



# Official Journal

## of the European Union

ISSN 1725-2423

C 167

Volume 46  
17 July 2003

English edition

## Information and Notices

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# EN

## I

(Information)

## COURT OF AUDITORS

## SPECIAL REPORT No 5/2003

concerning PHARE and ISPA funding of environmental projects in the candidate countries  
together with the Commission's replies

(pursuant to Article 248(4), second subparagraph, of the EC Treaty)

(2003/C 167/01)

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## SUMMARY

I. The audit covered PHARE and ISPA funding of environment projects financed during the period 1995 to 2000 in the 10 candidate countries of central and eastern Europe. The objective of the audit was to assess the effectiveness of PHARE and ISPA aid to the environment sector in the candidate countries, notably in relation to helping to prepare these countries for accession.

### *Institution-building projects in the environment sector*

II. The audit found that the Commission's assistance to support institution-building in the environment sector in the candidate countries has been only partially successful. As the Commission itself recognised in its 2001 and 2002 Enlargement Strategy Papers, there is still a need for candidate countries to further strengthen their administrative capacities in the environment sector (see paragraph 8). This situation partly reflects both the limited scale of funding which the Commission committed to institution-building (see paragraph 9), despite the particular challenges faced by institutions in this sector (see paragraph 7), and the only modest impact of the twinning and technical assistance projects that have been funded (see paragraphs 11 to 14). The Commission's institution-building strategy has placed too much reliance on the twinning instrument which cannot be expected to overcome many of the underlying structural problems faced by candidate countries' administrations. These problems may hinder their capacity to comply with the environmental *acquis* (see paragraphs 11 to 14). The weaknesses in administrative capacity persist in relation to ISPA, not only at national level but also at final beneficiary level, where attention should be paid to establishing sufficient capacity to ensure the sustainability of infrastructure projects (see paragraphs 15 to 17).

### *The financing of environmental infrastructure projects*

III. Candidate countries should have developed environmental and financing strategies at an earlier stage to identify priority projects and how to finance them most efficiently (see paragraphs 18 to 21). ISPA has sought to reduce the level of grants below the 75 % ceiling (see paragraph 23) and has cooperated effectively with the EIB, EBRD and other international financing institutions to achieve this (see paragraph 26 to 28). Nevertheless, the Court considers that there remains further scope for reducing grant levels (see paragraphs 24 and 25).

### *The management of environment infrastructure projects*

IV. Institutional weaknesses were also reflected in problems with project cycle management which the Commission has not always effectively addressed. Thus candidate countries encountered difficulties in preparing projects to an adequate standard, and the consultants financed by the Commission to rectify these problems sometimes did not perform satisfactorily (see paragraph 31). The Commission for its part did not employ sufficient resources at the project appraisal stage (see paragraph 32). For certain infrastructure projects, notably waste water treatment plants, there was a risk that they would be too large (see paragraph 34). Candidate countries were experiencing significant difficulties tendering ISPA contracts, partly because of the complexity of the Commission procedures, and required more support in this area. ISPA project budgets did not systematically include the necessary funds to recruit engineers with sufficient experience to supervise contracts effectively (see paragraphs 35 and 36). While most infrastructure projects, once up and running, were satisfactorily implemented, a few important exceptions were found (see paragraph 39).

V. The Court's recommendations are focused on:

- the continuing need for significant institution-building (see paragraphs 40 and 41),
- the need to target scarce grant financing more effectively and increase funding from other sources (see paragraphs 42 and 43),
- the need to improve absorption capacity by strengthening project preparation and tendering capabilities (see paragraphs 44 and 45).

## INTRODUCTION

### *The environment sector and the enlargement of the European Union*

1. The environment sector, which is covered by Chapter 22 of the accession negotiations, represents one of the most challenging areas to be tackled in preparing for the enlargement of the European Union for the following reasons:

- (a) it requires the transposition of a large body of environmental *acquis* consisting of approximately 140 directives relating, *inter alia*, to air quality, water quality, waste management, nature protection and industrial pollution control, as well as sector-wide legislation, such as environmental impact assessments and access to environmental information;
- (b) a huge investment in infrastructure is needed for the implementation of certain key directives. For example, recent estimates place the total costs of compliance between 79 and 110 billion euro, making the environment sector the single most investment-intensive sector <sup>(1)</sup>;
- (c) it requires the development of monitoring structures, including the requisite human resources, budgets and equipment, for the enforcement of the legislation that has been transposed;
- (d) it necessitates the building of institutions at central, regional and local levels with the administrative capacity for the overall management of the transposition, implementation and enforcement of the environmental *acquis*.

2. Candidate countries were required to have transposed and enacted all the environmental *acquis* prior to accession. However, given the enormous investment needs of the environment sector, it has always been clear that candidate countries need to be granted long transitional periods to construct the infrastructure needed to comply with certain investment-intensive directives in the context of the Chapter 22 negotiations. Therefore no specific minimum level of implementation of these directives was set for the provi-

sional closure of the environment chapter although the Commission did require candidate countries to submit implementation plans. On the other hand, as far as enforcement structures and general administrative capacity were concerned, the candidate countries are required to demonstrate that the relevant institutions will be operating satisfactorily by the time of the accession.

3. During the period covered by the Court's audit there were several developments in the Commission's approach to its funding of the environment sector:

- (a) for the years 1995 to 1997 the Commission's financing continued to be based, as from the outset of the PHARE programme in 1989, on a demand-driven approach whereby each candidate country was free to allocate its PHARE funds according to national priorities;
- (b) following the December 1997 Luxembourg European Council which launched the present enlargement process, the PHARE programme was reoriented to focus entirely on the pre-accession priorities set out in each country's Accession Partnership. In addition, the Commission issued a Communication setting out its strategy for the environment sector <sup>(2)</sup>;
- (c) Funding for environmental infrastructure projects was greatly increased in 2000 with the introduction of the Instrument for Structural Policies for Pre-Accession (ISPA) which made available 1 040 million euro <sup>(3)</sup> per year over the period 2000-2006 for large infrastructure investments in the environment and transport sectors <sup>(4)</sup>. PHARE funding, which over the period 1995-99 had amounted to approximately 368 million euro, or on average 73,6 million euro per annum, from 2000 onwards was intended to be directed mainly to institution-building. PHARE and ISPA commitments by country over the period 1995-2000 in the environment sector are set out in *Table 1*.

<sup>(2)</sup> Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee, the Committee of the Regions and the candidate countries in central and eastern Europe on 'Accession strategies for environment: Meeting the challenge of enlargement with the candidate countries in central and eastern Europe' [COM(1998) 294 final].

<sup>(3)</sup> In 1999 prices.

<sup>(4)</sup> Article 2.3 of the ISPA Regulation requires a 'balance to be struck' between the funding of these two sectors.

<sup>(1)</sup> Communication from the Commission 'The challenge of environmental financing in candidate countries' (COM (2001) 304 final).

**Table 1***Phare and ISPA commitments in the environment sector 1995-2000**(EUR Million)*

	Phare	ISPA	Total
Bulgaria	35,2	52,0	87,2
Czech Republic	26,6	27,9	54,5
Estonia	24,5	15,8	40,3
Hungary	55,1	42,6	97,7
Latvia	27,4	26,6	54,0
Lithuania	33,5	18,2	51,7
Poland	99,7	133,7	233,4
Romania	60,3	120,6	180,9
Slovakia	20,9	11,6	32,5
Slovenia	15,0	11,2	26,2
<b>Total</b>	<b>398,2</b>	<b>460,2</b>	<b>858,4</b>

Source: European Court of Auditors.

**The Court's audit**

4. The objective of the Court's audit was to examine the effectiveness of PHARE and ISPA funding to the environment sector, particularly in relation to preparing candidate countries for accession. The audit sub-objectives were designed both to assess the effectiveness of the strategic and financing framework established by the Commission and the candidate countries and the economy, efficiency and effectiveness of individual institution-building and investment projects. The audit covered the commitment and implementation up to the end of 2001 of PHARE and ISPA funding for the environment sectors from the 1995 to 2000 budgets and included an audit of projects in all ten candidate countries benefiting from PHARE and ISPA assistance. File reviews and interviews were carried out both at the Commission headquarters and Commission Delegations and meetings held with the Ministries of Environment, regional and local authorities, as well as final beneficiaries in the candidate countries.

5. In total PHARE projects amounting to 270 million euro were audited. This represented approximately 67 % of the total value of funding for PHARE environment projects over this period excluding environment infrastructure projects funded under the PHARE cross-border cooperation (CBC) programme and regional

environmental programmes <sup>(1)</sup>. In addition, 22 of the 39 ISPA environment measures committed in 2000 were subject to site visits. The commitments for the ISPA measures audited amounted to 307 million euro, or approximately two thirds of total ISPA environment commitments. The audit of ISPA was designed to build on the Court's observations on the setting up of the ISPA instrument contained in its Annual Report 2000 <sup>(2)</sup>. All the supreme audit institutions in the candidate countries participated in the audit to varying degrees, either through auditing part of the sample of projects selected by the Court using the Court's methodology or supporting the Court's auditors in preparing and during their on-the-spot missions.

6. The report's findings are focused on three main areas:

- (a) the continued significant need for institution-building;
- (b) the need to target scarce grant financing more effectively;

<sup>(1)</sup> The PHARE cross-border cooperation programme was excluded from the scope of the audit because the Court had already issued a special report on this programme, including its environmental aspects. The regional programmes were not examined because these played a greatly reduced role under the new 1998 PHARE guidelines.

<sup>(2)</sup> OJ C 359, 15.12.2001, p. 290 to 300.

- (c) the need to increase absorption capacity by strengthening project preparation and tendering capabilities.

#### INSTITUTION-BUILDING PROJECTS IN THE ENVIRONMENT SECTOR

##### *Limited scale of PHARE funding committed to institution-building in the environment sector*

7. From its inception in 1989 the PHARE programme has supported institution-building. The Commission recognised the particular importance of institution-building in preparing for the accession in its new PHARE guidelines issued in 1998 which stated that henceforth 30 % of the annual PHARE budget should be allocated to this area. Institution-building for the purposes of this 30 % allocation was defined by the Commission as 'the process of helping the candidate countries to develop the structures, strategies, human resources and management skills to strengthen their economic, social, regulatory and administrative capacity' <sup>(1)</sup>. In the environment sector institution-building is essential both to ensure that environmental authorities are operating satisfactorily by the time of accession and to enable them to efficiently and effectively implement the huge investment programmes required to comply with the *acquis* (see paragraph 2). Furthermore, institution-building is a particular challenge in the environment sector because Ministries of Environment are relatively new, while regional and local authorities as well as environmental agencies also require assistance to meet their responsibilities in relation to the *acquis*. Moreover, both coordination between the Ministry of Environment and these other institutions and coordination between the Ministry and other ministries is often very difficult and has to be developed.

8. The main conclusion on the environment sector in the Commission's 2001 Strategy Paper on enlargement was the 'need to further strengthen administrative, monitoring and enforcement capacity'. The Commission's 2002 Strategy Paper reiterated this message stating that 'candidate countries needed to focus their

efforts on reinforcing their overall administrative capacity.' The Court's audit of the PHARE and ISPA programmes confirms the Commission's conclusions in view of the findings presented in the following paragraphs (9 to 17).

9. The problems described by the Commission partly reflect the limited scale of funding committed to institution-building in the environment sector over the period 1995 to 2000. Until 1998 funding priorities were established by the candidate countries, which generally did not attach a high priority to using PHARE for institution-building (see paragraph 10). The Commission's increased focus on institution-building in 1998 gave an impetus to the systematic commitment of funds to environment institution-building projects that year. However, in 1999 and 2000, although the accession partnerships and national programmes for the adoption of the *acquis* provided a strategic framework for programming PHARE according to the priorities for complying with the *acquis*, several countries had only either very small or no institution-building projects in this sector. The average annual amount committed to environment Twinning projects, the main instrument for institution-building, in these two years was 30 % less than in 1998 (see Table 2). This is particularly problematic as 2000 in fact proved to be the last year to commit funds to projects in order to ensure their full implementation before accession in 2004.

10. The limited funding committed by the Commission over the period 1995 to 2000 in conjunction with the candidate countries to institution-building in the environment sector partly reflects the higher priority attached by candidate countries to environment infrastructure projects, notwithstanding the imperative need to ensure environmental institutions were functioning adequately by the time of accession. In addition, it can be linked to the fact that the Ministries of the Environment in most candidate countries do not have a strong influence, other longer-established ministries often being given preference when it came to allocating PHARE resources between competing projects. Furthermore, some environment ministries had difficulty in drawing up institution-building project proposals for PHARE funding to the standard required for approval by the Commission. In its PHARE programming guidelines for 2002 the Commission insisted that candidate countries make institution-building their number one priority and detailed Action Plans for addressing institutional weaknesses were drawn up. However, projects funded from the 2002 budget will generally not be completed until 2005.

<sup>(1)</sup> 'Guidelines for PHARE programme implementation in candidate countries for the period 2000 to 2006 in application of Article 8 of Regulation 3906/89'; Commission Decision SEC(1999) 1596 final. Brussels, 13 October 1999.

**Table 2***Phare commitments for twinning projects in the environment sector 1998-2000*

(EUR Million)

	1998	1999	2000
Bulgaria	1,75	2,60	3,16
Czech Republic	0,85	0,85	2,39
Estonia	0,81	0,00	0,00
Hungary	1,89	0,00	1,11
Latvia	0,65	0,00	0,00
Lithuania	1,30	1,00	0,00
Poland	2,97	2,02	2,79
Romania	1,20	0,00	0,80
Slovakia	1,22	1,20	0,70
Slovenia	0,49	0,00	0,00
<b>Total</b>	<b>13,13</b>	<b>7,67</b>	<b>10,95</b>

Source: European Court of Auditors.

**Limited impact of PHARE twinning and technical assistance projects**

11. Up until 1998 institution-building projects were carried out through technical assistance. In 1998 the Commission introduced 'twinning' as its main instrument to support the increased importance it gave to institution-building <sup>(1)</sup>. Twinning involves the secondment of civil servants from Member States to candidate country ministries to advise on accession preparations. The instrument has two key features:

- (a) the Commission stated that twinning would 'guarantee' fully operational results. This is to be seen in contrast to the previous reliance on technical assistance which was frequently criticised for simply producing long and unusable reports;
- (b) twinning would be based on closer cooperation with the candidate countries, reflecting the changed status of these countries as they moved nearer to accession, the intention being that senior counterparts from candidate countries' ministries would work alongside representatives of Member State administrations rather than be simply recipients of consultancy services.

<sup>(1)</sup> The Court's Special Report 6/2003 on 'twinning' (see page 21 of this Official Journal) gives a comprehensive assessment of the twinning instrument.

12. The Court audited 19 of the 42 environment sector twinning projects financed between 1998 and 2000, focusing on those where implementation was ongoing or completed and a further 15 technical assistance contracts. For 12 of the 14 twinning projects which had been completed it was found that while the twinning project had achieved at least some of the results foreseen for the project, particularly in relation to the transposition of the *acquis*, it had not comprehensively met all the objectives set out under the related covenant. Thus twinning, while contributing to institution-building, was not an instrument which brought guaranteed results.

13. A major factor hindering the achievement of results was the administrative capacities of the candidate countries. In most cases, staff in the Ministries of Environment were unable to dedicate themselves full-time to working alongside representatives of the Member State, often because the Ministries were under-resourced and could not find the time to integrate the additional tasks associated with the twinning covenant into their regular work. The Court's audit of technical assistance contracts found similar problems to those identified for twinning projects. In several countries, the contracts examined showed that the ministries relied heavily on technical assistance inputs because of their own limited resources. This lack of resources made it difficult to ensure an adequate transfer of knowledge. Personnel that had been trained often left the ministries, either due to the better pay in the private sector or because of political changes following elections.

14. The Commission's institution-building strategy has placed too much reliance on the twinning instrument which cannot be expected to overcome many of the underlying structural problems faced by candidate countries' administrations, particularly in the tight accession timeframe. Moreover, the successful implementation of twinning projects depends heavily on Member State and candidate country inputs and cooperation rather than on the Commission's own management. In so far as the Commission has sought to attach conditions to its funding of PHARE programmes, to try to ensure adequate staffing arrangements by beneficiaries, such conditions have generally not been strictly followed-up. The fact that there is no *acquis* in relation to institution-building means that the standards to be achieved by public administrations are not specified and the Commission has not established objective and measurable criteria to define the level of 'adequate' administrative capacity in the environmental sector although it has done this in other areas to the extent that the *acquis* enables it to do so.

### *The need for institution-building in the context of ISPA*

15. The institutional weaknesses described also affected the management of ISPA by candidate countries. Even at the end of 2001 the majority of countries did not have fully functioning structures for managing ISPA. These weaknesses were reflected in the poor quality of some of the National ISPA strategies (see paragraph 18) and the problems in submitting priority projects prepared to the required standards which the Court already referred to in its Annual Report 2000 <sup>(1)</sup> (see paragraphs 30 and 31). In most countries there was a lack of technical engineering expertise in the Ministry of the Environment.

16. In common with other institutions in the candidate countries, none of the institutions involved in ISPA environment projects had progressed to the point where they were deemed capable by the Commission of operating the Commission's Extended Decentralised Implementation System (EDIS). EDIS involves the Commission moving from the *ex ante* to *ex post* control of tendering and contracting on the assumption that it will be able to rely on the financial management and control systems in the candidate countries. It had been planned for EDIS to be introduced at the beginning of 2002 but the Commission did not begin to systematically provide technical assistance to help candidate countries to prepare for EDIS until December 2001. It is unlikely that EDIS will be introduced in any country until 2003 at the earliest.

<sup>(1)</sup> Annual Report concerning the financial year 2000, paragraph 6.23 (2001/C359/01, OJ C 359, 15.12.2001, p. 295).

17. At the level of the final beneficiary there was also a widespread need for more institutional strengthening. Since the main objective of ISPA is the financing of construction contracts for infrastructure projects, it did not systematically provide assistance for institution-building measures to support the beneficiaries of these projects. Of particular importance was the need to provide technical assistance to water companies to improve their operational and financial management. The experience of the Cohesion Funds points to the risk of financing infrastructure such as waste water treatment plants, for which beneficiaries do not have sufficient funds to cover the operating and maintenance costs after the project has been completed.

### **THE FINANCING OF ENVIRONMENTAL INFRASTRUCTURE PROJECTS**

#### *Shortcomings in environmental strategies*

18. PHARE and ISPA funding represents only a small fraction of the huge financing needs of the environment sector in the candidate countries as Table 2 shows. In order to ensure that the scarce resources available for environment projects are used as effectively as possible there is a need to prioritise projects and fund those with the greatest potential impact first. In practice, national environment strategies have too often contained long lists of different projects to be implemented without any ranking or prioritisation for their preparation and implementation. In addition, even when the Commission moved away from a demand-driven to an accession-driven approach to PHARE in 1998 (see paragraph 3(b)) too much attention was given to projects' readiness for implementation and not enough to how high the project ranked as a priority compared with others. In fact, project readiness often depended more on regional and local initiatives to prepare projects than on national priorities. Similarly, while for ISPA the Commission has required each country to submit a 'National ISPA Strategy', these documents were in some cases built up around projects under preparation rather than necessarily the highest priority projects.

19. PHARE and ISPA funding of environmental infrastructure has largely been allocated to the water sector (see Table 3). Despite the huge needs for investment in the air sector, very little has been funded by PHARE and ISPA, even though this sector was identified as a priority in all the National ISPA strategies. This is above all because most of the investment needs for the air sector relate to privately owned large combustion plants and the Commission has not yet developed an approach to funding such projects which would respect the requirements of the ISPA Regulation, notably in regard to compliance with competition rules.

**Table 3**

*Phare and ISPA commitments 1995-2000 for environment infrastructure projects by environmental sub sector compared with estimated total needs*

(EUR Million)

Sector	Phare	ISPA	PHARE and ISPA Total	Estimated Total Needs <sup>(1)</sup>	PHARE and ISPA as % of total needs
Water and wastewater	225,0	366,8	591,8	54 000	1,10
Solid and hazardous	18,7	94,0	112,7	15 000	0,75
Air	15,0	0,0	15,0	53 000	0,03
Total	258,7	460,8	719,5	122 000	0,59

<sup>(1)</sup> EDC: Compliance costing for approximation of EU environmental legislation in the CEEC, April 1997.  
Source: European Court of Auditors.

20. Approximately 14 % of funding has been used for waste management projects. However, although a key priority in this area is the creation of larger regional landfill sites and the closure of smaller often unplanned landfills, PHARE and ISPA have frequently financed new landfills in the absence of national and regional waste management plans. For example, although the Commission approved three ISPA projects for solid waste in Hungary in 2000, for which the estimated total ISPA contribution amounted to 29,6 million euro, the national waste management plan was only adopted in September 2001, and the regional and local waste management plans were still under preparation in 2002. Moreover, two PHARE projects on waste management which were to be used as inputs into these plans only started at the beginning of 2001. In several other countries, waste management plans were also only developed at a very late stage.

#### **Co-financing of PHARE and ISPA grants**

#### **Delays in establishing financing strategies**

21. Given the amount of funding required and the scarcity of such funding, there was also a need for the candidate countries to establish financing strategies at an early stage to identify other sources of finance (national and local budgets, tariff increases, loans, etc.) as co-finance for the PHARE and ISPA grants. However, as late as June 2001 the Commission still found it necessary to issue a formal communication on the challenge of environmental financing in the candidate countries' to assist candidate countries 'to define clear and credible financing plans for their accession needs' <sup>(1)</sup>. The Communication concluded by stressing that the need for continuing to develop financing strategies for

the three main sectors (water, waste and air) had become 'even more urgent'.

#### **Reducing grant levels for income generating projects**

22. Since infrastructure projects relating to water/wastewater and solid waste are income generating, a key factor in deciding whether and, if so, how much grant financing is necessary is to establish how far such projects can be financed by local consumers through increases in tariffs for the services. Revenue from tariffs may either directly fund projects or be used to finance loans. However, this key aspect of income generation potential was not systematically addressed in the project fiches used for appraising PHARE projects.

23. In contrast, for ISPA specific attention has been paid to income generation issues when determining what percentage of the measure should be financed through an ISPA grant. Although it is in the interests of final beneficiaries to maximise the proportion of grant financing received, one of the main achievements of the Commission in managing ISPA has been to avoid setting all grants at the maximum percentage of 75 % stipulated in the ISPA Regulation. By bringing in other forms of financing from national sources and international loans, ISPA can be compared favourably with the Cohesion Fund, for which grants to Member States have often been set in practice at the maximum allowable level of 85 %. Nevertheless, as shown in the following paragraphs, there remains further scope for reducing the grant level which would then enable more projects to be financed.

<sup>(1)</sup> Communication from the Commission: the challenge of environmental financing in the candidate countries, Brussels 8 June 2001 (COM(2001) 304 final).

24. The basic cited by the Commission, when considering the appropriate level of tariffs for determining the part of the project which could be financed by loans instead of ISPA grants, is that for water tariffs the upper limit of affordability for consumers is 4 % of average household income <sup>(1)</sup>. Nevertheless, the justification for the level at which the ISPA grant was set for a given measure has not always been clear. For several measures the ISPA documentation did not state what the new tariff levels would be as a percentage of household income. For measures where this percentage was clearly stated, with the exception of Romania where tariff levels were actually over 4,0 %, the average water tariff levels for ISPA measures were only approximately 3,0 % of average household income and varied considerably between projects. As rises in tariff levels of as little as 0,1 % can significantly increase the capacity of local authorities and water companies to finance infrastructure projects from their own resources, ISPA grant levels could have been lower if tariff rates nearer to the limit of affordability of 4 % had been adopted.

25. In Lithuania the tariff level for the Vilnius sewerage measure, where ISPA's contribution was 20 million euro, was foreseen to be as low as 1,8 % of average household income. In Poland, ISPA made a contribution of 47,5 million euro in Torun which had the lowest water tariffs of Poland's sixteen district capitals and where tariffs, even after the project, were only planned to rise to 2,5 % of average household income. In the nearby town of Bydgoszcz, where ISPA provided financing of 66,2 million euro, representing a grant level of 49 %, the financial analysis prepared by technical consultants showed there was scope for a significantly lower percentage of grant financing by raising tariffs.

### Effective cooperation with international finance institutions

26. Following the 1993 Copenhagen Council, PHARE funds were made available for financing infrastructure projects, including environmental ones, in conjunction with the International Financial Institutions (IFIs). It was intended that PHARE funds would have a multiplier effect by attracting IFI finance to projects which would not otherwise receive it. While initially such cooperation largely took place on a project-by-project basis, a more systematic approach was introduced in 1998 with the signing of a Memorandum of Understanding (MoU) on pre-accession preparation between the European Commission, the EBRD and the

World Bank. In 2000 this MoU was extended to include the Nordic Investment Bank (NIB) and the Nordic Environmental Finance Corporation (NEFCO). Cooperation with the European Investment Bank (EIB) was also intensified, particularly in the context of the EIB's pre-accession facility.

27. The establishment of the PHARE large-scale infrastructure facility (LSIF) for the period 1998/1999 enabled such cooperation to take on a more concrete form. However, although the LSIF placed special emphasis on financing projects which would lever maximum additional financing from IFIs, in some cases it was used to help complete existing IFI projects (e.g. Romania, Baltic States).

28. In the framework of ISPA, the Commission has established effective cooperation with the EIB, the EBRD, the NIB and NEFCO. Even if it was not always clear whether the optimal ratio of grant to loan financing had been achieved (see paragraphs 24 and 25 above), the availability of ISPA grants enabled banks to finance projects which would not generally have gone ahead otherwise.

29. A further important potential source of financing was public-private partnerships (PPP). However, such financing also carried with it the risk of ISPA subsidising private companies. Up until 2002 the Commission was still in the process of defining guidelines on PPP which would enable ISPA to use PPP while minimising this risk. There is a need to work closely with IFIs in this area too.

### THE MANAGEMENT OF ENVIRONMENTAL INFRASTRUCTURE PROJECTS

#### *Difficulties in preparing projects for ISPA funding*

30. The very large increase in funding for environment sector infrastructure projects resulting from the introduction of ISPA in fact led to absorption problems in most candidate countries, despite their huge needs. One indication of this is the estimated total value of environment measures committed under ISPA in 2000. As Table 4 shows, in four countries less than 35 % of the estimated total ISPA contribution related to environmental measures (Czech Republic, Hungary, Lithuania, Romania)

<sup>(1)</sup> These figures are based on World Bank studies carried out in Poland.

**Table 4***Estimated total ISPA contribution for environment sector as a % of estimated*

	Total ISPA contribution for all measures Estimated total ISPA contribution for environment sector (EUR million)	Estimated total ISPA contribution for environment and transport sectors (EUR million)	Estimated total ISPA contribution for environment sector as a % of estimated total ISPA contribution for all measures
Bulgaria	78,0	1 58,0	49,40
Czech Republic	34,5	100,1	34,50
Estonia	19,8	33,9	58,40
Hungary	70,1	259,8	27,00
Latvia	37,7	80,8	46,70
Lithuania	22,8	65,3	34,90
Poland	250,0	527,2	47,40
Romania	181,4	528,3	34,30
Slovakia	27,2	65,8	41,30
Slovenia	14,0	23,3	60,10
Total	735,5	1 842,5	39,90

Source: European Court of Auditors.

31. Project applications submitted by the administrations of the candidate countries were often not prepared to the standard required to receive ISPA funding. As a result the Commission required the candidate countries to employ significant technical assistance financed from a PHARE framework contract to try to improve the quality of the proposals and thus enable the budget to be committed. However, because the technical assistance was taken on at a relatively late stage and was overburdened by the sheer amount of work to be carried out in a very short space of time, it did not always provide the results expected. As a result, in several countries (e.g. the Czech Republic, Latvia) the national authorities had instead to fund national experts to perform the work. Moreover, the Commission was obliged to insert conditions into Financing Memoranda concerning the completion of preparatory work which had to be met before project implementation could begin.

32. The Commission's own capacity to appraise applications and supplementary work carried out by consultants was initially limited by the fact that in January 2000 it had allocated only five A grade officials to ISPA. For by far the largest beneficiary country, Poland, (ISPA environment commitments of 133 million euro in 2000) only one official was allocated to the environment sector until November 2001. A further constraint was the lack of engineering expertise in the Commission. To help overcome this, a framework contract was made with the European Investment Bank, whose engineers and economists already had a large amount

of experience of Cohesion Fund projects. However, the Commission could not make systematic use of this high quality assistance because of the limited budget available for this purpose.

33. From 2000 ISPA replaced PHARE funds as a source of financing for project preparation. However, despite the limited project preparation capacity in beneficiary countries, their take-up of these funds was slow. Thus only two technical assistance projects in candidate countries were committed in 2000 for a total of 3,7 million euro.

34. A major technical issue at the project design stage for the most common type of infrastructure project, wastewater treatment plants (WWTP) and their related networks, is the capacity of the WWTP. Designs were often established during the Communist era and based on a much higher demand for water due mainly to the very low tariffs. The delays in using LSIF technical assistance to appraise projects (see paragraph 31) meant that there was little time to appraise the WWTP designs while some of the factors influencing the optimal size of the capacity were difficult to estimate given the rapid changes taking place in the economies

concerned <sup>(1)</sup>. Several cases were identified where the Commission had approved projects where there was a clear risk that the capacity foreseen would prove too large, which would result not only in the PHARE/ISPA grants being uneconomically used but also that the subsequent operating costs would be greater than necessary:

- (a) In Bulgaria the reasons and justifications for increasing the Sofia WWTP from 500 000 m<sup>3</sup>/day to 700 000 m<sup>3</sup>/day (17,3 million euro) were unclear. The PHARE financed consultants stated that there was a lack of certainty concerning the need to increase plant capacity to 700 000 m<sup>3</sup>/day. They estimated that the average daily flow would fall by 40 % from a maximum of 468 368 m<sup>3</sup> per day in 2004 to 280 800 m<sup>3</sup> in 2020;
- (b) In Lithuania, where there had been a particularly sharp drop in water consumption, there were strong indications that the Jurbarkas WWTP (PHARE: 2 million euro) had been designed with an overly large capacity. In Kaunas PHARE-funded pumping stations were also too large for current and projected needs (PHARE: 7,75 million euro);
- (c) In Poland, the Szczecin Maritime WWTP (PHARE: 1,1 million euro) had only been functioning at only 40 % of its capacity since its opening in April 2000. Also in Poland it was noted that the LSIF had co-financed (5 million euro) with the World Bank a water supply project in Bielsko Biala providing support for water tanks which had a combined capacity of 80 000 m<sup>3</sup>/day whereas current demand was approximately 55 000 m<sup>3</sup>/day;
- (d) For two ISPA projects in Hungary (Győr: 14,5 million euro) and Romania (Braila: 44,9 million euro) there were strong indications that the proposals submitted for the WWTP capacity would lead to a plant that was too large for current and future needs.

### **Weaknesses in tendering and supervision**

35. Since 1998 a key criterion for selecting PHARE projects has been their readiness for implementation. In reality projects approved for funding often required significant further preparation. When combined with the inexperience of beneficiaries in organising tenders, this led to more than half of the PHARE infrastructure projects audited only being contracted in the last quarter of the period for contracting laid down in the Financing Memoranda.

<sup>(1)</sup> Such factors included household water consumption levels which were falling in response to tariff increases, the prospects of local industries, estimated population change and likely income growth.

36. The contracting of ISPA measures was also considerably delayed when compared with the timetables set in the Financing Memoranda. At the end of 2001 only one ISPA works contract had been concluded for 1,9 million euro in Slovenia. While the preparation of tenders for large infrastructure projects is a complex undertaking, and the time schedule established by the Commission in the Financing Memoranda was generally not realistic, there are a number of other reasons why tendering is behind schedule:

- (a) the lack of experience of most beneficiaries, both at central and local level, in the preparation of tender documentation using Commission and FIDIC <sup>(2)</sup> procedures;
- (b) although the Commission committed 7 million euro in 2000 to finance posts in its Delegations for engineers to supervise ISPA implementation, including tendering, in half of the Delegations the engineer took up his post only in September 2001 or later;
- (c) in some cases projects suffered from delayed and inadequate work by consultants financed by the Commission to draw up the tender documentation;
- (d) initial problems related to different provisions for tender evaluation in the Commission's decentralised implementation system procedure manual and the new Practical Guide which it introduced in January 2001;
- (e) problems with EBRD co-financing, mainly in Poland and Romania, because of differences between EBRD and Commission procurement procedures which were eventually resolved when the ISPA Regulation was modified in December 2001; and
- (f) in some cases the need for beneficiaries to meet certain conditions, usually resulting from incomplete project preparation (see paragraph 31), before implementation could begin.

37. The Commission and the beneficiary countries have favoured the use of 'design and build' over 'measured works' contracts. The former type of contracts have the advantage of placing the responsibility for the design of the infrastructure on the contractor, with the result that cost overruns are borne by the contractor rather than the beneficiary. On the other hand, because the contractor must cover this risk, the costs of such contracts can be expected to be higher than for measured works contracts, and these higher costs are borne by the PHARE and ISPA programmes rather than directly by the beneficiary. It is also noted that the Commission has not systematically required financial evaluations of tender bids involving 'design and build' contracts to take account of the long term operating costs of the project resulting from a particular design as well as the capital costs.

<sup>(2)</sup> Federation Internationale des Ingenieurs-Conseils.

38. Infrastructure projects have not always had an engineer of an international standard to supervise them. In the candidate countries, staff employed by the beneficiary itself have traditionally carried out the supervision and the Commission has not systematically ensured that the project includes the necessary budget to finance effective supervision. While the ISPA measures examined generally did include a budget for supervision, in several cases the amount concerned was less than 2 % of the budget.

39. Although in most cases, once the tendering had been completed, construction works were carried out as foreseen in the Financing Memoranda, the following projects proved problematic in their implementation:

- (a) in Lithuania, the implementation of the Klaipeda Water Treatment project (PHARE LSIF: 7,2 million euro) experienced serious difficulties because of poor project preparation and disputes between the beneficiary and the contractor in the absence of an independent engineer (see paragraph 38). Construction works had not yet begun at the time of the Court's audit in October 2001, 24 months after the contract had been scheduled to begin;
- (b) in Bulgaria, the original budget of 34 million euro for the rehabilitation of the Sofia Wastewater Treatment Plant was below the amount which the consultant considered 'to be the necessary minimum' to carry out the works adequately. Nevertheless the Commission subsequently reduced the budget to 22,4 million euro. As a result, the limited scope of the project meant that there continued to be a real risk that the plant would break down, posing a serious threat of pollution to local rivers and ultimately the Danube;
- (c) in Poland under the Podhale Geothermal Project (1999 PHARE LSIF: 14 million euro), which was designed to reduce air pollution, 4,82 million euro (34,4 % of the programme) was contracted for the construction of a 'spa centre' building. This construction project cannot be considered as contributing to the implementation of the environmental *acquis* nor is it an integral part of the PHARE project, which focuses on linking together the different elements of the heating system through the installation of pipelines. While the project fiche does refer to the extension of the project to greenhouses and spa hotels, the implication was that pipelines would be extended to existing facilities and not that a new spa centre would actually be constructed. Moreover, given the amount of funding devoted to this purpose, the project fiche should have clearly shown the budget for this component which it did not.

## CONCLUSIONS AND RECOMMENDATIONS

### *There continues to be a significant need for institution-building*

40. The audit found that the PHARE programme has only been partially successful in developing institutional capacity. Not only were in some cases the funds committed by the Commission insufficient, but the Commission's main instrument for institution-building, twinning, by no means always achieved the so-called 'guaranteed' results foreseen, mainly because of the institutional weaknesses the projects were intended to tackle. More generally, there were clearly limits to what the PHARE programme could achieve within the tight accession timeframe and the Commission's institution-building strategy placed too much reliance on the twinning instrument, which cannot be expected to overcome many of the underlying structural problems faced by candidate countries' administrations. Thus significant efforts remain to be made in institution-building, not least because of the key role national, regional and local authorities and operators have to play in meeting the environmental *acquis* through both planning and implementing environmental infrastructure projects and ensuring the sustainability of projects after construction.

41. It is recommended that the continued significant need for institution-building should be addressed as follows:

- (a) particular attention should be paid to the institution-building needs of national and local authorities in the environment sector when allocating further pre-accession or post-accession assistance. Such assistance should be based on a common strategy agreed between the Commission and the candidate countries for public administration reform;
- (b) more ISPA resources should be devoted to providing technical assistance at the level of the final beneficiary to improve the chances of operational and financial sustainability of infrastructure investments;
- (c) additional assistance should be given to introducing the extended decentralised implementation system (EDIS) for ISPA measures in candidate countries as much in advance of accession as possible in order to prepare them for managing the Structural Funds.

### *Scarce grant financing can be targeted more effectively*

42. The audit found that PHARE and ISPA funding could have been more effectively targeted if candidate countries had designed environmental and financing strategies at an earlier stage. While the Commission has generally kept ISPA grants

below the maximum level of 75 %, partly due to effective cooperation with the EIB and IFIs, there is further scope for reducing grant levels. Despite the enormous needs of the environment sector, the absorption capacity of the candidate countries is limited due to the continuing need for institution-building and for improvements in project cycle management.

43. To more effectively target scarce grant financing it is recommended that:

- (a) the Commission should increase support to the development of financing strategies and closely monitor their implementation;
- (b) more efforts should be made to develop projects in the air sector while it should be ensured that solid waste projects are based on national and regional strategies;
- (c) the Commission should seek to further increase the leverage of ISPA grants and establish and respect clearer criteria for setting the grant level;
- (d) the Commission should continue to develop its cooperation with the EIB, the EBRD and other IFIs and further explore possibilities for public-private partnerships.

***Absorption capacity should be increased by strengthening project preparation and tendering capabilities***

44. Difficulties in preparing project proposals and drawing up tendering documentation on the part of the candidate countries have resulted in delays and reduced their capacity to absorb the large increase in environmental funding provided by ISPA.

45. The following specific steps are recommended to strengthen project cycle management and absorption capacity:

- (a) the Commission should support and encourage candidate countries to invest the considerable resources necessary to develop a pipeline of projects to use the remaining ISPA and future Cohesion Fund financing;
- (b) the Commission should allocate sufficient staff and make full and timely use of technical assistance for the technical, financial and institutional appraisal of investment projects;
- (c) the Commission should provide candidate countries with significant technical assistance support to strengthen candidate countries' capacities to arrange competitive tendering for works contracts;
- (d) consideration should be given to making more use of measured works contracts for relatively simple environmental infrastructure projects and tender evaluation criteria should be developed to ensure that the economically most advantageous bids are selected for the design and build contracts required for more complex projects;
- (e) the Commission should ensure that the necessary funds are systematically included in the budgets of ISPA measures to enable them to be supervised by engineers of sufficient experience.

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 10 April 2003.

*For the Court of Auditors*  
Juan Manuel FABRA VALLÉS  
*President*

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## THE COMMISSION'S REPLIES

### SUMMARY

I. The Court's audit covers the first year of ISPA programming. Since 2001, the Commission already has undertaken various initiatives to redress the weaknesses identified by the Court.

II. Since establishment of the Copenhagen criteria, addressing institutional constraints has been a constant priority. The Madrid Council conclusions in 1995 indicated administrative capacity to implement the *acquis* as a key area of concern. In the absence of any specific *acquis* on overall public administration reform and in the context of subsidiarity, the Commission adopted an adaptive and innovative strategy in an area at the limit of its competence. By any historical standards, the PHARE assisted pace of change has been rapid. The Commission notes the Court's agreement that further institution-building is required and assistance will continue beyond accession, through the delivery of both the 2002 PHARE Action Plans, which mobilised 1 billion euro and through the transition facility. The observation on limited funding in this sector overlooks the impact of PHARE investment in regulatory institutions after 1999. Furthermore the observation hides the historical fact that for three years of the audit period, PHARE was demand driven during which the candidate countries preferred infrastructure projects to either addressing administrative capacity or investment in institutions. This was completely changed by the Commission opinion, which formed the basis of the Luxembourg Council conclusions in 1997. These accession-driven developments made it possible to massively increase PHARE (and later ISPA) allocations to projects and to progressively increase both capacity building and investment in institutions, which became 65 % of overall annual allocations after 1999. The Regular Reports became strategic tools for identifying institutional and administrative constraints and allowed assistance to be tactically targeted within the framework of the Accession Partnerships, the Action Plans and the negotiations.

In the context of ISPA, the Commission already responded to the Court's observations by providing technical assistance to strengthen the administrative capacity of final beneficiary where needed.

III. The Commission considers that the scope for reducing the grant levels is extremely limited. Many parameters need to be taken into account when calculating the grant rate, not least the income levels, which are substantially below the levels in the current EU, and access to international financial institutions (IFI) co-financing. Any further reduction of grant levels may result in unacceptable burdens, in particular on low-income households.

IV. Since the beginning of ISPA in 2000, the Commission has undertaken various initiatives to overcome these weaknesses. It has signed several framework contracts, including with the European Investment Bank (EIB), has asked for further studies to review the design capacity, provided training for public procurement (the Commission agrees with the Court's observations that procurement deficiencies in candidate countries are a major bottleneck), and as a rule includes funds for supervising engineers in projects.

Given the earlier demand driven context of PHARE, prior to the 1997 Luxembourg Council conclusions, the Commission could not address institutional weaknesses unless a candidate country requested it to do so as the Court observes in 3 (a) and (b) below. Furthermore, the unsatisfactory record of consultants in this regard compelled the Commission to launch an instrument that mobilised public sector expertise in the specific areas of the *acquis*.

See Commission comments on paragraph 39 on these exceptions to the satisfactory implementation of most projects.

### INTRODUCTION

2. Implementation plans were useful for the negotiation and for domestic planning in the countries. Any transitional measures granted have been based on close scrutiny of these plans. After this scrutiny, the EU has accepted limited Transition Periods in time and scope. The latter also include intermediate targets and are based on financing strategies contained in the implementation plans.

3. (c) Since 2000 PHARE funding in this sector is exclusively focussed on capacity building mainly through twinning and investment in regulatory institutions.

### INSTITUTION-BUILDING PROJECTS IN THE ENVIRONMENT SECTOR

9. From 1995 to 1997, PHARE was indeed demand driven. Priorities were established by the Candidate Countries who preferred infrastructure projects to institution-building. However, after the Luxembourg Council Conclusions in 1997, under the

Accession Partnerships 30 % of PHARE funding was allocated to institution-building overall, mainly through twinning. The PHARE Guidelines of 1998 established institution-building as the first priority. After the 1999 PHARE Guidelines, approximately 35 % of PHARE was also allocated to investment in regulatory infrastructure. Environmental ministries and agencies were able to use this allocation to purchase general and specialised equipment needed to implement the *acquis*.

The post-communist structures and administrative cultures bequeathed to the candidate countries presented a daunting prospect. There were many competing priorities to be addressed. Furthermore, in many countries essential regional or other reforms necessary for the implementation of the environmental *acquis* had not even been started and the Commission could not assist institutions that did not exist.

10. The limited funding committed by the Commission in conjunction with the candidate countries in the years 1995 to 1997 to institution-building and investment in regulatory infrastructure in the environment sector primarily reflects the higher priority attached by Candidate Countries to environment infrastructure projects.

Indeed the action plans were launched in 2002 and will not be completed until 2005. However, the 2000 projects will be completed before accession and the 2001 projects will be completed in 2004 the year of accession.

12. Through twinning the Commission pioneered an unprecedented transfer of know-how on complex and technical issues from the diverse administrative traditions in Member States to equally diverse Candidate Countries. Only the basic concept underlying the notion of 'guaranteed result' is outlined in paragraph 11. It was also essential in mobilising political will and resources in the candidate countries. Furthermore, the positive feedback from administrations engaged in twinning was essential in building Member State's confidence and secured closure of the negotiations in Copenhagen. This widely acclaimed success was the ultimate result delivered by twinning

13. The Commission agrees with the observations of the Court (personnel leaving the ministries once trained, reliance on foreign consultants, and similar consequences of lack of adequate administrative capacity and low salaries in the public sector of candidate countries). The Commission has undertaken several training activities in particular in the field of public procurement, but the risk remains that qualified staff leave the administration to take up jobs in the private sector (or in EU Institutions). The acute human resource constraints in public administration can

only be fully overcome through growth and development, underpinned by the economic security and solidarity provided through membership.

14. In the absence of any specific *acquis* as the Court observes and in the context of subsidiarity the Commission has not established criteria to define overall levels of capacity, as this is not applied to the diverse administrative cultures of Member States. Consequently, it is not possible to invent separate standards for candidate countries. This is precisely why twinning was so essential in exposing the candidate countries to existing practices, particularly given the fact that the Commission does not implement or manage the main body of the *acquis* but Member States do. Thus, the Commission pioneered an unprecedented strategy in an area at the limit of its competence to transfer know-how on complex technical issues from diverse administrative traditions to equally diverse candidate countries. Within this strategy the Regular Reports (on which the strategy papers and Accession Partnerships are based) tactically targeted the priorities and mobilised political will and resources in the Candidate Countries. The positive feedback from EU administrations engaged in twinning was essential in building the confidence that secured closure of the negotiations in Copenhagen. This evident success was one of the results undeniably delivered by twinning.

15. Various initiatives have been undertaken since 2000 to strengthen the administrative capacity in candidate countries (e.g. technical assistance provided through ISPA for project preparation or public procurement). As regards the Court's observations related to the quality of strategies and projects, the Commission already responded to these concerns when they were expressed in the Court's Annual Report 2000 (the preparation of strategies started already in 1999. There was a sufficient number of sound projects that complied with the ISPA Regulation and strategic objectives for accession).

16. The Commission has encouraged candidate countries to use ISPA technical assistance funds for preparation for the Commission's Extended Decentralised Implementation System (EDIS). By 2002, all ten ISPA beneficiary countries received technical assistance funds for the preparation of EDIS. This technical assistance also provides support for the financial management of Implementing Agencies. By the end of 2002, all ten countries had initiated the first step towards EDIS (Gap assessment), three had moved to the second phase (Gap plugging) and one country had finished phase three (Compliance assessment) by end of 2002.

The Commission in 2000 was concerned to ensure that the bodies responsible were setting up structures necessary to manage ISPA in accordance with the requirements of the existing system.

17. The Commission agrees that the primary objective of ISPA is to finance infrastructure. Institutional strengthening initiatives are included in ISPA measures only in case it relates to specific projects and implementing agencies. When applying for funds, candidate countries must provide information on the institutional setting for the implementation of the project. In some cases where this is considered necessary, ISPA measures include a component of technical assistance aiming to improve the financial and operational performance of final beneficiaries. During the project appraisal stage, but also during implementation, technical assistance is frequently provided through the framework contracts signed by the Commission, for example in the case of complex public-private partnership schemes for which institutional capacity is frequently lacking. Furthermore, the modulation of the ISPA grant rate takes also account of the capacity to cover operating and maintenance costs.

#### THE FINANCING OF ENVIRONMENTAL INFRASTRUCTURE PROJECTS

18. The Court expressed a similar concern in its Annual Report 2000, to which the Commission responded that the preparation of applicant countries for ISPA started already in 1999 with the negotiations of the strategies and the provision of guidance. These strategies define the priorities for ISPA financing, taking account when selecting high-priority projects of regulatory requirements, the investment needs, the impact or the availability of cofinancing. The aim of ISPA is to finance priority projects, which are mature enough to obtain financing and meet the funding requirements and standards. The projects financed in 2000 were projects designed to tackle the most urgent investment needs in the environmental sector.

Ranking is not more important than readiness. If a project is not 'mature' it cannot be financed.

19. No air pollution measures have yet been decided by the Commission which is essentially due to the complexity of such projects and consequently the lack of admissible funding applications. Although the national ISPA strategies for environment indicate for some countries air pollution projects as a priority, the Commission has not yet received an application that meets the eligibility criteria of the ISPA Regulation, including compliance with competition and State aid rules.

20. In the case of Hungary, delays were principally political in origin. The National Plan had been at Parliament since mid-2001 but was not approved because of differences between government and opposition on the financing of the National, the Local and the Regional Plans. Moreover, Chapter 22 (Environment) gives the Hungarian authorities time until accession to prepare regional plans. In order to start financing projects in this sector which is essential for compliance with the *acquis*, the Commission adopted a pragmatic approach by introducing a spe-

cific condition in the Financing Memorandum concerning the consortium agreements to be defined between the municipalities involved in each project. These agreements are the contractual basis between the municipalities for handling properly the municipal waste produced in the region.

21. In discussions of environment sub-committees under the Association Agreements and in all activities related with accession negotiations the Commission has emphasised the need for countries to identify early their infrastructure needs to comply with EU environment *acquis* and prepare detailed investment programmes. The June 2001 Communication was based on the evidence that countries still needed concrete guidance to prepare their Directive specific implementation plans to in support of their requests for transitional periods for investment-heavy directives and also required support in developing their financing strategies and project pipelines to ensure implementation of their commitments. Elaboration of such plans and project pipelines for the environment sector is a very demanding and complex task given the high number of stakeholders involved (from national to local authorities, from donors and grant agencies to private funders etc.).

22. Income generation is not the only key factor in appraisal of investment in public goods such as sewage systems. For the Commission, what is important is that commitment, ownership and sustainability of the project is assured by co-financing from public funds whatever the source. Furthermore, the Commission advises neither Member States nor candidate countries on what charges or tariffs consumers must pay for water services.

23. The Commission considers that the scope for reducing the grant level is extremely limited. The financial analysis which is an essential component of the project applications forms the basis for the calculation of the grant rate, taking account, *inter alia*, of the affordability levels and household income which is substantially lower than in the EU. In some cases any further reduction in the grant level would mean that the project would not get off the ground.

24. The guideline target for affordability (4 % for water, 1,5 % for solid waste) is not a legal requirement, and in any case it is based on average household. The burden on low-income households is certainly much higher, in particular in countries where average income is substantially below the EU average.

Moreover, there are other criteria which also need to be taken into account, such as the municipality's access to loan financing or to sources from the national budget, or the municipal expenditure programme. These factors combined allow the Commission to decide on an appropriate grant level. A lower grant level can make the project unaffordable for the municipality and thus delay urgent environmental investment.

25. Tariffs levels vary in Polish cities and there is no requirement to equalise them across all cities. In Torun, the city has already built a major treatment plant and the Commission grant (at 60 %) is only for an extension of the sewer network plus a small amount for drinking water treatment. Tariffs of 2,5 % of average household income in Torun are equivalent to 3,5 % of the income of the poorest 20 % of the population.

In relation to Bydgoszcz, there was no scope to lower the grant rate. None of the IFIs would lend more than 50 % (the availability of cofinancing is one of the criteria to take into account for the calculation of the grant rate).

28. As regards the Court's observation concerning adequacy of the grant rate, the Commission refers to its comments to paragraphs 24 and 25.

29. The Commission realised quite early in 2000 when it received some project applications that certain safeguards need to be put in place when grants are provided to public-private partnerships (PPP) schemes to ensure that basic principles are applied to protect the Community interest and that of the population concerned. Consequently, the Commission signed in 2001 a framework contract to obtain access to relevant financial and legal expertise and to provide advice beneficiaries in their dealings with private utility firms on a case basis. Furthermore, guidelines were developed in 2002 — in coordination with the EIB and the EBRD — with the view to assist beneficiary countries to tailor PPP schemes, and dissemination seminars are being organised in the Candidate Countries for early 2003 in which EIB and EDRB participate.

#### THE MANAGEMENT OF ENVIRONMENTAL INFRASTRUCTURE PROJECTS

30. Difficulties in achieving a balance between environmental and transport projects existed for two countries. The balance is to be achieved over the total seven years period, and the Commission is correcting this imbalance in a particular year during the whole seven years period.

31. The Commission agrees that in the running-in phase certain applications were not up to the standard to obtain financing from the Community budget, or IFIs, or in fact any funding institution.

Since 2000, when ISPA funds became available, the Commission has encouraged Candidate Countries to make use of these funds to prepare a strong project pipeline. Until the end of 2002, the Commission approved 14 of such technical assistance projects (equivalent to an ISPA grant of euro 232 million). These measures were essentially for improving project preparation capacities of Implementing Agencies, including financial analysis and Environmental Impact Assessment.

The fact that candidate countries augmented PHARE technical assistance with their own funded expertise was a positive response to their lack of capacity.

32. To overcome the difficulties described by the Court, the Commission not only concluded a contract with the EIB for project appraisal, but also two framework contracts with consultancy firms for engineering expertise in the environmental and transport sectors (in 2000) and a further framework contract for legal, financial and institutional matters for PPP (in 2001). The contracts are used systematically during the appraisal process but also for institutional advice to the national authorities.

However, the Commission could only make limited use of this high-quality assistance because of ceilings set by the EIB.

33. In 2000, PHARE resources were still available for the preparation of ISPA measures. Between 2000 and the end of 2002, 14 technical assistance measures for project preparation were decided by the Commission (see reply to paragraph 31).

34. The Commission shares the concern expressed by the Court as regards design deficiency and excess capacity, due largely to price-induced reduction of water consumption and industrial decline. Feasibility studies generally contain demand analysis, taking account of price elasticities, demographic developments and structural change. It is, however, true that some of the provisional design parameters for first-wave ISPA projects might have led to oversizing if no further measures were taken. The use of the 'Design and Build' type of contract allows in such cases to re-calibrate the design parameters.

- (a) The design parameter based on the peak storm flow confirmed by two independent consultants is 680 000 m<sup>3</sup>/day. The measured peak storm flow was 671 000 m<sup>3</sup>/day in February 1998. The same report of the PHARE financed consultants indicate that a typical storm or snow melt event can increase daily flow by about 250 000 m<sup>3</sup>/day. The average daily flow design parameter is 480 000 m<sup>3</sup>.
- (b) As the Court observes, water consumption had declined for several years. This will not last. Although oversize may seem apparent (at the water consumption norm 50-80 l/capita) due to difficult social conditions, the economy will revive with accession and original design capacities will be reached. Furthermore, extension of the wastewater collection systems in Jurbarkas, will contribute to meeting the designed capacity. Similarly, extension of sewage collection in Kaunas will be financed through ISPA 2001 and help meet design capacity there.
- (c) The assumptions in the project fiche were correct and took into account the possibility of a decrease in shipping movement in the Port of Szczecin. Thus the project remained viable even with a 60 % drop in shipping. Irrespective of the fact that the plant operates at 40 % of its capacity it should be born in mind that this is the only such facility in Poland able to handle this type of waste. In Bielsko Biala, there is an expectation that demand will rise, particularly as other neighbouring municipalities are foreseen to be connected to the water supply system.
- (d) For the Győr project, the Commission did have doubts about the capacity of the plant when approving the project in 2000 as the results of the studies undergone within the PHARE framework contract were not yet final. Therefore, the Commission required an assessment of the industrial load and the final capacity of the plant. This assessment confirmed the capacity of the plant. The Commission therefore does not consider that the capacity of the plant is too large.

In the case of Braila (Romania), the consultant contracted under the technical assistance/Supervision contract is currently undertaking a review of the design assumption in terms both of hydraulic flow and pollution load as it becomes evident that water consumptions and hence sewage discharges are reducing rapidly. This will have an effect upon the final sizing of the WWTP.

35. Despite the inexperience of the beneficiaries and the project maturity constraint the Commission notes the Court observation that the projects were contracted within the legally required period. This is a considerable achievement of both Commission assistance and of the Delegations support to the candidate countries.

36. The Commission agrees with the Court's assessment that the implementation of large infrastructure projects is a complex undertaking. The Commission would like to emphasise that the preparation of high-quality tender documents requires highly skilled expertise, which needs to be built up in candidate countries, and the tender process for large infrastructure contracts takes, in the best case, at least nine months from publication of procurement notice to the signing of the contract. Most of the Financing Memoranda for projects decided in 2000 were only counter-signed very late in 2000 with the majority in 2001.

- (a) The Commission has been and is addressing these deficiencies. It initiated various actions in 2001 and 2002, including training seminars in the candidate countries to enhance the capacity of the national authorities involved in the ISPA process in the field of public procurement. These activities are continuing in 2003.
- (b) ISPA implementation relied in 2000 and early 2001 largely on staff in Delegations responsible for PHARE. The recruitment of experts under the ISPA technical assistance budget commenced in 2001, before ISPA implementation became in full swing. The recruitment for these posts was largely completed by early 2002.
- (f) These conditions essentially relate to compliance with provisions of the EIA Directives, with which candidate countries had difficulties in 2000, given the complexity of this Directive. In 2001, the Commission undertook a series of training seminars to enhance the capacity of national authorities to implement the requirements of the EIA Directive.

37. The decision between the 'design and build' contract and the 'measured works/construction' contract depends on many parameters, one essential being the readiness and capacity of the employer to design. The 'design and build' contract price normally stay throughout the works as tendered (risks are mainly on the tenderer), but the 'construction' contract price tends to rise from the tender price due to unavoidable need of variations (risks are mainly on the employer). Price may rise to 20 % or more compared to the originally awarded tender price for construction contracts. Therefore, it is not predictable, which model gives the lower final price. Furthermore, any higher costs would be shared between ISPA and the final beneficiary proportionally to the grant rate.

Taking appropriately account of operating costs is a very complex matter, which is under investigation by the Commission. As an interim solution, tender dossiers specify in detail the requirements influencing the operating costs and these will then be discounted so that they can be compared between the different offers.

38. The Commission recognises that in some early projects the budget provisions for supervision have been too low. In the case of Romania, where this has been the case for some measures approved in 2000, the amount for supervision has been increased prior to tendering through reallocation between budget headings (to around 6 %).

39. (a) The difficulties are limited to the late start of works and extension of the contract duration. There is no related risk to implementation. The participation of an independent engineer would not have resolved difficulties that were unrelated to procedural and adjudication matters. Moreover, an independent engineer was not required as this contract follows the FIDIC Orange Book, where responsibility for project management lies with the employers representative, the functions and mandate of which are different to those of the FIDIC Engineer under the Red Book, to which the Court presumably refers.
- (b) The estimated budget for rehabilitation was indeed 33 million euro. Available PHARE funds were 23 million euro and essential works were undertaken within this budget precisely to avert any immediate risk of pollution mentioned by the Court. Nevertheless, the Commission intended further work to be undertaken as an integral element of overall reconstruction of the drinking water and sewage systems to be funded by ISPA. However, despite guidance in this regard the beneficiary never made a proposal that met ISPA eligibility rules. Furthermore, the concessionaire is required by the 1999 contract to invest a further 140 million euro in the system. Following the Court's observation the Commission consulted with engineers working on the plant there is no evidence that there is a significant or immediate risk of breakdown or related pollution of the Danube.
- (c) As has been identified in the text the problem in this case relates to the content of the project fiche. No problem exists regarding implementation since this has been carried out according to the requirements of the project fiche.

## CONCLUSIONS AND RECOMMENDATIONS

40. The development of horizontal institutional capacity is beyond the remit of the PHARE programme. The remark on insufficient funding omits the impact of directly related investment in regulatory infrastructure in the overall context of institution-building after 1999 and hides historical aspects. In 1995 to 1997, PHARE was demand driven and the candidate countries preferred projects to institution building. The Commission opinion and the Luxembourg conclusions in 1997 radically

changed this approach. In the absence of any specific *acquis* and in the context of subsidiarity the Commission has not established criteria to define overall levels of administrative-capacity, as this is not acceptable to the diverse administrative traditions of Member States. Thus, it is not possible to invent separate standards for candidate countries. This is why twinning was so essential in exposing the candidate countries to existing practices, as Member States implement the main body of the *acquis*. Thus the Commission pioneered an unprecedented strategy to transfer know-how on complex issues from diverse administrative traditions to the equally diverse candidate countries. Within this strategy the Regular Reports tactically targeted the priorities and mobilised political will and resources in the candidate countries. The positive feedback from EU administrations engaged in twinning was essential in building the confidence that secured closure of the negotiations in Copenhagen. This widely acclaimed success was one of the results undeniably delivered by twinning.

41. (a) In the framework of the negotiation of Chapter 21 (Regional policy) candidate countries committed themselves to increase their efforts to bring the administrative capacity of the bodies responsible for the management of the Cohesion and Structural Funds. The development of the human resources for Cohesion and Structural Funds management will be closely monitored.

Both PHARE and the transition facility after accession will provide further institution-building assistance in this field. Given the limits of Commission competence, as with current Member States, public administrative reform is a responsibility of the candidate countries.

- (b) The financial analysis which forms the basis for the calculation of the grant rates assesses the capacity to ensure financial viability; further technical assistance is provided to strengthen the capacity of the final beneficiary on a case by case basis.
- (c) By end of 2002, all candidate countries received technical assistance funds for the preparation for EDIS.

42. The Commission considers that the scope for reducing the grant level is extremely limited, given the low income levels in candidate countries, the need for urgent investment and their macroeconomic weakness.

The Commission shares the concerns expressed by the Court. It has made available technical assistance funds under ISPA to strengthen the capacity of candidate countries to prepare environmental projects (also for the Cohesion Fund) and for implementation.

43. (a) Elaboration of such strategies is a very demanding and complex task given the high number of stakeholders involved (national and local authorities, donors, the private sector, etc...). Support activities from the Commission which started in the framework of the Priority Environment Projects for Accession (PEPA) programme in 2000 continue within a new PHARE multi-country project, inspired on the PEPA programme, which will run during 2003.
- (b) The Commission has not yet received funding applications for air pollution projects that meet the required eligibility criteria; solid waste projects need to meet the requirements of the relevant EC Directives and be consistent with sectoral plans.
- (c) On average, the grant rate is 65 %. The Commission considers the criteria for establishing an adequate grant rate are clear: they include the application of the polluters pays principle, availability of own sources for covering operating and maintenance costs, affordability, credit-worthiness of the company benefiting from the ISPA grant, availability of IFI cofinancing.
- (d) The Commission cooperates with the EIB, the EBRD and other IFIs as appropriate during the entire project cycle; the Commission has recently prepared guidelines for public-private partnership schemes which should facilitate the preparation of PPP schemes that are suitable for Community funding.
44. Weaknesses in some funding applications did not result in difficulties to absorb the environmental funding in 2000. However, the Commission agrees with the Court that candidate countries have difficulties in tendering and contracting. The Commission provides assistance to reduce these deficiencies.
45. (a) In its dialogue with Candidate Countries, the Commission encourages them to use ISPA technical assistance for preparing a project pipeline for ISPA and the Cohesion Fund. This has been taken up by Candidate Countries, but continued efforts are required to ensure a sufficient project pipeline, in particular for the Cohesion Fund.
- (b) The Commission concluded in 2000 two technical assistance contracts and in 2001 a further contract for providing advice on public-private partnership issues.
- (c) The Commission is providing advice and technical assistance to strengthen the public procurement capabilities in candidate countries.
- (d) The choice of the contract model is based on technical considerations.
- (e) The Commission agrees with the Court. Service contracts for supervising engineers are included in ISPA measures as rule.
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