous meetings have been held with the Israeli Ministry of Defence. Numerous meetings are also held with Israel (at different levels and in various fora) in the framework of EU–Israel bilateral relations and through the delegation in Tel Aviv. The effectiveness of such demarches could be enhanced by a more consistent and robust approach on the matter from Member States.

75.

The Commission agrees to establish performance indicators, taking into account that many factors affecting performance are external and outside the control of the PA. Palestine is not an independent country whose government has a normal control of a wide range of resources to meet specific targets.

Pegase DFS is a political instrument whose objective is to maintain the viability of the two-state solution by sustaining the basic living conditions of the Palestinian people. The lack of donor funding through Pegase is more a result of donor fatigue or of the economic situation rather than a deliberate decision to not use Pegase. As mentioned earlier, some donors also prefer to fund development projects (rather than DFS) because they entail more visibility.

76.

A direct negotiated procedure was requested and approved as per Article 168(2) of the implementing rules of the financial regulation and was duly justified at the time.

It should be noted that the verification and management procedures applying to the PDFS programmes are being reviewed (see paragraph 38).

In 2011, the need for increased competition was taken into consideration and is being addressed, with the launch of an international tender process to contract *ex ante* and *ex post* audit services related to the implementation of all Pegase DFS programmes. The forecast notice was published in August 2012 and the new contracts are expected to be signed by the end of 2013.

A service contract tender for the management and implementation of the programme will be launched in 2014 (see response to paragraph 37).

77.

At the end of 2011, the Commission launched a project to assess the needs and identify feasible projects in the area of CSR in Palestine. On this basis, and starting in the second half of 2013, a comprehensive support to the PA will be provided for CSR funded by the EU. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

REPLY OF THE COMMISSION AND THE EEAS

78.

The issues surrounding the civil servants who are not able to work in Gaza are complex in the circumstances of the Gaza Strip where objective verification is difficult. DFS is a PA-driven programme. The Commission supports politically the PA (core of the future Palestinian state), which decided to continue paying all eligible workers in both the West Bank and the Gaza Strip regardless of their working status, which is, in any event, very difficult to clarify. It is worth recalling that amongst those civil servants not working in Gaza, many are effectively locked out by the de facto authorities.

Any decision to stop contributing to salaries in Gaza is expected to be politically very sensitive.

The issue of VAT and other taxes on fuel delivery with Israel extends much further than Pegase and is part of an overall issue in relations between the EU and Israel. Efforts had been made by the Commission to get an exemption from paying VAT on the fuel deliveries, but the discussions were not successful.

It is apparent that the issue can only be resolved at the highest political levels.

The Commission considers that it cannot be criticised for not being able to establish how VAT and excise duties which it pays are used by the authorities, whether Israeli or Palestinian, under the Paris protocol of the Oslo agreements which establishes conditions for transfers of certain tax revenue from Israel to the PA, but to which the Commission/EU is not a party.

This was one of a number of factors which led to the Commission ceasing to finance fuel deliveries.

79.

For details of the PEFA assessment, see reply to paragraph 61 above.

80.

The Commission and the EEAS agree to review the Pegase mechanism and take the recommendations made by the Court into account.

The EEAS and the Commission are reviewing the Pegase mechanism on a regular basis according to the changes on the ground (e.g. PSRG component after 'Operation Cast Lead' and more recently the component for East Jerusalem hospitals).

However, the Commission strongly disagrees that a 'major' review of Pegase needs to be undertaken.

81. (a)

The Commission and the EEAS agree to this recommendation which has already been partially implemented. Palestine's new AP is the first of the new generation of APs negotiated since the review of the ENP, which includes priority objectives to be achieved which have been jointly agreed by both the EU and the PA. The text is more closely aligned to development assistance needs (and vice versa) than its predecessor, which was concluded before the setting-up of Pegase.

81. (b)

The Commission and the EEAS partially agree to this recommendation.

As from 2014, the EU will embark on a 2-year programming cycle for the development part of its financial assistance. The Pegase programme was not initially planned to be part of this multiannual programming, but the Commission and the EEAS will reconsider their position.

Although the Commission and the EEAS maintain their reservations on this point, they are prepared to take steps towards implementing this recommendation insofar as possible.

81. (c)

The Commission and the EEAS agree to this recommendation; performance indicators will be introduced in the areas mentioned by the Court for Pegase (see our response to paragraph 31).

REPLY OF THE COMMISSION AND THE EEAS

82. (a)

The Commission agrees to this recommendation. The process of competitive tendering is ongoing. In 2011, the need for increased competition was taken into consideration and is being addressed, with the launch of an international tender process to contract *ex ante* and *ex post* audit services related to the implementation of all Pegase DFS programmes. The forecast notice was published in August 2012 and the new contracts are expected to be signed by the end of 2013. A service contract tender will be launched in 2014 (see response to paragraph 37).

82. (b)

The Commission agrees to this recommendation and will pursue ongoing plans to simplify the Pegase DFS management system. EUREP is now responsible for administering the Pegase database, which was moved to the EUREP building at the beginning of October 2013.

83.

The Commission and the EEAS disagree with this recommendation. On conditionality, refer to our response to paragraph 40. For CSR, the Commission launched a needs assessment in 2011. On this basis, support to the PA will be provided in 2013. EUREP will ensure close links between this action and the CSP programme, also facilitating stronger leverage over policy dialogue.

The EEAS and the Commission also consider the implementation of the Palestinian reform and development plan and the Palestinian national development plan, on whose priorities Pegase was and remains based, as a measure of conditionality.

A PEFA assessment was launched in March 2013 and the PEFA report was formally sent to the Ministry of Finance in June 2013 and was accepted by the ministry in the same month. It was published on 2 September 2013. The EU contributed to this World Bank-led assessment through the financing of one expert.

84.

The Commission and the EEAS agree only partially to this recommendation.

The Commission and the EEAS agree to enter into discussions with the PA concerning the funding of salaries and pensions in the Gaza Strip with a view to obtaining an agreement that would take into account the concerns of the Court.

85.

The Commission agrees to this recommendation.

European Court of Auditors

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IN THIS REPORT, THE EUROPEAN COURT OF AUDITORS ASSESSED HOW WELL THE EUROPEAN COMMISSION AND THE EUROPEAN EXTERNAL ACTION SERVICE MANAGED THE PEGASE DIRECT FINANCIAL SUPPORT (DFS) PROGRAMME WHICH HAS BEEN THE EU'S LARGEST PROGRAMME IN THE OCCUPIED PALESTINIAN TERRITORY SINCE 2008, PROVIDING APPROXIMATELY 1 BILLION EURO IN FUNDING FROM 2008 TO 2012.

IT CONCLUDES THAT THE COMMISSION AND THE EUROPEAN EXTERNAL ACTION SERVICE SUCCEEDED, DESPITE DIFFICULT CIRCUMSTANCES, IN IMPLEMENTING THE PEGASE DFS PROGRAMME. HOWEVER, A NUMBER OF ASPECTS OF THE CURRENT APPROACH ARE INCREASINGLY IN NEED OF AN OVERHAUL. WHILE SOME IMPORTANT RESULTS HAVE BEEN ACHIEVED, THEIR SUSTAINABILITY CANNOT BE ENSURED WITHOUT MAJOR REVISIONS SUCH AS ENCOURAGING THE PALESTINIAN AUTHORITY TO UNDERTAKE MORE REFORMS, NOTABLY IN RELATION TO ITS CIVIL SERVICE. AT THE SAME TIME, A WAY NEEDS TO BE FOUND TO ENGAGE ISRAEL INTO TAKING THE NECESSARY STEPS TO HELP ENSURE THAT PEGASE DFS IS EFFECTIVE.



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