

## I

*(Information)*

## COURT OF AUDITORS

**SPECIAL REPORT No 18/2000****concerning the programme to supply agricultural products to the Russian Federation, together with the Commission's replies***(submitted pursuant to Article 248(4), second subparagraph, of the EC Treaty)**(2001/C 25/01)***CONTENTS**

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## EXECUTIVE SUMMARY

In 1998 the Russian Federation was simultaneously affected by poor harvests and a financial crisis. As a result of the crisis the European Union (EU) feared that its agricultural exports might fall substantially, as the Russian Federation was its second largest meat export market. The United States of America adopted a food aid programme for Russia. The EU also wanted to secure its presence there. In response to a request from the Russian Government, the Council decided, in December 1998, to supply agricultural products to the neediest regions of the Russian Federation free of charge (see paragraph 1).

The programme was not to be allowed to impede EU agricultural exports to Russia (some of them subsidised), nor to disturb the local market. For that reason the selling price of the products was not to be lower than that of similar products obtained locally or imported from the EU. As for the neediest regions, for which these products were intended, they hoped to have them as cheaply as possible. At the same time, the Russian authorities also wanted to maximise the sales revenue in order to use it for social measures (see paragraph 2).

The Court found that there had been no prior analysis of needs. The necessity of the aid was not proven. Moreover, Russia exported cereals in 1999. Many Russians found it difficult to obtain proper food supplies, but the difficulty was due to a lack of financial resources rather than lack of food as such. Russia's ability to import EU food products in the long term was not examined sufficiently. Even though the EU feared a drop in its meat exports to Russia, they in fact increased in 1999, partly due to the export refunds whose impact the Commission had underestimated (see paragraphs 6 to 11).

Collection of the counterpart funds generated by the sale of these products was often delayed, mainly because of the difficulty of selling the meat. Regions which had problems in paying the funds within the time allowed, and were already among the neediest, were also threatened with financial penalties by the Russian federal authorities. Furthermore, the Commission was more concerned with optimum collection of these funds than with their utilisation (see paragraphs 14 and 42 to 47).

Generally speaking, the impact of the programme was reduced because:

- the Commission agreed to the Russian federal authorities' making a link between the allocation of aid to regions and the latter's ability to provide a financial guarantee, even though the programme was supposed to give priority to assisting the neediest regions (see paragraphs 11 and 53),
- as the selling price of the meat was very high, in order to prevent its competing with Community imports, and with local produce as well, the meat remained in storage in Russia for many months and the consignments, although very expensive, thus had no significant impact on the local market in 1999, even though at the end of 1998 the Council had considered it imperative that the products reach their destination as soon as possible (see paragraphs 35 and 36).

The principal declared objective, of improving the precarious situation of the Russian people and regularising agricultural markets by supplying to the neediest regions agricultural products that were to reach their destination in the shortest time possible, was only partially achieved. The aid was not essential, in so far as Russia was able to obtain supplies on the international market by leaving private operators to take the necessary action. If the intention was that Russia should be given food aid, a humanitarian programme on a smaller scale that targeted the neediest social groups would have been more appropriate. As regards the desire to keep the Russian export market, the aim was achieved more effectively and at proportionately lower cost by means of export refunds (see paragraphs 55 to 61).

## INTRODUCTION

### *Programme objectives*

1. In 1998 the cereal harvest in Russia was particularly poor <sup>(1)</sup>. In August of the same year the country was hit by a serious financial crisis as well. On 6 November 1998 the USA decided to grant food aid to Russia. The European Union (EU) also wanted to secure its presence there, Russia being its second most important meat export market <sup>(2)</sup>. In response to the Russian Government's request of 12 November 1998 the Council adopted Regulation (EC) No 2802/98 <sup>(3)</sup> of 17 December 1998, making provision for the free supply of agricultural products to the neediest regions of the Russian Federation. Selling these products on local markets was to create a counterpart fund to finance social measures. Since this operation was to help redress a precarious situation among the Russian people, and at the same time regularise agricultural markets in Russia, the Council considered it imperative that the aid reach its destination as soon as possible.

2. The Commission's implementation of the Council Regulation was subject to significant constraints. The programme must not be allowed to impede EU agricultural exports to Russia (some of them subsidised), nor to disturb the local market. For that reason, the selling price of the products was not to be less than that of similar products obtained locally or imported from the EU. On the other hand, these products were intended for the poorest regions, which wished to obtain them for the lowest price possible. In addition, since the Regulation (Article 1(4)) stipulated that the revenue was to be earmarked for social measures, the Russian authorities wanted to obtain the maximum possible counterpart funds in order to use them as budget support.

<sup>(1)</sup> 48 Mio tonnes, compared with an average of 73 Mio tonnes over the five previous marketing years, according to the Russian Government's official estimates.

<sup>(2)</sup> See Mr Fischler's 'Background note for the Agricultural Council of 28 September 1998': 'As regards EU agricultural products and especially animal products, maintaining the normal level of export to Russia is essential, as the balance on the European markets is highly dependent on exports to Russia'.

<sup>(3)</sup> OJ L 349, 24.12.1998, p. 12.

**Programme components**

3. This complex, ambitious programme provided for the supply of 1,85 million tonnes of food products with a value of 377,7 million euro to around 50 regions out of the 89 administrative entities that constitute the Russian Federation. Cereals and rice accounted for approximately 40 % of the total value, against 50 % for meat products, with skimmed-milk powder making up the balance. With the exception of pigmeat, which was bought on the

Community market, all the products were taken from intervention stocks.

4. The costs of monitoring (mobilisation in Europe and distribution in Russia) and transporting the products to the Russian border were charged to the Community budget. Taking into account the savings on storage costs and export refunds, which are estimated at 71,5 million euro, the net total cost of the programme financed with EAGGF appropriations was estimated at 411,1 million euro (see Table I).

Table I

**Estimated programme cost**

Product	Quantity (in tonnes)	Value <sup>(1)</sup> (in EUR)	Transport as far as Russian frontier (cost in EUR)	Total cost (in EUR)
Wheat	1 000 000	105 800 000	25 000 000	130 800 000
Rye	500 000	29 900 000	12 500 000	42 400 000
Rice	50 000	17 500 000	2 500 000	20 000 000
Beef	150 000	75 000 000	30 000 000	105 000 000
Pork	100 000	110 000 000	20 000 000	130 000 000
Skimmed-milk powder	50 000	39 500 000	2 500 000	42 000 000
<b>Total</b>	<b>1 850 000</b>	<b>377 700 000</b>	<b>92 500 000</b>	<b>470 200 000</b>
Technical assistance, monitoring, audit and evaluation				12 400 000
Savings on storage costs and export refunds				- 71 500 000
<b>Total net cost</b>				<b>411 100 000</b>

<sup>(1)</sup> Estimated accounting value at the level of intervention stocks as of end-September 1998, except for pork, where the price taken was the market price at the time of estimation.

Source: DG AGRI.

**Scope of the audit**

5. Given the significant inherent risks of implementing this programme <sup>(1)</sup> the Court's audit mainly centred on its implementation in Russia. The audit objective was, firstly, to verify the effectiveness and impact of the programme and, secondly, to examine the Commission's performance as regards both the transport of products to their destination and the collection of counterpart funds, as well as ensuring that they were used for the intended purposes. As the Commission had made provision for the delivery of the products during the first six months of 1999 (point 3.11 of the Memorandum of Understanding), the on-the-spot audit was carried out in the second half of 1999, at the Commission and its Delegation in the country, on the premises of the

Russian authorities concerned (Ministries of Agriculture and Finance, State pension fund, operators responsible for distribution) and in nine beneficiary regions. The total value of the supplies allocated to the regions visited represents approximately 35 % of the entire programme. Meetings were also arranged in Moscow with counsellors from embassies of Member States and the United States of America, local representatives of the International Monetary Fund (IMF) and the World Bank, and with the United Nations Food and Agriculture Organisation (FAO).

**PREPARATION OF THE PROGRAMME****Analysis of needs**

6. At the meeting of the Agriculture Council of 28 September 1998, the Commission stated that there were no food shortages in Russia and that on a macroeconomic level there was enough money to buy foodstuffs. It also pointed out that most analysts considered that Russian food imports would resume as soon as

<sup>(1)</sup> See Council Regulation (EC) No 2802/98 of 17 December 1998: '... despite all the precautions which have been and will be taken, the operation inevitably involves inherent risks' (OJ L 349, 24.12.1998, p. 12).

exchange rates had stabilised <sup>(1)</sup>. In November 1998 it nevertheless submitted a proposal for a programme of food supplies to Russia.

7. The actual need for such a programme formed the subject of an extensive debate in Russia, with semi-public trade organisations in favour and private-sector operators and the groups in favour of the economic reforms against. Despite warnings from the World Bank, the Commission did not analyse the negative impact that such a programme might have on the emerging private sector (local producers, new private operators). Neither did it attempt to assess how far internal trade barriers were affecting the supply of cereals, even though in November 1998 the FAO had expressed the view that if there were any shortages in Russia, they would be local and attributable to the existence of these internal barriers <sup>(2)</sup>.

8. Although the supply of cereals on the Russian market was actually lower in 1998, there is no evidence to show that Russia could not have resorted to imports, despite the financial crisis of August 1998 <sup>(3)</sup>. Moreover, the problem for a large part of the population was not so much food shortages as lack of money to buy food <sup>(4)</sup>. Furthermore, according to Russian cereals experts <sup>(5)</sup>, the official statistics underestimated cereal stocks by 10 % to 20 %, especially as regards production capacity and the stocks held by private operators.

9. Article 3.9 of the Memorandum prohibits the export, for the duration of the programme, of products of the same kind as those supplied by the EU, except in cases where the contracts were signed before 1 October 1998. According to the OECD, between July 1998 and February 1999 Russia exported 1,04 Mio tonnes of cereals, thus exceeding the record volume of 1997/1998, and was a net exporter of cereals during the second half of 1998 <sup>(6)</sup>. Although it was not established that exports to Russia took place in violation of the Memorandum, it must, however, be noted that the European Union adopted a programme of food aid to Russia at the very moment when Russian cereals exports were reaching record levels.

10. Following the devaluation of the rouble, the Commission particularly feared that there would be a substantial drop in Russian imports of meat <sup>(7)</sup>. However, it overestimated the duration of the financial crisis in Russia and, at the end of 1998, Community exports of pigmeat to Russia had already returned to their pre-August 1998 level. When the pigmeat supplied under the programme arrived in Russia, it had to compete with commercial imports (see paragraph 35). The effect of increasing export refunds for pork and extending the export facilities for Russia was largely to blame for this situation. Disregarding food aid, EU exports to Russia in 1999 were, in fact, relatively stable in the case of beef and even increased relative to previous years in the case of pigmeat (see Table 2).

Table 2

**Exports of meat from the EU to Russia (1997 to 1999)**

Year	Exports of beef		Exports of pigmeat	
	Total	Excluding aid	Total	Excluding food aid
1997	427 403		358 988	
1998	260 282		335 984	
1999	535 521 <sup>(1)</sup>	397 071	591 000 <sup>(2)</sup>	532 500

<sup>(1)</sup> Based on applications for export licences.

<sup>(2)</sup> Including approximately 450 500 t subject to export refunds.

Source: DG AGRI.

<sup>(1)</sup> See 'Background note for the Agricultural Council of 28 September 1998.'

<sup>(2)</sup> For example, price regulations varied from region to region, the main cereal-producing regions speculated on price rises by banning exports to other regions.

<sup>(3)</sup> In the World Bank's opinion Russia was in a position to import cereals and meat, in view of the state of its balance of trade. See 'Outlook for Russian agriculture', World Bank, 1999.

<sup>(4)</sup> Sources: 'European Union Heads of Mission assessment on the situation of Russian agriculture, harvest and food aid', September 1999 and 'The Association of Russian Agricultural Reform Funds'.

<sup>(5)</sup> Especially the main Russian cereals-marketing company, OGO, and the Institute for the State of the Agrarian Market (ISAM).

<sup>(6)</sup> OECD: A review of recent developments in agricultural policies, markets and trade in Russia and the NIS, April 1999.

<sup>(7)</sup> In 1997 Russia relied on imports for approximately a third of its meat supply.

11. Neither did the Commission make a detailed examination of the supply situation in the various beneficiary regions proposed by the Russian authorities. For example, there is no objective factor, except, perhaps, privileged contacts with the federal authorities, to justify the choice of certain regions <sup>(1)</sup>. The Commission was mainly content to exclude the Moscow and St Petersburg regions from those that were eligible <sup>(2)</sup>, so as not to penalise European exporters, estimating that 85 % to 90 % of EU meat exports went to these regions. These imported products do not necessarily remain in these regions, however, because the big meat-processing factories situated in these regions in fact sell their products all over the Federation <sup>(3)</sup>.

### **Preparation of the legal base and implementation framework**

12. The legal framework for the programme was prepared very quickly, because of the supposed urgency of the programme. The Russian Government submitted its request in November 1998, the Council adopted the Regulation for this operation in December and the Commission signed a Memorandum of Understanding governing the implementation of the programme in January 1999. The Commission negotiated the Memorandum with the Russian Ministry of Agriculture without having an opportunity to consult the Ministry of Finance which, however, plays an essential role in the collection of counterpart funds (see paragraphs 42 to 47).

13. The Commission drew up the operational procedures for the programme, together with the Russian authorities, on an ad hoc basis. As some aspects were not covered in this first Memorandum, signed on 20 January 1999, the Commission negotiated a supplementary Memorandum with the Russian authorities in February 1999 in order, in particular, to take into account the Council's demand that monitoring and controls should take place on Russian territory. It was only in July 1999 that both parties accepted the terms of reference of the Russia-European Commission working group (set up to assist programme implementation) laying down additional implementing rules.

14. As regards the counterpart funds, the Commission agreed to allocate 80 % of them to paying off the pension fund arrears, which was a priority of both the Russian Government and the International Monetary Fund (IMF). Despite the volume of funds to be collected, the international community's concern over the lack of transparency in Russian public finance and the numerous irregularities revealed at this time by the Russian Court of Auditors in the management of pension funds, the Commission did not make an analysis of this fund's function, its current and projected financial statute and its precise utilisation before taking this decision of principle (see paragraph 42).

<sup>(1)</sup> World Bank report 'Outlook for Russian agriculture', October 1999.

<sup>(2)</sup> Poverty rates in these regions outside urban centres are, however, amongst the highest in Russia; these regions received American food aid.

<sup>(3)</sup> Part of the meat supplied by the EU was, moreover, processed in these regions.

## **IMPLEMENTATION OF THE PROGRAMME**

### **Budgetary resources**

15. In the Commission's view, it would have been preferable for the programme to have been financed on the basis of 1999 appropriations, but the Council and the Parliament preferred to use unused appropriations from the 1998 budget <sup>(4)</sup>. Since it was not possible to effect any budgetary commitments in 1998, the Commission requested the carryover of 400 million euro from the 1998 financial year to 1999. At the beginning of 1999, while awaiting the Budgetary Authority's formal decision on the carryover of appropriations, the Commission found itself in a situation where it was impossible to start the programme, because of the absence of appropriations. It then transferred 10 million euro from article B1-3 1 2 'School milk' to article B1-3 1 5 'Food aid for Russia'.

### **Resources deployed by the Commission**

16. The decisions on how the programme was to be implemented were taken centrally, in Brussels. Neither DG Agriculture nor DG External Relations nor the Delegation in Moscow were given any additional resources with which to implement it. The American Embassy in Moscow had a staff of around 20 persons to manage similar aid, with more decisional freedom. Whereas it, for example, decided price adjustments or product destinations on a weekly basis, the only major change decided upon by the Commission (to change the regions eligible), required the authorisation of two Members of the Commission and took more than two months.

### **Mobilisation of foodstuffs**

17. At the end of 1998, in its financial forecasts, the Commission made provision for an average budget of 110 EUR/100 kg for the supply of pigmeat. The average price for this meat, ex-slaughterhouse, on the Community market in 1999 was, in fact, 112 EUR/100 kg. However, the price paid within the programme framework amounted to an average of 150,5 EUR/100 kg. The Commission's pigmeat forecasts did not take into account the costs of freezing, packaging, handling, transport and storage. The cost of the consignments of pigmeat was 31,4 % greater (per tonne) than the Commission's forecasts.

18. The Council Regulation clearly stated that it was imperative that products should reach their destination as soon as possible, and the Memorandum concluded with the Russian authorities provided that the Commission would endeavour to supply the

<sup>(4)</sup> See the Commission's reply to paragraphs 2.16 and 2.17 of the Court's annual report concerning the financial year 1998 (OJ C 349, 3.12.1999, p. 52).

products to the Russian ports or the Russian border during the first half of 1999. By mid-July 1999, only 45 % of these products had arrived in Russia. By the end of 1999, 89 % of the volume of products, but only 58 % of their value, in terms of the initial programme, had been delivered to the beneficiary regions. Deliveries of wheat, rye and rice were practically complete, but only two thirds of the beef and half of the pigmeat and skimmed-milk powder had been delivered.

19. The Commission was, in fact, obliged to suspend mobilisation of the products for almost four weeks until the Russian authorities accepted the Community's safety, hygiene and health certification procedures. Mobilisation of the products was subsequently suspended for more than a month, because of the difficulty of reaching a settlement between the Commission and the Russian authorities on the pricing mechanism. Additionally, deliveries of pigmeat were suspended for some time because of the Belgian dioxin crisis (see paragraph 40) and it was not until July 1999 that the Russian health authorities accepted the delivery of milk powder.

20. Because of these delays almost half the grain arrived during or after the harvest, large amounts of meat arrived during the summer when demand for this product was at its weakest and it was impossible for the full programme to be carried out. The delays also made it necessary to extend the control work commissioned from outside companies. The totals of the contracts for monitoring in Europe and in Russia rose from 2 million euro to 5,5 million euro and from 4 million euro to 8,8 million euro respectively.

21. On 22 December 1999 the Commission decided to break off the programme. Since the Commission was unable to use all the carryovers of appropriations before the end of the 1999 year, an amount of 64,5 million euro lapsed. In consequence, even though most of the grain had already been delivered, the 41 500 tonnes of pigmeat, 11 550 tonnes of beef and 5 000 tonnes of skimmed-milk powder initially promised to the Russian authorities for an overall value of more than 71,2 million euro were not delivered. Since the programme no longer had to finance the transport of these products, the total cost of implementation was thus reduced by 74,4 million euro relative to the forecasts (see *Table 3*).

Table 3  
Actual implementation of programme (April 2000)

Products	Quantities (in tonnes)		Value (in EUR)				Cost of transport (in EUR)		Total cost (in EUR)	
	Delivered	Difference relative to forecasts	Value/tonne <sup>(1)</sup>	Difference relative to forecasts	Total value <sup>(1)</sup>	Difference relative to forecasts		Difference relative to forecasts		Difference relative to forecasts
Wheat	974 000	- 26 000	81	- 24,8	78 894 000	- 26 906 000	22 897 105	- 2 102 895	101 791 105	- 29 008 895
Rye	460 000	- 40 000	47	- 12,8	21 620 000	- 8 280 000	16 160 850	3 660 850	37 780 850	- 4 619 150
Rice	49 750	- 250	331	- 19,0	16 467 250	- 1 032 750	1 902 405	- 597 595	18 369 655	- 1 630 345
Beef	138 450	- 11 550	500	0,0	69 225 000	- 5 775 000	24 780 594	- 5 219 406	94 005 594	- 10 994 406
Pork	58 500	- 41 500	1 495	395,0	87 457 500	- 22 542 500	12 483 954	- 7 516 046	99 941 454	- 30 058 546
Skimmed-milk powder	45 000	- 5 000	790	0,0	35 550 000	- 3 950 000	4 344 165	1 844 165	39 894 165	- 2 105 835
<b>Total</b>	<b>1 725 700</b>	<b>- 124 300</b>			<b>309 213 750</b>	<b>- 68 486 250</b>	<b>82 569 073</b>	<b>- 9 930 927</b>	<b>391 782 823</b>	<b>- 78 417 177</b>
Technical assistance, monitoring, audit and evaluation									16 400 000	4 000 000
Savings on storage costs and export refunds									71 500 000 <sup>(2)</sup>	
<b>Total net cost</b>									<b>336 682 823</b>	<b>- 74 417 177</b>

<sup>(1)</sup> Accounting value at level of intervention stocks as of 1 October 1998, except for pork, where the price taken is the market price at the time of estimation.

<sup>(2)</sup> Commission estimate.

Source: DG AGRI.

### **Transport of products**

22. The actual cost of transporting the milk powder was approximately 93 % higher than the initial estimate. As for the transport costs for rye, they were 40 % higher than forecast (see Table 3), because the forecasts had not allowed for carriage of the product to the Community port for shipment. The financial forecasts in respect of the cost of the programme which were submitted to the Budgetary Authority by the Commission therefore underestimated the cost of the deliveries of milk powder, rye and pigmeat (see paragraph 17).

23. The Commission entrusted to a monitoring company the task of checking the quantities and quality of the products removed from intervention stores by carriers. There were delays in forwarding the beef, because the company in question did not have enough staff to monitor the loading of the goods which, in France, were spread among some 30 warehouses. Furthermore, during controls of operations concerning the release from storage of common wheat destined for Russia, UCLAF ascertained that the company's inspectors were not always present when the grain was loaded.

24. Almost 40 % of the deliveries were shipped via Baltic ports. Approximately 25 % of cereal deliveries were routed via Muuga (Estonia), although handling charges there are higher than at Riga or St Petersburg. The higher costs, which were mainly due to the monopoly control exercised over the port facilities<sup>(1)</sup>, were borne by the beneficiary (see paragraph 26).

25. Better analysis of the handling and storage capacities on the spot and better coordination with the Americans would have enabled the Commission to avoid some of the congestion in the ports.

26. Some meat was also transported as far as the Urals by lorries coming from Europe, i.e. more than 2 000 km inside the Russian borders. Since the Russians did not bear these costs, the transport costs due to the European operators, port handling charges and demurrage (4,5 million euro) were deducted by the Commission from the overall budget allocated for the supply of products to the neediest regions.

27. The European carriers experienced considerable delays in payment and in the release of their bank guarantees by the intervention bodies. These delays were partly to blame for the increases in the level of the bids for the subsequent tranches of the operation as operators tried to cover the additional costs incurred.

### **Distribution in Russia**

#### **Implementation by the Russian authorities**

28. On conclusion of an invitation-to-tender procedure that, in terms of the selection criteria adopted, could barely be described

as open, the Russian Ministry of Agriculture and Food entrusted the distribution of the products to operators who came from the former central planning system and had retained close links with it (see paragraph 51).

29. The Russian Government did not comply with the Memorandum of Understanding, which stipulated that the Russian Government was to bear the costs for domestic transport (Article 3.3). The buyers had to pay transport costs to the national operators, as well as extra commission of between 2,5 % and 3 % to the regional operators chosen by the regional governments, which often maintained close links with these same authorities.

#### **Delivery of products to the regions**

30. Although most of the products (97 % by value) were safely delivered to the selected regions, shortfalls were nevertheless established when the goods reached their destinations. For example, out of the 196 950 tonnes of meat and 45 000 tonnes of skimmed-milk powder delivered to Russia, 7 947 tonnes of the former and 3 045 tonnes of the latter had not arrived by April 2000.

31. The monitoring system established by the Commission in collaboration with the Russian authorities made it possible to limit losses during shipment of products to the beneficiary regions. However, the terms of the contract with the company responsible for monitoring in Russia did not provide for an adequate reporting system, even though improvements were made after an initial Court audit in July 1999 identified shortcomings. The monitors were required to verify the quantities of products from their arrival at the Russian frontier through to delivery to the processing plants. In practice, however, where the meat was sent to the beneficiary regions' cold stores first, the monitors did not check whether the meat was subsequently delivered to processing plants in those regions, as the terms and conditions stated that such checks would be made only if the Commission specifically asked for them.

#### **The selling price of products**

32. For the purposes of determining amounts to be deposited in the special account, the Russia-European Commission working group (see paragraph 13) was to meet every two weeks to determine an estimated value in roubles in the Russian Federation for the shipments provided. These estimates were to be considered definitive only after the approval of the European Commission had been received on a non-objection basis within five working days. Within 120 days of the arrival of the shipment at the Russian border, or 75 days from the time of arrival of the commodities at the point of intended destination in the targeted region, whichever came first, the Government of the Russian Federation was to deposit an amount equal to the estimate into the special account established for the sole purpose of receiving such funds. Any inability on the part of the Russian Federation to collect the sales proceeds in line with the estimates would not nullify the Government's obligation to make full deposits to the special account within the periods specified above.

<sup>(1)</sup> OLAF is investigating certain anomalies that were established following a call for tenders for transport via this port.



33. Proceeds to be deposited in the special account were to be based upon the estimated values of shipments as determined by the working group, and approved by the European Commission. The estimated shipment values had to be discussed with the working group to determine the cause for the shortfall and to identify remedies. If total actual proceeds were subsequently determined to be larger than total estimated proceeds, the Russian Federation had to deposit the difference in the special account.

34. The Commission regularly fixed a net port price in agreement with the Russian authorities, in order to determine the amount of the initial deposit that the Government of the Russian Federation was to place on a special account after delivery of the products. However, it was not the Government of the Russian Federation which paid the initial deposit but the Russian operators, who transferred the counterpart funds to this account (frequently late) after the products had been sold to the first buyer (see paragraphs 42 to 47).

35. Products were sold by the Russian authorities for the net port price (estimated in agreement with the Commission) plus the commissions charged by national and regional operators, as well as handling, transport and storage costs, and not necessarily at prices that did not disturb the local market, as required by the basic Regulation. In consequence prices for the meat were sometimes much higher than the price of commercial imports (often of better quality) from the EU <sup>(1)</sup> or other central European countries. In September 1999, for example, pigmeat supplied by the EU was sold for 25 roubles/kg. The meat, plus transport and handling charges, reached a price of 33 roubles/kg, whereas commercial imports for total prices varying between 15 and 23 roubles/kg were observed in several regions away from Moscow and St Petersburg.

36. As the selling price of the meat supplied under the programme was considered uncompetitive by the processing companies, most of the meat was held in cold stores in the various regions for several months. No less than 37 000 tonnes of beef (or 26,7 % of the quantity of beef supplied) was still in storage awaiting sale as of mid-February 2000 and 35 000 tonnes of pigmeat (or 60 % of the supplies of this product) as of mid-March 2000. In other cases the meat was redirected to other, more solvent, regions, thus increasing the transport costs, and hence the selling price, still further.

37. It was too late by the time the Commission ordered the programme audit that was to establish whether the products had been sold at market prices and whether the payments to the counterpart funds reflected those prices. In fact, that audit had still not begun in March 2000, one year after the first consignment of products. Even if it is possible to show that some operators made an undue profit on some products, it will be difficult for the Commission to demand that the difference be allocated to the counterpart funds. Moreover, by acting in this way, the Commission did not ensure that the price fixed for the sale of the products did not disrupt the local market.

<sup>(1)</sup> At Archangel, Samara, Nizhny Novgorod and Smolensk in particular.

### Quality and use of the products

38. Although the wheat supplied was of intervention standard (and, in particular, was suitable for bread-making), it was not of adequate bread-making quality according to Russian standards. The flour mills could only use it by mixing it with higher-grade Russian or Kazakh wheat. The quality of the wheat supplied by the EU, which, according to local operators, was inferior to the quality of the wheat supplied by the Americans, was the cause of a certain amount of resentment on the Russian side. The Commission is aware of this problem and is considering raising the intervention criteria, especially as regards protein levels.

39. The quality of the rye and rice supplied by the EU was, in general, appreciated by the beneficiaries. The rye, however, was used for purposes other than those intended. Following tests by an agreed laboratory in Hungary, it was found that rye (almost 5 000 tonnes) delivered to Smolensk was unfit for bread production. Contrary to the Commission's instructions, it was sold for alcohol production and the corresponding counterpart funds were paid. A similar quantity of rye delivered to Tula met the same fate, even though the same laboratory concluded that the quality of the product was acceptable. Furthermore, in the region of Sverdlovsk, 4 000 tonnes of rye was used, not for the specified purpose of making bread, but for feeding poultry, although the quality of the product was not questioned.

40. When the dioxin crisis erupted in Belgium, deliveries of Belgian pigmeat had already been made. Sales of this product, which was suspected of being contaminated with dioxin, were then suspended while the necessary tests were carried out. These showed that 104 tonnes were actually contaminated. The costs connected with the supply of this meat were borne by the European tenderer, who eventually disposed of it as feed for fur-producing animals. The fact that contaminated meat had been supplied made it even more difficult to sell the meat supplied.

41. Some processing companies did not want any beef because, as a rule, it had been held in cold storage in the EU for three years. In addition, in some of the cold stores visited by the Court's auditors in Russia, the temperature was sometimes considerably higher than the - 18°C required for storing meat.

### The counterpart funds

42. Initially the amount of counterpart funds was expected to be around 320 million euro. The Council Regulation stated that the net receipts from the sale of the products were to be used for the implementation of social measures. The Russian Government's Decree No 130 (see paragraph 9) went further, however, specifying that the funds would be allocated to the federal pension fund budget for the payment of pensions and discharge of the pension indebtedness accrued in 1998 (see also paragraph 14). The Commission was nevertheless able to obtain an agreement that 20 %

of the funds would be used for other specific social purposes <sup>(1)</sup>. In most of the regions visited by the Court's auditors the regional authorities would have preferred a substantial part of the counterpart funds generated by the programme to have been earmarked for the development of local agriculture, a wish that had already been expressed by the Russian Ministry of Agriculture when the programme was being negotiated with the Commission in November 1998. The use of the counterpart funds for agricultural programmes could have been made conditional upon the adoption of certain reforms in this sector.

43. Both the Commission and the Russian Government attached the utmost importance to the collection of the counterpart funds. The Russian Government accordingly tried to establish a system of guarantees that would result in a reduction of central budgetary transfers to regions which did not pay for the products. However, these guarantees were not always enforceable. The largest beneficiary region (Sverdlovsk), for example, did not itself stand guarantee for the consignments of meat but delegated this responsibility to a private company instead. When the latter was unable to sell the meat at the price demanded it withdrew from the programme and the meat remained in cold stores. In addition, some regions which were unable to provide the required guarantees preferred to reduce their meat orders and the produce went to other more prosperous regions (see the annexed table comparing the poverty indicator for the regions with the amount of aid allocated per head of the population).

44. As the Government of the Russian Federation did not pay the initial deposit as stipulated in the Memorandum of Understanding (see paragraph 32), the rouble equivalent of 129,4 million euro had been collected by mid-March 2000, that is to say, only 74,5 % of the total amount of counterpart funds that the programme was supposed to have generated by that date. As the counterpart funds were kept in a non-interest-bearing bank account and the annual inflation rate in Russia was 36,5 % at the end of 1999, the value of the frozen funds earmarked for social projects (see paragraph 47) was rapidly eroded.

45. At the same date the payment arrears for the counterpart funds amounted to the equivalent of 44,4 million euro. The main regions affected were in arrears <sup>(2)</sup> primarily because they could not sell the meat at the prices set. These regions, which were among the poorest, were also exposed to financial penalties from the central authorities, which proposed to deduct the amounts that the regions still owed by way of counterpart funds from any financial transfers to which they might be entitled.

46. Due, in particular, to an improvement in the collection of revenue as well as to the fact that pension levels did not keep pace with the rate of inflation <sup>(3)</sup>, the pension fund arrears had been paid off in full by 1 September 1999. In consequence, only 882 million roubles of the 8 500 million roubles that were to be drawn down against the counterpart funds were used to pay off the

arrears. Apart from a relatively modest amount set aside for the repayment of a loan which the Russian authorities had taken up in order to pay off the arrears, most of the counterpart funds earmarked for the pension fund were used for several months to finance an increase in pensions.

47. In January 2000, the Russian Government had still not presented any plan for using the 20 % of the counterpart funds earmarked for specific social purposes or for projects acceptable to the Commission. The Commission itself still had no precise idea, at that time, of the use to which this 20 % should be put, even though it had frozen, for social projects, the equivalent of 35,7 million euro in roubles that were steadily depreciating (see paragraph 44). However, in January 2000, the equivalent of 20,5 million euro was transferred to the Ministries of Health and Employment without authorisation from the Commission and 11,6 million euro of that had already been spent without any project having been proposed to the Commission. In April 2000, in view of the difficulty of reaching agreement with the Russian side regarding individual projects, the Commission finally agreed to finance some budget items proposed by the Health and Employment Ministries.

## IMPACT OF THE PROGRAMME

### *On the price of foodstuffs*

48. The programme was supposed to help regularise agricultural markets in Russia. In 1999, however, there was, in general, a strong increase in prices. The cost of 25 basic products rose by 42 % between January and September 1999.

49. The price of the wheat bought by the flour mills rose from 33 to 101,2 EUR/t between January and September 1999 <sup>(4)</sup>. In view of the political sensitivity of the availability and price of bread, the regional executives tried by various means, and administrative price controls in particular, to prevent increases in the price of bread from being passed on to consumers directly. In some regions the weight of a loaf of bread was quite simply reduced from 500 grams to 400 grams while the price remained approximately the same. Nevertheless, it may be considered that by increasing the supply of cereals for breadmaking by 5 % <sup>(5)</sup>, the Community programme prevented an even bigger price rise.

50. Consumer prices in the meat sector more than doubled between August 1998 and September 1999, bringing about a widespread fall in consumption <sup>(6)</sup>. If it was possible to limit the increase in meat prices, it was due more to the export refunds which enabled local operators to contain prices than to the

<sup>(1)</sup> The counterpart funds for the American aid programme were allocated to this pension fund in their entirety.

<sup>(2)</sup> Republic of Komi and regions of Kemerovo and Yaroslavl.

<sup>(3)</sup> Pensioners' purchasing power is estimated to have fallen by 45 % against 1998 levels.

<sup>(4)</sup> Russian Ministry of Food and Agriculture

<sup>(5)</sup> Even if half the deliveries did not reach their destinations until after the harvest.

<sup>(6)</sup> 'European Union Heads of Mission assessment on the situation of Russian agriculture, harvest and food aid', September 1999.

Community aid programme which, as of September 1999, had recorded the sale of only limited quantities of meat. The increase in the level of refunds for pigmeat from 40 to 70 EUR/100 kg between November 1998 and July 1999 proved to be a more economic and effective instrument for securing the continuity of Community exports of pigmeat to Russia (see *Table 2*). The Commission actually estimated that in May 2000 the total cost of the export refunds on 450 000 tonnes of pigmeat exported to Russia in 1999 amounted to between 270 and 290 million euro <sup>(1)</sup>, whereas the supply of only 58 500 tonnes of the same product under the programme amounted to some 101 million euro, including the costs of monitoring and technical assistance for implementing the programme. This measure made it possible to partly cover the deficit on the Russian market and also had a positive impact on pigmeat prices by reducing stocks in the Community market while allowing the EU to keep its export market (see paragraph 35).

### **On the private sector**

51. The operation was criticised by the large private Russian operators set up in the 1990s, which considered that the programme strengthened operators from the old regime to their detriment <sup>(2)</sup>. The fact that, in some regions, the cold stores were filled to capacity for many months as the meat could not be sold for the price demanded by the Russian authorities, prevented some local producers from selling their products when they wished although they were often already in a difficult financial position (see paragraph 35). While the Tacis programme was trying to develop local agriculture, food aid prevented it from taking full advantage of the rouble devaluation that had made imported foodstuffs less competitive <sup>(3)</sup> and allowed the local authorities to postpone until later indispensable agricultural reforms <sup>(4)</sup>.

52. At the same time the CIS countries were receiving exceptional Tacis aid (20 million euro) to alleviate the effects of the financial crisis in Russia. However, the food aid took away these countries' export markets. During the first six months of 1999, while imports of pigmeat into Russia increased by 32 % compared with the corresponding period of 1998, imports of this product from other CIS countries fell by more than two thirds <sup>(5)</sup>.

<sup>(1)</sup> Source: DG AGRI D/02. The exact amount will not be known until the accounts have been cleared.

<sup>(2)</sup> See, in particular, 'Food aid is not what Russia really needs although it gives an opportunity to certain lobbying groups to use it to their benefit', E. Serova, Centre for Agrarian Policies and Economic Issues, Institute for Economy in Transition, Moscow 1999 and 'Outlook for Russian agriculture', World Bank, October 1999.

<sup>(3)</sup> Recovery of competition emphasised in 'European Union Heads of Mission assessment on the situation of Russian agriculture, harvest and food aid', September 1999.

<sup>(4)</sup> See: The Association of Russian Agricultural Reform Funds, Assessment of the impact of food aid on the availability and affordability of food in Russia report, first quarter of 2000.

<sup>(5)</sup> Source: Russian Ministry of Food and Agriculture, Price Policy and Monitoring Division and 'Outlook for Russian agriculture', World Bank, October 1999.

### **On supplies to the regions and on the neediest groups**

53. Because the Commission agreed to the Russian authorities' requiring a financial guarantee from regions which requested supplies of food products, the poorest regions, which the programme was supposed to help but which could not provide such guarantees, forwent certain products which they had, however, considered that they needed. Furthermore, the poorest regions refused to buy the meat supplied by the EU, because they found the selling price too high, and the meat went instead to more favoured regions. Thus regions such as Belgorod and the republic of Komi, which are among the least poor regions in Russia, received more aid than Ingushetia and Daghestan, which are severely affected by poverty (see Annex).

54. Unlike the American aid which, from the outset, provided for 191 000 tonnes of products to be distributed free by NGOs to the most vulnerable groups in the population, the EU aid benefited the neediest groups only to a limited extent, although the basic Regulation laid down that exceptionally 'the products supplied may be distributed free to the neediest people of the regions concerned' <sup>(6)</sup>. It was only in March 2000 that the Commission allocated a small quantity of products (3 000 tonnes of beef and 1 000 tonnes of rice) for free distribution to refugees and their hosts via NGOs in Ingushetia. It is clear that the products supplied by the EU did little to improve the living conditions of the poorest groups <sup>(7)</sup>. It is especially true of an expensive product such as meat. The counterpart funds nevertheless helped to improve the pensioners' lot and made it possible for the Health and Employment Ministries to finance projects of a social nature.

### **CONCLUSION**

55. The need for the programme in the form it took is arguable; the country exported cereals in 1999 (see paragraph 9) and the hardships facing a large part of the population were attributable more to a lack of financial resources than to the failure of supply (see paragraphs 6 to 8). Supplying meat proved to be particularly complicated and expensive (see paragraphs 17, 36, 40 and 41) and, with no guarantee as to its final destination (see paragraph 30), appeared to be particularly unjustified.

56. The desire to maximise the revenue from sales of the products, and thus the counterpart funds, ran counter to the programme's principal declared objective of helping the neediest regions (see paragraphs 42 to 47).

<sup>(6)</sup> Council Regulation (EC) No 2802/98 of 17 December 1998, Article 1(4).

<sup>(7)</sup> Around 52 million Russians (35,3 %) live below the poverty line, according to the Russian Ministry of Social Development. In 1999 the most needy consumed 8,2 times less meat and 2,9 times less bread than the average for the better off.

57. Such an operation could have been carried out specifically for the benefit of the poorest regions by dealing with the regional authorities and traders direct. Such an approach would have made it possible to assist the development of the private operators and to avoid strengthening the old, centralist State structures (see paragraphs 28 and 51).

58. When the Commission proposed this operation to the Council, it underestimated the length of time for which the financial crisis in Russia would last and underestimated the impact of export refunds, which also contributed supplies to the Russian market, but at less cost, and, at the same time allowed Community exporters to retain their market (see paragraph 10). The Commission should also have made its aid more conditional on the adoption of reforms that would promote a recovery in agricultural output and should have called for the setting-up of a system to encourage trade between producer regions and deficit regions (see paragraph 7).

59. The deadlines for the implementation of the programme were greatly overstepped (see paragraphs 18 to 20) and the Commission was unable to deliver all the products initially planned before the carryovers of appropriations lapsed (see paragraph 21). Nevertheless, it managed to minimise the losses incurred during transport of the products to the beneficiary regions (see paragraph 30).

60. Not having assigned or redeployed the necessary human resources to the Delegation on the spot (see paragraph 16), the

Commission was unable to effect adequate monitoring, particularly as regards the adaptation of the selling prices of the products in the various regions (see paragraph 37). Moreover, the need to constantly refer them back to headquarters in Brussels before any decision could be taken on changes to the prices and quantities allocated to the beneficiary regions led to delays in the implementation of the programme.

61. The principal declared objective, of improving the precarious situation of the Russian people and regularising agricultural markets by delivering to the neediest regions agricultural products that were to reach their destination as soon as possible, was only very partially achieved. The lot of the people that were most at risk was little improved by the consignments of cereals, and certainly not by the consignments of meat, as the people in this category did not have the financial resources with which to buy the products. The counterpart funds, on the other hand, helped to improve the situation as regards health care and pensioners (see paragraphs 46, 47 and 54). As regards regularising markets, the impact of consignments of cereals was limited, especially as less than half the consignments reached their destination before the harvest (see paragraphs 48 and 49). As for the consignments of meat, they had no impact on the market in 1999, and a large proportion of the meat was still unsold in March 2000 (see paragraph 50). Furthermore, some of the most favoured regions benefited as much from the programme as the regions with the highest poverty rates, if not more (see paragraph 53).

This report was adopted by the Court of Auditors in Luxembourg at the Court meeting of 5 October 2000.

*For the Court of Auditors*

Jan O. KARLSSON

*President*

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## ANNEX

## COMPARISON OF POVERTY INDICATOR TO ALLOCATED EU FOOD AID PER CAPITA BY REGION

Region	Area	Percentage of households below the subsistence level (June 1999)	Order of ranking according to % of households below the subsistence level	Allocated EU food aid per capita (roubles)	Order of ranking according to EU food aid allocation
Ingushetia	Caucasus	96,3	1	73,64	29
Aga Buryat	East Siberia	85,8	2	0,00	NA
Koriak	Far East	82,2	3	0,00	NA
Chita	East Siberia	79,9	4	0,00	NA
Dagestan	Caucasus	75,2	5	137,54	15
Magadan	Far East	72,6	6	0,00	NA
Tuva	East Siberia	71,4	7	366,14	1
Komi-Perm	Urals	70,7	8	0,00	NA
Kalmykia	Volga	70,5	9	22,40	50
Chuvashia	Volgo-Vyatsky	65,6	10	120,05	19
Volgograd	Volga	65,3	11	47,18	38
Nenets	North	63,5	12	0,00	NA
Leningrad	North West	63,0	13	0,00	NA
Archangelsk	North	62,5	14	202,32	10
Novosibirsk	West Siberia	61,2	15	40,95	42
St Petersburg	North West	59,7	16	0,00	NA
Mari-El	Volgo-Vyatsky	59,6	17	202,39	9
Kamchatka	Far East	59,3	18	0,00	NA
Mordovia	Volgo-Vyatsky	59,2	19	170,91	13
Amur	Far East	58,6	20	0,00	NA
Astrakhan	Volga	58,1	21	60,59	33
Ust Orda	East Siberia	57,8	22	0,00	NA
Khakassia	East Siberia	57,4	23	0,00	NA
Penza	Volga	56,6	24	0,00	NA
Buryatia	East Siberia	56,3	25	52,71	36
Altai Rep	West Siberia	56,2	26	0,00	NA
Yakutia	Far East	55,7	27	132,11	16
Kemerovo	West Siberia	55,1	28	209,40	7
Kabardino	Caucasus	55,0	29	103,94	23
Taimir	East Siberia	54,9	30	0,00	NA
Tver	Central	54,6	31	181,66	12
Altay Kraj	West Siberia	54,6	32	13,49	53
Saratov	Volga	53,3	33	50,98	37
Sakhalin	Volgo-Vyatsky	53,0	34	0,00	NA
Kirov	Volgo-Vyatsky	52,8	35	34,19	46
Stavropol	Caucasus	52,1	36	0,00	NA
Tula	Central	51,4	37	219,25	6
Krasnodar	Caucasus	51,2	38	0,00	NA
<b>Average</b>		<b>50,6</b>		<b>69,34</b>	
Sverdlovsk	Urals	50,3	39	208,91	8
Karelia	North	49,9	40	325,25	2
Moscow oblast	Central	49,3	41	0,00	NA
Smolensk	Central	49,2	42	319,90	3
Kostroma	Central	48,5	43	99,50	24
Chelyabinsk	Urals	47,8	44	4,20	54
Omsk	West Siberia	47,7	45	0,00	NA
Kurgan	Urals	47,4	46	123,72	17
Bashkortostan	Urals	47,2	47	13,64	52
Pskov	North-West	47,1	48	223,24	5
Nizhny Novgorod	Central	46,7	50	85,25	27
Novgorod	North-West	46,7	49	58,59	34
Ryazan	Central	46,5	51	84,64	28
Khabarovsk	Far East	46,4	52	0,00	NA
Udmurtia	Urals	46,1	53	61,82	32
Orenburg	Urals	46,0	54	25,64	49
Karachey	Caucasus	45,7	55	98,22	25
Samara	Volga	45,5	56	109,39	20
Tomsk	Urals	44,8	57	41,74	41
Kaluga	Central	44,3	58	105,50	22
Perm	Urals	44,0	59	44,04	39
Kaliningrad	North-West	43,6	60	55,52	35
Yaroslav	Central	42,8	61	187,23	11
Adygea	Caucasus	41,7	62	149,05	14
Voronezh	Chernozem	41,4	63	31,35	47
Vologda	North	41,2	64	108,41	21
Primorye Kraj	Far East	41,1	65	0,00	NA
Ivanovo	Central	40,5	66	69,33	31
Tatarstan	Volga	40,5	68	37,99	44
Vladimir	Central	40,5	67	29,41	48
Komi	North	39,8	69	257,29	4
Ulyanovsk	Volga	39,0	70	72,41	30
Irkutsk	East Siberia	38,3	71	0,00	NA
Bryansk	Central	37,5	72	90,81	26
Krasnoyarsk	East Siberia	37,4	73	40,24	43
Kursk	Chernozem	36,2	74	43,14	40
Rostov	Caucasus	36,2	75	18,93	51
Murmansk	North	34,6	76	0,00	NA
Tyumen	West Siberia	33,3	77	0,00	NA
Orel	Central	29,6	78	0,00	NA
Khanty	West Siberia	29,6	79	0,00	NA
Tambov	Chernozem	28,7	80	37,24	45
Moscow	Central	28,4	81	0,00	NA
Iamal	West Siberia	28,3	82	0,00	NA
Lipetsk	Chernozem	27,3	83	0,00	NA
Belgorod	Chernozem	21,3	84	121,51	18

Source: Goskomstat and Economic Section of the Delegation of the European Commission in Moscow.

## THE COMMISSION'S REPLIES

### EXECUTIVE SUMMARY

The programme, the largest ever food delivery programme undertaken by the EU, has achieved some very positive results. The combined effect of both the EU and American programmes made a significant contribution to the stabilisation of market prices and to the issue of affordability by the use of counterpart funds to clear pension arrears and to enable significant pension increases to be made (Article 4, Council Regulation (EC) No 2802/98).

The Commission services faced numerous difficulties in implementing the programme undertaken by the EU. The primary task of delivering the food supplies to the agreed destinations was achieved with relative speed, despite a lack of human resources within the Commission itself.

In the view of the EU, the need was evident and was supported, *inter alia*, by the following facts:

- according to official Russian statistics, the 1998 cereals harvest was one third below the average harvest of the preceding years,
- the marked fall in the importation of meat products brought about by the financial crisis in autumn 1998,
- an analysis carried out by the other donor.

Furthermore, even if money existed inside Russia on a macro level, it was impossible for private operators to execute commercial imports as they could not bear the risks linked to the erratic dollar-rouble conversion rate.

It is not the case that meat prices were primarily set at levels that safeguarded commercial imports from the EU. The first price protocol for the programme (adopted on 14 May 1999) agreed price estimates which corresponded to prices set by the Russian administration in its decision of 5 February 1999.

The Court considers that a targeted humanitarian programme would have been more appropriate, but the NGOs which would have been charged with the execution of such a programme did not have sufficient resources to execute a programme of this magnitude throughout the Russian Federation. Furthermore, such a programme would not have produced the considerable benefits produced by the generation of counterpart funds which were used to wipe out pension arrears and contributed to the increase in basic pensions.

The Court's observations relate to a programme that is still under way. In accordance with the Council Regulation, the Commission contracted independent consultants to carry out an evaluation of the programme. The final evaluation report from the consultants will be published shortly. Even though the Commission has monitored and managed the risks associated with the implementation of the programme, a full and final audit, as mandated by Article 1(4) of the Council Regulation, is also planned.

### INTRODUCTION

#### *Scope of the audit*

5. Although the Court recognises the significant risk inherent in the programme, its observations do not fully take account of the dynamics of managing the risk in the programme's implementation. The Commission, in applying point 3.16 of the Memorandum of Understanding, was forced to suspend deliveries on two occasions during the first half of 1999, each for a period of one month. Inevitably, this has had an impact on the Commission's ability to respect the delivery schedule referred to by the Court.

### PREPARATION OF THE PROGRAMME

#### *Analysis of needs*

6. The following factors were taken into consideration when the possibility of launching a food-aid programme to Russia was considered.

- (a) In the Russian Federation 31 % of the population is under the poverty line and after a particularly poor harvest of cereals and the severe financial crisis of August 1998, the European Union considered that the situation did justify some form of external assistance.
- (b) After information was provided by some of the EU Member States, the World Bank and the other donor, and after a fact-finding mission was sent to Moscow, the European Union concluded that Russia was unable to carry out normal commercial imports for the winter and that she had no financial resources to import food from abroad.
- (c) In the event, the low economic and budgetary opportunity cost of supplying food products from EU intervention stocks made a food aid programme an attractive alternative to direct balance of payments support. Sales of the food could provide budgetary support and effective targeting could solve the affordability problems for vulnerable groups.

Following the formal food aid request from the Russian Government on 12 November 1998, and in the light of a food aid programme being launched by the other major donor, the European Union finally took the decision to supply agricultural products to the Russian Federation.

The programme was designed to meet two basic needs:

- availability of food, by increasing supplies and thereby keeping prices at an 'affordable level',
- affordability, by using counterpart funds to speed up the payment of pensions arrears.

7. One of the major aims of the programme was to ensure that the local markets were not disrupted. To achieve this, the Russian Federation and the Commission sought to use the existing systems for the distribution and processing of the food supplies. In the main, Russian operators were used for distribution in Russia and the processing of food was kept to the local level. In doing so, the programme has not had a negative impact on the private sector. On the contrary, the food supply programme has provided Russian transport and industry with a lifeline to survive and recover from the economic recession.

8. With bad harvests and the collapse of the processing industry there is no doubt that food reserves in Russia were low. The EU food supply programme together with those of the other donor sought to increase the supply of foodstuffs. By redistributing the majority of the sale proceeds to State pensioners, one of the poorest sections of Russian society was better enabled to purchase the increased supplies available on the market.

9. The exports referred to by the Court would have been subject to irreversible contracts entered into by the Russian private sector. Point 3.9 of the Memorandum of Understanding (MoU) specifically permits the export of goods similar to those supplied under the programme where the contracts for such exports have been concluded prior to 1 October 1998.

10. The products delivered under the programme were supplied to regions which are not traditional markets for commercial imports. Furthermore, as indicated in paragraph 35 of the report, the sale price of meat was often higher than that of commercial imports.

The fact that EU exports to Russia were maintained in 1999 for beef meat and even increased for pigmeat at the same time as the food aid was arriving is further evidence that there was a real need for this aid.

11. The Commission had no time to examine in depth whether the list of regions presented by the Russian authorities really

reflected the needs of the regions. However, the list was examined during the negotiations on the MoU in coordination with the experts of the Delegation in Moscow. Not only Moscow and St Petersburg were excluded but also several other regions, as they were not considered to be among those in need. This was also one of the main reasons for the exclusion of Moscow and St Petersburg and was also the reason why the lists of destinations were regarded with inflexibility.

### ***Preparation of the legal base and implementation framework***

12. The question of the urgency of the programme has been confirmed by the Council of the EU in Regulation (EC) No 2802/98 authorising the programme and also by the action of the other main donor. The Ministry of Agriculture was the representative of the Russian Government at the negotiations on the Memorandum of Understanding, although the Commission had requested the presence, in addition to that of the Ministry of Agriculture, not only of the Ministry of Finance, but also the Ministries of Transport and Health and the State Customs Committee. In the final analysis, it was for the Russian Government to decide which Ministries represented it during the negotiations.

13. The original MoU negotiated at the beginning of December 1998 did not contain any omissions by reference to the original Commission proposal which only foresaw delivery of the goods to the Russian frontier. Taking into account the limited time for execution, it was indispensable that the MoU already negotiated be operational as early as possible. The additional MoU was necessary to complete the arrangements required for internal monitoring imposed by Council Regulation (EC) No 2802/98, and its entry into force was required only with effect from the time the goods started to arrive at the Russian frontier.

14. Along with the other donor, the Commission sought for the larger part of the counterpart funds to be made available to the Russian Federation pension funds. The Commission had nevertheless taken the precaution that any release of the funds to the pension funds would be subject to prior approval from the joint working group and therefore from the Commission services.

The Commission services carried out checks on the statute, systems and control mechanisms of the pension funds before any of the counterpart funds were released. The viability of the financial systems was validated with other donors and international organisations having dealings with the State pension funds. The Commission was reassured that the pension funds are also subject to the audit of the Audit Board of the Russian Federation.

The efficacy of the choice made has been confirmed by many control and monitoring missions undertaken on behalf of the Commission services.

## IMPLEMENTATION OF THE PROGRAMME

### *Resources deployed by the Commission*

16. As the increased level of risk became apparent the Commission was obliged by the legislative authority to monitor and audit the flow of food and of the resulting finances generated by the sales in Russia.

Other similar programmes were better resourced. It would have been better if the Budgetary Authority had provided for sufficient personnel resources to manage such a complex programme. Nevertheless, the Commission was able to optimise the use of the limited resources available for this programme with a high degree of inter-service cooperation.

### *Mobilisation of foodstuffs*

18. Considering that the first deliveries commenced in March, and taking into account the various suspensions and delays which the programme encountered, the Commission services consider that the mobilisation of goods took place within the time frame originally foreseen in the Memorandum of Understanding.

In some cases, notably that of skimmed-milk powder, delays were deliberate and reflected the desire on the Russian side to receive the food at a time when it would be needed.

In effect, at the end of 1999, within nine months of commencement, 97 % of the largest EU food aid programme ever had been delivered to the Russian frontier. The fact that only 58 % in value of products were delivered to their final destination at the end of 1999 was because the Russian authorities proceeded with mass interim storage of high value products (beef, pork, and skimmed-milk powder) which was contrary to the technical annex to the MoU.

19. With the exception of pigmeat, all the suspensions mentioned were imputable to the Russian authorities, either as a result of their unwillingness to accept the intervention standards, which had already been made clear in the MoU, or their unwillingness to reach an early negotiated resolution of difficult issues which arose during implementation.

20. The timing of the deliveries was influenced by the large quantities of products which had to be mobilised and the need to minimise the risk of port congestion and consequent claims for demurrage costs

21. The quantities indicated in the Council Regulation were indicated as maximum possible quantities and as such were not quantities promised to the Russian authorities. Despite the delays the programme encountered, it remains the case that 97 % of the quantities foreseen under the programme was delivered within the space of nine months. On 22 December 1999 the Commission therefore considered that its mandate covering the physical delivery of food products had been met and accordingly decided not to carry over the credits necessary to mobilise the maximum quantities possible.

### *Transport of products*

22. The original transport costs for rye did not include the costs of transport from an internal point of storage to the port of exit as, at the time of preparation of these estimates, the precise location to be used and quantities to be drawn from each location were unknown. Had the quantities used, as quite often is the case, been located close to ports, then the estimates would have been more accurate. In the event, the stocks chosen for shipment were often located inland and the transport costs were therefore higher than initially foreseen. For skimmed-milk powder and pigmeat the divergence between estimated cost and actual cost was due to a lack of previous experience in the purchase (pigmeat) and transport (milk powder) of such products.

23. The Commission has always been conscious of the need to verify that the amounts invoiced for monitoring were correct, and for this reason the SCR commissioned an independent audit of the invoices of the monitoring companies. This audit report concluded that there were no grounds for disallowing work performed by these monitoring companies.

See also the reply to paragraph 37, for details of the controls put in place by the Commission.

24. The Baltic ports were used, simply because from the outset it was evident that the Russian ports alone would not be able to absorb the quantities in question. Discharge and transit costs for quantities passing via the Baltic ports were for the account of the Russian authorities. Additionally, an offer for delivery to St Petersburg which did not include discharge of the cargo cannot be compared with an offer for Riga or Muuga where discharge and transit on Baltic territory was included.

No instances of demurrage were recorded at Muuga and very limited instances at Riga, indicating a high level of efficiency at these ports. Nevertheless, the Commission was aware of the monopolistic situation in Muuga and imposed alternative ports wherever possible.



25. The port congestion which arose during the period July/August was not due to an insufficient analysis of the handling capacities of the port or insufficient coordination with the other donors, but simply due to the fact that the Russian operator insisted on shortening the delivery schedule for the third tranche of cereals. The schedule eventually implemented was longer than that demanded by the operator, who coordinated both the EU and American programmes, and resulted in less congestion than would otherwise have been the case.

27. During the course of the programme the Commission on several occasions recalled in writing to the Member States, and repeated during management committee meetings, the need to deal promptly with the release of guarantees, payments on account and final payments on presentation of the appropriate documentation.

Additionally, in cases where particular dossiers presented problems, the Commission services repeatedly advised that partial payments be made for that part of the dossier which did not present difficulties. It is unfortunate that on many occasions this advice was not followed and the operators suffered serious delays.

### **Distribution in Russia**

#### **Implementation by the Russian authorities**

28. The Commission wishes to emphasise the cooperation aspects of the food supply programme. In the spirit of cooperation the Russian Federation agreed to be responsible for the transport of food supplies delivered to its borders. This arrangement was made not only for the European Union's programme but also held for that of the other donor supplying food assistance.

#### **Delivery of products to the regions**

30. There were difficulties over the delivery of a quantity of skimmed-milk powder and meat. Nevertheless, monitoring of deliveries from interim storage in St Petersburg was carried out on all consignments. In the case of goods leaving the stores without precise details of their final destination, or where goods did not arrive at the predetermined final destination within a certain time-frame, dispatch details were meticulously recorded and followed up. Through the forum of the joint working group (JWG) the Russian operator gives precise details which indicate that the goods have been received at those destinations originally agreed. The verification by the technical assistance unit in Moscow of the information supplied was still ongoing in September 2000 and the Commission expects that all quantities will be accounted for.

#### **The selling price of products**

36. A reason for problems in the sale of meat came from the timing of deliveries. The bulk of the meat was delivered during

the late summer and autumn of 1999. This coincided with the period when indigenously-produced meat was most available. By comparison, the remaining stocks of meat (almost 40 000 tonnes of beef and 35 000 tonnes of pigmeat) were dispatched from store relatively quickly between February and May 2000, when local supplies were depleted. In the case of beef, this was assisted by a decrease in price. In the case of pigmeat, the Russian side rejected a decrease in the price offered by the EU, and went on to sell the meat notwithstanding. This implies that the problem of initially slow sales was an underlying one of timing, rather than price alone.

37. The Commission has gone to great efforts to minimise and limit the risks associated with a complex and inherently risky operation. The audit effort was composed of three strands:

- the use of Commission staff, specialising in audit, to assess and minimise the financial risk associated with the programme by establishing tighter internal controls,
- the use of external auditors to examine the cost claims submitted by monitoring companies to ensure that the claims were reasonable and supported by underlying records,
- the use of external auditors for the examination of the financial flows associated with the programme.

The third component involves engaging external auditors for *ex-post* checks on the financial flows resulting from the sale of food deliveries and the use of the proceeds. The Commission considered it inappropriate to start the audit before the majority of supplies had been delivered and sold to avoid basing the audit on incomplete documentation, which would have been neither effective nor efficient. The contracting of external audit assistance has, indeed, been delayed.

The Court's claim that the surplus generated on the sale of food supplies cannot be collected seems to imply that the Russian Federal Government will be or is unable to honour the agreements entered into. The Commission has confidence in the Russian Federal Government's ability and intention to fulfil not only the spirit, but also the letter of the signed agreements.

#### **Quality and use of the products**

38. The Commission in Regulation (EC) No 824/2000 of 19 April 2000 amended the requirements for intervention wheat which now specify increasingly higher minimum levels of protein for the marketing years 2000/2001 to 2002/2003.

39. The lodgement to the special account in respect of the

quantities used for the production of alcohol was the same as if the rye had been used for its original purpose i.e. bread-making.

Despite the favourable laboratory analysis in respect of the rye delivered to Tula, the Russian authorities refused to accept it for bread-making. The Commission eventually authorised the use of the quantities in question for animal feed but with a lodgement to the special account consistent with the use of rye for bread-making.

The total rye allocation for the Sverdlovsk region was 5 000 tonnes, and a certain amount of this was found to have been diverted to animal feed processing plants rather than to bread mills. At that time the poultry industry was in a critical condition, and a letter dated 23 April 1999 from the regional administration to the director of the *oblast* grain operator explains the decision and states the precise amount of rye to be allocated to each factory. This indicates that the rye was not re-exported to other regions. The full amount due for the shipment was submitted in two separate payments for RUR 3,5 million.

### ***The counterpart funds***

42. In many regions the local administrations would have preferred to use special account funds to finance agricultural development programmes. Although the Russian central administration proposed that a proportion of the funds be channelled to the development of local agriculture, this was ruled out at an early stage. The decision not to fund agricultural development has been vindicated by the independent evaluators, on the grounds that the Russians were not sufficiently committed to reform the agricultural sector. Furthermore, to make the food supplies foreseen by the programme conditional on the reform measures would correspond to an objective that had not been intended by the Council. The primary concern was to respond to a critical food shortage brought about by exceptional and unforeseen circumstances and not to undertake any far-reaching structural reform.

43. The Court notes that the Russian Federation has gone much further than the requirements of the MoU and the OMoU in asking the regional authorities for financial guarantees to secure the delivery of the food supplies. As far as the Commission is concerned this is an internal matter for the Russian Federation and, given the financial situation in Russia, should be seen as a measure of prudence on the part of the Federal Government which is ultimately responsible for the sums due to the special account.

44. The Commission did consider the need for the Russians to hold the special account as an interest-bearing account. In conformity with 'Government Regulation on the Federal Treasury of the RF#864 of the Council of Ministers — 27 August 1993', the Treasury was obliged to open the special account in the central bank. To have this disposition modified to allow the account to be interest-bearing would have introduced unacceptable delays to the programme.

45. The problem of guarantees is an internal matter for the Russian Government, who is responsible for payment, as the MoU makes clear. The Commission has consistently argued, at successive joint working group meetings and bilateral meetings with the Deputy Prime Minister, for the prompt clearance of arrears.

46. As of 1 September 1999 RUR 882 million went directly to liquidating the arrears in the pension fund. However, the pension fund was able to take a sizeable loan from the Sberbank on the strength of the funds it knew would accrue from both the EU and the other food delivery programme.

Transfers from both programmes together with other fiscal resources enabled sizeable increases to take place in State pensions throughout the Federation. The first, on 1 November 1999, was 15 %; the second, on 1 February 2000, was 20 %; and the third, on 1 May 2000 was 7 %. In real terms this represented a 48 % increase of basic pensions.

47. With regard to the 20 % usage of the special account for budget support to the Ministries of Health and Labour it is true that the original intention was individual project funding. However, because of the delay on the part of the Russian administration in submitting appropriately designed proposals, and the fact that the Commission did not have sufficient resources to properly assess and evaluate proposals, the decision was taken to switch to budget support.

Nevertheless, in doing so the Commission insisted on there being a sustainable audit trail in place to the point where the transfers from the special account were deposited to the nominated budget lines. These approved budget lines (and not all the budget lines proposed by the Russian side have been approved by the Commission) represent expenditure targeted at the most vulnerable groups.

### **IMPACT OF THE PROGRAMME**

#### ***On the price of foodstuffs***

48. There was little if any negative impact of the programme on the local market, and the supply of cereals did stabilise prices for basic food products.

50. Even if the 58 500 tonnes of pigmeat had been exported commercially, almost EUR 41 million of the EUR 101 million mentioned would have been charged to the Community budget in any event in respect of export refunds. In addition, the constitution of the counterpart funds from the sale of the 58 500 tonnes delivered, which amounted to almost EUR 54 million and which assisted in the clearance of pension arrears, would not have been possible if only export refunds had been implemented. The Commission considers that the cost of EUR 101 million is therefore justified.

**On the private sector**

51. The Commission wishes to emphasise the fact that the Russian Federation was responsible for organising the transport of food supplied under the programme within the Russian Federation. Unlike the Tacis programme, the food supply programme was designed to meet an urgent need and not necessarily to reform the agricultural sector. According to the independent evaluators, the EU food programme has undoubtedly eased the situation of many processors by providing *de facto* free credit. In the wheat/flour/bread chain, this permitted a swift supply and contributed to a stabilisation of prices on urban retail markets. In the grain chain, the programme was used to stabilise prices of flour and bread, thus preserving affordability of basic food for poor consumers.

52. The Commission has no evidence that the EU programme undercut the exports of neighbouring countries.

**On supplies to the regions and on the neediest groups**

53. All regions of the Federation received products under the EU and other programmes taken together. The table given in the Annex of the Court's report therefore should be read in the overall context of those programmes.

Although there may have been a bias by the Russian Government in the allocation of food under the EU programme towards those regions that could pay or provide the necessary guarantees, the impact of the supplies and special account disbursement has been felt throughout the Federation. Irrespective of whether or not a particular region received products through the programme, there has been no differentiation in the way pension arrears have been cleared and pensions increased.

This twofold effect led to increases in demand and in affordability in those poorer regions, and thereby ensured the availability of food supplies through normal commercial channels.

54. 'Free distribution' was permitted by the Council Regulation only in 'exceptional circumstances', the principal objective of the programme being to make food available at prices which would not disturb the local markets. The provision of large scale 'free food' would certainly have undermined local markets and for this reason the quantities so far supplied in this way have been limited. Nevertheless, the Commission continues to consider requests for free supplies from the quantities still remaining in stock under the programme.

**CONCLUSION**

55. The Council's primary intention in launching the programme was to address the critical food supply situation in over 50 regions throughout the Russian Federation, and the programme developed relatively quickly.

Council Regulation (EC) No 2802/98 was published on 17 December 1998. Before any product could be mobilised detailed tender regulations for product procurement and transportation had to be put in place. Commission Regulation (EC) No 111/1999 was adopted, without delay, and published on 19 January 1999. Nevertheless, operational modalities had to be put in place for the programme, especially for dealing with the goods after arrival at the Russian border, before products could be dispatched from EU stores. Memoranda of Understanding (including technical annexes) were negotiated and concluded with the Russian authorities by early February 1999.

This process of putting in place the necessary legal texts cleared the way for the first tenders, which were in fact launched while the MoUs were being negotiated. Despite the speed at which the Commission services worked, the award of these first tenders had to be postponed because of the failure of the Russian authorities to notify and agree the certification procedures for all products being mobilised. It was not until 15 March 1999 that the Member States made the first transport tender awards and the programme finally got under way.

As at October 1999 approximately 1,33 million tonnes i.e. 73 % of the global quantity had been shipped (over 55 000 tonnes per week) and most of this quantity had already arrived at the various final destinations. Despite a number of programme suspensions, procurement difficulties, especially for pigmeat, and considerable logistical problems, the performance of the Commission services in delivering the food represents considerable success in implementing the wishes of the Council. This success was achieved despite the failure to secure sufficient resources to manage the single biggest food delivery programme that the EU has undertaken.

56. The contradiction between the main aim as stated by the Court and the implicit aim of maximising receipts from the sale of food products is more theoretical than real. In fulfilling its mandate, the Commission has minimised the risks attached to the programme while ensuring the successful delivery of foodstuffs to the regions as requested by the Government of the Russian Federation. Through contributions to pension funds and social activities, the proceeds from the sale of the food products have helped the vulnerable sections in Russian society.

57. The Commission does not believe it would have been appropriate to implement the programme without the full cooperation of the Government of the Russian Federation. To ascribe other objectives not covered by the legal base to an already complex programme would have introduced an unmanageable level of risk.

58. The absence of the food aid programme might have led to a need for even higher export refunds. In addition, it has permitted the constitution of counterpart funds which aided the clearance of pension arrears and contributed to the significant increase in basic pensions. This helped to provide pensioners with the means to purchase the increased supplies available.

The Council Regulation required the proceeds of the special account to be used for social purposes and therefore precluded conditioning the programme to agricultural reform. (See also reply to paragraph 7).

59. Despite the delays the programme encountered, 97 % of the quantities foreseen under the programme were delivered within the space of nine months. On 22 December 1999 the Commission concluded that its mandate covering the physical delivery of

the food supplies had been met. The level of losses both during the transport to Russia and within Russia was remarkably low for an operation of this size and level of risk.

60. The Commission recognises that that more could have been done had resources been liberally available. Nevertheless, the Commission continues to press the Government of the Russian Federation to resolve all outstanding problems satisfactorily and in full compliance with the MoU and the OmoU.

61. The objectives of the programme were twofold: to ensure that food was available, and to make sure it was affordable. There was little negative impact on local markets, and the positive effects of the programme were felt throughout the Russian Federation.

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