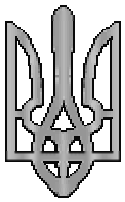
ENVIRONMENTAL FINANCE



Performance Review of the State Environmental Protection Fund of Ukraine

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This report is also available in Russian under the title:

Обзор деятельности Государственного фонда охраны окружающей природной среды Украины

FOREWORD

This report presents the results of a Performance Review of the State Environmental Protection Fund of Ukraine. It aims to support the Ukrainian government in its efforts to improve the management of the public environmental finance system in line with international good practices. The report provides an objective analysis of all important aspects of the administration of the Fund, identifies the strengths and weaknesses of the Fund's operations and proposes a Reform Plan for strengthening its expenditure management capacity. The recommendations could be used as a basis for discussion and consensus-building among key stakeholders in Ukraine on the future strategic development of the Fund.

The OECD *Good Practices for Public Environmental Expenditure Management* served as a benchmark to assess the performance of the State Fund in terms of environmental effectiveness, fiscal prudence and management efficiency.

This report was prepared within the framework of the Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force), whose secretariat is located in the OECD's Environment Directorate. The project was managed by Nelly Petkova, with support provided by consultants Olivier Dumoulin and Andrei Piskunov from Fitch Ratings, Rafal Stanek (SST-Poland) and Oksana Volosko-Demkiv (Ukraine). The preparation of this report was financially supported by the Governments of Switzerland - the Swiss Agency for the Environment, Forests and Landscape - and by the Netherlands, through its Ministry of Housing, Spatial Planning and the Environment.

The report is based on available documents and data, as well as on inputs from Ukrainian experts and officials and from representatives of international institutions (see Annex VI for officials interviewed). The cut-off date for most of the financial data used and analysed in the report is end of 2004; more recent data were used when available. We thank specifically Mikolay Pilipchuk and Oleg Kulik from the Ministry of Environmental Protection and Ludmila Lukash from the Ministry of Finance of Ukraine for their substantial contribution during the project implementation.

The report has been reviewed by Xavier Leflaive and Brendan Gillespie from the OECD. Grzegorz Peszko (the World Bank) and Vladimir Morozov (Ukraine) provided useful comments on the report. Carla Bertuzzi helped with collecting and verifying statistical data. Dinara Aknazarova and Claire Cornfoot provided administrative support to the project. All these contributions are gratefully acknowledged.

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LIST OF ABBREVIATIONS

BOD	Biological oxygen demand
CEE	Central and Eastern Europe
COD	Chemical oxygen demand
CoM	Cabinet of Ministers of Ukraine
EAP	Environmental Action Programme for Central and Eastern Europe
EAP Task Force	Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe
EBRD	European Bank for Reconstruction and Development
EECCA	Eastern Europe, Caucasus and Central Asia
EIA	Environmental impact assessment
EIB	European Investment Bank
ENPI	European Neighbourhood and Partnership Instrument
EU	European Union
FDI	Foreign direct investment
FI	Financial intermediary
GDP	Gross domestic product
IFI	International financing institution
IMF	International Monetary Fund
IRR	Internal rate of return
LHS	Left-hand side (in charts)
m^3	Cubic metre
MDGs	Millennium Development Goals
MEP	Ministry of Environmental Protection of Ukraine
mln	Million
NEAP	National Environmental Action Programme
NGO	Non-governmental organisation
NPV	Net present value
OECD	Organisation for Economic Co-operation and Development
O&M expenditure	Operating and maintenance expenditure
PEEM	Public environmental expenditure management
PPP	Polluter Pays Principle
RHS	Right-hand side (in charts)
TACIS	Technical Assistance to the Commonwealth of Independent States of the EU
UAH	Ukrainian gryvnya (Ukrainian national currency)
UNDP	United Nations Development Programme
USAID	US Agency for International Aid
USD	United States dollar
WHO	World Health Organisation
WWTP	Wastewater treatment plant

EXCHANGE RATES

In the conversion of financial data presented in this report, i.e. Ukrainian gryvnya (UAH) into US dollars (USD) and Euros (EUR), the following annual average exchange rates were used:

Exchange Rates, UAH/USD, and UAH/EUR, Annual Average

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
UAH/USD/	1.47	1.83	1.85	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.12
UAH/EUR					4.41	5.03	4.81	5.04	6.02	6.61	6.39

Source: EBRD Transition Report Update, May 2006, National Bank of Ukraine.

Map of Ukraine

EXECUTIVE SUMMARY

Background and Objectives of the Review

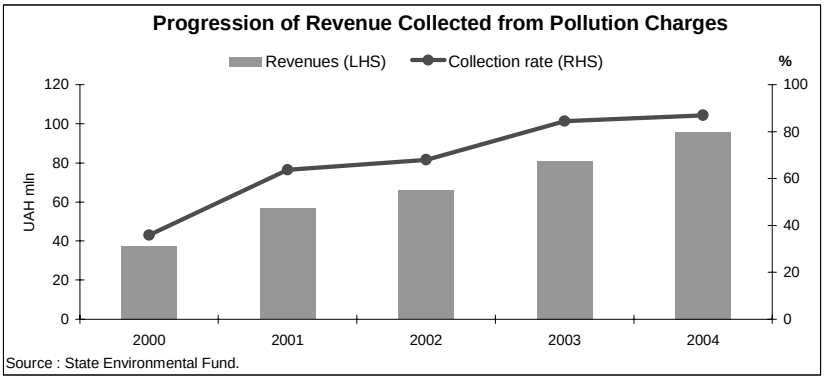
This report reviews the performance of the State Environmental Protection Fund of Ukraine and recommends how it could be improved. The analysis starts from the view that the use of subsidies for environmental investments is a second-best solution that may be justified in transition economies provided that subsidies are managed and disbursed according to sound principles of public finance and environmental policy. The OECD Council Recommendation on *Good Practices for Public Environmental Expenditure Management* (C(2006)84) provides the framework for the report.

The system of environmental funds in Ukraine was initially created in 1991 on the basis of the Law on Environmental Protection. The Funds were established as extra-budgetary funds at three levels – republican (state), the autonomous Fund of the Republic of Crimea and local (including at an oblast, city (Kiev and Sebastopol), village and settlements level). In 1998, the Funds were included as regular budgetary lines into the State and respective local budgets. Their main resources are pollution charges and fines earmarked to finance expenditure to address environmental problems. The Funds are not distinct legal entities and have no separate management structure nor dedicated staff. The State Environmental Protection Fund (the State Fund) is under the direct supervision of the Ministry of Environmental Protection (MEP) and its programmes are administered by regular Ministry's officials.

Unbalanced Performance

Since its establishment, the system of environmental funds in Ukraine has undergone significant transformations. In general, the performance of the funds has benefited from wider reforms in public finance that have strengthened their financial discipline. The State Fund is now part of the state budget; its revenue and expenditure are channelled through the State Treasury and audited by the Accounting Chamber. The Fund is legally required to prepare annual reports. Given the strict rules imposed by the Budget Code and annual budget laws, the Fund has followed a cautionary and prudent fiscal policy. Generally, the Fund complies with the main criteria of fiscal discipline. However, much remains to be done to strengthen the accountability for decisions and to minimise inefficiencies associated with earmarking.

The Fund's revenues come from an array of pollution charges. However, part of these resources is also used to finance other Ministries' programmes thereby reducing their environmental impact. The Fund's share of collected revenue varies from one year to another. After consolidation into the State budget in 1998 and with the transfer of responsibilities for the revenue collection to the State Tax Inspectorate, the Fund's resources significantly increased and almost doubled between 2000 (about Euro 7.4 million) and 2004 (Euro 14.5 million). Barter and other non-monetary transactions have been largely eliminated and all revenue is now collected in cash.



On the expenditure side, disbursement mechanisms available to the Fund are clearly specified in the legislation and seem appropriate with regard to the Fund's capacity to manage them. However, grants provided by the Fund resemble mostly direct purchases on behalf of the government. On the other hand, the expenditure management practices of the Fund have remained largely unreformed. Two interrelated dimensions of the performance of the Fund require particular attention: project cycle management, and environmental effectiveness.

The routine project cycle management practices, as employed by the Fund, are inadequate. The Fund has no dedicated professional staff and a separate administrative structure to manage its resources. The responsibilities for appraising and selecting projects for financing are split between many people and levels, including the Cabinet of Ministers. These responsibilities are only vaguely specified with no clear lines for accountability. Due to the large number of levels involved, the decision-making process is slow and unproductive. It does not ensure the selection of the most cost-effective projects in line with national environmental policy objectives.

Project appraisal is a very formal process, focused on checking project proposals for compliance with legal and budgetary requirements. Current staff, at the Ministry or local level, do not have the necessary skills and expertise to conduct sound appraisal in accordance with good international practices.

One consequence of this selection process is that the environmental performance of the Fund is particularly difficult to assess. First, the Fund supports a great number of environmental programmes across all environmental media. These programmes are poorly designed with vaguely defined objectives, they lack clearly verifiable indicators and specific time-bound targets. Second, the one-year budget perspective of the Fund's expenditure is incompatible with the multi-year implementation schedules of the investment projects it supports. This jeopardizes the completion of projects. The Fund administration does not monitor the results achieved by the projects it has financially supported.

A Path for Reforms

In its current form, the State Fund appears to be essentially a budget line to collect and spend public money. The lack of an appropriate policy and institutional structure (a strategic vision; clear environmental priorities; dedicated staff; adequate procedures to identify, appraise, select and monitor projects) hampers its capacity to efficiently support the implementation of the national environmental policy. The absence of a clearly formulated national environmental policy is an additional constraint in this regard. This situation calls for urgent reforms if the continued operation of the Fund is to be justified.

The benefits of appropriate reforms are multifaceted: they could provide much needed financial support to address a range of serious environmental challenges in Ukraine; they could promote the development of an environmental project preparation capacity in the country; they could encourage the expansion of financial and capital markets to support environmental projects. Such reforms could also

enable the Fund to become internationally-recognised as a potential partner for foreign sources of financing of environmental investments in Ukraine.

Experience from other Central and East European (CEE) countries shows that reforms should be based on three main factors: identification of a particular niche for the Fund, where it can demonstrate value-added in contributing to addressing environmental problems of national policy significance; providing support for projects that bring concrete results on the ground; a strong and lasting political commitment to the reform, at the government level.

The recommendations developed as part of this Review could provide a starting point for the reform of the Fund. They can also serve as a basis for launching a national dialogue on the State Fund in the system of public environmental finance in Ukraine. In this context, it is proposed that the Ministry of Environmental Protection should:

1. Reduce the number of local funds and concentrate the resources at a national and oblast level, to obtain a critical mass of resources;

2. Identify a particular niche for the Fund, where it will play a strategic role in support of national environmental policy priorities (e.g. achieving European Union/World Health Organisation (WHO) water standards in hotspot areas). This should follow an open discussion with various stakeholders in the country;

3. Design a proper organisation and management structure of the State Fund (director, multi-stakeholder supervisory board, own functional department and procedures). An executive unit should be established within the MEP, and staffed with 4-8 people exclusively responsible and accountable for the complete cycle management of environmental projects to be financed by the Fund. The capacity of this unit in project cycle management should be significantly strengthened. Procedures should be designed (particularly to promote the opportunities offered by the Fund; to appraise, select, finance and monitor projects), based on available international experience;

4. Define the programmes of the Fund in line with good international practices: in terms of eligible projects and beneficiaries (municipalities, industries, NGOs), eligible project costs, clearly identified and robust criteria for appraisal, selection and financing of projects;

5. Introduce a medium-term budget framework to allow for the smooth implementation of multi-year projects;

6. Introduce and maintain regular monitoring and control of individual investment projects implemented with support by the Fund. Collect data at a national level and develop a database on projects financed by the Fund, containing key financial, technical and environmental information.

1. INTRODUCTION

Since its independence in 1991, Ukraine has undergone significant political and economic changes. After the political events at the end of 2004, the new Government moved quickly to articulate new policy goals. Along with macroeconomic stabilisation, the government agenda focused on accelerating Ukraine's institutional transition toward a modern market economy. Much of this agenda is anchored in a medium-term strategy for greater integration with the European Union and global markets.

As part of this political agenda, Ukraine has started modernising its public institutions and management practices, bringing them closer to international standards. In general, transparency in the public sector has increased, in some cases significantly. It is in this spirit of overall openness that the Performance Review of the State Environmental Protection Fund has been conducted.

1.1 Objectives of the Performance Review

The major objective of the Review was to conduct an independent and objective evaluation of all important aspects of the administration and management of the State Environmental Protection Fund of Ukraine against good international practices, such as those presented in OECD's *Good Practices for Public Environmental Expenditure Management*. The report analyses the strengths and weaknesses of the Fund's performance and proposes a Reform Plan for further improving the effectiveness and efficiency of the State Fund and the system of environmental funds in Ukraine. Thus, the review aims to support the Ukrainian Government in its efforts to improve management of the public environmental finance system in the country to bring it in line with good international practices.

Box 1. Good Practices for Public Environmental Expenditure Management

The *Good Practices for Public Environmental Expenditure Management* (*Good Practices for PEEM*) provide guidance on how to design and implement public environmental expenditure programmes. They address the principles, procedures and organisational frameworks that are likely to be most acceptable for Ministries of Finance and foreign sources of financing. The *Good Practices* also help evaluate how a public environmental expenditure programme performs in terms of *environmental effectiveness, management efficiency and fiscal prudence, transparency and accountability*. This methodology has already been used by the EAP Task Force to evaluate a number of environmental funds in both Central and Eastern Europe (CEE) and Eastern Europe, Caucasus and Central Asia (EECCA). These *Good Practices* have been developed taking into account both the CEE and OECD countries' experience in this area and have been the subject of a series of discussions at different international fora. The *Good Practices* were endorsed by the Ministers at the fifth "Environment for Europe" Ministerial Conference held in Kiev, Ukraine in 2003. In addition, OECD member states have adopted the *Good Practices for PEEM* as Council Recommendation[1] to guide their work in the area of public environmental expenditure management.

The *Good Practices* are presented in the form of three Checklists that can be used to measure the performance of public environmental expenditure programmes against internationally recognised standards. Each of the three Checklists contains five major principles, which are operationally described in terms of specific criteria. This methodology makes it possible to present compliance with these good practices in a visual way, through a performance triangle (for more information see Annex V).

[1] The OECD Council comprises Ambassadors of the 30 member countries to the Organisation. It is the main decision-making body of the OECD. Council Recommendations are not legally-binding on member states but their acceptance by the OECD countries suggests a willingness to implement them.

1.2 Performance Review Process and Methodology

In 2005, the Ministry of Environmental Protection (MEP) of Ukraine agreed to have the performance of the State Fund reviewed by the OECD/EAP Task Force Secretariat, using the OECD methodology for evaluating such institutions. The Swiss Agency for the Environment, Forests and Landscape and the Dutch Ministry of Housing, Spatial Planning and the Environment provided financial support for the project. The project was implemented under the supervision of the OECD EAP Task Force and with the support of a team of consultants from the international rating agency Fitch Ratings, and from Poland and Ukraine.

The methodology used to evaluate the performance of the Fund is based on the three pillars identified in the *Good Practices for PEEM*, that is, the Fund's operations are assessed, to the extent possible, in terms of environmental effectiveness, management efficiency and fiscal prudence. In addition, over the past year, the EAP Task Force has worked closely with Fitch Ratings to include criteria based on the methodology that Fitch uses to rate public entities. The credit analysis performed by Fitch proves to be particularly helpful as a supplement to the fiscal prudence evaluation developed in the *Good Practices*. The OECD has thus used some of the Fitch analytical tools to complement its methodology for conducting the fiscal and financial assessment of the Fund. This exercise has confirmed the value and the applicability of the improved methodology in assessing public environmental expenditure programmes against internationally recognised standards and criteria.

The review was implemented in close co-operation with the MEP. The review involved three stages: preparatory activities, review and drafting mission, and preparation of the final report. A comprehensive set of background documents concerning, and relevant to, the Fund were examined by the review team prior to the appraisal mission (see Section 7 on References). The appraisal and drafting mission took place 13-17 March 2006 when the team visited Kiev. During that time the team engaged in extensive discussions with MEP managers of the programmes supported by the Fund, other MEP staff, experts from other ministries and state institutions, clients of the Fund and other organisations, all concerned with or directly involved in shaping the country's environmental policy. A number of interviews were held with representatives of international organisations and financing institutions active in Ukraine (see Annex VI).

The results and recommendations presented in the report were discussed at a meeting with the participation of major stakeholders held in Kiev on 30 June 2006. In addition, the results and the lessons learned from this performance assessment will be presented at other international fora and will be disseminated through other meetings and mechanisms.

This report provides an opportunity and is a basis for discussion within the Ukrainian Government on future institutional reforms of the State Environmental Fund of Ukraine.

Box 2. Earmarking in a Transition Economy

Generally, OECD environmental policy is guided by the Polluter Pays Principle (PPP). This principle implies that polluters should bear the full cost – *without subsidies* – of compliance with the goals established by the relevant administration. The PPP provides for certain exceptions to its "no subsidy" philosophy. Specifically, a subsidy may be justified if it is well targeted (i.e. the environmental objectives to be achieved by the subsidy are clearly specified), limited in size and duration and does not introduce significant distortions in markets and trade. It can also be used where considerable external benefits or provision of public goods are involved. Thus, if subsidies are to be used, their need should be clearly demonstrated.

In principle, earmarking is discouraged as it often leads to the inefficient use of resources and encourages institutional vested interests. However, in the transition period, earmarking has been recognised as a mechanism that increases the stability and predictability of resource flows to some critical social sectors.

The development of an effective environmental finance system, based on the Polluter Pays Principle, is constrained during the transition to a market economy. This is due to several factors, including weak environmental management and enforcement, underdeveloped capital and financial markets, scarce private financing, uncertain political and fiscal systems and weak civil society. Though not a "first best" mechanism, Funds have been internationally accepted often as a useful supplementary instrument of environmental policy in the transition period, provided they are properly designed, managed and apply certain good performance standards, such as those included in the *Good Practices for PEEM*.

2. LEGAL AND POLICY FRAMEWORK

Since the country's independence in 1991, Ukrainian environmental policy has undergone major changes, including the establishment of new institutions and the development of new environmental laws and programmes. However, many of these programmes remain declarative in character as they lack resources to finance them. To ensure a more stable and predictable flow of resources for the implementation of these programmes, the government created earmarked environmental funds.

2.1 Legal Framework

Over a period of approximately fifteen years since its establishment, the system of environmental funds in Ukraine has evolved significantly. The funds were initially created back in 1991 on the basis of the Law on Environmental Protection No. 1264-XII of 25 June 1991[2] (Article 47). The 1991 Law establishes funds at three levels – republican, autonomous (Fund of the Republic of Crimea) and local level, the latter including oblast, city (Kiev and Sebastopol), village and settlement levels. They were established as extra-budgetary funds, and are not legal entities.

The above Law also introduces the main sources of revenue for the funds (see Section 4.1 for more information) and the indication of the main types of expenditures to be financed by the funds. Pollution charges form the main revenue base. These charges were introduced by the Cabinet of Ministers (CoM) Resolution No. 18 of 13 January 1992 on the Procedure for Setting and Collecting Pollution Charges. Back then, MEP local territorial bodies were made responsible for collecting the revenue generated by pollution charges.

Environmental funds were made operational in 1992 in order to manage the revenue raised from pollution charges. In addition, the above Resolution No. 18 approves the Regulations on the Extra-Budgetary Republican Environmental Protection Fund.

The year 1998 saw a number of significant changes in the system of public finance in Ukraine. One of the main reforms was the consolidation of (almost all)[3] extra-budgetary funds into the state budget. As a result, numerous extra-budgetary funds were either eliminated or consolidated into the "special funds" of the state budget.

Expenditure from "special funds" are classified and presented in the budget in the same way as other expenditure. To supervise budget execution, a State Treasury and Treasury Single Account were established in the 1990s. Since then all public monies have been channelled through this account. Spending budgetary units (ministries, agencies, etc.) are not allowed to keep their own bank accounts.[4] As a result, the resources of the State Environmental Fund are now controlled by the State Treasury. In addition, the State Tax Inspection was given the responsibility to collect the revenue from pollution charges. An Accounting Chamber, to control the expenditure of budgetary entities, was created as well. All these reforms in the public finance system of Ukraine were further consolidated by the

[2] The most recent amendments to the law date from 9 February 2006.

[3] Four extra-budgetary funds remained and are still operational. These include: the pension fund, the social insurance fund, the fund for the protection of the disabled and the unemployment fund.

[4] Except for the four extra-budgetary funds and the bank accounts of spending units in foreign currencies.

Budget Code, which was enacted in July 2001 and amended in July 2003. The Code represents the main legal framework for public expenditure management in the country.

These major changes were subsequently reflected in related legislation for the State Fund. In 1998, the Law of Environmental Protection was amended (with respective changes in the annual Budget Law) to include the Fund in the state budget of Ukraine and local funds in the respective local budgets. The Republican Fund became the State Fund and continued to function as a budgetary special fund of the MEP, fed by revenue from earmarked pollution charges.

A new CoM Resolution on the Procedure of Setting and Collecting Pollution Charges was approved (Resolution No. 303 of 1 March 1999). The Regulations on the Republican Fund were first amended in 1998 through a CoM Resolution on the Statute of the State Environmental Fund (No. 634 of 7 May 1998) and then in 2002 (CoM Resolution No. 181 of 15 February 2002). In general, these Resolutions restate the budgetary nature of the Fund, define the sources of revenue and their distribution across different levels, as well as set the main lines of spending. Thus, according to the Statute, the Fund is under the supervision of the MEP, with the Minister of Environment as the main administrator of its resources. The oblast and local funds are subordinated to local administrations (the Executive Committees of the local Soviets). As of 1 January 2005, there were 9 820 of these funds.

One important legal requirement introduced by the above Regulations is a passport for budgetary programmes. The Fund's annual expenditure are presented in the budget in the form of programmes. The passport is the programme profile form that contains information on the programme, including objectives and performance indicators. The preparation of these programme passports is obligatory. In principle (at least), the State Treasury does not authorise payments for any spending unit that has not prepared its programme passport within one month of the enactment of the budget.

The annual Law on the Budget provides an important legal framework for the operations of the Fund, as the planning process by which the Fund establishes its annual expenditure is closely linked to the preparation of the state budget. In addition, the annual Law on the Budget can introduce changes in the distribution of resources from pollution charges between the different levels and different institutions, thus overriding specific legislation for the Fund.[5] In 2006, the Fund is financing 8 budgetary programmes. However, there are also 15 budgetary programmes managed by 5 other ministries that are financed with resources from pollution charges. These other ministries include: Ministry of Industry, Ministry of Emergency, Ministry of Agriculture, State Water Management Committee, and the National Space Agency. The MEP endorses these programmes but does not control the spending of their resources.

On the expenditure side, the Fund's operations are guided by a "list of types of activities that qualify as environmental measures". The first such list was approved by the Cabinet of Ministers on 17 September 1996 (Resolution No. 1147). This list has been modified several times over the years. Each time a new area for funding from the Fund is identified, the list is adjusted accordingly. These resolutions stipulate that the Fund's resources can be used for environmental purposes only.

Expenditure for the budgetary programmes financed from the Fund are determined also in accordance with the Procedure for Planning and Financing of Environmental Measures from the State Environmental Fund (Order of the Minister of Environment of 21 May 2002 and registered at the Ministry of Justice on 6 June 2002 under No. 482/6770). This Order sets the procedures for applying for support from the Fund and evaluating project proposals by Ministry staff.

In addition, the Budget Code sets the general procedures for financial control, audit and assessment of the effectiveness of the use of budget resources. The State Treasury sets the specific reporting rules for budgetary entities. In case of violations of the Budget Code and commensurate with the degree of the violation (e.g. unauthorised use of budget funds, spending such funds for purposes

[5] This is done upon proposal by the Ministry of Finance and approval by the Cabinet of Ministers.

other than those provided for under budget appropriations), these can result in civil, disciplinary, administrative or criminal penalties of relevant officials in consistency with the procedures established by the laws of Ukraine. However, secondary legislation for the Fund does not refer to any of these laws (civil or criminal law) and does not make any provisions to make them operational.

One particular point that deserves attention concerns the efforts of the MEP to pass a specific Law on the National Environmental Fund. There have been many such attempts over the years, but with no success so far. The last failure of the Parliament to adopt such a law was in February 2006.

Table 1. Major Laws and Regulations Relating to the State Fund – Evolution of the Legal Basis

Name of the Law/Regulation
Law on Environmental Protection No. 1264-XII of 25 June 1991, last amended on 9 February 2006
CoM Resolution No. 18 of 13 January on the Procedure for Setting and Collecting Pollution Charges and on the Regulations on the Extra-budgetary Republican Environmental Protection Fund, cancelled in 1999, through CoM Resolution No. 303 of 1 March 1999, with further amendments over the years
CoM Resolution No. 1147 of 17 September 1996 on the List of Types of Activities which Qualify as Environmental Measures, subsequently amended in 2001, 2003, 2004
CoM Resolution No. 634 of 7 May 1998 on the Statute of the State Environmental Fund, subsequently amended in 2002 and most recently in 2006, through CoM Resolution No. 462 of 7 April 2006
Budget Code of Ukraine of 21 June 2001, last amended in 2003
Order of the Minister of Environment No. 189 of 21 May 2002 and registered at the Ministry of Justice on 6 June 2002 No. 482/6770 on the Procedure for Planning and Financing Environmental Measures from the State Environmental Fund
CoM Resolution No. 773 of 18 August 2005 on the Procedure for the Use of Resources from the State Budget to Soften Commercial Credits Taken for Environmental Investments, most recently amended in 2006, through CoM Resolution No. 375 of 29 March 2006
Law on the Budget (Annual)
Law on the Procurement of Goods, Works and Services for Public Funds, most recently amended on 14 December 2005

Analysis

Over the 15 years since its establishment, the system of environmental funds in Ukraine has undergone significant changes closely related to the evolution of the public finance system in the country. At the beginning, the funds were extra-budgetary, existing outside of the main budgetary control mechanisms. Over the years, extra-budgetary funds grew so numerous that they seriously threatened the stability of the public finance system. Ukraine started reforms in 1998. Since then, Ukraine has achieved significant results in improving its public expenditure system. A State Treasury has been established, payment transactions of all spending units are channelled through the Treasury Single Account, a Budget Code was implemented, and former extra-budgetary funds have been consolidated into the budget. As a result, financial discipline in the use of public resources has been strengthened considerably. Efforts have been made to introduce performance-based budgeting. All these changes point to the commitment of Ukrainian authorities to move the public expenditure management system towards more transparency and efficiency and closer to international standards. Therefore, the legal underpinning of the Fund has generally improved. However, specific secondary legislation for the Fund is not sufficiently adapted to these processes. This legislation is still very cumbersome and sometimes confusing.

The State Environmental Protection Fund is now fully consolidated into the state budget and is subject to internal and external control procedures valid for all budgetary entities. Its resources are earmarked for environmental protection activities and appear as “special fund” in the budget. In general, the involvement of the tax authorities in the collection of pollution charges has resulted in a

several-fold increase of revenue available to environmental funds. However, this increased level of resources does not seem to have translated into significant environmental investment efforts.

Even the earmarking of the revenue from the pollution charges has not particularly helped the funds. Part of the revenue has been diverted to support other ministries' programmes. It is not clear how decisions for allocating these resources to other ministries are made. The process is not transparent or predictable. All the more so since the environmental effectiveness of the resources spent by these other ministries is not particularly obvious. Coupled with the huge number (thousands) of small funds that exist in Ukraine, this dissipation of revenue across so many different levels does not result in significant environmental improvements and does not allow for the creation of a critical mass of resources to support bigger environmental investments (although investment expenditure supported by the State Fund have been growing in recent years). This point has been raised by many international institutions and the MEP staff are fully aware of it.

In addition, the current one-year budget perspective is a major source of uncertainty, as many of the projects supported by the Fund require stable financing over several years at least. Ukraine is currently considering introducing a medium-term budget framework. Some steps have already been made towards implementing a medium-term fiscal framework (on a 2-year basis), but an aggregate medium-term expenditure framework (3-4 years) is essential for public mechanisms financing long-term infrastructure investments.

One major weakness of legislation for the Fund is the requirement for staff responsible for appraisal to carry out direct public procurement for projects that have been selected for financing. Public procurement is a valid and necessary function of the public administration, but it is not and should not be a responsibility of public finance mechanisms. The main task of funds is to appraise, select and finance projects, with procurement left to beneficiaries and procurement results verified for compliance with legislation by the funds' staff. In fact, in the case of the State Fund, beneficiaries and contractors/investors are often the same person. The Fund organises the tenders and agreements are signed directly with selected contractors. In addition, current legislation for the Fund does not ensure operational independence of the staff or provide protection against *ad hoc* and political pressures.

Over the years, the MEP has tried to address some of these concerns through a law on the Fund. A number of draft laws have been prepared and all drafts have been rejected by the Parliament so far. It seems that in general the process of drafting legislation in Ukraine is cumbersome. There are a lot of parties involved in this process, with the Council of Ministers having the last say before presenting the draft to the Parliament. Often, in this process, the draft changes significantly in comparison to the original intentions of its authors. Moreover this situation shows that there is no consensus in the government on how to strategically use the Fund. This also points to a lack of leadership that is necessary for pushing ahead with reforms of the Fund.

The last version of the draft law, which was once again rejected by the Parliament in February 2006, proposes to streamline the system of environmental funds. The major change proposed is to re-create the State Fund as a legal entity with its own staff and proper management structure, where the main clients of the Fund could be represented in the supervisory body in order to balance different interests. However, it is worth noting that the legal identity of the Fund *per se* is not sufficient to ensure operational independence of the staff from political pressures. Clear rules and procedures are needed in order to ensure transparency of and accountability for decisions made.

In addition, the draft law proposes to introduce a two-tier structure for the Fund, with the State Fund at the head, and the 27 oblast, the 2 city (Kiev and Sebastopol) and the autonomous (Republic of Crimea) funds as its subsidiaries. These proposed changes indicate a good understanding of the problems of the Fund. However, an open and fair discussion with all interested parties is needed in order to reach a general agreement and ensure a broad support for the reforms of the Fund.

Conclusions and Recommendations

The legal basis of the Fund has significantly evolved since its establishment in 1991/1992. The main changes are related to the overall reforms of the public finance system in Ukraine. Most of these changes have already brought positive results, as the Fund's resources have increased and control over spending has improved. Major problems on the expenditure management side, however, still persist.

The lack of national consensus on the future of the Fund and the perceived weaknesses in its management practices are reflected both in the diversion of part of the Fund's revenue to other ministries and in the difficulties of negotiating a law on the Fund. There is a need for an open discussion with all interested stakeholders on the future of the Fund, which will also make the Fund better understood and ensure broad political support for the envisaged reforms. In order to address these issues, the Ukrainian government should:

- Conduct consultations with all major stakeholders – not only within the government, but also with civil society, academia and business and professional organisations – in order to agree on a strategy for the use of the Fund's resources. This will allow all interested stakeholders to better understand the needed reforms and will facilitate negotiations on the draft law for the Fund.

- Reduce drastically the number of local Funds and concentrate the resources at national and oblast level, thus bringing them closer to project owners.

- Return revenue from pollution charges currently used by other ministries to the management supervision of the MEP. This would make it possible to create a critical mass of resources for significant environmental investments and ensure better control with regard to the achievement of environmental objectives.

- Introduce a medium-term budget framework to allow for the smooth implementation of multi-year projects.

- Introduce provisions for ensuring operational independence and proper accountability of staff working on the Fund and operationalise these provisions in regulations on the Fund.

- Split public procurement from project cycle management and create a separate specialised unit at the national level responsible for project cycle management only.

2.2 Strategic Role and Objectives of the Fund in Environmental Policy

The objectives of the State Fund are defined in a number of strategic documents, programmes and regulations. As currently stated in the Statute of the Fund (Article 1), the Fund's resources should be used to support environmental protection and resource saving activities connected with environmental protection. They should be used for preventing, decreasing and eliminating environmental pollution, and also for financing research work in this field. In addition, the Fund should support activities that correspond to the main directions of the state policy in the field of environmental protection, natural resource use and environmental safety.

These main directions are outlined in the strategy document – *Principal Directions of the State Policy of Ukraine in Environmental Protection, Use of Natural Resources and Ensuring Environmental Safety*. This document was adopted by Parliamentary Decree on 5 March 1998. Broadly speaking, the priorities identified in this document correspond to the budget programmes supported by the Fund.

In addition, the spending priorities of the Fund are guided by the existing state environmental targeted programmes. Box 3 below shows the programmes that existed in 2005.

Box 3. State Environmental Targeted Programmes – 2005

In 2005, there were 11 state environmental targeted programmes. These included:

- Programme of long-term development of nature reserves in Ukraine ("Nature Reserves") (Law No. 177, 1994, Programme Code 011).
- State programme for upgrading the equipment of the hydro-meteorological survey system and of the ambient environmental pollution survey system ("Meteorology") (CoM Resolution No. 579, 1996, Programme Code 029).
- National programme for the environmental rehabilitation of the Dnipro River Basin and the improvement of quality of drinking water (Law No. 123, 1997, Programme Code 037).
- National programme for the development of the national environmental network of Ukraine for the period 2000-2015 (Law No. 1989-III, 2000, Programme Code 102).
- National toxic waste management programme (Law No. 1947-III, 2000, Programme Code 103).
- National programme for the protection and rehabilitation of the environment of the Black and Azov Seas (Law No. 2333-III, 2001, Programme Code 126).
- Programme for the implementation of the Convention on Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and their Destruction for the Years 1999-2008 (Presidential Decree No. 50/99, 1999, Programme Code 216).
- Comprehensive programme for national implementation of decisions passed at the World Sustainable Development Summit for the years 2003-2015 (CoM Resolution No. 634, 2003, Programme Code 271).
- Programme for the ban of production and use of ozone-depleting substances (CoM Resolution No. 256, 2004, Programme Code 301).
- State programme for flood prevention and management (CoM Resolution No. 545, 2004, Programme Code 315).
- State research-and-engineering programme for development of topography and geodesy and national cartography for the years 2003-2010 (CoM Resolution No. 37, 2003).

These broad programmes, adopted by the Parliament, have mostly a declarative character and no stable sources of financing to implement them. They are usually used in planning expenditures of the Fund and mostly as a reference for justifying the support for a certain activity.

On the basis of the above documents, State Fund resources are currently spread between 8 budget programmes managed by the MEP and 15 budget programmes managed by 5 other ministries. A more precise formulation of the Fund's annual spending priorities is attempted with the Budget Law of each year. The 2006 Budget Law (Article 43) provides for State Fund resources to be allocated *inter alia* to the following activities:

- Arrangements related to environment protection (par. 25);
- Protection of settlements and arable lands from damage caused by water (par. 26);
- Integrated anti-flood protection in the Tisa River basin in the Zakharpatia Oblast (par. 27); and

- Restructuring and liquidation of chemical and mining companies, and implementation of urgent environment protection measures in the areas where the companies operate (par. 28).

In addition, there are other strategic environmental policy documents, such as the government programme to implement the United Nations Millennium Development Goals (MDGs) or the EU approximation, but these do not seem to be directly reflected in the objectives of the State Fund.

Analysis

The *Principal Directions* remains the main strategic document for Ukraine in the field of environmental protection. It focuses mostly on identifying problems and describing the state of the environment in Ukraine as it used to be 8-9 years ago. It covers environmental problems in all media and all sectors. Environmental funds are identified as one of the sources of finance but no clear niche is envisaged for them. Given its all inclusive scope, it is difficult to see what guidance this document could provide to the managers of the Fund for the allocation of limited resources to priority areas. In addition, this 1998 document is already out-of-date and since its adoption it has not been reviewed or revised.

Even if the budget programmes supported by the Fund broadly correspond to the national priorities identified in the above strategic document, these priorities are often so vaguely specified (e.g. arrangements related to environment protection) that they can accommodate any environmental activity. One way to derive annual priorities for the Fund is to look at the distribution of its resources across different programmes. Actually, the budget does mirror the Fund's priorities. Thus, in 2006, the three areas that are planned to obtain most of the Fund's support are: waste management (30% of the Fund's budget), followed by wastewater management (20%) and a programme for providing interest rate subsidies to credits extended by commercial banks (about 13%). However, these priorities are not translated into specific targets and there are no clear indicators for the environmental effects to be achieved. The lack of clear targets and the short-term (annual) perspective of the Fund's programmes do not make it possible to provide real guidance for resource allocation. Such an approach to priority setting is not conducive to rational planning and management of public resources. As a result, it is difficult to prove the Fund's effectiveness as a tool for implementing national environmental policy priorities. There is a real need for identifying a strategic niche for the Fund and narrowing down the priorities, particularly within sectors.

The Environmental Financing Strategy for the Municipal Water and Wastewater Sectors in Ukraine[6], prepared in 2003, provides some guidance as to possible objectives and targets for the sector. The Financing Strategy is one tool which supports the decision-making process and helps rationalise the planning of expenditure. This Financing Strategy has developed several scenarios. One of them is the EU scenario. The policy objective for the municipal water sector over the next 20 years (between 2003 and 2023), as spelled out in this scenario, is bringing the water supply and wastewater sectors close to compliance with EU water and wastewater utility standards. This objective is further specified in terms of targets related to service coverage, water quality and service level. Such targets include, among others, achieving a 95% connection rate to water supply and sanitation services, and full biological treatment complying with EU standards for all towns with a population of over 2 000 inhabitants. The investment programme under this scenario is envisaged to be implemented during the period 2003-2013. The total cost of this programme is estimated at Euro 4 billion, to be financed from different sources: public budget (including environmental funds), private sector finance, utilities' own resources (from water tariffs), and foreign sources of finance.

While the revenues of all environmental funds have been steadily growing, they are still negligible in relation to the expenditure needed for this sector. However, the resources of the State Fund (along with resources allocated from the state budget), if well targeted, could significantly

[6] Prepared in the framework of cooperation with the Danish Environmental Protection Agency.

contribute and provide support to few critical projects in the sector. The selection procedure should ensure that the projects identified are really critical and add to the achievement of the targets set by the Government.

Conclusions and Recommendations

No strategic role has been identified for the State Fund in supporting the implementation of the national environmental policy of Ukraine. This also reflects the lack of political consensus on the scope and on the most effective use of the Fund's resources.

Policy-making has been hampered by the slow build-up of legal foundations and a rapid succession of governments, which may well be the reason why the *Principal Directions* have not been revised to this very day. Strategic development remains within the Soviet-style framework, where the focus is on the managerial rather than on a strategic mode of policy-making. Thus, policy decision-making and priority-setting is mostly based on legislative acts. These, by their very nature, do not facilitate discussions of different policy options and risks entailed by these options.

Ukraine needs a new modern environmental strategy and action programme that reflect all political and economic changes in the country, including the new patterns of production and consumption and the new realities for demand for environmental finance. This will make it possible to better target the scarce public resources where they are most urgently needed.

Without realistic objectives and targets, clearly stated in policy documents, it is difficult to assess the environmental effectiveness of the Fund. It is also difficult to hold anybody responsible for achieving or not achieving non-existing objectives, and to evaluate if subsidies are really needed. Of course, the programmes supported by the Fund are all important, but they are not equally urgent and the Fund cannot be a cure-all for all these problems. There is a need to re-formulate objectives, to narrow them down and to translate them into realistic and measurable targets. This is not an easy exercise. It will require broad public support as well as a good economic analysis and justification, rather than a vague and *ad hoc* programming approach. Clearly stated objectives and targets, against which the Fund's effectiveness could be more easily assessed, would only increase the Fund's visibility and make it better appreciated at home and by the international community. In this context, the MEP should:

- Specify a strategic niche for the Fund's support (also in relation to international commitments, e.g. support for achieving MDGs in the urban/rural water supply and sanitation sector);

- Establish a few real priorities for the Fund (e.g. support for achieving EU/WHO water standards in hotspot areas); and

- Prepare a sound economic analysis to justify supporting these objectives, and also involve key stakeholders in the process.

3. FUND ADMINISTRATION - INSTITUTIONAL AND MANAGEMENT SET-UP

On the basis of the 1998 Budget Law of Ukraine, the State Fund was incorporated into the state budget, and the local funds into the corresponding local budgets. Consequently, the State Fund is now a special Fund, part of the state budget of Ukraine.

3.1 Institutional and Management Set-up

The budgetary structure of the State Environmental Protection Fund has been replicated at the regional (oblast) and local levels. Theoretically, in accordance with current legislation, each single village has the right to create its own fund, and also has the possibility to delegate it to the upper government tier. The national, regional and local funds are totally separate from each other and there is no legal way for resources to be transferred between the local and national levels. Executives of regional and local governments make decisions with regard to the use of the money accumulated by regional and local funds.

Institutionally, since it was established, the State Fund has been under the supervision of the MEP. Legislation defines the MEP as the "main administrator of the Fund". Practically, this task is embodied by the Minister of Environment, who is the ultimate decision-making authority of the Fund. This means that the list of environmental activities to be financed by the Fund is approved by the Minister before it is sent to the Cabinet of Ministers for approval.

Being part of the state budget, the National Fund is not a legal entity. Neither does it have a separate management structure with dedicated staff. The Minister devolves tasks related to the management of the Fund's resources to Ministry administrators. Each year, the Minister issues an Order and approves a list of Ministry officials (sets up a Working Group), who are made responsible for selecting projects to be supported by the Fund.

In 2006, the Working Group consisted of the following 11 Ministry representatives: Deputy Minister (chair of the group); Head of the Department of Strategic Planning, Economics of the Use of Natural Resources and Environmental Management; Head of the Department of Biological, Water, Land Resources and Environmental Networks; Head of the Department of Environmental Safety and Management of Municipal Waste and Hazardous Chemical Waste; Head of the Division of Budget Planning and Execution; Head of the State Environmental Inspectorate; Head of the Division on Accounting; Head of the Legal Department; Head of the Science and Technological Activities Division; Head of the Division of Environmental Funds; and an expert from this same Division. No representatives from other government agencies or from the client community are part of this Working Group. Neither legislation nor Minister's orders stipulate the duties, powers and responsibilities of the members of this Group.

Since 2002, the State Fund has been divided into budget programmes formulated and managed by relevant structural units of the MEP, which have been made responsible for the substantive administration of the respective programmes. However, their responsibilities as managers of the budgetary programmes are not specified explicitly anywhere in legislation for the Fund. The functions of controlling the implementation of environmental projects, including acceptance of completed works (e.g. construction works) in different regions of the country, are carried out (formally) by officials of the central Ministry and its territorial bodies.

The Division of Environmental Funds of the MEP is responsible for the organisation and the coordination of the Fund's activities. Division staff are mostly involved in developing methodological guidelines on issues pertaining to both the revenue and expenditure side of the Fund and the respective legal basis. This Division has 7 staff members. The management of the financial resources is carried out by the Finance and Economics Department of the MEP.

The State Fund, as a mechanism for distributing subsidies, has a very complex decision-making process and procedures. This process is mostly defined (on a practical level) in the Order of the Minister of Environment (No. 189 of 21 May 2002 on the Procedure for Planning and Financing of Environmental Measures from the State Environmental Fund). This planning is done mostly based on requests submitted by applicants for financial support from the Fund. Broadly speaking, the planning process for Fund expenditure looks like this:

Table 2. Decision-Making and Planning Process for State Fund Expenditure

1.	**Planning of environmental activities for the budget programmes of the State Fund is done by the MEP.** This planning is done based on the previous year's requests and new areas for support. The budget programmes are approved by the Parliament as part of the state budget at the end of the year.
2.	Starting at the beginning of the next calendar year, **applicants submit their requests** to the appropriate territorial bodies of the MEP according to the place where the project will be implemented, or to the central body or executive power to which they belong: these applications should be submitted by 15 April of the current year. **Local branches of the Ministry carry out the preliminary analysis (eligibility screening) of applications, prepare environmental conclusions and transmit the requests that have been assessed positively to MEP headquarters.** Functional departments of MEP headquarters can submit requests from 1 January to 1 May of the current year.
3.	**MEP headquarters review/appraise all submitted requests.** Requests that are incomplete or do not provide accurate information are rejected. The relevance of the applications is checked against the list of defined environmental protection measures and other relevant requirements. If they do not comply, applications are rejected.
4.	**Prepared proposals are submitted to the Division of Environmental Funds to be considered by the Working Group of the State Fund,** with a possible expenditure split for budget programmes within the forecasted cash inflow of the State Fund. The members of the Working Group are appointed through a MEP Order. Responsible executives, together with the Working Group, make a preliminary selection of environmental protection activities for the budget programmes.
5.	**Proposals are submitted to the Minister of Environmental Protection** for approval after all necessary recommendations have been made. Responsible executives submit approved proposals to the Economics and Finance Department, which is responsible for preparing the budget request of the MEP.
6.	**Budget requests of the MEP are then submitted to the Ministry of Finance for approval.** According to legislation, within one month after approval of the state budget, the MEP submits final proposals of budgeted programmes for the Minister of Environment's approval.
7.	Within 5 days, **the approved plans are submitted by the Minister of Environment to the Cabinet of Ministers of Ukraine**. The costs of these plans are transmitted to the Ministry of Finance for approval.
8.	After approval and confirmation by the Cabinet of Ministers and the Ministry of Finance of the plan and the costs, **responsible executives of the budget programmes inform concerned authorities at all levels about the outcomes of the process**, who then carry out public tenders for the implementation of the programmes and conclude agreements with project winners.

In summary, for the selection and final approval of the activities that will be submitted to the Cabinet of Ministers and the Parliament, the functions and responsibilities of the Fund are split among the territorial bodies of the MEP (eligibility screening), the MEP headquarters (review of proposed applications and appraisal), the Working Group (initial selection of individual projects and allocation of resources across individual programmes to be financed from the Fund), and the Minister of Environment (as the highest decision-making authority of the Fund). However, the Cabinet of Ministers is crucial with regard to the final decisions.

As can be seen from the above description, the responsibilities for programming, appraisal and selection are split among many different players and levels. This makes the process very cumbersome and causes problems with the timely preparation of programmes to be financed from the Fund.

Analysis

The management structure of the Fund is determined by its budgetary nature. Strictly speaking, the Fund is a line in the state budget whose resources are earmarked for specific purposes on an annual basis. As such, the Fund has no separate legal status and it cannot take legal action in its own name. The Fund has no proper management structure with dedicated staff and own offices. The day-to-day responsibilities for managing the Fund's programmes and resources are split among different people at the MEP headquarters and its territorial bodies.

Good international practices show that environmental Funds consist of two governing bodies: a **management (executive) unit** responsible for the daily operations of the Fund, such as project cycle management, financial management and external relations, and a **supervisory body** that is responsible, among others, for establishing spending priorities, setting internal policies, approving the annual plan and budget, internal operating procedures and project portfolios.

A management structure, as described above, does not exist for the Ukrainian Fund. The division of labour is split among too many people and levels without clearly specified lines of responsibility and subsequent accountability for decisions. It is difficult to see who really bears responsibility for failures or misuse of the Fund's resources (apart from the Minister as part of his/her political responsibility).

While most of the formal elements for managing an environmental fund are present in the structure of the State Fund, these elements only vaguely correspond to practices employed by similar well-performing institutions in other countries. An environmental fund is a financing institution, whose core activity is the appraisal and selection of projects for financing. In the case of the State Fund, these two core functions are carried out jointly by the territorial bodies of the Ministry and officials at various structural departments at MEP headquarters. MEP staff at headquarters check applications for compliance in a very formal way (basically verifying proposals against the list of environmental measures and other formal requirements). From discussions with local staff during the review mission, it seems that communication between the national and local level is poor. Thus, Ministry officials, tasked with this responsibility, cannot make well informed judgments and decisions. In addition, there is often duplication of responsibilities between the two levels. Furthermore, this management structure is not appropriate for selecting the most cost-effective projects to be financed with the Fund's resources.

The Working Group exhibits some features resembling those of the supervisory board of a Fund (in terms of selecting projects and deciding on preliminary allocations of resources across the budget programmes of the Fund). It is not clear, however, which criteria the Working Group uses to select projects at this stage. Actually, this Group has purely advisory functions. The real decision-making power lies with the Minister. It is likely that some members of the Group are also involved in project appraisal.

In addition, as the Working Group is constituted on a yearly basis, continuity and institutional memory are difficult to ensure. One striking feature of this Group is its composition: all its members come from the MEP. Good international practices show that it is best when supervisory bodies consist of representatives from different agencies with an interest in environmental finance, such as the Ministry of Finance, Ministry of Economy, and the Parliament. Representatives of the Fund's clients (e.g. municipalities, businesses, etc.), as well as of academia and NGOs, could also participate in the decision-making process (as proposed by the draft Law on the National Environmental Fund). Such a balanced representation could only benefit the Fund, as it would be perceived as a more open and transparent institution, willing to co-operate.

With the current status of the Fund, the Minister of Environment logically holds the highest responsibility for decisions related to financing from the Fund. It is not clear though what the real powers of the Minister are in relation to the projects submitted for her/his approval by the Working Group. The problem is that the projects submitted by the Group to the Minister are not ranked in any order of importance for financing, hence the Minister has much discretion in choosing projects for approval. Good international practices suggest that the Minister can approve the entire project portfolio (as appraised by experts) and veto individual projects, but he/she should refrain from including new projects to the list submitted by the Working Group.

There is also a lack of transparency with regard to the final choice that the Cabinet of Ministers makes between different activities. Though the Cabinet intervenes at a late stage in the decision process, it plays a critical role. The outcome of the preceding steps, which aim at a certain objectivity, does not appear to be that important for CoM final choices. The political process therefore does not seem to be strictly confined to programming and supervision. This may allow for political interferences in the decision process. Procedures are indeed not sufficiently precise to avoid such loopholes which allows the CoM to make choices without any clear justification. For example, legislation does not specify on what grounds the CoM can alter the list of projects submitted by the MEP. This weakness was already pointed out by the World Bank in its 2003 report.[7.] According to this report, too many different stakeholders and interests are involved in this Fund.

Arbitrage between ministries within the Cabinet happens way too late in the year (last quarter). Then, given the time necessary to organise public tenders and select contractors, the time that is required to carry out the task is often too long. The distribution of the State Fund's managerial functions between different departments of the MEP has resulted in poor coordination and slow realisation of project cycle tasks. This has often led to incapacity to fully utilise resources available to the Fund or to *ad hoc* spending at the end of the year. This may well be one of the reasons why some of the revenue from the pollution charges has been allocated to other ministries.

Altogether, the current management structure of the Fund is highly decentralised, very heavy and complicated. The problem, however, is not so much the highly decentralised structure *per se*, as such structures exist in some OECD countries as well (e.g. Austria). The real problem lies in the lack of clear responsibilities and rules assigned to different levels and units with regard to programming and project cycle management. Well-defined responsibilities go hand in hand with respective accountability and need to be specified in terms of **who** is responsible for **what** and **to whom**. Clear lines of responsibility and subsequent accountability, coupled with transparent rules and procedures for all stakeholders involved, provide the basis for managerial independence. In the case of the State Fund, responsibilities, rules and procedures are only vaguely defined.

[7] World Bank, *Building Foundations for Sustainable Growth*, 2003.

Conclusions and Recommendations

Experience shows that such a decentralised structure can be most successful in mature economies with very strong control mechanisms and very clear lines of responsibility at each stage of the project cycle. Such a decentralised structure is an option in rich countries where most of the heavy environmental investments have already been made, and subsidies are not used as an incentive to prioritise investments, but rather to encourage additional environmental improvements.

The current institutional structure of the Fund is not conducive to selecting cost-effective projects that could bring real results on the ground. Decisions on financing are not transparent. Re-organising the Fund along the lines suggested by good international practices should become an absolute priority for the MEP, if they are to preserve this source of financing at this level. While the Budget Code has banned the creation of extra-budgetary funds, there are nonetheless opportunities to do so within the existing budget framework.

One option is to keep the State Environmental Protection Fund as a budgetary fund under the control of the MEP, but to give it operational independence and clear lines of responsibility. A proposal along these lines is included in the draft Law on the National Environmental Fund. The MEP would exert direct control over the Fund's activities. However, there would also be a multi-stakeholder supervisory board and an executive unit of at least 4-8 technically competent people (engineers, economists), who would be responsible for project cycle management on a daily basis. Additional training should be provided for such staff. This unit could become a part of the Division on Environmental Funds in the Ministry. It would benefit from the existing infrastructure and would not require significant additional administrative costs (apart from salaries). Similar experience in other ministries (education, culture) shows that such structures can be effectively created. A reform of the Constitution voted in 2004 now allows for this type of solution; no new Law would be needed, and a Ministerial Order may be sufficient. However, the legal basis of the Fund would be strengthened with a Law, which would also make the Fund more understandable and credible to foreign partners.

This proposed structure may work best for funds with multi-year budgets. It seems that Ukraine is moving in this direction. By creating such a structure and developing its human capacity, the MEP could adopt these changes. Table 3 below presents a brief indication of how responsibilities for managing the Fund could be split between different levels of the Ministry. It will be difficult, however, to completely eliminate CoM decision-making power, but it could be limited to decisions relating to strategic choices.

Alternatively, the MEP may choose to explore the possibility of creating an independent public agency under the supervision of the MEP with its own assets. Another possible option could be to consider outsourcing the executive management of the Fund to a professional Fund Manager under a management contract with the government. This will require organising a tender and approval of the professional Fund Manager by the Supervisory Board, as well as entail respective additional administrative costs. Austria provides a relevant example, where the Kommunalkredit Bank is managing the government environmental fund. Outsourcing could be a choice only if the government has very strong control over the Fund Manager's operations and develops clear rules, procedures and criteria for the regular evaluation of the professional Fund Manager performance.

Table 3. Proposed Structure for the State Environmental Protection Fund as Part of the MEP

Fund's Body	Functions/Responsibilities
MEP (Minister)	Administrator of the Fund Makes final decisions on the allocation and use of the Fund's resources
Fund Supervisory Board	Composed of representatives of the MEP, other key ministries, representatives of beneficiaries (associations of local authorities, industries), members of the Parliament. To be operational, the Supervisory Board should consist of not more than 9-11 people (experience shows that this number is conducive to good decision-making), appointed for a period of at least 2-3 years, with clear procedures for appointment and dismissal of its members, voting procedures Advice on the use of the Fund's resources (determination of environmental programmes of the Fund, approval of projects selected by technical staff). Prepares recommendations for the Minister Prepares and approves internal policies for the Fund
Fund Executive Office	Consists of 4-8 staff (engineers/technical people and finance/economic analysts) and implements the Fund's mandate on a daily basis (project cycle management) + a Director (who signs contracts on behalf of the Minister) The members of the Supervisory Board (and the Director of the Fund office) are appointed and dismissed by the Minister of Environment upon proposal by their relevant institutions

Priorities should be as follows:

- Clarify the institutional set-up of the Fund.
  - Affirm the leadership of the MEP in the project selection process and prevent the Cabinet of Ministers from making decisions without clear justification.
  - Simplify the decision-making process and reporting lines between the Fund and the MEP.
- Given the regular increase in revenue available to the Fund, strengthen the current management structure in order to increase the spending ability of the Fund.
  - Distinguish the Fund's identity from that of the MEP. Split responsibilities for programming and project cycle management from procurement and ensure the operational autonomy of the Fund. Prepare a draft resolution to be adopted by the CoM.
  - Design a proper organisation and management structure (director, multi-stakeholder supervisory board, own functional department and procedures). Specify appointment procedures for the supervisory and management boards, as well as performance criteria against which they will be evaluated.
  - Allocate//hire professional dedicated staff to work exclusively on Fund programmes.

- Develop specific training programmes for staff in line with the Fund's activities.

- Explore the opportunity of establishing an independent government agency with its own account and assets under the auspices of the MEP. Such an initiative will require a new CoM resolution.

- Alternatively, consider outsourcing the executive management of the Fund to a professional Fund Manager. This Manager should be selected by competition and on a merit basis.

3.2 Personnel Management

Given the absence of a proper management structure, the Fund has no staff that can be dedicated entirely to its activities. In practice, it is administered by employees of the MEP.

There are no special personnel management procedures for recruiting and appointing staff dealing with the Fund's operations since current staff also deal with other activities of the Ministry. Therefore, staff working on Fund activities are subject to procedures that are valid for other civil servants of the MEP.

There are apparently no formal procedures for the training and professional development of staff or for regularly reviewing and assessing their performance.

Analysis

Given the growing importance of the State Fund in the environmental protection funding system of Ukraine (see Section 4.1), it is becoming critical to vest it with proper resources and dedicated full-time staff. This would allow for the specialisation of staff, who would work exclusively on the Fund's activities and accumulate experience in this field, triggering higher efficiency. In addition, transforming the Fund into a real financing mechanism will require hiring staff skilled in appraising and selecting projects for financing, with good technical and economic competences, and knowledge of the market of environmental services in Ukraine. Some specific training programmes (formal and on-the job) for this dedicated staff could be designed in order to train these specialists in best international practices of project cycle management.

If a specialised Fund Executive Office is created, performance criteria for evaluating the results of the staff's work against clearly stated objectives need to be developed. As international practice suggests, these criteria need to be clearly spelled out in the regulatory and/or operational documents on the Fund and staff members need to be regularly evaluated against the criteria.

3.3 Control (Internal/External) and Auditing

Based on the MEP Order for Planning and Financing of Environmental Measures from the State Fund, internal control of the Fund's programmes is carried out by the Environmental Economics Department of the MEP, which is also in charge of controlling the Fund's expenditure. This Department controls the use of Fund's resources, but its control functions are limited to the review of information on implementation results submitted by the Ministry's territorial bodies (the MEP Order No. 418 of 28 October 2002 "On the Approval of Reporting Forms of Results of the Implementation of Environmental Projects under Budgetary Programmes of the State Fund").

Audits of the State Fund are performed by the Accounting Chamber of Ukraine (the supreme audit institution of Ukraine) and the main Finance and Inspection Department of the Ministry of Finance. In 2005, the Accounting Chamber conducted an audit on the effectiveness of the use of state

and local environmental fund resources disbursed in 2003 and 2004 (mostly a legal audit of the Fund). It made a number of recommendations for changes and improvements. However, the recommendations of the Accounting Chamber report, which were very critical, do not seem to have had any significant consequences for the Fund in terms of resources. On the contrary, the State Fund's share of pollution charge revenue has been increased without any major changes in the Funds current management structure. The current performance review of the Fund, implemented within the framework of the OECD, is a commendable effort to improve the Fund's openness and visibility.

Analysis

The control system to monitor the use of State Fund resources functions in accordance with existing legislation but appears to be insufficient. The chief administrator of the Fund, i.e. the MEP, finds it difficult to get complete and reliable information about actual spending. According to the Accounting Chamber, the Ministry does not have documents that could easily certify the reliability of data disclosed in the annual report issued by the Fund. In addition, the report states that it was not possible to check the reliability of the information on completion of environmental projects at the level of the MEP since the Ministry has only general information submitted by its territorial branches and no supporting documents. The review team experienced similar difficulties in obtaining this information.

3.4 Transparency, Public Disclosure and Access to Information

Financial and accounting reporting of the Fund is conducted within the framework of the general reporting activity of the MEP. The reporting procedure of the responsible executives and territorial bodies for the implementation of environmental activities of the Fund is defined by MEP Order No. 418 of 28 October 2002.

According to the Statute of the Fund, a report on the Fund's activities is published annually as a separate publication. This report is submitted to the Cabinet of Ministers and to other interested bodies, and to public organisations whose activity is related to environmental protection. The Fund did not issue such annual reports for 2004 and 2005 which does not help improve the Fund's transparency.

Despite this reporting, the Fund remains basically unknown to potential clients and the public at large. The MEP does not provide information on the Fund to the mass media to advertise this funding opportunity. The Ministry's website contains a heading on the Fund indicating different sources of information, but there is not one single document on the Fund posted on the Internet.

The MEP does not make an effort to reach out to potential clients by actively seeking to inform people about the Fund. Very few people and institutions are aware of this financing mechanism.

There is a consultative body (Public Council of All-Ukrainian Environmental NGOs) at the Ministry, which consists of civil society representatives.[8] The very existence of this body within the framework of the government is a commendable achievement. However, the access of this body to relevant information on the Fund is also sporadic.

Analysis

Introducing the requirement of preparing an annual report on the use of budgetary resources by each budgetary entity is an important step towards improving transparency. However, annual reports contain no data on actual environmental results achieved with the Fund's support. Most data presented in these reports are aggregate and do not allow any in-depth analysis. These data are mostly analysed

[8] There are similar bodies in all other Ministries as well.

in terms of meeting budgetary requirements and ceilings. When the review team requested detailed data, the MEP could not provide them even though they had more than 3 months at their disposal to organise the data collection.

There are apparently no ex-post reports on performance and results achieved by individual projects: little information on this aspect is gathered and disclosed to the public. Civil servants, in charge of managing the Fund's resources at MEP headquarters, are not aware of how projects are implemented. For instance, MEP officials are not able to provide a list of beneficiaries of the Fund's support based on their public or private status. This information appears to be rather difficult to obtain as it remains stocked in each territorial branch of the Ministry and is not compiled to be transmitted to the national level. By any standard, this lack of information at a national level is a serious omission and creates conditions for mismanagement of funds.

Apparently, the information made public by the Fund is insufficient. The Fund's communication policy does not ensure that all applicants have equal access to information on funding opportunities. The Fund should therefore try to advertise this funding mechanism and encourage more applicants to apply, especially from 2006 onwards when its available resources are expected to skyrocket. It should also ensure that potential beneficiaries of the Fund's financial support have similar opportunities to obtain information from the Fund and submit applications.

Besides, the annual report issued by the Fund does not seem to be very broadly distributed and therefore falls short of satisfactorily informing a larger public. The Fund should enhance its capacity to disclose public information and, more important, provide it in a more detailed and user-friendly manner. Setting up and regularly maintaining a specific website would be useful in this regard.

In its 2004 report on the Fund, the Accounting Chamber also notes that there is no co-ordination centre that could accumulate all information on financing environmental activities at the national/regional level. This results in duplication of finance allocations from different sources for the same activities. Creating a centralised information database at national level is crucial for making decisions on the allocation of resources provided by the Fund.

Conclusions and Recommendations

Although there is significant progress in certain areas (e.g. disclosure of information and increased transparency), a lot more remains to be done. Formally, the Fund fulfils all legal requirements, but the outcomes are not always very useful or meaningful. The MEP should aim to:

- Develop performance criteria for evaluating the results of staff work against clearly stated objectives. As international practices suggest, these criteria need to be clearly spelled out in the regulatory and operational documents on the Fund and staff members should be regularly evaluated against these criteria in order to increase transparency and accountability.

- Introduce and maintain regular monitoring and control of individual investment projects implemented with the Fund's support. Improve the presentation of data and information in the Fund's annual reports with a focus on real results and achievements.

- Improve transmission of information between territorial branches of the Ministry and its headquarters, which should centralise information on the Fund's activities, and develop and maintain a database which, once the information has been entered, could facilitate the preparation of reports on the Fund by different queries.

- Develop information disclosure tools (website, communication actions on the Fund's activities, etc.).

4. OPERATIONS OF THE FUND

Three main issues are discussed in this chapter: Fund revenue (sources and trends), expenditure (trends, disbursement mechanisms, procurement) and project cycle management procedures. These are analysed and assessed with regard to good international practices. Each of these sections finishes with a set of detailed recommendations.

4.1 Fund Revenue

The revenue sources of the State Fund are specified in the national legislation. According to the Law on Environmental Protection, these include:

- Pollution charges (for air emissions by stationary sources and motor vehicles, wastewater discharges into water bodies and solid waste disposal), which constitute the main revenue sources for the Fund;

- Fines and claims for damages caused by the violation of environmental legislation during business and other activities; and

- Earmarked and voluntary contributions provided by companies, institutions, organisations and private citizens.

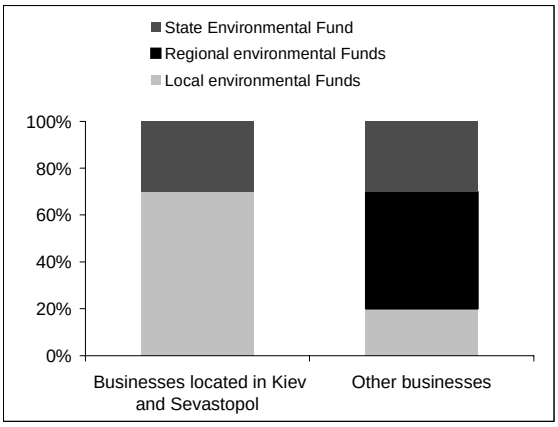
The State Fund only receives revenue from pollution charges while local and regional environmental Funds also benefit from revenue from pollution fines. So far, the Fund has not received any voluntary contributions.

The procedure for generating State Fund resources, their distribution and control of their use for targeted purposes is established by the Statute of the State Fund, which was approved by Cabinet of Ministers Resolution No. 634 of 7 May 1998[9] and Cabinet of Ministers Resolution No. 181 of 15 February 2002. This legislation stipulates that pollution charges should be split between local (village, settlement, town) Funds, oblast (regional level) Funds, the Autonomous Republic of Crimea Fund and the State Fund as follows:

Regarding pollution charges paid by businesses located in Kiev and Sebastopol: Oblasts (regional) and the State Fund receive respectively 70% and 30% of the revenue. Regarding pollution charges paid by other businesses: local, regional (Oblast) and the State Fund get respectively 20%, 50% and 30% of the revenue (see Chart 1).

[9] Most recently amended on 7 April 2006 through CoM Resolution No. 462, which was after the review mission.

Chart 1. Distribution of Revenue from Pollution Charges between Different Levels



From 2006 onwards, 65% of the total revenue from pollution charges will be allocated to the State Fund which, as a consequence, will see its revenue increase significantly.

4.1.1 Pollution Charge Base and Rates

Pollution charge rates are proposed by the MEP and established by the Cabinet of Ministers after reaching agreement with the Ministry of Finance and the Ministry of Economy. Pollution charges are defined by the Cabinet of Ministers Resolution No. 303 of 1 March 1999 (Approval of the Procedure for Setting and Collecting Pollution Charges). Pollution charges are collected for:

- Emissions of pollutants into ambient air from stationary and mobile sources of pollution;
- Discharges of pollutants directly into water bodies; and
- Disposal of waste.

Pollution charges for emissions by stationary sources, for wastewater discharges and for waste disposal are determined by the type of pollutants and the hazard class of waste. The charge for emissions by mobile sources of pollution is based on the actual volume of fuel used and its type: the rate is expressed in UAH per tonne.

Pollution charges are closely linked to the system of pollution permits. Basic rates are set for 25 air pollutants and 9 mandatory water pollutants, for both within and above permissible levels. Pollution charges on waste are differentiated according to their toxicity, and are grouped in 4 categories. In addition, other pollution charges can be imposed by local governments upon proposal by territorial branches of the MEP. Charges for pollution above the level fixed by permits are 5 times higher than the rate for pollution within permit limits. Charges for pollution within limits are considered “production costs” for companies, while charges for pollution above permissible limits are not considered production costs and are paid out of company profits.

Charges for pollution by stationary sources of pollution, wastewater discharges and waste disposal are calculated by those who pay the charge based on the limits set in pollution permits (for wastewater discharges and waste disposal) and on actual pollution volumes for air emissions, wastewater discharges and waste disposal. Charges for pollution by mobile sources of pollution are calculated by those who pay the charge based on actual amounts of fuel used as well as the type of fuel.

Pollution charges are paid quarterly up to the 20th of the first month after the reporting quarter. Final payment of the charges for the reporting year is made within a 10-day period after submission of the annual reports with statistics on the amounts of air emissions, wastewater discharges, waste disposed and fuel used by physical persons and legal entities.

Charge reporting to the State Tax Inspection is done at the place of registration once per quarter within 40 days after the reporting period. The last charge calculation for the year is submitted within 40 days after the last calendar day of the fiscal year.

Before 1999, pollution charges were collected by local MEP bodies. After this responsibility was transferred to the tax authorities, the State Tax Inspection has imposed stricter control on the timeliness and completeness of collecting pollution charges.

The State Tax Inspection has an agreement with MEP territorial bodies to check the accuracy of pollution volumes by sources of pollution. The MEP territorial bodies provide the State Tax Inspection with a list of businesses, establishments, organisations, citizens, private entrepreneurs which, according to established procedure, have been given pollution permits, permits for special water use rights and waste disposal sites.

All of the Fund's revenue is received and transacted in cash and there are no non-monetary transactions. Revenue is recorded in State Treasury accounts before proceeds are allocated to environmental expenditure programmes.

4.1.2 Historical Trends

The State Fund's revenue has significantly increased between 2000 (UAH 37.4 million) and 2004 (UAH 96 million) (see Table 4). The new collection system for pollution charges set up in 1999 has led to a significant improvement in the collection rate of pollution charges, rising from 36% in 2000 to 87% in 2004.

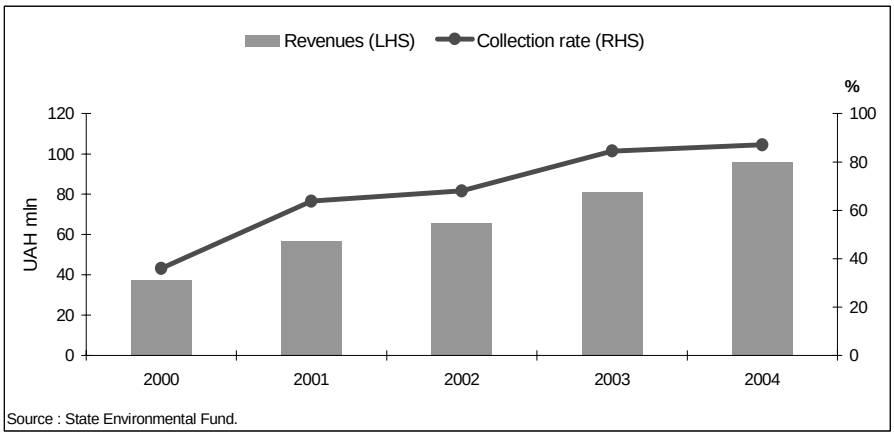
Table 4. Collection Rate for Pollution Charges

	1998	1999	2000	2001	2002	2003	2004
Revenue (UAH mln)	6.9	10.9	37.4	56.6	65.9	81.0	95.9
Collection rate (%)	n.a.	n.a	35.9	63.7	68.0	84.5	87.0

Source: Source: State Environmental Fund.

Leaving aside the effects of inflation (based on current prices), another structural factor that has led to the increase in collection efficiency is the indexation of pollution charges. Periodically, taking inflation into consideration, the rate of the charge is indeed indexed: in 2006, the charge rate was indexed at 2.373. Already at the end of the 1990s, this indexation was recommended by the World Bank as one of the conditions for extending an adjustment loan (subject to different changes made in some sectors). This progression (Chart 2) has been very rapid, at a compound annual growth rate of 27% per year. Indexation and the involvement of the State Tax Inspection have supported revenue growth. It should also be noted that relevant changes were made to tax legislation in 2003, which further enhanced the collection rate of pollution charges.

Chart 2. Progression of Revenue Collected from Pollution Charges



According to Article 50 of the Budget Code of Ukraine, the Ministry of Finance is responsible for making a prognosis for and analysis of budget revenue. Reviewing the available information and taking into consideration MEP proposals, the Ministry of Finance provides a prognosis for revenue obtained from pollution charges that will be allocated to environmental Funds and broken down by administrative-territorial units of Ukraine.

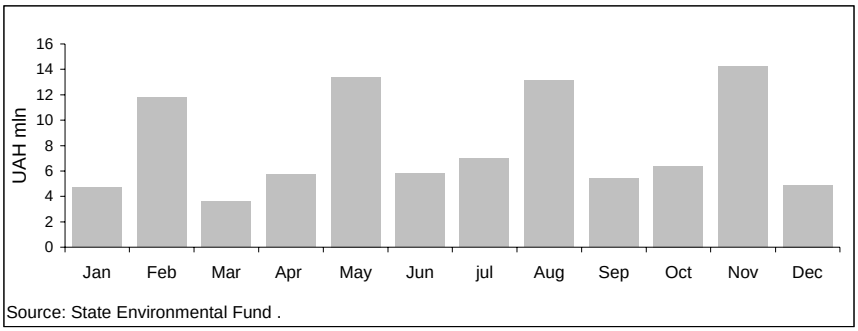
In 2003, the regional distribution of revenue from pollution charges was as follows: the largest payments made to the State Fund came from oblasts of Ukraine with developed heavy industry – Donetsk (26%), Dnepropetrovsk (18%), Lugansk (9%), Zaporozhie (8%), and Kharkiv (5%). The share of these oblasts was some 67% of total revenue from pollution charges. Payments to the State Fund from pollution charge revenue collected in eleven other oblasts represented less than 1% of the revenue total, and the Volyn and Chernovtsy oblasts provided the least revenue (0.4% each).

Analysis

Revenue sources that are allocated to the State Fund are legally considered to be public funds. Pollution charges remain the main and basically only revenue source of the State Fund. The revenue of the Fund has been steadily growing over the past years. The reforms in the collection process (tax inspection involvement, indexation for inflation) have had a very positive effect on the levels of resources available to the Fund. Its revenue doubled in 2004 compared to 2000, when the system became operational. Fund revenue continued to grow rapidly in 2005 and is likely to further increase in 2006 due to a change in the distribution of pollution charge revenues between local, regional and national levels. The State Fund is bound to receive 65% of the expected revenue from pollution charges, amounting to some UAH 500 million in 2006.

Chart 3 below illustrates the seasonality of the cash inflows with a peak of revenue every three months. This is supposed to guarantee regular revenue inflows to the State Fund so that it can start funding programmes relatively early in the year. Some observers consider these data unrealistic and argue that the State Treasury has traditionally delayed the transfer of earmarked pollution charges to the Fund until the end of the year. It is difficult to assess if this has really been the case and if it has limited the Fund's activities. The inability of the State Fund to select projects early on in the year seems to be a more relevant reason for understanding why it has resources left over.

Chart 3. State Fund Monthly Inflows – 2004



Source: State Environmental Fund .

Pollution Charge Base and Rate

The stability and predictability of revenue flows are crucial for the Fund's planning. The revenue flows are very much determined by the way the charge base and rate are set. The revenue base of the Fund is narrow, as pollution charges are its single most important revenue source. The possibility of broadening the revenue base of the Fund appears to be limited. Some other environmental taxes, such as the tax on natural resources, are a possibility. If these taxes were earmarked to be managed by the State Fund, the Fund would be compelled to finance related activities, such as reforestation or reclamation of land degraded by mining activities. A careful assessment of expected revenues and required expenditure could help determine if it would be worthwhile for the Fund to receive this revenue and at the same time be obliged to finance such expenditure. In reality, however, this tax is already allocated to the state general budget and reversal of the situation is very unlikely unless there is strong political support for it.

There are also some product charges (e.g. on imported containers and packaging) that, in some CEE countries, provide a significant source of revenue for their national environmental Funds. In EECCA, Moldova and Armenia have successfully introduced such product charges. In Armenia, these charges, which were designed for raising revenue and not as incentive instruments, cover 22 product categories (as of beginning 2000), but the exact list of product categories subject to the charges and their rates have varied. While in Armenia revenue from these charges goes directly to the state budget, in Moldova the levy on air pollution emissions released by mobile sources using leaded and unleaded gasoline and diesel fuel has been earmarked to and managed by the Moldovan National Environmental Fund. Since its introduction, this levy has been the single most significant revenue source of the Moldovan Fund (more than 90% at the beginning of 2000). In Ukraine, the revenue from these charges is already managed by a specialised state enterprise and it would be difficult for the Fund to compete for these resources.

On the other hand, judging by the number of pollutants that are subject to charges, the revenue base of the Ukrainian State Fund seems somewhat broad. Although mandatory pollution charges have been significantly limited, the number of currently existing pollution charges is still very high. Environmental inspectors do not have enough resources to effectively control self-monitoring by so many polluters. The lack of reliable data from the Tax Inspectorate on individual charges does not allow for a proper assessment of their performance. However, it is common knowledge that in Ukraine, as in other EECCA countries, usually only a small number of major pollutants account for a large share of revenue from pollution charges. This revenue must cross-subsidise the collection of all other charges for which the cost of collection is higher than the amount of revenue these charges generate. Thus, the system imposes a heavy burden on both polluters and authorities. Most OECD countries have designed pollution charges for only 2-3 of the most important pollutants. The majority of OECD countries, however, have an extensive system of product charges, which are easier to monitor and administratively less costly to collect.

In addition, the rate set for pollution charges in Ukraine, although relatively high in comparison with other EECCA, is still below the rate in OECD countries. For comparison, while the rate of pollution charges for a tonne of NO_x and SO_2 is about Euro 30 in Ukraine, it is about Euro 100 in neighbouring Poland, Euro 31.36 in the Czech Republic, Euro 19.39 in Latvia, and Euro 138.73 in Lithuania. Moreover, the BOD_5 rate in Lithuania is set at Euro 206.79/tonne, and in Poland at Euro 810/tonne, versus about Euro 8/tonne in Ukraine. In particular, when comparing the Ukrainian rates to the high marginal costs of pollution abatement technologies available on the market, it is difficult to see what incentive the pollution charges could provide to polluters to make costly investments and reduce pollution. Thus, pollution charges in Ukraine are mostly instruments for raising revenue and, as such, do not differ fundamentally from other taxes of the state.

Taxation System

The current taxation system in Ukraine has weaknesses as well. Some observers, such as the World Bank and the Accounting Chamber, have already identified some of these.

First, it seems that some businesses avoid paying pollution charges. The World Bank describes this situation in its 2003(a) report. It points out that the (present) system seems to depend heavily on lobbying for exemptions by the largest companies. Many of the heavy industry firms, which are still owned by the state, do not make profits. However, as they are considered strategic for the Ukrainian economy, they are subsidised and allowed not to pay taxes or to pay them through barter. Since 2003, not much has changed in this system. Even now, mining companies enjoy preferential treatment when paying pollution charges for waste disposal of non-toxic waste.

One major criticism made by the Accounting Chamber is that the central administration does not try to increase revenue from pollution charges by extending the list of entities subject to these charges. Local branches of the MEP are in charge – together with the state tax and statistical authorities – of maintaining information on economic actors that pollute the environment and are therefore liable to paying pollution charges. In 2004, according to the Accounting Chamber, none of the territorial MEP branch offices had produced such a list, therefore making control difficult. These local branches gather information essentially on polluters that have been granted permits for polluting (emission and discharges of fixed sources and waste disposal), and so have information only on polluters that have voluntarily applied for relevant permits: permits for air emissions and special water use are indeed only issued upon request from polluters.

Statistical authorities also gather information on polluting entities, but this does not include information on those operating “mobile pollution sources”. Owners of private cars do not pay charges for air emissions, although cars are becoming a major source of pollution in Ukraine. Air pollution charges are only imposed on company car fleets, which is information that companies report independently to the tax authorities. According to the Accounting Chamber, neither the MEP, the State Tax Inspection, nor state statistical bodies have complete and reliable information on the precise number of economic actors that operate mobile pollution sources**.** This lack of an integrated approach to the registration of polluters allows for evasion of environmental charges. A product charge on the sale of motor fuel paid by all users would be a more effective option in this case.

Revenue Structure

In addition, pollution charges are collected at the place of registration of the company, which may be different from its actual location of operation, making control even more difficult. Charge rates for pollution within permissible levels (and most companies try to stay within these limits) are calculated as normal production costs by companies, and are passed on to the final consumer, without significantly affecting the company’s behaviour.

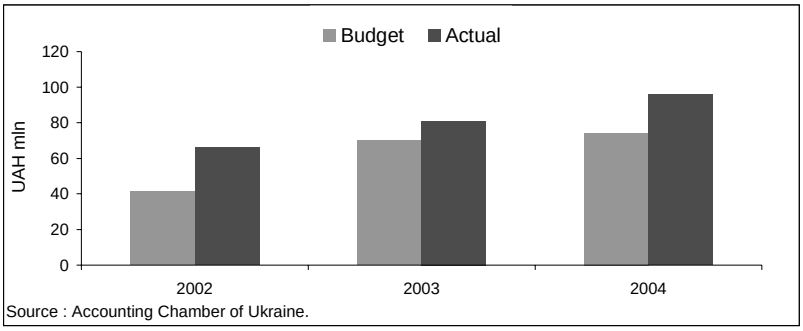
In addition to the weakness of the taxation system, the State Fund has no possibility to adjust its sources of revenue depending on its expenditure needs. For each modification in the distribution of

revenue between the different levels, a new law needs to be voted. This means that the resources of the Fund cannot be modified without the approval of the national Parliament. This brings some security and stability to the Fund since a simple decree or a CoM resolution is not sufficient to change its revenue sources. At the same time, this can introduce a certain level of rigidity into the system and make it difficult to reform, if that should become necessary.

Significant amendments to the revenue structure of the State Fund should not be made too often since they may require an adaptation of its organisation: this year, the Fund is likely to have to finance larger or more projects due to its additional revenue from pollution charges, and this may require new human resources. Moreover, some stability, or at least some possibility to receive better revenue estimates from the tax authorities, would enable the Fund to develop multi-year financial plans, which are necessary for supporting significant projects.

The lack of reliable revenue projections has negatively affected the predictability of revenue from pollution charges. Over the past few years, actual revenue has regularly outperformed expectations. Given the difficulty of the State Fund to anticipate these evolutions, there have been significant left-over funds at the end of the year. In 2002, Fund revenue reached UAH 65.9 million (i.e. 159% of the planned revenue), while in 2003, it was UAH 81 million (116% of the planned revenue), and in 2004, UAH 96 million (129% of the budgeted revenue).

Chart 4. Actual versus Budgeted Revenue from Pollution Charges



Source : Accounting Chamber of Ukraine.

Better predictability of revenue is a key element in an efficient budgetary process. This necessity is reinforced in the case of the State Fund because it disburses in year N the resources it has received the same year. If the Fund received money in year N to spend in year N+1, then precise revenue forecasts would be much less of an issue. For the time being, it appears that revenue planning tools are almost non existent. This has been confirmed by the Accounting Chamber in its report for 2003-2004.

As a consequence, the risk of recording actual revenue diverging from budget figures is strong. In case of revenue performance that is better than expected, it does challenge the Fund's ability to finance projects and leads to unspent amounts that could be used the year after. If the Fund records revenue lower than anticipated, this would require a downward adjustment of its expenditure, which could be harmful if projects are already launched. Indeed, there is no guarantee from the State Tax Inspection that the estimated amount of revenue used to build the budget will be actually collected. The Fund merely gets what is actually collected, with no compensation mechanism in place. This means that the Fund bears a revenue performance risk. This risk can be mitigated by maintaining a buffer of unused resources in its budget to compensate for any possible revenue shortfalls.

Earmarking of Revenue

According to the Accounting Chamber, revenue fluctuations do not facilitate the efficient use of revenue and would be the major reason behind the accumulation of unspent funds.

Table 5. Available Funds at the Beginning of the Year – mln UAH

01/01	2002	2003	2004
According to the State Fund	6.1	21.2	34.0
According to the Accounting Chamber of Ukraine	-	28.5	34.3

As shown in Table 5 above, there are some discrepancies between the Fund's data and those published by the Accounting Chamber in its report for 2003-2004. Beyond these differences in the figures, it appears that the leftover resources at the end of the year are significant, illustrating a lack of efficiency. Indeed, the Fund should not receive an earmarked tax resource to create too large unused reserves in a context of insufficient resources for environmental protection measures.

The earmarked character of the Fund by law is designed to ensure that some funding is available for environmental protection policies and that it is not used for other purposes. This is a case where international good practices accept earmarking as a temporary measure. Earmarking has allowed the Fund to accumulate growing resources and to finance projects without having to negotiate resources every year within the state budgeting process.

However, over the past few years, it appears that the earmarked character of the pollution charges has not been strictly respected as some Ministries have been allowed to use this money for other programmes. In 2005, only half of the funds from pollution charges were allocated to environmental protection projects. According to MEP officials responsible for State Fund management, the main reasons for this were (i) the unexpected additional revenue, which was indeed much higher than projected, and (ii) political events, which prevented the Fund from functioning correctly. Bypassing mandatory earmarking is not efficient in terms of revenue allocation since this further dissipates available funds for environmental purposes that, in any case, are significantly insufficient in Ukraine.

Conclusions and Recommendations

Since responsibilities for collecting the revenue from pollution charges have been transferred to the State Tax Inspection, the revenue of the Fund has drastically increased. This has brought new challenges for the Fund. The increased level of resources has also attracted the vested interests of different stakeholders. In addition, loopholes in the taxation system, coupled with flaws in the design of pollution charges, undermine the credibility of pollution charges as a tool of environmental policy. Therefore, it is proposed that the MEP should:

- Favour revenue stability, i.e. limit as much as possible changes in the share of environmental pollution charges allocated to the State Environmental Protection Fund.
- Improve forecasting tools to increase visibility of revenue and minimise revenue leftovers at the end of the budget year.
- Ensure the strict respect of earmarking, i.e. that higher than projected revenue will not be used for purposes other that those stipulated by law.
- Increase transparency of the definition of the tax base and of tax exemptions that are granted.
- Fight preferential treatment and tax evasion by reinforcing control of the level of pollution declared by polluters.
- Limit the number of revenue-raising pollution charges to fewer than 10 on the basis of a detailed analysis of the performance of these charges. Replace charges on air pollution from mobile sources by a product charge on fuels.

- Consider introducing charges on environmentally-damaging products (e.g. tires, used batteries, etc), which could ensure a stable revenue stream for the Fund. Consider this option in the face of reducing a number of non-performing pollution charges. Introducing a new environmental charge/tax should always be justified on environmental grounds by linking it to polluting inputs.

4.2 Fund Expenditure

This section focuses on several main issues, including: programming/planning, beneficiaries of the Fund, disbursement mechanisms employed by the Fund, issues related to procurement and expenditure trends.

4.2.1 Programming / Planning

The planning of Fund expenditures is done on an annual basis. This process is closely linked with the preparation of the state budget. In 2006, Fund expenditures were split among 8 budget programmes. The budget programmes were prepared according to the requirements laid down in Order No. 189 on Planning and Financing of Environmental Protection Measures from the State Fund, approved by the MEP on 21 May 2002 and registered by the Ministry of Justice on 6 June 2006 under No. 482/6770.

According to the legislation, each government agency responsible for managing budget programmes should prepare programme passports. The development of these passports is a responsibility of the structural departments of the MEP. The 2006 budget programmes financed from the State Fund include:

- Monitoring the state of environment and enforcement of, and compliance with, environmental legislation;
- Wastewater treatment;
- International cooperation in the area of environmental protection, sustainable development, environmental education and dissemination of environmental information;
- Waste disposal and handling of hazardous substances;
- Creating of a national environmental network;
- Improvement of air quality;
- Financial support for environmental activities (including through interest rate subsidies); and
- Preservation of biodiversity in the Azov-Black Sea corridor.

Analysis

Overall, the system of expenditure planning appears inadequate. It lacks precise costing of the resources needed to implement the programmes. In turn, programmes lack clearly set quantitative and qualitative indicators of planned activities (although this is the intention behind budget passports). Indeed, financing assessment remains rather formal and, in many cases, the actual implementation of projects results in much higher costs than estimated. In addition, this results from a lack of capacity of MEP staff to assess total costs properly. All this is also related to a lack of requirements for the submission of detailed supporting documents and precise financial estimates of projects costs. At the

same time, the MEP does not envisage allocating/hiring qualified staff to work specifically on project proposal documentation, including the assessment of project costs. As a result, costs are too broadly assessed when projects are selected. In addition, good practices require that programmes be defined in terms of:

- eligible beneficiaries and projects;
- eligible project costs (which are much narrower than total project costs);
- co-financing requirements;
- rates of support from the State Fund for different types of projects;
- clearly identified and robust criteria for appraisal, selection and financing of projects.

Such conditionalities could help shield the Fund from being used for non-environmental or marginally environmental purposes by executive decisions. Currently, most of these crucial programmatic elements are missing in the programme definitions contained in the passports.

Another major weakness of the Fund, related to the above, is its poor ability to disburse its resources. This is mostly a consequence of the decision-making process, which is not well adapted to the budget rules. Indeed, the Ministry of Environmental Protection is not able to select projects sufficiently early in the year: as a result, money transferred to the local level is in many cases not spent before the end of December and has to be returned to the State Fund.

According to the Accounting Chamber report, the distribution of available resources under the different budget programmes to beneficiaries is not always appropriate. For instance, out of 30 activities that were registered in 2003-2004 under the programme “prevention and reduction of environmental pollution”, 11 were related to the “management of waste and hazardous chemicals”, although there is a specific programme on the “management of waste and hazardous chemicals”, which supposedly should have financed these projects. Thus, the fact that projects can be funded through different budget programmes introduces additional confusion in the budget process.

Also, the annual nature of the expenditure of the State Fund can be seen as a significant constraint to the implementation of environmental investment projects, as many of these projects require stable fanancing over several years. Both MEP staff and beneficiaries devote a lot of time to handling applications for year to year financing for the same projects, with no guarantee that they will obtain support. In addition, this short perspective of the financing cycle does not allow for proper appraisal of projects, as costs are considered on a yearly basis and benefits are often not considered at all (for more infornmation, see Section 4.4 on Project Cycle Managenment). It is thus not at all certain that the most cost-effective projects will be supported with resources from the State Fund.

4.2.2 Beneficiaries

Potential beneficiaries of the State Fund are legal entities, both private and public, applying for funding to implement environmental projects. Since 2002, private persons cannot be recipients of Fund support. In 2003, the Fund received 674 applications, out of which it financed 264 projects.

The distribution of expenditure between the State Fund and regional and local environmental Funds is as follows: the State Fund finances projects of national importance at 100%, but these projects are not further defined. State environmental programmes consider projects that encompass several oblasts as having “national significance”. The State Fund can also support local and regional projects, but these projects require co-financing by other sources, such as company resources, local budgets, and local environmental Funds. For instance, in 2003, wastewater treatment projects supported by the State Fund were mostly carried out by oblast administrations.

There is a disproportion between the revenues that the State Fund receives from different regions and its expenditure in these regions, thus reflecting a redistribution of financial means between regions. For example, the main source of Fund revenue has traditionally been air pollution charges, while most of the expenditure have been for water projects.

Analysis

In practice, the distribution of responsibilities between the State Fund and local and regional environmental Funds is not clear. Projects of "national importance" do not seem to be defined precisely, as under this distinction some applicants have been able to apply to different sources for funding to cover the same costs. Although co-financing for regional and local projects is required, co-financing limits and eligible costs are not specified anywhere in the legislation for the State Fund.

4.2.3 Disbursement Mechanisms

Theoretically and according to legislation, the State Fund can use two disbursement mechanisms: grants and interest rate subsidies. Until 2005, State Fund expenditure was disbursed in the form of grants only. Due to budget regulations and the corresponding legal limitations on the use of budget resources, the Fund was not allowed to make use of other financial instruments (such as loans). In 2005, a new instrument – interest-rate subsidy – was introduced.

However, in the case of the State Fund, the financing provided resembles direct purchases on behalf of the government, even for investment projects. In fact, beneficiaries do not receive any money from the Fund. Contracts are signed directly between the contractor, who carries out the work or provides the service, and the territorial branch of the MEP. The Fund – via the local branch of the State Treasury – makes a direct payment to the contractor. As a result, the asset that is produced or bought becomes and remains a property of the state. However, there are some mechanisms that allow the transfer of asset ownership to the beneficiary (business, local authority).

There are exceptions to this direct payment procedure: some organisations active in the field of scientific research may receive grants on their own accounts with the possibility of using them over several years. This mechanism is used due to the nature of the activities of these organisations, which require multi-year funding to implement research programmes.

In 2005, a new disbursement instrument was introduced. The Cabinet of Ministers approved a resolution that makes it possible for the Fund to subsidise credits extended by commercial banks for the implementation of environmental protection projects.[10] This mechanism allows the Fund to provide support to such projects by softening the interest rate on bank credits. Compensation for interest rates is calculated as follows:

- for short-term credits: 10% annually in national currency and 7% annually in foreign currency; and
- for long-term credits: 14% annually in national currency and 9% annually in foreign currency.

Short-term credits should reach maturity in less than one year, while long-term credits can go up to three years. Compensation can be provided on the condition that rates do not exceed 20% per year for short-term credits, and 21% for long-term credits in national currency.

[10] CoM Resolution No. 773 of 18 August 2005 on the Approval of the Procedures for the Use of State Budgetary Resources for the Reduction of the Cost of Commercial Credits for Environmental Protection Activities.

Analysis

In practice, the State Fund has used only grants so far. Yet, even the grants the Fund provides to finance investment projects are difficult to qualify as "grants" according to the internationally understood meaning of the word. The Fund's actions are actually direct purchases of goods and services on behalf of the government, rather than selecting projects for financing. It is the territorial MEP branches that purchase goods and services according to public procurement procedures and transfer them to beneficiaries (state or local administration, businesses).

The level of complexity of the Fund's operations and the choice of financial products are proportional to its institutional capacity to manage the associated risks. For the time being, grants also correspond to the needs of beneficiaries whose capacity to invest and raise debt is limited.

Grants are the simplest and most transparent instrument for transferring subsidies. If properly implemented, they allow Fund staff to accumulate experience with financial management, contracting, appraisal and implementation monitoring. On the other hand, grants leverage small amounts from other financing sources, particularly when co-financing is not required. Although the Fund has exclusively used grants, given the nature of the grants, the managers of Fund programmes have had very little chance to actually develop new skills in such areas as appraisal and monitoring of project implementation. Therefore, fundamental organisational and management reforms, as well as capacity-building, will be needed before the Fund can operate competitive grants (let alone loans) in a manner that is in line with good international practices.

The new instrument – the interest rate subsidy – has just been introduced and the State Fund has no experience with it yet. It is a commendable step, though. In principle, the interest rate subsidy is a special form of a direct grant. The interest rate subsidy is used to reduce the effective interest rate on a credit. The crucial difference between an interest rate subsidy and a grant is obvious: the grant can be made independently, or even in the absence of additional financing. On the contrary, the interest rate subsidy is provided only after the project has already met financial and creditworthiness criteria leading to a lender's willingness to invest in it. One particular issue related to the interest rate subsidy is that this subsidy may have an impact on interest rates offered by lenders. Knowing that the applicant can secure an interest rate subsidy from the State Fund, the bank may want to increase the interest rate on the credit, thus increasing its profit. It is therefore important that the MEP carefully study the financial market and select the banks with which it will be working on a competitive basis.

At this stage, the State Fund should avoid other more sophisticated instruments, such as loans or loan guarantees (as suggested by the Draft Law on the National Environmental Fund). These require special skills in managing risks and assessing the creditworthiness of potential borrowers, which are skills that are currently not available at the MEP. Developing such skills in-house will take quite some time. Alternatively, hiring highly qualified people to work in-house, or hiring a bank (to do a creditworthiness analysis) for a fee, will mean significant additional costs.

There is formally no difficulty in planning and incurring expenditure on a multi-year scale. In practice, the rigidity of the yearly budgeting principle puts a limitation on the financing and implementation of multi-year projects. All unspent funds at local level must be returned to the State Fund at the end of the year, even if the project is not completed. Officially, an uncompleted project should receive financing again for the year after. In practice, the high number of non-completed projects proves that this is not the case.

Disbursing funds in this way constitutes a limitation on the implementation of multi-year financing and projects. A solution that is used for some scientific bodies could be extended to other projects that require funding over several years. The State Fund could indeed directly transfer money to a beneficiary, with the obligation that these funds be spent on a specific project, but within a timeframe that is longer than one year. They could be placed in a special account controlled by the

State Fund. In cases where the beneficiary does not meet deadlines or other contractual obligations agreed with the Fund, the account could be blocked.

4.2.4 Procurement

The main procurement procedure used by the State Fund is advertised bidding. Advertising is done according to the Law on Procurement of Goods, Works and Services for Public Funds (adopted in its present form in 2000 and most recently amended on 14 December 2005) and through the Public Procurement Bulletin or other Ukrainian mass media, as well as through relevant international publications. The Law on Procurement covers entities within state and local governments, public enterprises, and private enterprises in which the public share is 50%. The Law on Procurement does not apply to contracts concerning the supply of water and energy and wastewater treatment and maintenance, but it does apply to the waste management sector (Article 3).

An announcement or invitation to bidding has to be published 45 days before bidding. This period may be shortened to 15 days if reasons for the change are given in the bidding results report. Proposals submitted by participants can be rejected at any stage of the bidding procedure if participants provide inadequate information or do not meet declared qualifying requirements. Notification of approved proposals is to be sent to the successful bidder 5 days after approval, and the procurement contract is to be signed within 14 working days.

For procurement of goods, works, and services, a permanent tender committee has been established at MEP headquarters.

Analysis

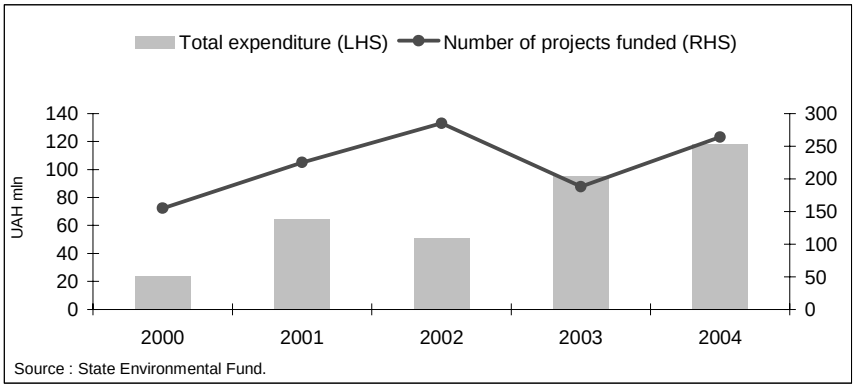
In contrast to international best practices, the MEP and its territorial branches organise tenders and select contractors themselves. As has been pointed out several times in this report already, public procurement is not a function of financing mechanisms, private or public. Banks and investment funds, for example, do not do tendering for their clients, they select and finance projects. It would be more efficient to have the State Fund concentrate on project cycle management and project financing, rather than have it involved in direct procurement of equipment and construction services on behalf of the government. These tasks should indeed be carried out by beneficiaries or, as appropriate, left to regular government departments.

In addition, as has been confirmed by the Accounting Chamber, the inefficient use of public funds is in some cases associated with inadequately designed contracts between MEP departments at oblast level and companies. Some contracts are not accompanied by plans for the use of budgetary funds, lists of materials and works to be purchased and completed or terms of completion that could specify the purpose of the budgetary allocations.

4.2.5 Disbursement Trends

The number of projects implemented with financial support from the State Fund has progressed rapidly between 1999 and 2004, in line with rapid growth in revenue. The number of projects carried out in 2005, however, was not available.

Chart 5. Expenditure Growth and Number of Projects Supported by the State Fund

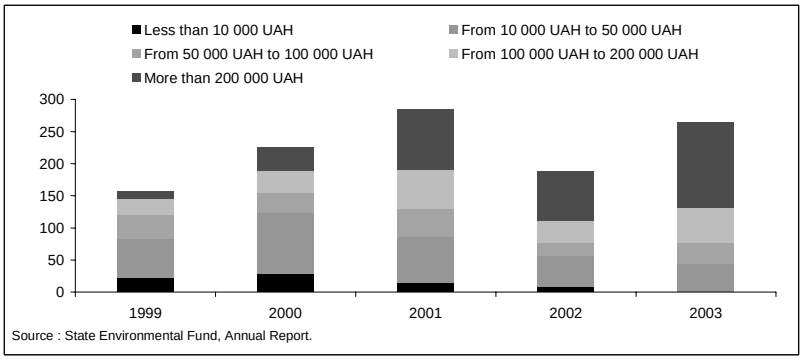


The decline in expenditure in 2002 is not explained but was visible both in terms of expenditure levels and the number of projects supported. Over the past few years, the State Fund has reported two major expenditure trends, as indicated in Charts 6 and 7 below:

A. Progressive increase in the average budget of supported projects

In 1999, small projects with a budget under UAH 50 000 represented more than half of the applications funded, and 78% of the applications had total project costs of below UAH 100 000. At that time, significant projects, whose costs exceeded UAH 200 000, were marginal, accounting for merely 7% of all applications. This situation has progressively changed over the past few years. In 2003, the share of projects with total costs above UAH 50 000 dropped to 17%, while 50% of the projects supported by the State Fund reported costs exceeding UAH 200 000 (See Chart 6).

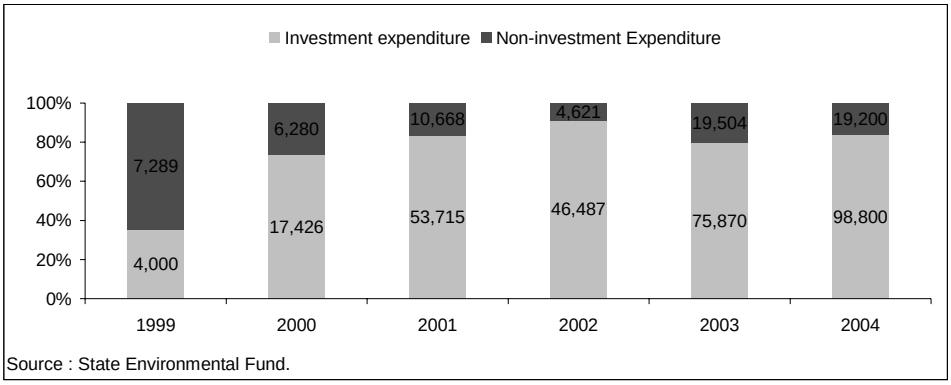
Chart 6. Breakdown of Projects by Budget Size



This growth in the total cost of projects financed by the State Fund can in part be explained by the automatic impact of inflation, but may also result from a change in the breakdown of expenditure.

B. Growth of the share of support for investment expenditure in the total expenditure of the State Fund

Chart 7. Expenditure Breakdown by Investment and Non-Investment Expenditure



Source : State Environmental Fund.

Over the same period, a parallel rise of investment expenditure can be observed. Investment expenditure accounted for 84% of total expenditure in 2004 compared to 35% in 1999. It can be assumed that investment expenditure was used to pay for construction projects or purchase of costly equipment, thus leading to an automatic increase in the total cost of projects.

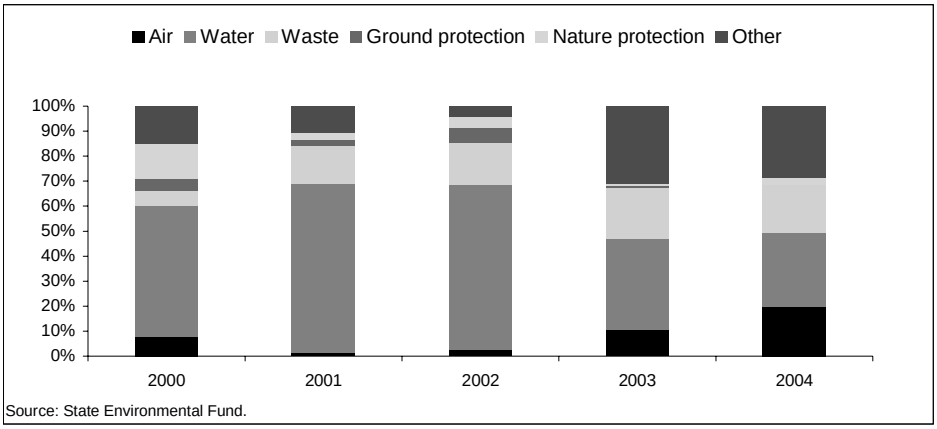
Table 6. Comparison between Investment and Non-Investment Expenditure

UAH mln	1999	2000	2001	2002	2003	2004
Investment expenditure	4.0	17.4	53.7	46.5	75.9	98.8
Non-investment expenditure	7.3	6.3	10.7	4.6	19.5	19.2
Total expenditure	11.3	23.7	64.4	51.1	95.4	118.0

Source: State Environmental Fund.

Water projects continue to constitute the largest part of the State Fund's portfolio. However, their share has significantly decreased since 2002, when they accounted for 66% of total expenditure, to reach 30% in 2004. Inversely, air protection projects – traditionally marginal in the total – have grown rapidly since 2002 to reach UAH 23 million in 2004, i.e. 20% of the total expenditure of the Fund. In 2004, the State Fund reported an expenditure breakdown for sectors it supported that was much more balanced than in 2000.

Chart 8. Expenditure Breakdown by Sector



Source: State Environmental Fund.

Table 7. Expenditure Breakdown by Sector

UAH mln	2000		2001		2002		2003		2004	
Air	1.8	*8%*	1	*2%*	1.3	*3%*	10.3	*11%*	23.2	*20%*
Water	12.5	*53%*	43.3	*67%*	33.7	*66%*	34.4	*36%*	35.1	*30%*
Waste	1.4	*6%*	9.9	*15%*	8.7	*17%*	19.5	*20%*	22.4	*19%*
Soil protection	1.1	*5%*	1.5	*2%*	3.1	*6%*	0.8	*1%*	0.5	*0%*
Nature protection	3.3	*14%*	1.8	*3%*	2.3	*4%*	1	*1%*	3.3	*3%*
Other	3.6	*15%*	6.8	*11%*	2.1	*4%*	29.5	*31%*	33.5	*28%*
Total	**23.7**	**100%**	**64.3**	**100%**	**51.2**	**100%**	**95.5**	**100%**	**118**	**100%**

Source: State Environmental Fund.

Analysis

The State Fund has reported some positive expenditure trends since 2000 with regard to international best practices. The growth of the individual size of projects and the strong progression of investment expenditure in the total may have favoured the implementation of more efficient environmental protection measures. Moreover, the Fund now reports a more balanced expenditure breakdown by sector, which mitigates the traditional criticism of the "non-link between revenue and expenditure" made of the Fund. Indeed, the Fund has often been reproached in the past for not supporting projects in the sector where most of its revenue comes from, that is, air pollution charges have been providing most of the Fund's revenue, while its expenditure has been focused on supporting water projects.

However, despite these positive developments, the Fund still has serious weaknesses in the practical implementation of projects. A major problem facing the Fund is its inability to complete projects that have obtained its support. For instance, the Accounting Chamber reports that in 2003 the Fund provided support to 7 investment projects for the reconstruction and purchase of pollution abatement equipment of which only 1 project was actually completed. The Fund therefore accumulates projects that remain only partially funded and for which the funding in year N+1 is not guaranteed. To get additional funding, these projects have to go through the selection process again. There are many cases where the funding necessary to complete a project is not made available the year after (this was the case, for example, with some wastewater treatment plants). The impossibility to commit funds in a multi-year framework introduces a lot of uncertainty for project owners as additional funding has to be requested each year. And this costs time and money to both applicants and project owners. In addition, this limits the creditworthiness of project owners and the leverage capacity of the Fund.

Conclusions and Recommendations

Overall, programming and planning of the Fund's resources do not meet good international practices. Crucial programmatic elements are missing. On the other hand, the disbursement mechanisms available to the Fund are clearly specified in legislation and seem appropriate with regard to the Fund's capacity to manage them. Grants provided by the Fund, however, resemble mostly direct purchases on behalf of the government. This practice does not allow Fund managers to develop skills in proper project cycle management.

Expenditure of the Fund has been steadily growing in line with growth of revenue, and more and more investment projects are being supported. However, this does not prevent the Fund from having difficulties with disbursing its resources.

Therefore, it is suggested that the MEP should:

- Define the programmes of the Fund in line with good international practices, in terms of eligible projects and beneficiaries (municipalities, industries, NGOs), eligible project costs, and clearly identified and robust criteria for appraisal, selection and financing of projects.

- Shorten the decision-making process: reduce the number of stakeholders taking part in the process and give the final "real" decision-making authority to the Minister of Environment.

- Clarify the concept of "a project of national importance" to be supported by the State Fund.

- Establish co-financing rates for different classes of projects and set maximum/minimum thresholds (in terms of project financial size) for projects to be supported by the Fund.

- Phase out direct procurement and introduce real direct grants.

- Give beneficiaries or projects that require multi-year perspective financing the possibility to receive funds in their own accounts that they can spend over several years (as is the case for some NGOs involved in scientific research). Or, better yet, ensure multi-year financing for priority projects.

- Increase the transparency and consistency of revenue and expenditure data. Prepare a database of individual projects and report expenditure by sector, type of beneficiary, and project type.

4.3 Fiscal Prudence

Fiscal prudence implies meeting requirements imposed by law in the preparation and execution of the budget. Fiscal prudence is defined in terms of integrity of the revenue (all budget revenue is collected in cash and channelled through a state treasury single account), fiscal discipline, transparency and accountability. This section discusses issues related to accounting standards and policies applied by the State Fund as well as liquidity and long-term debt management practices. These are important elements ensuring fiscal prudence and better control over the proper execution of the budget programmes financed by the Fund.

4.3.1 Accounting Policies and Standards

4.3.1.1 Budget Code

The State Environmental Protection Fund is defined as a special Fund by the State Budget Code (Article 13). It is therefore part of the state budget, which is divided into general and special funds. The Fund's budgetary structure is very basic. It functions practically as a special account at the State Treasury, where all the financial resources generated by pollution charges are kept and from which payments are made through a payment order of the MEP. The Fund's budgetary structure functions as follows:

- On the revenue side, it reports a single revenue item, consisting of revenue generated by pollution charges.

- On the expenditure side, budgetary items are classified by functions. In 2006, the State Fund is subdivided into 8 budget programmes. According to Article 2 of the Budget Code, a budget programme is defined as "a systematised list of activities aimed at achieving a

common goal and tasks, whose implementation is proposed and fulfilled by a spending unit in accordance with its responsibilities".

Each of these programmes is vested with a specific amount of resources to be used for specific expenditures. The amount of expenditures is both an authorisation and a ceiling on the resources to be spent for these activities during the year.

According to Article 13.7 of the Budget Code, expenditure of a special fund must correspond to the resources that the relevant special fund receives for a respective purpose.

The Fund does not report any other type of expenditure (staff, goods and services). In its annual report, however, it does provide a simple breakdown of its expenditure, which is separated into current and capital items.

According to the Budget Code, the Cabinet of Ministers must prepare a draft Law on the State Budget containing the budget of the general fund (or general budget) and special funds, such as the State Environmental Protection Fund.

Resources can be reallocated between the different budget programmes of the State Fund budget, but this is very rare and requires a new vote by Parliament.

The end of the fiscal year is fixed at 27 December of year N. By this date, the Fund must stop disbursing money. On 4 January of year N+1, the Ministry of Finance controls budget implementation of each Ministry, including the management of the State Fund's resources by the MEP.

4.3.1.2 Accounting Standards

The Fund follows cash flow based accounting standards. However, it does not produce income and cash flow statements in accordance with international standards, does not report balance sheets and has no proper assets. Also, it does not present any statement on its receivables and payables. Financial information reported by the Fund looks as that provided in Table 8 below.

The State Fund's budget cannot report a deficit since the Statute of the State Fund stipulates that its expenditure can only be cashed out within the limits of the revenue cashed in (see also Article 23.4 of the State Budget Code). The Fund is allowed to create a budgetary reserve of up to 10% of its annual costs to face unexpected expenditure.

Table 8. Financial Reporting by the State Fund

UAH mln	1998	1999	2000	2001	2002	2003	2004
Balance at the beginning of the year	0	4.2	0.2	13.9	6.1	21.2	34
Revenue	6.9	10.9	37.4	56.6	65.9	81	95.9
Expenditure	2.7	11.3	23.7	64.4	51.1	95.4	118.1
Balance at the end of the year	4.2	3.8	13.9	6.1	21.2	6.8	11.8

Analysis

The Budget Code applying to the State Fund is conservative. It faces no risk of deficit since it is not allowed to spend more than what it actually receives. Risks of unexpected funding shortfalls can be minimised through the creation of a budgetary reserve and continued prudent budgeting of revenue.

The Fund does not produce any medium-term financial forecasts: it strictly applies and adheres to the annual budgeting rule. As mentioned earlier, this is a major weakness of the Fund in terms of financial management since it makes the implementation of multi-year projects difficult. Should the Fund decide to finance environmental projects over several years, it would have to commit funds for the first year and then reallocate left-over funds the year after, and continue doing this year after year.

Better reporting of financial information by the Fund is constrained by its status as a budgetary fund submitted to the State Budget Code. However, the Fund could provide additional information on its financial situation in its annual report.

4.3.2 Long-term Debt and Portfolio Management

4.3.2.1 Debt Management

The Fund cannot take on debt on its own, and it does not benefit from any guarantee from the state.

Analysis

The Fund's inability to raise external funding may be seen as a drawback in a context of insufficient available resources for environment protection measures in Ukraine. However, putting aside legal aspects, the Fund currently does not seem to have sufficient resources allowing it to raise external funds or sufficient capacity to manage additional resources.

Moreover, giving the Fund the possibility of taking on debt on its own may not be efficient since it is very likely that it would have to pay a higher risk premium, that is a higher interest rate compared to the State of Ukraine. In the end, the costs of borrowing would be higher for the Fund than if the state borrowed under its own name and transferred additional resources to the Fund.

4.3.2.2 Liquidity Management

All resources of the Fund are deposited in an account at the State Treasury. The State Treasury of Ukraine registers payments from pollution charges for the Fund in the Treasury's unified account in accordance with the classification of state budget revenues, which was adopted by Order of the Ministry of Finance No. 604 of 27 December 2001 "On Budget Classification and its

Implementation": by code 50080100 – "Payments of Energy Sector Enterprises to the State Environmental Protection Fund"; by code 50080200 – "Other Environmental Pollution Payments to the State Environmental Protection Fund"; and by code 50080300 – "Environmental Pollution Payments of Physical Persons".

Analysis

This deposit policy at the State Treasury ensures that deposit risk is minimised. All resources that remain at the end of the year can be carried over to the following year.[11] State Fund resources that are not used by the local branches of the State Fund by the end of the year are returned to the Fund and are not deposited at the local level.

In the worst case scenario, the State Treasury could decide to use earmarked funds for its own liquidity needs and delay their transfer to the State Fund. It seems that this has happened in the past but is no longer the case at present.

4.3.2.3 Investment Capacity

The Fund has no legal capacity to invest in third entities. Therefore, it cannot establish subsidiary companies, i.e. form joint ventures or invest in equity in private/public companies.

Conclusions and Recommendations

Given the strict rules imposed by the Budget Code and annual Budget Laws, the Fund meets the main criteria of fiscal discipline and mostly follows a cautionary and prudent fiscal policy. Nevertheless, it is suggested that:

- If the Fund can commit resources beyond one year, it should aim to further improve its accounting practices, in particular for multi-year commitments (payables/liabilities).
- Build multi-year budgetary projections (for instance on a three-year horizon).

4.4 Project Cycle Management

Project cycle management is a key function of environmental Funds. It is the process by which they decide how to allocate their resources. The project cycle includes a sequence of activities designed to identify, appraise, select, implement and monitor projects financed by the Fund. Typically, project cycle management is the shared responsibility of the Fund's management and staff, with the supervisory board taking on the task of approving projects for financing.

4.4.1 Procedures for Project Cycle Management

As part of the state budget, the entire project cycle of the State Fund is subordinated to the budget preparation procedure based on the Budget Code and annual budget laws. In general, the budget of Ukraine is divided into a general fund and special funds. The latter include earmarked funds that should be spent on purposes for which they were created. In certain cases, when there are not

[11] This rule is valid for the special funds of the State budget only.

sufficient resources in special funds, additional resources may be transferred to them from the general fund.[12]

The budget process comprises the following stages (Chapter 4, Article 1 of the Budget Code of 2003): 1) formulation of draft budgets; 2) consideration and approval of the State Budget Law and decisions on local budgets; 3) execution of the budget, including making amendments, as necessary, to the State Budget Law and respective decisions on local budgets; and 4) preparation and consideration of reports on budget execution and making decisions on these reports.

Altogether, the project preparation procedure takes about 2 and a half months, including submission of the draft budget prepared by the Ministry of Finance to the Cabinet of Ministers and approval of the budget by the Parliament. More details on the budget preparation procedure are provided in Chart 9.

The procedures for project cycle management of the State Fund are stipulated in a number of legal documents, which include:

- The 1996 CoM Resolution No. 1147 on the types of activities of environmental protection that can be financed by the national, oblast and local Funds - this Resolution aims at introducing some kind of eligibility for the types of projects that can be financed with support from the State Fund. It also serves to validate budget lines of state expenditure related to environmental protection.

- The 1998 CoM Resolution No. 634 on the Statute of the State Environmental Fund[13] – it sets the main principles, rules and procedures for providing financing from the Fund.

- The 2002 MEP Order on Planning and Financing of Environmental Measures from the State Environmental Fund, No. 189 - this Order expanded the conditions for obtaining funding, specified the MEP's responsibilities with regard to the State Fund, clarified procedures for considering applications and made territorial branches of the MEP responsible for certain parts of the project cycle.

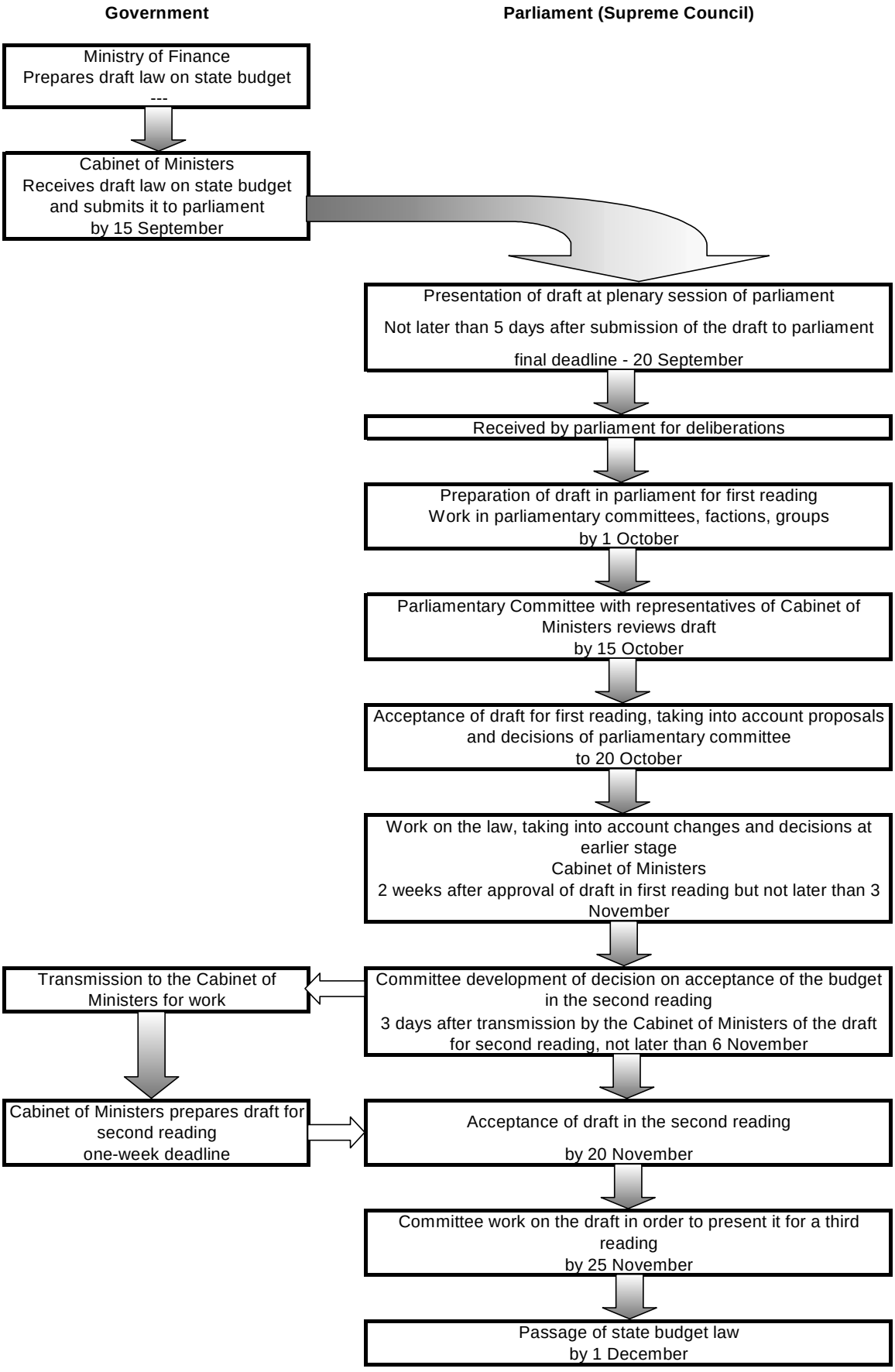
- State Environmental Targeted Programmes (national, regional or local) – these are broad sector specific programmes, usually approved by the Parliament or the Cabinet of Ministers. They can be seen as providing the Fund with longer-term objectives for financing.

- Annual Budgetary Programmes to be financed from the Fund – these programmes serve as annual spending plans for the Fund. They are approved by the Parliament as part of the annual Budget Law and are prepared by the MEP.

[12] Article 13, paragraph 6 of the Budget Code of 2003: "Transferring resources from the general fund to a special budget fund shall be permitted only within the amounts of budget appropriations by way of amending the State Budget Law of Ukraine or decision made by the concerned Rada."

[13] Most recently amended through CoM Resolution No. 462 of 7 April 2006 (adopted after completion of the review mission).

Chart 9. Budget Preparation Procedure



4.4.2 Project Cycle Step-by-Step

The following section contains a review of the project cycle, including project identification, appraisal, selection, implementation, monitoring and reporting. It briefly looks at the state targeted programmes and the budget programme passports as important sources of indicators for measuring the State Fund's efficiency. It concludes with an assessment of the objectivity, fairness and transparency of the procedures and criteria of project appraisal and selection employed by the State Fund and then offers recommendations.

4.4.2.1 Project Identification

The State Fund plays a passive role in identifying projects. Identification is the responsibility of the territorial branches of the MEP, and is carried out as part of the preparation of the budget programmes supported by the Fund, which are developed by MEP staff. In 2005, there were 11 budget programmes, and in 2006 these were reduced to 8.

The collection of project proposals starts at the beginning of the calendar year. Submitted projects need to conform to the type of environmental expenditure that is identified in the List of Environmental Activities and that also appears in one of the state, regional or local targeted programmes. The above List identifies more than 85 activities and seems to include all possible environmental measures. In addition, project proposals have to correspond to one of the budget programmes supported by the State Fund. In the event of an environmental emergency situation related to environmental protection, applications can be submitted outside of the usual project cycle. Potential applicants need to be familiar with all these documents as a prerequisite for obtaining financing from the Fund. The Fund makes no efforts, either at national or local level, to reach out to potential beneficiaries and identify viable projects.

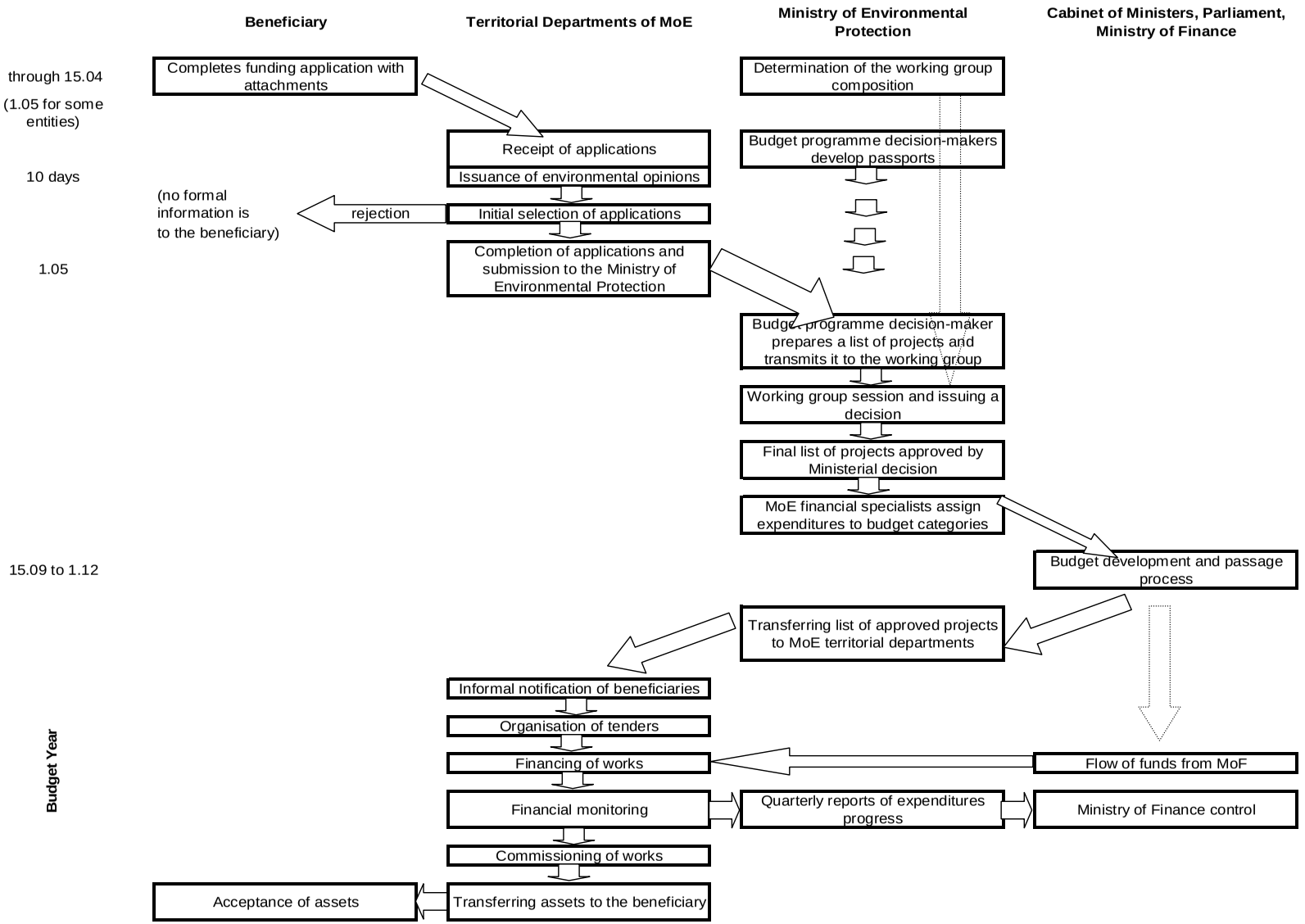
An overview of the complete procedure of the Fund's project cycle management is provided in Chart 10.

4.4.2.2 Project Appraisal and Selection

The 1998 CoM Resolution No. 634 on the Statute of the Fund and the 2002 MEP Order No. 189 set the basic principles, rules and procedures for providing financing from the State Fund. They do not, however, contain clear criteria for assessing environmental or cost-effectiveness of submitted projects or selection criteria for that matter. There has been an attempt to streamline the appraisal process and provide further guidance in this regard. In 2003, the MEP developed *Methodological Guidelines for the Appraisal and Selection of Environmental Projects to be Financed from the State Environmental Protection Fund* (the Guidelines), whose main aim was to provide instructions on conducting the appraisal process.

Appraisal conducted by the Fund consists of two parts: initial selection (eligibility screening) and full appraisal. Eligibility screening is done by the territorial branches of the MEP. Full appraisal is the responsibility of experts from the MEP at national level (according to the Guidelines). There is only one type of an application form used for both stages.

Chart 10. Project Cycle Management Procedure of the State Fund



a/ Eligibility Screening

The main purpose of the initial selection process is establishing the conformity of the project proposal with the List of eligible project types to be financed from the State Fund (CoM Resolution 1147). This is done on the basis of the application form submitted by the applicant. Each project requesting support should provide proof of compliance with this List. In addition, the application form should also quote the full title of the "national, regional or local programme, name and date of a law of Ukraine, decree of the Supreme Council of Ukraine, resolution, decision or order document of the Cabinet of Ministers, decision of a local governmental body or local authority that could be used as project justification." The chapter, section and sub-section of a document in which the project is listed should also be specified.

Eligibility screening ends with the preparation of an "environmental reference", which constitutes the opinion of local level experts about the conformity of the proposal with the activities list and the specific programme the project could be linked to. Project proposals that have passed this eligibility test are forwarded to the MEP to be further reviewed. According to the Guidelines, each project that has passed the initial screening must receive such a reference prepared by the local MEP department within 10 days of submission of the application. However, this requirement does not seem to be always respected (judging from the application forms for projects supported by the Fund which were examined by the review team).

b/ Application Form

A major element of the project cycle is the preparation of the application form by an applicant. The applicant should submit the form along with required attachments to the territorial branch of the MEP between 1 January and 15 April. If the applicant is a government agency or an entity that belongs to the MEP, the deadline is 1 May.

The applicant should attach to the application form the following items: an estimate of project costs, project implementation timetable, and an extract from the state, regional or local targeted programme that the project proposal corresponds to. The application form transferred to the MEP should also include the environmental reference prepared by the local department of the MEP. Providing inadequate or incomplete information in the application is a reason for a negative environmental reference (essentially meaning a rejection of the application). Annex III contains an example of the application form used by the State Fund.

In addition to formal information concerning the contact details of the applicant, and type of ownership and location of the project, the application form requires information on the applicant's compliance with legislation (e.g. payment of pollution charges, pollution fines and compensation for damages as a result of the violation of the legislation, conformity with state programmes). The form also contains questions on project content, such as description and duration of the project, impact (national, regional or local), applied technology (foreign/domestic), and project costs that the State Fund should cover. Information on environmental effects (in terms of pollution reduction per year) is only required if the project is expected to be completed within the year, that is, within the year when the applicant seeks support from the Fund.

While the applications should contain information on whether applicants pay pollution charges, there is nothing preventing them from receiving support from the Fund if they have not paid these charges. This became apparent during interviews conducted at the Fund and is also indicated by the Guidelines, which lack an entry on consequences for not paying pollution charges. Moreover, the application form does not require data on operating and maintenance costs and contains only very weak information on environmental effects (mostly in descriptive terms) expected to be achieved with support from the Fund. Application forms that were submitted to the State Fund and examined by review team members show that the forms require the bare minimum of information necessary for

requesting public support. When completed, the forms consist of not more than 3 pages, and are often only 1-2 pages long which is highly insufficient, particularly when investment projects are considered.

c/ Appraisal

Project appraisal is based on a set of criteria – technical, environmental and financial. These criteria were identified in the Guidelines as follows:

- Correspondence with the overall objective of the budget programmes, including tasks and targets established in these programmes;
- Environmental effectiveness;
- Economic effectiveness (understood as the period after which the project will start generating a positive cash –flow);
- Scale of the environmental impact (national, regional, local);
- Availability of natural resources and energy use indices (this refers to information or data on the amount and structure of resources that are required to complete the project);
- Use of tested devices, equipment, technology;
- Level of advancement of the proposed project with regard to its implementation at the time of submitting the application;
- Availability of applicant's own financial contribution;
- Guarantees by other stakeholders for their commitment to contribute financially to the project;
- Terms of project implementation; and
- Pollution charge payment record of the applicant.

Experts at MEP headquarters review the applications submitted by the territorial branches of the Ministry and conduct an appraisal. This process does not seem to be very different from what MEP staff do at the local level. Appraisal essentially consists of re-checking applications screened by local experts for conformity with legal requirements. No unit costs are provided. All numbers are aggregated. Hence, these costs cannot be compared with and verified against market prices. Information on environmental results from the project is not required unless the project is expected to be completed in the same year as when the application was submitted. No economic and financial analysis is conducted, either at the local or the national level. It is not clear how the above set of criteria enter the appraisal and selection process, in particular since the *Guidelines* do not provide any guidance on how these criteria should be evaluated.

The review/appraisal process of the applications at MEP headquarters ends with the compilation of a list of projects that is then submitted to the Working Group. The projects on the list are neither scored nor ranked in any order of importance.

d/ Selection

Once appraisal has been done and the list of projects has been compiled, the MEP Working Group is convened to deliberate on the selection of projects. Unlike experts at the MEP, Working

Group members do not have access to the completed application forms. They make their decisions based on the following information:

- Title of the project;
- Name and address of the applicant;
- Project completion level (in %);
- Project costs: total, and costs requested to be financed by the Fund (in a given year, in total);
- Budget classification code; and
- Justification for financing from the State Fund (e.g. reference to a state targeted programme).

In principle, the Working Group is guided by the following general project selection criteria:

- Is the project included in any state targeted programmes or is the project at least in conformity with the general objectives of any state targeted programmes (alternatively, is the project included in a regional programme, which at the same time is part of a state programme)?
- Does the project appear on the list of activities for financing from the Fund?
- Project scale (does it support the implementation of a national, regional or local programme?);
- Level of project completion; and
- Other sources of financing committed to the project.

The Working Group operates collectively and does not have a formalised evaluation method. It usually meets once a year, but if the Fund has more resources to allocate than expected, then additional meetings of the Group may be convened. The Working Group does not have specific deadlines, but it must operate within the defined budget preparation calendar.

The minutes of the Working Group contain the list of selected projects that will receive support from the Fund. Again, these projects are not ranked in any order of importance. This list of projects is then submitted to the Minister for approval. The Minister may alter (modify) these projects through a formal decision. It is not clear how and on what grounds the Minister selects the final list of projects. After the Minister's approval, the list goes to the Council of Ministers for their final approval and decision. The Ministers can further modify the list without any clear justification.

At the next stage, financial specialists from the MEP assign the projects to their respective budget programmes in accordance with their budget classification. Finally, the respective territorial branches of the MEP are informed of the outcome of the selection process.

4.4.2.3 Project Implementation

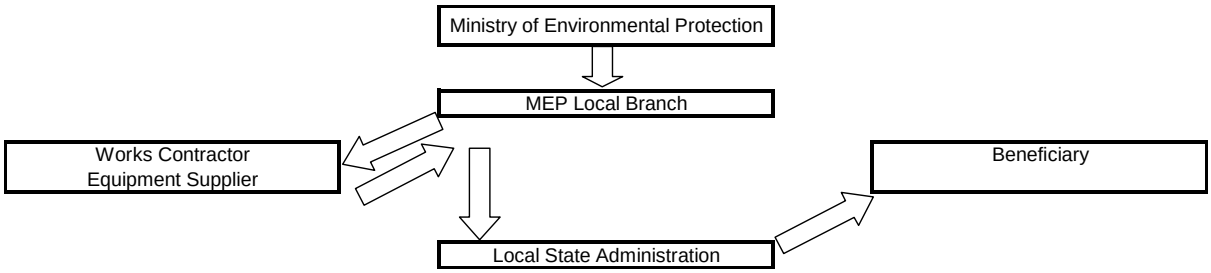
Once the list of projects selected for receiving support from the State Fund has been approved, it is sent to the appropriate territorial MEP branches that are responsible for project financing.

Applicants whose projects have been rejected are not officially notified of the status of their proposals. Successful applicants are contacted by the appropriate territorial branches of the MEP.

The territorial branches of the Ministry are charged with the responsibility of preparing tender documentation and organising the tenders for the procurement of goods, works and services for the projects that have been selected for financing from the State Fund. Beneficiaries thus do not actually receive any money in their bank accounts and do not select contractors for supplying the goods and services needed for the implementation of the project. This work is carried out by the MEP departments at the local level. However, these departments do not have staff specialised in public procurement, particularly given the broad scope of projects that are financed. After organising the tender and selecting the contractor, the local MEP departments organise the work, monitor performance in cooperation with the beneficiary, and pay the contractors directly.

In this context, given that the MEP finances the construction of assets directly, it formally remains the owner of these assets. As most of the beneficiaries so far have been state or local government entities, this issue has not posed serious problems to date. However, the State Fund also supports projects submitted by enterprises that are partially privatised (companies with shares held by non-government entities), and in this case it is evident that the asset transfer procedure is not yet fully developed. Typically, no contract exists between the territorial branch of the MEP and the beneficiary (the contract is between the MEP branch and the contractor). Actually, under these circumstances, it is the MEP (MEP as the owner of the assets), and not the beneficiary, that is responsible for demonstrating the environmental effects of the investment.

Chart 11. Project Implementation Process



Five percent of the financing that is made available by the State Fund may be allocated to contract an administration and supervision person (a contract engineer responsible for technical and administrative supervision of the works to be implemented). In order to provide this supervision, the territorial MEP branches use the services of the Capital Construction Department that exists in each oblast administration. This arrangement makes it possible to have better supervision over implementation of the project carried out with support from the Fund.

As all expenditure must be settled within a given budgetary year and given the need to prepare a project for implementation (transferring the resources to the territorial branches of the MEP, preparation of tender documentation, conducting tender), in practice only a few months are left for project implementation itself. Obviously, this creates a lot of difficulties. An additional constraint, which further exacerbates this situation, are the relatively short construction seasons in Ukraine for some types of investments.

4.4.2.4 Monitoring and Reporting

As mentioned earlier, the territorial branches of the MEP are responsible for monitoring the implementation of the projects in accordance with the agreement with the selected contractor. The territorial MEP branches, however, do not provide information on results from monitoring to the MEP at headquarters. Aggregated data and information are not available at the national level. The MEP (the

person responsible for the particular budget programme) prepares quarterly and annual reports on spending the State Fund's resources, but these are strictly financial reports and reporting is related to the implementation of the budget programme passports. These reports serve mainly to monitor state budget execution and not to check the actual status/completion of the projects and attainment of environmental effects supposedly achieved with the Fund's money. Monitoring and reporting are conducted according to MEP Order No. 418 of 28 October 2002.

4.4.2.5 Budget Programme Passport

Being part of the state budget, the expenditure of the State Fund are organised in budget programmes. According to the legislation, each government agency responsible for managing budget programmes should prepare a passport for the programmes. The programme passport consists of a number of elements. An example of such a passport is provided below based on the contents of the Wastewater Treatment Budget Programme. It contains the following information:

- List of budget codes (i.e., Ministry, Department, Budget Programme);
- Amount of budget allocations;
- Legislative basis for the programme;
- Budget programme objectives;
- Budget allocations by type of activity (whether under the general or special fund of the state budget);
- Budget allocations by economic classification code (capital construction, major repairs, purchasing equipment, etc.);
- List of state targeted programmes that this programme supports;
- Indicators for monitoring the implementation of the programme (in terms of estimated costs and outputs);
- Effectiveness; and
- Quality (in terms of environmental effectiveness).

The development of the passports for the programmes financed from the State Fund is the responsibility of the budget resources managers in the respective MEP departments. All projects selected for financing from the Fund are assigned to one of the 8 budget programmes and each budget programme corresponds to a specific line in the state budget (budget classification). Thus, the passport is crucial for the evaluation of the Fund's project cycle as it is the only document that contains indicators that are monitored and subject to review by controlling government bodies (e.g. the Accounting Chamber).

The last three components in the above list of passport information are especially important as they provide the basis for assessing the performance of both the budget programme and the State Fund. In the example of the passport for the Wastewater Treatment Programme given above, the following performance indicators are used for these three components:

- Costs (estimated costs) and outputs (e.g. number of wastewater treatment facilities designed, constructed, reconstructed or enlarged);

- Effectiveness is defined in terms of the average cost of the sewage system and the average cost of designing, constructing, reconstructing or enlarging wastewater treatment facilities; and

- Quality is defined as the rehabilitation or construction of sewage collectors measured in kilometres and the reduction of pollutants after treatment (calculated in tonnes/year).

These are measurable indicators and they do provide a realistic basis for the objective evaluation of the effectiveness of the budget programme and also of the State Fund. Whether they are the best indicators is a different issue.

4.4.2.6 State Targeted Programmes

State targeted programmes are broadly defined sector specific programmes, usually approved either by the Parliament or the Cabinet of Ministers. Most of these programmes were developed and adopted in the 1990s. Due to a lack of resources, their implementation rate is very low. Since then, these programmes have not been reviewed or revised. However, they do play an important role in the project cycle of the Fund as they are useful in determining some eligibility criteria for Fund support.

Some observations on state targeted programmes, based on the "National Programme for the Environmental Rehabilitation of the Dnipro River Basin and the Improvement of Quality of Drinking Water", are provided below. This programme broadly contains:[14]

- a statement of the problems that need to be addressed in order to improve the state of the environment in the Dnipro River Basin;

- a statement of the main objective of the programme and how this objective can be attained;

- a division of programme tasks into stages, including a list of the major tasks of each stage;

- a list of priority tasks and subtasks;

- a description of the cost estimate of programme implementation and sources of funding (only very briefly outlined);

- a description of mechanisms for programme implementation and control over programme performance;

- economic and organisational mechanisms for implementation of the programme; and

- international cooperation.

More important, the programme contains a list of the approximate investments required to improve the environmental state of the Dnipro River and to improve the quality of drinking water; the list covers a time period until 2010. The entire programme foresees expenditure of UAH 4.2 billion from 1997 to 2010, of which UAH 2.0 billion are planned for expenditure in the period 2001-2010. Programme expenditure is calculated in 1996 prices. Given annual inflation, increased prices of materials, energy and salaries, the Programme needs an overall revision.

Significantly, the programme also contains a "list of the urgent natural protection measures regarding the improvement of the environmental state of the Dnipro River". This list mentions all the

[14] For more specific information on this programme, see Annex II.

priority projects by name and location (by oblast and city) and defines the needed investment in terms of a unit of measure (e.g. thousands of cubic metres of daily capacity, kilometres of dike fortifications, etc.). As a result, a project included in this list stands a much greater chance of receiving financing from the State Fund. However, the responsibilities for implementing the programme are split between numerous agencies at national and local level, without a clear mandate for implementing the work or ensuring a stable flow of resources. In addition, programme activities are financed sporadically and, in practice, the financing process is not controlled. Moreover, implementation of the projects included in the programme is not analysed, so it is not clear if all these measures are even environmentally effective.

Analysis of the Project Cycle

The project cycle used by the State Fund contains most of the formal elements of such a cycle. However, is it very decentralised and involves many different levels and participants. This approach does not allow for a careful verification of the information and data provided by applicants or the calculation of key indicators that could be used in comparing and selecting the most cost-effective projects for financing. Although there are a number of guiding documents (CoM Resolutions, MEP Orders, the Guidelines), they do not make the process any clearer or more straightforward. It is commendable, however, that the MEP has made the effort to compile the main instructions for evaluators in a single document - the Guidelines.

The weaknesses in project cycle management exhibited by the State Fund are numerous. Some of the major drawbacks include:

- Identification of good projects is particularly poor – there are no attempts to reach out to potential beneficiaries (apart from public beneficiaries) and to disseminate information on the State Fund.

- The project cycle uses a two-stage evaluation approach. In principle, this is the right approach, particularly for investment projects. During the first stage, only basic information is required in order to assess if the project is in general eligible for support from the Fund (e.g. if the project is in conformity with national objectives and programme priorities), thus saving time and resources of both applicants and MEP staff if the proposal is not eligible. At the second stage, for purposes of appraisal, detailed data and information are requested from eligible applicants and key indicators are calculated. However, in the case of the State Fund, there is one single application form that, from the outset, requires the applicant to prepare a complete set of information (for both stages of the evaluation process). Given the current practice of closing projects at the end of each budget year, this haste is not surprising.

- The application form contains very scant information on environmental effects (typically in a descriptive form). However, this information is only required if the project is expected to be completed in the year when support from the Fund is requested. Given the annual budget framework of projects, and the difficulty to specify environmental effects, the results of the evaluation and selection process can in no way be based on environmental effectiveness.

- Only data on investment costs are required and no reference to operating and maintenance costs or tariff policy is made. The lack of such data prevents the Fund from evaluating the capacity of project owners to operate and maintain the project in the future and achieve the objectives of the project for which they have obtained support from the Fund. In addition, this limited information does not allow the calculation of crucial indicators (such as the cost-effectiveness indicator). Coupled with the weak capacity of staff at local level to evaluate projects and the time constraints at MEP headquarters to check and verify information and data, it is difficult to see how the most cost-effective projects can be selected for financing.

- No proper appraisal (no financial and cost-effectiveness analysis) and ranking of projects is carried out. Duplication of duties at national and regional level with regard to checking applications for conformity with current legislation often occurs.

- Appraised projects are not ranked in any order of importance, hence there are no rules for determining which projects should be financed first with limited resources.

- Due to the lack of clear rules, procedures and criteria, the final project selection is altogether poor and highly discretionary (left to the Cabinet of Ministers). Hence, all previous rules and procedures become somewhat meaningless.

- This makes monitoring and reporting very formal. These responsibilities are carried out essentially for meeting budgetary requirements and not for achieving environmental effects.

Overall, it seems that preparing the application does not require significant effort on the part of the applicant. However, given that the State Fund exists within the state budget cycle and only finances investment projects for one year at a time, more complex project preparation, followed by detailed analysis by the Fund staff, would not be possible. On the other hand, the single-year planning cycle that the Fund imposes on potential beneficiaries rewards *ad hoc* planning rather than the comprehensive design of investment projects. Thus, the Fund misses an opportunity to encourage the development of project preparation capacity in the country.

Yet infrastructure projects should be examined to ensure their financial and economic sustainability. Neither the application form nor the *Guidelines* provide any indication for evaluating how likely the project is to be completed or which environmental effects it is likely to achieve. To be able to do this, at least an analysis of the project and of the beneficiary's cash flow is needed. Without such an analysis, the payback period indicator, as defined in the Guidelines, becomes meaningless.

Infrastructure projects also require an examination of environmental effectiveness. Simply stating that an applicant should provide all applicable environmental indicators is not sufficient to determine this effectiveness. This is mostly because guidance on how to measure it is too vague. A more useful approach would be to measure an actual effect (such as pollutant reduction, measured in tonnes), or track qualitative criteria (such as whether a project is located in a polluted area, whether it involves the use of a modern technology, etc.). The Guidelines should provide information on how these data should be analysed.

While some of the indicators in the budget programmes do provide a certain basis for evaluating public expenditure for environmental projects and the overall performance of a given budget programme, a useful addition would be to specify key pollutants that are tracked as priorities for reduction. Instead of average cost (such as the total cost of sites divided by the number of sites), the budget programme passport should also track the unit cost of the "quality" measures (e.g. the cost per kilometre of sewage collectors). These costs and effects should also be discounted in order to be able to compare projects with different implementation schedules and different results in net present value (NPV) terms. Comparisons, however, should only be done between comparable projects (e.g. the basket of air projects or the basket of wastewater treatment projects).

In general, state targeted programmes provide useful information and examining them is a positive exercise. They allow to define some long-term objectives in their respective areas. At the same time, these programmes already contain lists of projects (mentioned by name) that could automatically be supported by the State Fund. However, no financial and economic analysis has been carried out for these projects. In addition, the programmes have not been revised to reflect their current relevance, higher prices, the availability of new technologies on the market, or their capacity to attract additional financing from other sources. Neither have they been ranked in any order of

importance or urgency for financing. Cost-effectiveness does not really seem to be an issue in providing the Fund's support for such investments.

In addition, the objectives of the programmes (based on the example of the Dnipro River Programme) are very generic (e.g. stopping pollution of water bodies, stopping the disposal of untreated surface sewage waters into bodies of water within the territories of cities and rural settlements) and there are no targets and indices of performance specified in the programmes. Such vague objectives provide little guidance for operationalising the implementation of the programmes.

Indeed, the abundance of lists of activities under the Dniepro River Programme (see Annex II for more information) underlines the overall shortcomings of the environmental investment finance system, as embodied also by the State Fund - long lists of tasks, but with a lack of clear guidelines on what should come first and on how performance should be measured. This method contributes to the *ad hoc* approach to environmental problem-solving. This is evident in how potential beneficiaries need to apply year after year for support to finance multi-year investments, even in cases where investments are clearly priorities. Overall, the state targeted programmes provide a relatively weak tool for establishing environmental financing priorities.

Conclusions and Recommendations

Project cycle management of the State Fund is not conducted in accordance with international good practices for financing institutions. Neither the environmental effects nor cost-effectiveness of the projects financed with the State Fund's resources are evaluated. As a result, it is not evident that the most environmental and cost-effective projects are supported by the Fund. While some rules and criteria exist, they are inadequately defined. In general, the decision-making on financing individual projects is discretionary and not always justified. The monitoring and evaluation of projects implemented with the Fund's support are effectively absent. No information on achieved results is available at a national level, which makes the subsequent planning process even more difficult. The single-year perspective of the Fund's support further exacerbates these problems.

What is needed is an improved organisational structure for the process: a well-designed project cycle with clear rules, procedures and criteria, and several experts who work exclusively on the appraisal of projects.

Given the budgetary nature of the Fund and the fact that appraisal and selection are the core functions of financing institutions, some more detailed recommendations are offered below. The MEP/Fund should:

1. Improve communication with potential applicants. Provide clear signals with regard to the types of projects that the Fund is willing to support.

2. Introduce separate processes for different types of projects/expenditure, using a true two-stage project selection process for investment projects,[15] and a one-stage appraisal process for non-investment projects.

3. Introduce more rigorous and binding eligibility, appraisal and selection criteria. Make cost-effectiveness (achieving environmental results at a minimum cost) a prominent selection criterion.

[15] An example of a two-stage application process based on the experience of the Krakow Provincial Fund for Environmental Protection and Water Management (Poland) is provided in Annex IV.

More rigorous appraisal procedures and criteria should be introduced. The Fund currently has some criteria that are essentially "hard" (eligibility) cut-off criteria, but they are not identified as such in documents. It is important that these threshold criteria be clearly specified and made available to the public. These threshold criteria might include the following:

- Project type eligibility, based on annual priorities of the Fund;
- Applicant's (legal status) eligibility (the Fund currently has this criterion);
- Demonstration that the applicant can finance project costs if the request for support is for less than 100% of project costs (the Fund also has this criterion but the *Guidelines* do not specify that a formal analysis be conducted to demonstrate this ability); and
- The project meets the minimum/maximum funding levels (thresholds) set by the Fund.

For applicants whose projects meet the pre-selection criteria, a full application should be required. It should include information on all costs (including O&M costs), which implies an investment and financing schedule showing the investment from start through to completion and also operations. Seeing a snapshot of one year of the investment will not provide the Fund with the signals it needs to determine if the applicant will be able to complete the project in the future, with or without the Fund's assistance. This kind of presentation of the investment will also allow the Fund to examine the financial sustainability of the project (e.g. by calculating the NPV, internal rate of return on investment), which will indicate the need, or not, for public support for the project.

For investment projects, the application form should require more detailed information on expected results of the investment to accommodate environmental and cost-effectiveness analysis. Environmental effectiveness might be measured in terms of pollution reduction before and after the implementation of the project, while cost-effectiveness should involve checking whether environmental results can be achieved at a minimum cost. This would involve measuring the full lifetime investment and O&M costs of the project against the reduction of the level of a given pollutant achieved as a result of the implementation of the project.

The Fund (MEP) should also prepare manuals and guidelines with specific and detailed instructions for applicants on how to prepare the information needed and for Fund staff on how to analyse this information. Either the environmental effectiveness criterion or the cost-effectiveness criterion could be used to rank projects. Projects should be ranked within project categories (e.g., wastewater, air, solid waste). With an aggressive effort to identify projects, the Fund could presumably receive more applications than it can finance, at which time a ranking system will be essential.

4. Introduce and maintain regular monitoring and evaluation of investment projects implemented with support by the Fund.

Monitoring is a crucial part of a successful project cycle, particularly with regard to investment projects, as their implementation phase is a period when the Fund's resources have been disbursed but have not yet yielded a return. Monitoring should continue into the operational stage when project benefits are expected to occur. For this, the Fund (MEP) will need strong in-house capacity to monitor the investment process and ensure that the beneficiary spends the Fund's money on achieving the project objectives. Information on results from the monitoring activities should be available at the MEP level as well.

During the evaluation phase, the Fund should assess the achievement of the project objectives. This is also the time for the Fund to look at its internal operations during the project cycle and analyse

the causes of success and failures. Systematic evaluation is a critical learning device and a prerequisite for building capacity and skills to improve the management of future project cycles.

5. Project cycle management could be greatly enhanced by making the following improvements:

- Make managers responsible and accountable for project cycle management, including project identification, appraisal and selection.

- Create a unit at national level that will be fully responsible for the complete project cycle. Particular improvement would be needed in engineering, economic/financial and legal skills of the staff.

5. POTENTIAL ROLES IN LEVERAGING FOREIGN FINANCIAL RESOURCES AND RELATIONS WITH THE COMMERCIAL BANKING SECTOR

This section provides a brief overview of the main sources of foreign finance in Ukraine that could provide support to environmental and environmentally-related investments in the country and the role the State Fund could play with regard to these sources of finance. In addition, the section looks at the Fund's relations with the commercial banking sector and at possible ways for using public money to further develop the financial market for environmental investments in Ukraine.

International financing institutions (IFIs) and bilateral donors are important sources of finance for both investment and non-investment (technical assistance) projects in Ukraine. About 30 international technical assistance donors (both bilateral and multilateral) are active in the country. The total amount of international technical assistance provided to Ukraine in 2005 in all areas was around USD 400 million.

The **European Union** is the largest donor for Ukraine. Assistance provided by the European Community alone has amounted to more than Euro 2 billion since 1991. This includes assistance under the TACIS programme (including its national, regional, cross-border and nuclear safety components), as well as macro-financial assistance and support under thematic budget lines. The EU has an Action Plan with Ukraine (as part of its European Neighbourhood Policy). The section on the environment covers measures at national, regional and international level to address issues related to environmental governance, sector-specific actions to prevent deterioration of the environment, and enhanced regional and international cooperation on environment issues. The EU characterises the implementation of the environmental objectives of the Action Plan in 2005 as moderately good. An increase in EU funding for Ukraine is expected with introduction of the European Neighbourhood and Partnership Instrument (ENPI) in 2007. The EU has also decided to increase its level of support through the TACIS Programme for legislative approximation, including technical assistance to meet EU norms and standards, and to help Ukraine pursue the reform process. In addition, Ukraine participates in meetings of the Danube-Black Sea Task Force to implement a trans-boundary approach to water management and in the EECCA component of the EU Water Initiative.

The level of foreign direct investment (FDI) in financing environmental protection is unknown as data for this sector are not available. However, FDI in Ukraine is still generally low (in comparison to Central Europe), at a level of USD 1.7 billion in 2004. In 2005, this figure exceeded USD 4.8 billion due to the sale of a state-owned metallurgical company.

5.1 Overview of Major IFI Sources of Finance in Ukraine

IFI loans are currently the main available source for long-term debt in Ukraine. Although borrowing from the domestic banks in Ukraine is expected to grow, commercial lending is still expensive (even more so for environmental projects, which do not bring short-term profits): maturities still remain relatively short (typically 1-2 years), interest margins relatively high (8% or more), with over-collateralisation requirements of 150% or more and available primarily to larger, export-oriented enterprises. Commercial banks perceive credit for environmental projects as relatively risky since such projects generate external economic benefits rather than short-term private profits. Hence, the public budget has an important role to play in this context. This section also looks at the role the State

Fund could play with regard to foreign sources of finance (particularly IFIs) in order to leverage additional resources and maximise the overall level of environmental investments in the country.

The conditions for loans vary with IFIs. Typically, the **World Bank** loans are repayable over 20 years with a 5-year grace period. The World Bank has had commitments to Ukraine totalling over USD 4.5 billion for 33 projects. By 1 July 2005, 19 of these were completed, over 10 new projects were under preparation and the World Bank's current portfolio in Ukraine comprises 12 on-going projects. World Bank projects with environmental-related components currently being implemented in Ukraine include:

- Kiev District Heating Improvement Project (USD 200 million);
- Hydropower Rehabilitation Project (USD 106 million);
- Lviv Water and Wastewater Project (USD 24.25 million); and
- Rural Land Titling and Cadastre Development Project (USD 195.13 million).

The World Bank usually offers two main types of loans – investment loans and development policy loans. Investment loans are made to countries for goods, works and services in support of economic and social development projects in a broad range of economic and social sectors. Development policy loans (formerly known as adjustment loans) provide quick-disbursing financing to support countries' policy and institutional reforms. These loans are interest free.

The **EBRD** provides loans for the public sector and for private and entrepreneurial initiative at market-based interest rates, repayable over 5-10 years with a negotiable grace period of less than 3 years. For private sector projects, EBRD finances a maximum of 35% of total capital; for the public sector, this support goes up to a maximum of 70%. In Ukraine, the EBRD mainly provides direct investments in such areas as agribusiness, bank equity, bank lending, energy efficiency, general industry, equity funds and transport. It also finances infrastructure projects, such as the "Zaporizhia Water Utility Development and Investment Programme", entailing an investment in the water supply and wastewater management sector. The project is financed by a loan of USD 20.5 million out of a total project cost of USD 31.9 million. Past and present EBRD projects in Ukraine with environmental implications are listed in Table 9.

It should be noted, however, that the difficulty of cities in Ukraine to raise debt is a serious constraint to launching EBRD projects. Only recently have larger cities developed the capacity to incur debt (creditworthiness) that enables them to pursue and obtain EBRD assistance. However, this avenue remains an option mostly for larger cities. No methodology exists for "packaging" projects at a regional level so that smaller cities, operating within the package, could take advantage of loan financing. A further limitation of working with the EBRD is the need to apply a tariff policy that would not limit the possibility of repaying a loan using revenue generated by the project, as the current practice is.

The **European Investment Bank** (EIB) signed a Framework Agreement with Ukraine in 2005 with the intention of financing projects in the areas of environment, transport, telecommunications and energy infrastructure in Ukraine. This includes priority Trans-European Network (TEN) projects connecting Ukraine and the European Union.

Table 9. Selected EBRD Environmentally-Related Projects in Ukraine

Project Name	Sector	Date Disclosed
Donetsk District Heating	Energy efficiency	17 Feb 2006
Dnipropetrovsk District Heating Loan	Energy efficiency	17 Feb 2006
Harkiv Wastewater Treatment	Municipal and environmental infrastructure	17 Feb 2006
Harkiv District Heating Loan	Energy efficiency	16 Feb 2006
Dnipropetrovsk Municipal Water and WasteWater Project	Municipal and environmental infrastructure	15 Sep 2004
Energy Alliance	Energy efficiency	10 Oct 2003
UkrEsco II	Energy efficiency	10 Oct 2003
Kherson Municipal Utility Development Project	Municipal and environmental infrastructure	2 Oct 2001
Mariupol Municipal Utility Development Project	Municipal and environmental infrastructure	28 Sep 2001
Kharkiv Solid Waste Management Project	Municipal and environmental infrastructure	14 Apr 2000
Kyivenergo - District Heating Rehabilitation Project	Energy efficiency	1 Oct 1997
Zaporizhia - Water Utility Development and Investment Programme	Municipal and environmental infrastructure	23 Jul 1997
Ukraine Energy Service Company - UkrEsco	Energy efficiency	16 Apr 1997
Krivoy Rog Power Plant Rehabilitation Project	Power and energy	8 Apr 1997
Starobeshevo Power Modernisation Project	Power and energy	15 Oct 1996

5.2 World Bank Requirements for Local Financial Institutions

In providing support to recipient countries, donors and IFIs often look for local financing mechanisms (public or private) that can be used to on-lend their resources to final beneficiaries or to provide other "retail" financial services. Donors and IFIs have specific criteria for choosing local financial institutions as partners in their operations.

The World Bank is considering providing assistance to the Ukrainian government in a possible pilot sale of the country's emission allowances under the Kyoto Protocol. The revenues from this sale could be used to support modernisation of industrial enterprises to improve their energy efficiency and environmental performance. In order to be able to disburse revenues from emissions trading to final beneficiaries, the Government of Ukraine would have to establish a financial mechanism that would be credible to foreign buyers and the Ukrainian public. Box 4 illustrates what foreign partners would consider as a credible local financial institution.

A quick review of these criteria demonstrates that it is premature to consider the State Fund as a potential financial intermediary for international financial institutions. The Fund could not fulfil even less demanding functions, such as being a co-financier or providing project identification and appraisal services, without major improvements in staffing, managerial capacity, autonomy, administrative structure and business procedures. The Fund's inability to produce financial statements prepared and audited in accordance with international practices would also be a major obstacle to cooperation with reputable foreign partners. In addition, the quality of the Fund's portfolio is not measured and is not known. The Fund scores best on its capacity to mobilise domestic resources.

Box 4. The World Bank Eligibility Criteria for Local Financial Intermediaries (LFI)

The World Bank eligibility criteria for local financial intermediaries[16] have been developed for local institutions providing specific financial services, namely on-lending large World Bank loans to a great number of small final borrowers. Not all of the criteria are relevant to publicly owned environmental funds, which do not provide lending services. However, these criteria can illustrate the type of issues that large international financial institutions consider when evaluating the credibility of their potential local institutional partners. The most relevant criteria in the Ukrainian context include:

- adequate profitability, capital, and portfolio quality, as confirmed by financial statements prepared and audited in accordance with accounting and auditing principles acceptable to the Bank;
- appropriate capacity, including staffing, for carrying out sub-project appraisal (including environmental assessment) and for supervising sub-project implementation;
- capacity to mobilise domestic resources;
- adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled LFIs are involved); and
- appropriate prudential policies, administrative structure, and business procedures.

Using these criteria, the Bank determines the eligibility of the proposed LFI. New and existing LFIs that do not meet all the eligibility criteria may participate in a Bank financial intermediary lending if they agree to implement an institutional development plan that includes a set of time-bound monitorable performance indicators and provides for a mid-term review of progress.

Conclusions and Recommendations

Although international support for environmental projects is increasing, it seems that the level of finance for environmental investments in Ukraine is still low, in particular given the scale and acuteness of environmental problems in the country. These investments are constrained by a number of factors, including: weak enforcement of environmental legislation, lack of a clearly identified environmental strategy, lack of well-designed viable projects to be implemented, and underdeveloped capital and financial markets. Commercial bank credits are still expensive and international finance may not be immediately available for environmental projects that need long-term financing. Hence, public budget sources will continue to play a crucial role.

Experience from CEE countries with well-performing environmental Funds shows that such Funds have been used by both donors and IFIs in different capacities, for example as :

1. Financial intermediary;

2. Project implementation unit; and

3. Co-financier.

Given the current administrative structure of the State Fund and its staff experience with managing even simple grants, the Fund is not mature to function as a LFI for the World Bank (or for any other IFI for that matter). The Fund is not ready to act as a project implementation unit either, as its project cycle management procedures are too rudimentary and its main experience in this area is with reviewing applications for consistency with budget programmes. The Fund will need to introduce transparent and robust procedures for project appraisal and for monitoring project implementation before it can even consider such a role.

[16] World Bank, *Operational Policy Statement on Financial Intermediary Lending*, OP/BP 8.30 (1998), revised in August 2004.

Currently, the Fund can qualify as a co-financer of investment projects supported by IFIs or donors. It can provide matching grants. Through its new disbursing mechanism, the interest rate subsidy, it can also envisage expanding support for borrowers who borrow from IFIs. On a positive note, the Fund is increasing its support for investment projects, which can help it to more rapidly develop skills necessary for appraising investment projects in accordance with good international practices.

Developing such skills and strengthening its project cycle management capacity will help improve the Fund's credibility. Experience with other Funds in the CEE region shows that greater credibility attracts the interest of donors/IFIs, and this often results in additional resources for national environmental Funds to manage. If the MEP is interested in considering such an option, it should aim at reforming the State Fund in line with good international practices for such institutions.

5.3 Relations with the Commercial Banking Sector

To date, the relations of the State Fund with the banking sector have been very limited. The budget programme for providing interest rate subsidies, introduced in 2006, should change this situation and enable the Fund to gain experience in this area. It should be noted, however, that due to a lack of applications, this programme will most likely not be active in 2006. Potentially, the Fund could help to further develop the financial market for environmental investments in Ukraine.

By requiring applicants to provide co-financing from their own sources, the Fund could encourage applicants to obtain credits from commercial banks (or through other mechanisms, such as bonds) to finance infrastructure (especially municipal) investments. Indirectly, the Fund would thus encourage the development of not only the entire municipal infrastructure sector, but also of the capital market in Ukraine. Currently, the Fund tends to adapt its rules to the level of resources that the beneficiaries can provide (without incurring loans), which leads to rather small-scale projects and projects whose implementation lasts for years.

In EECCA, environmental administrations often use practices and financing instruments that discourage banks from financing environmental projects. Public funds have sometimes been used to finance projects that could have been commercially viable. When financing environmental investments from the budget or extra-budgetary funds, administrations at national or regional level have usually preferred to offer grants covering 100% of project costs or direct loans, rather than use banks as co-financiers or intermediaries. None of the public environmental Funds in the EECCA region has been encouraged or required to co-finance projects with commercial banks (e.g. by matching grants) or to lend through them in order to increase the leverage effect of public money. Instead, when environmental authorities or even donors develop new financial products for public environmental Funds, they generally choose financing instruments that do not facilitate bank credit for the environmental sector, such as direct lending to replace matching grants.

In that perspective, Ukraine could become an exception and pave the way for innovative alliances between the State Fund and the financial community (both domestic and international), as the Fund could be used to leverage additional finance from commercial banks and/or IFIs, and transfer expertise (including knowledge of the local conditions) in environmental project management (project appraisal, monitoring).

6. CONCLUSIONS AND FURTHER ACTIONS

Since its establishment, the system of environmental Funds in Ukraine has undergone significant changes. These have been closely linked to the evolution of the public finance system in the country. Most of these changes have already brought positive results and have contributed to the improvement of the fiscal discipline and transparency of the State Fund.

The Fund has been consolidated into the state budget, and state control over its spending has significantly increased. Responsibilities for collecting revenue generated by pollution charges were transferred to the State Tax Inspectorate, which has led to an important increase in the Fund's revenue. Compared to 2000, when the system became operational, this revenue doubled in 2004. Barter and other non-monetary transactions have been largely abolished. As a result, the Fund has started financing more and bigger investment projects.

Because of these changes, the Fund is facing a number of new challenges today. Its increased revenue has attracted the interest of various stakeholders in the government. The Fund's resources have been diverted from the Ministry of Environmental Protection (MEP) and allocated to programmes managed by other government agencies. In 2006, 5 other ministries are benefiting from the revenue of pollution charges. The amount of resources channelled to the 5 ministries represents about 30% of the Fund's legal resources. The Fund has no control over spending by other government entities.

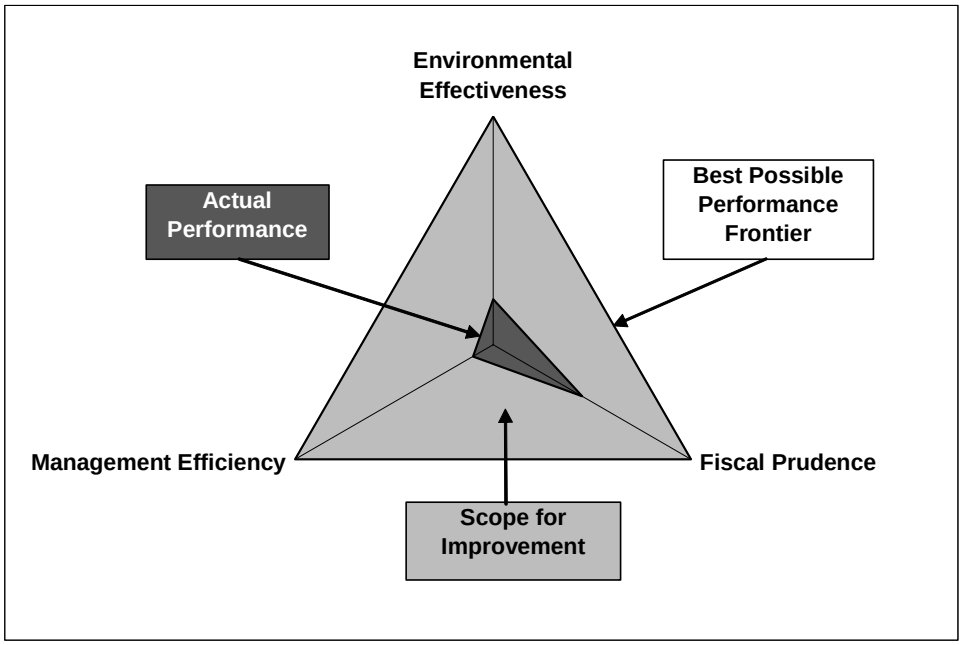
Despite this increase in revenue levels, programming and expenditure planning remain weak. Crucial elements of programme design are missing. The Fund's programmes lack specific objectives and realistic targets. This results in an *ad hoc* approach and unpredictable planning. The Fund's planning, which is closely linked to the preparation of the state budget, is further aggravated by the one-year budget perspective used for providing financing. This annual expenditure framework introduces a lot of uncertainty in the planning process and is incompatible with the multi-year implementation schedules of investment projects supported by the Fund. As a result, many such projects remain uncompleted. Also, the very complex, cumbersome and discretionary decision-making process that is used for selecting projects for financing has made it difficult for the Fund to disburse its resources by the end of the budget year, which raises concerns about its efficiency.

In addition, the project cycle employed by the Fund does not ensure the selection of the most cost-effective projects for financing. Responsibilities for project cycle management are split among many people at both national and regional level. Appraisal is a very formal process, essentially limited to verifying if project proposals comply with budget codes and legal requirements and correspond to different state, regional and local environmental programmes. The Fund uses no clear appraisal criteria and practically does not consider environmental effects when choosing project proposals. Monitoring and evaluation of implemented projects are effectively missing. No information on results achieved by these projects is collected at a national level, which makes subsequent planning even more difficult. This has prevented the MEP and managers of the Fund's programmes from developing crucial skills in project cycle management and financing. Instead, they have focused on public procurement. While knowledge and expertise in public procurement are important for public administrations, they are not the core functions of finance mechanisms. These drawbacks and inefficiencies of the Fund's project cycle management have resulted in the inefficient use of its resources.

Given the current administrative structure of the State Fund and its staff's limited experience with good project cycle management, the Fund is not in a position to play a major role with regard to foreign sources of finance. The best the Fund can offer at this point is matching grants to investment projects supported by IFIs or donors. Even in this case, before the Fund can consider such a role, it will need to adopt transparent and robust criteria and procedures for project appraisal and for monitoring project implementation.

The compliance of the State Fund with the Good Practices for PEEM is poor with regard to its environmental effectiveness and management efficiency. Due to reforms implemented in the public finance system of Ukraine, the Fund scores better in terms of fiscal prudence. Chart 12[17] provides a visual representation of the performance of the Fund compared against the Good Practices for PEEM. As can be seen in the Chart, the actual performance of the Fund is low compared to the best possible performance frontier. This low performance shows the need for a significant targeted institutional reform and strengthening of the Fund, as indicated by the "Scope for Improvement" box in the triangle.

Chart 12. Performance Assessment of the State Environmental Protection Fund of Ukraine: 2006



The present legal framework in Ukraine is sufficient to create an effective, operational mechanism at national level to manage the resources from pollution charges. The preparation of the draft Law on the National Environmental Fund is a good opportunity to design a professional and credible institution with a strong capacity to identify and select good projects. A careful and transparent process is needed to draft the new version of this Law. In order to secure broad support for the reforms of the Fund, this process should involve all key stakeholders in the country. However, before the institution at national level is ready to manage resources successfully, a great deal of regulatory improvements will be needed, especially in the areas of accountability, establishing (real) priorities, and developing skills in project cycle management. These reforms would also be a necessary condition for the Fund to become internationally recognised as a potential partner for foreign sources of financing environmental investments in Ukraine.

[17] For explanation of the construction of the triangle, please see Annex V.

The reforms of the State Fund should be an integral part of a general overhaul of the whole system of environmental Funds in Ukraine. The dissipation of resources across different levels and agencies threatens the stability of the Fund and its future as a tool for implementing priority environmental policies. Reforming the Fund in accordance with good international practices will not be easy. It will require significant political support and commitment. Without a strong and dedicated leadership, the reform process risks getting stalled, as has been the case so far.

Below is a summary of recommended reforms that have emerged from this Review. These are split into short and medium-term recommendations, and are offered to our counterparts from the MEP and the Ukrainian government for consideration. The proposed improvements constitute a Reform Plan for the Fund which was discussed at a stakeholders' meeting in Kiev on 30 June 2006.

Reform Plan for the State Environmental Protection Fund

I. Short-term Improvements (to be implemented through internal organisational restructuring)

1. Conduct consultations with all major stakeholders in order to agree on a strategy for the use of the Fund's resources. On the basis of the state targeted programmes and the List of Environmental Activities, identify a specific narrow niche and a few priority types of projects to be financed by the Fund.

2. Distinguish the Fund's identity from that of the MEP. Split and clearly specify responsibilities for programming and project cycle management. Improve relations with the local level.

3. Design a proper organisation and management structure (director, multi-stakeholder supervisory board, own functional department and procedures). Specify the appointment procedures for the supervisory and management boards and the performance criteria against which they will be evaluated.

4. Establish an executive unit within the structure of the MEP staffed with 4-8 people exclusively responsible for managing the complete cycle of environmental projects to be financed with support from the Fund. Strengthen the capacity of this unit in project cycle management.

5. Separate (organisationally) the government procurement and expenditure management (project financing) units. Allocate clear responsibilities for project appraisal and selection to the expenditure management unit. For this unit, phase out direct procurement and introduce real direct grants.

6. Introduce and maintain regular monitoring and control of individual investment projects implemented with support from the Fund. Collect data at national level and develop a database on projects financed by the Fund, containing their key financial, technical and environmental information.

7. Develop information disclosure tools (website, communication actions on the Fund's activities).

II. Medium-Term: Recommendations for Reform in the Legal Basis and Institutional Framework of the Fund

Legal Framework and Objectives

- Reduce drastically the number of local Funds and concentrate the resources at national and oblast level, thus bringing them closer to project owners.

- Return revenue from pollution charges currently used by other ministries to the management supervision of the MEP. This would make it possible to create a critical mass of resources for significant environmental investments and ensure better control with regard to the achievement of environmental objectives.

- Introduce a medium-term budget framework to allow for the smooth implementation of multi-year projects.

- Introduce provisions (procedures, rules, appraisal and selection criteria) for ensuring operational independence and proper accountability of staff working on the Fund and operationalise these provisions in regulations on the Fund.

Fund Administration – Institutional and Management Set-up

- Reduce discretionary elements in the selection of projects for financing and shorten the decision-making process: reduce the number of stakeholders taking part in the process; rank projects by priority; affirm the leadership of the MEP; and ask the Cabinet of Ministers to justify its overruling of the MEP's selection decisions.

- Develop specific training programmes for staff in line with the Fund's activities.

- Explore the opportunity of establishing an independent government agency with its own account and assets under the auspices of the MEP or of outsourcing the management of the Fund to a professional manager. Such an initiative will require a new CoM Resolution.

Revenue

- Limit the number of revenue-raising pollution charges to fewer than 10 on the basis of a detailed analysis of the performance of these charges. Replace charges on air pollution from mobile sources by a product charge on fuels.

- Consider introducing charges on environmentally-damaging products (e.g. tires, used batteries, etc), which could ensure a stable revenue stream for the Fund.

- Fight preferential treatment and tax evasion by reinforcing control of the level of pollution declared by polluters.

- Favour revenue stability, i.e. limit as much as possible changes in the share of environmental pollution charges allocated to the Fund.

- Improve forecasting tools to increase visibility of revenue and minimise fund leftovers at the end of the budget year.

- Ensure the strict respect of earmarking, i.e. ensure that higher than projected revenue is not used for purposes other than those stipulated by law.

Expenditure

- Define the programmes of the Fund in line with good international practices – in terms of eligible projects and beneficiaries (municipalities, industries, NGOs), eligible project costs, and clearly identified and robust criteria for appraisal, selection and financing of projects.

- Establish co-financing rates for different classes of projects and set maximum/minimum thresholds (in terms of project financial size) for projects to be supported by the Fund.

- Initiate multi-year budgetary projections (for instance on a three-year horizon).

Project Cycle Management

- Make managers responsible and accountable for project cycle management, including project identification, appraisal, selection, and monitoring.

- Strengthen the capacity of managers conducting project appraisal. Particular improvement will be needed in engineering, economic/financial and legal skills of the staff.

- Introduce rigorous and binding eligibility, appraisal and selection criteria. Make cost-effectiveness (achieving environmental results at minimum costs) a prominent selection criterion.

- Improve communication with potential applicants. Provide clear signals with regard to the types of projects that the Fund is willing to support.

- Introduce and maintain regular monitoring and evaluation of investment projects implemented with support from the Fund (technical, financial, and environmental performance).

- Undertake another review within a 2-3 year period to check progress with implementation of the recommendations and update them as necessary.

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ANNEXES

ANNEX I: UKRAINE – MAIN MACROECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP at market prices (USD mln)	37 023	44 597	50 149	41 892	31 569	31 262	38 009	42 393	50 133	65 039	81 664
Real GDP growth (%)	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	2.6
Gross Fixed Capital Formation (% GDP)	23.3	20.7	19.8	19.6	19.3	19.7	19.7	19.2	20.6	20.2	..
Unemployment (end-of-year; in % of labour force)	5.6	7.6	8.9	11.3	11.6	11.6	10.9	9.6	9.1	8.6	..
Consumer Price Inflation:											
(average; %)	376.4	80.2	15.9	10.6	22.7	28.2	12.0	0.8	5.2	9.0	13.5
(end-period; %)	181.7	39.7	10.1	20	19.2	25.8	6.1	-0.6	8.2	12.3	10.3
Population (mln)	52	51	51	50	50	49	49	48	48	47	46
Current Account Balance (USD mln)	- 1 152	- 1 184	- 1 335	- 1 296	1 658	1 481	1 402	3 173	2 891	6 804	2 183
Trade Balance (USD mln)	-2702	-4296	-4205	-2584	244	779	198	710	- 269	3 741	- 1 576
Current Account/GDP (in %)	-3.1	-2.7	-2.7	-3.1	5.3	4.7	3.7	7.5	5.8	10.5	2.7
External Debt - Reserves (USD mln)	6 974	7 043	7 676	11 603	12 486	10 466	9 143	8 530	7 847	10 855	3 885
External Debt/GDP (in %)	21.4	19.8	19.2	28.6	42.8	37.8	31.8	30.1	29.1	31.0	29.6
External Debt/Exports of Goods and Services (%)	48.6	46.6	54.3	73.7	81.3	60.5	57.4	54.7	50.4	50.7	54.5

Source: EBRD *Transition Report Update*, May 2006; IMF *World Economic Outlook Database* 2006.

ANNEX II: EXAMPLE OF ALLOCATION OF RESOURCES BY TYPES OF EXPENDITURE UNDER THE DNIEPRO RIVER BASIN STATE TARGETED PROGRAMME

This Annex offers a more detailed presentation of and some observations on the structure of the state targeted National Programme for the Environmental Rehabilitation of the Dnipro River Basin and the Improvement of the Quality Drinking Water".

Broadly, this programme presentation contains:

- A statement of the problems that need to be addressed in order to improve the state of the environment in the Dnipro River Basin.

- A statement of the main objective of the programme ("provides the opportunity to create the necessary preliminary conditions for the effective solution of the [...] major problems through the improvement of the state of the environment of the Dnipro River Basin and water supply") and how this objective can be attained (i.e. prevention of pollution of surface and underground waters, ecologically safe use of water resources, renewal and support of the hydrological balance of rivers, measures to prevent negative impacts on water, and improvement of the management system for the protection of water resources and their use).

- A division of the programme's tasks into two stages, including a general description of these two stages and a list of the major tasks of each stage.

- A list of priority tasks and subtasks. Most of the priority tasks contain a brief description of the strategic objective, whereas the subtasks typically contain a list of long-term and intermediate goals. Some descriptions of the tasks and subtasks are detailed and contain cross-references to other state programmes (and demonstrate occasional overlap among these programmes).

- An estimate of costs for programme implementation and sources of funding (the document is very weak on the second point).

- A description of the mechanisms for implementing and funding the programme and exercising control over monitoring its performance.

- Economic and organisational mechanisms and control for implementation of the programme.

- Issues related to international cooperation with regard to programme implementation.

The programme presentation also contains a list indicating the approximate volume of investments required to improve the environmental state of the Dnipro River basin and to improve the quality of drinking water. The list covers the time period 1997-2010. Total expenditure for the entire programme is estimated at UAH 4.2 billion for the period 1997-2010, of which UAH 2.0 billion are to be spent during 2001-2010 (in 1996 prices).

Resources for implementing this programme are envisaged to be allocated to institutions at both national and oblast level, including:

1. **oblast state agencies (**construction and reconstruction of facilities and water supply and wastewater collection networks, measures for the regulation of wastewater collection in urban areas and measures for prevention of water pollution from cattle breeding wastewater); and

2. **ministries and agencies** – Ministry of Industry, State Committee for Oil and Gas, Ministry of Oil Industry, Ministry of Machine Manufacturing, other sectoral ministries and agencies (Ministry of

Energy, Ministry of Agriculture and Food Manufacturing, State Committee for Food Industry), State Committee for Water Management, State Committee for Land, Ministry of Forestry, Ministry of Environmental Protection and Nuclear Safety, State Committee for Geology and Subsoil Use and Ministry of Fishery. Money is also allocated for scientific-technical support for programme implementation to the Ministry of Environmental Protection and Nuclear Safety, the State Committee for Housing and Municipal Economy, the National Academy of Science, the Ministry of Health and other ministries and agencies (State Committee for Hydrometeorology, State Committee for Urban Construction, State Committee for Land, Ministry of Agriculture and Food Manufacturing).

Investments have been carried out, or are planned, for the following project areas:

1. Quality and protection of surface and ground waters, of which:

- Improvement of existing water sewage collection for entities of communal housing services.
- Improvement of existing water sewage collection for enterprises:
  - **5.1**% of the total funds planned for 2001-2010 are targeted at the "construction (reconstruction) of wastewater treatment facilities of industrial enterprises" administered by the Ministry of Industry, Ministry of Machine Manufacturing, Ministry of Coal Industry, Ministry of Energy, Ministry of Agriculture and Food Manufacturing, State Committee for Food Industry and State Committee for Oil and Gas.
  - **6.6**% of the total funds planned for 2001-2010 are targeted at the "prevention of pollution of water by infiltration from storage tanks of industrial (especially toxic) waste and city dumps, oil products, toxic chemicals, etc." administered by the Ministry of Industry.
- Improvement of existing water sewage collection services from agricultural lands:
  - **30.8**% of the total funds planned for 2001-2010 are targeted at the "construction of anti-erosion hydrotechnical facilities" administered by the State Committee for Land.
  - **a residual amount (0.5**%) of the total funds planned for 2001-2010 are targeted at the "prevention of pollution of water bodies from wastewater discharged by enterprises with intensive cattle breeding" administered by the oblast state agencies.
- Improvement of existing water sewage collection services on urbanised territories:
  - **9.0%** of the total funds planned for 2001-2010 are targeted at the "improvement of existing water sewage collection services on urbanised territories" administered by the oblast and Kiev city state agencies.
  - **7.8%** of the total funds planned for 2001-2010 are targeted at the "reorganisation of the system of water sewage collection services" administered by the oblast and Kiev city state agencies.
  - **1.2%** of the total funds planned for 2001-2010 are targeted at "equipping storm-water sewerage networks with facilities of capturing pollutants in storm waters" administered by the oblast and Kiev city state agencies.
- Ensuring the environmentally safe operation of water reservoirs of the Dnipro cascade:
  - **2.3%** of the total funds planned for 2001-2010 are targeted at "measures to increase the fish stock of reservoirs;" administered by the Ministry of Fishery.
- Prevention of pollution of ground waters:

- **a residual amount (0.7%)** of the total funds planned for 2001-2010 are targeted at "measures for the protection of ground waters (organisation of monitoring and investigations)," administered by the State Committee for Geology.

2. Environmentally safe use of water resources, of which:

- Improvement and increase of technical and technological level of special water use.

- Introduction of low- and water-free technologies, recycled wastewater, close (discharge-free) systems of industrial water supply:

  - **6.6%** of the total funds planned for 2001-2010 are targeted at the "construction and reconstruction of facilities for recycling industrial water supply of enterprises" administered by the Ministry of Industry, Ministry of Machine Manufacturing, Ministry of Coal Industry, Ministry of Energy, Ministry of Agriculture and Food Manufacturing, State Committee for Food Industry and the State Committee for Oil and Gas.

3. Renewal and maintenance of favourable hydrological state of rivers and measures for control of adverse impacts on waters, of which:

- Creation and improvement of water-protection zones and coastal strips.

- Work on rivers and bodies of water:

  - **6.2%** of the total funds planned for 2001-2010 are targeted at the "regulation of river beds, renewal and maintenance of a favourable hydrological regime and sanitary state of river bank fortifications" administered by the State Committee for Water Management.

  - **5.1**% of the total funds planned for 2001-2010 are targeted at "bank fortifications" administered by the State Committee for Water Management.

- Implementation of agro-technical, agro-forest melioration and hydro-technical anti-erosion measures:

  - **a residual amount (0.4**%) of the total funds planned for 2001-2010 are targeted at the "construction of anti-erosion hydro-technical facilities along with water- and ground-protection measures" administered by the State Committee for Water Management.

  - **2.4**% of the total funds planned for 2001-2010 are targeted at the "creation of protective forest plantations on lands threatened by erosion, including water-protection" administered by the Ministry of Forestry.

- Prevention of adverse impacts on waters:

  - **7.7**% of the total funds planned for 2001-2010 are targeted at the "construction of hydro-technical facilities"; the programme does not specify which body is responsible for this area.

  - **3.4**% of the total funds planned for 2001-2010 are targeted at the "construction of protection anti-flood dikes"; the programme does not specify which body is responsible for this area.

- Works targeted at improving the network of the basin-wide nature reserve inventory.

4. Introduction of the river basin management principle in the use, protection and restoration of water resources.

5. Improvement of quality of drinking water.

6. Reduction of the effects of radioactive pollution:

- **3.7**% of the total funds planned for 2001-2010 are targeted at "ensuring the scientific-technical support and reserve fund of the programme."

Appendix 2 (Measures for environmental improvement of the Dnipro River basin and the quality of drinking water) to the programme contains tables outlining required investments. These include:

- Table 1 – Construction (reconstruction) of water supply and sewerage systems in towns and settlements until 2000 (by units and costs by oblast);
- Table 2 – Investments in construction of anti-erosion hydro-technical facilities (divided into periods: 1997-2000 and 2001-2010, provided by oblast);
- Table 3 – Average annual area of agro-technical anti-erosion works (hectares by oblast);
- Table 4 – Area of damaged lands to be recultivated (hectares by oblast);
- Table 5 – Area of eroded and technologically polluted arable lands that are subject to conservation (hectares by oblast);
- Table 6 – Area of creation of water-protection forest plantations (hectares by oblast);
- Table 7 – Works and investments for preventing pollution of water systems by wastewater resulting from intensive cattle breeding during 1997-2010 (processing capacity by oblast with approximate costs);
- Table 8 – Works and investments in existing water sewage services on urbanised territories during 1997-2010 (capacity by oblast with approximate costs);
- Table 9 – Works and investments in restoration and maintaining a favourable hydrological regime and sanitary state of rivers (length of rivers by oblast with approximate costs for periods 1997-2000 and 2001-2010);
- Table 10 – Work and investments in the fortification of riverbanks and water systems (length of rivers by oblast with approximate costs for periods 1997-2000 and 2001-2010);
- Table 11 – Work and investments in water-protection and ground-conservation (area of land by oblast with approximate costs for periods 1997-2000 and 2001-2010);
- Table 12 – Amount of works and investments in construction of facilities for prevention of the adverse impact on water (number of units and length of dikes by oblast with approximate costs for periods 1997-2000 and 2001-2010);
- Table 13 – Creation of protection forest plantations on land threatened by erosion (area by oblast with approximate costs for periods 1997-2000 and 2001-2010);
- Table 14 – Development of sites of the nature reserve inventory (specific location, area and costs); and
- Table 15 – Amount of investments in measures for engineering water-protection in the zone of the Chernobyl Nuclear Power Plant (specific list of projects, cost, period of financing 1997-2000 and 2001-2010).

Some of the tables (14 and 15) contain references to specific projects or locations. Such projects usually stand a better chance of obtaining financing from the State Fund.

ANNEX III: APPLICATION FORM USED BY THE STATE FUND

1. Project title _____

2. Information on the applicant:
2.1. Full name _____
2.2. Address _____
2.3. Phone, fax _____
2.4. Form of ownership _____

3. Information on the beneficiary (if different from the applicant):
3.1. Full name _____
3.2. Address _____
3.3. Phone, fax _____
3.4. Form of ownership _____

4. Information on payments of pollution charges:
4.1. Pollution charges due and actually paid during previous two years
charged _____in _____, actually paid _____
charged _____in _____, actually paid _____
4.2. Fines and compensations for losses in the case of violation of the environmental legislation during the previous two years:
charged _____ in_____, actually paid _____
charged _____ in_____, actually paid _____

5. Location (address) of the project site: _____

6. Project description:
6.1. The impact of environmental effect (local, regional or state level)
_____
6.2. Compliance with environmental legislation (reference to key documents or programmes outlining the environmental policy) _____
_____
6.3. Purpose and main tasks (environmental project objective – prevention, liquidation or reduction of pollution and short description of the project) _____
_____
_____
6.4. Environmental aspects (a detailed description of the pollutants to be removed or limited as a result of project implementation only if the project is fully completed and equipment comes into operation the same year when support from the Fund is provided. To the extent possible, the applicant should quantify the environmental effect by calculating appropriate indicators, e.g. reduction of pollution per year)
_____
_____
6.5. Introduction of resource and energy saving technologies (provided only if project is fully completed and equipment comes into operation the same year when support from the Fund is provided) _____
_____
7. Technical documentation (information on the main developer, date of approval): _____
_____
8. Applied technologies (local or foreign technology, level of its development): _____
_____

9. Project cost (in real prices):
9.1. Total project cost (thousand UAH) _____
9.2. Level of project implementation on the date of submitting the request (% of total project value)
_____
9.3. Financing from the State Fund (code of the functional and economic classification of budget expenditures (KEKB), thousand UAH)
Total _____, including the year _____
(year of application) _____KEKB _____
Actual expenditures in previous year _____ KEKB _____
9.4. Own financial resources (thousand UAH) total _____
e.g. in _____ year (year of application) _____
9.5. Other financial sources (thousand UAH) total: _____
Name of sponsor _____ amount of finance _____
e.g. in _____ year (year of application):
Name of sponsor _____ amount of finance _____

10. Project duration (the date of beginning, the date of completion, project duration): _____
_____

11. Payback period (period after which the project will start generating positive cash flow)**:** _____
_____

Director

Chief Accountant

_____

If the project includes capital investments, the following annexes should be attached to the document:

- Estimate of expenditures to be financed from the State Fund in the year _____;
- Project implementation schedule in the year _____;
- Copies (or extracts) of documents, mentioned as project background_____

Estimates of Project Costs Requested to Be Financed by the State Environmental Protection Fund

“_____”

(project name as in the application form)

in _____ year

Activities (Implementation Stages)	Cost (Thousand UAH)	KEKB
...		
...		
Total Project Cost		

Seal

Head

Chief Accountant

Conditions for the preparation and presentation of cost estimates for construction works are defined by State construction norms.

Time-Table for Implementation of the Project

“_____”

(project name as in the application form)

Supported by the State Environmental Protection Fund

in _____ year

Activities (Implementation Stages)	Implementation Period Starting at the Moment of Financing (Months or Weeks)											
										0	**1**	**2**
...												

Seal

Head

Chief Accountant

ANNEX IV: EXAMPLE OF A TWO-STAGE APPLICATION AND APPRAISAL PROCESS

The purpose of this annex is to provide an overview of a two-step application process based on the experience of the Krakow Provincial Fund for Environmental Protection and Water Management (Poland) (the Krakow Fund). The Krakow Fund is widely regarded as one of the most successful Central and East European environmental funds.

The Krakow Fund supports the implementation of national, regional and local environmental policy by co-financing activities that achieve significant environmental benefits at the lowest possible cost. To this end, the Krakow Fund employs explicit and objective procedures and criteria for the evaluation of environmental project applications. The use of these procedures and criteria result in systematic and clear decision-making processes at the Fund. Broadly speaking, the project selection procedure at the Fund comprises two main stages. The first stage is project screening. The second stage is the appraisal, ranking and selection of projects that have been screened as meeting the basic requirements of the Fund and qualify for receiving financial support from the Fund.

During the first stage, the Krakow Fund collects so-called "Project Information Forms" containing basic project data completed by project proponents. The purpose of the preliminary selection is to reveal at an early stage those proposals that do not have a chance to be financed by the Fund. A second aim is to identify, as early as possible, those projects that might be eligible for financing but require additional and better preparation. In the pre-selection stage, the Krakow Fund applies "cut-off" criteria in the form of questions to which applicants answer "yes" or "no." If a proposal fails to meet even one of the criteria it is excluded from further consideration. This enables the applicant to save expensive project preparation costs and also saves Krakow Fund employees time since they do not have to review projects that do not meet even basic requirements.

During the second stage, the applicant completes a full application form which consists of three parts: general information on the applicant and the project (part "A"); technical and environmental information, such as on the type of technology to be used, the location of the project and the expected environmental impact (part "B"); and economic/financial information on the applicant and the project (part "C"). A fourth part contains Attachments to the Application. Along with the application form, the applicant receives guidelines on how to complete the form.

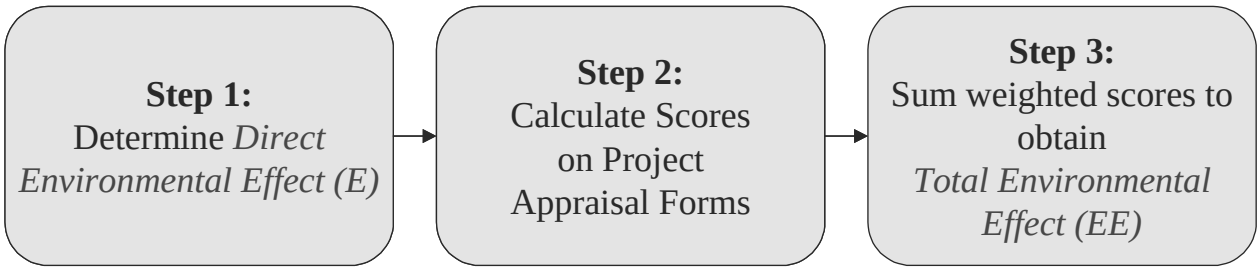
This annex concludes with an example of a full application form submitted to the Krakow Fund for a wastewater management project. Part A of this application contains general information about the applicant (type of applicant, contact information, etc.) and the project (type of investment, etc.). Part B, based on the provided example of a wastewater management project, contains information on the sewer network (length, technical data) and environmental data (wastewater treatment parameters) before and after the project. Part C contains information on investment outlays, type of assistance requested (loan or grant), proposed loan instalments and repayment schedule, forecast of revenues and operating costs, other financial obligations, depreciation rates on assets, etc. Required attachments include: financial documents (budgets, financial statements, analysis of creditworthiness), ownership titles to land involved, permits, environmental impact assessment (EIA), project status and preparation, feasibility study, etc. After completing the Application Form, the applicant submits it with attachments to the Krakow Fund. While applications are accepted on an on-going basis, they are evaluated quarterly.

Technical Evaluation

For investment projects, the Krakow Fund technical staff examine the environmental and technical components of the application (part "B") according to an appraisal table. The final outcome of the technical appraisal is the aggregated environmental effect indicator for the project, which is shown as an absolute

value of the effect "weighted" by the level of compliance with "soft" criteria used by the Krakow Fund in the process of project appraisal. In essence, this is a scoring procedure that rewards projects that are consistent with the Krakow Fund's environmental objectives. Categories include type of technology, extent of the solution (is more than one issue, such as wastewater treatment and sludge management, addressed?), location of investment (in a protected area, in a large agglomeration?), number of beneficiaries (large population covered by investment or one small section of a city/town?), etc. The higher the conformity with the Krakow Fund's objectives, the higher the score. Further, the Krakow Fund weighs the different evaluation categories to show the relative importance of one category over another (for instance, the importance of the technology over the extent of project preparation, or vice versa). This score is then multiplied by the direct environmental effect (for instance, volume of incremental wastewater treated as a result of the project). The final outcome of this evaluation is the total environmental effect (EE).

Calculating EE depends on the type of environmental project and it is done in three subsequent stages, as shown below.



Step 1: The direct environmental effect differs by the type of project. For a wastewater management project, the direct environmental effect is typically the volume of wastewater treated as a result of the project.

1) For communal wastewater:
If **BOD_5 < 350** g / m^3
Or **N-NH_4 < 70** g / m^3
=> then E = volume of wastewater treated (e.g. 6 200 m^3/day)

2) For industrial and combined wastewater:
If **BOD_5 > 350** g / m^3,
Or **N- NH_4 > 70** g / m^3,
=> then E = k × volume of wastewater treated
where:

$$k = \sqrt{\frac{BOD5}{300}}$$

or

$$k = \sqrt{\frac{N - NH4}{60}}$$

Note: Choose the higher 'k': The higher 'k' is chosen if both BOD_5 and N-NH_4 are available; this provides a more liberal estimate of the environmental effect.

Step 2 involves calculating a score based on reported project characteristics. A sample form for a wastewater treatment project is shown below. Using this form, a project evaluator can calculate the total environmental effect (EE) (Step 3). This result is combined with the results of the economic evaluation to obtain the Environmental Project Efficiency (EPE) score, which is the basis for project ranking.

Example of a Technical Appraisal Table for a Wastewater Management Project (Used in Step 2) (points and weights given are illustrative)

P	*Criteria*	*Max. Points*	*Sum of Points*
P_1 *Level of preparation; proposed solution*		**Weight 0.15**	
$P_{1.1}$	Project technological and management concepts agreed (see Feasibility Study)	1	
$P_{1.2}$	Project results in compliance with current regulations in force	1	
$P_{1.3}$	Receiver of waste and sludge has been identified and confirmed	1	
$P_{1.4}$	Environmental Impact Assessment complete	1	
$P_{1.5}$	Public tender for project implementation complete	1	
$P_{1.6}$	Decision on the conditions for construction and management of land plot	1	
$P_{1.7}$	Construction design complete	1.5	
$P_{1.8}$	Permits: water and construction permits obtained	1.5	
Together P_1 (sum of points multiplied by weight)			
P_2 *Significance of the effects, modernity of project*		**Weight: 0.35**	
$P_{2.1}$	Protection of water intakes, located downstream from the wastewater treatment plant (WWTP) outfall and further than 10 km from the WWTP	1	
$P_{2.2}$	Protection of water in recreational and water sport areas	1	
$P_{2.3}$	Protection of water in nature reserves	1	
$P_{2.4}$	Protection of water as the 3rd or 4th purity class	1	
$P_{2.5}$	Technology	3	
Together P_2 (sum of points multiplied by the weight)			
P_3 *Significance of effects – protection of human health and environment*		**Weight 0.50**	
$P_{3.1}$	Protection of water intakes located downstream from the WWTP outfall and closer than 10 km (1 point) or closer than 5 km (2 points) or closer than 3 km (3 points)	3	
$P_{3.2}$	Receiving water protection body, classified as 1st purity class (2 points) or 2nd purity class (1 point)	2	
$P_{3.3}$	Sewage system development in built-up areas	1	
$P_{3.4}$	Final destination of sludge has been determined	1	
Together P_3 (sum of points multiplied by weight)			
P	**Total sum of points ∑ P**		
E Direct environmental effect			
E_k	**For municipal sewage** – (based on the volume of treated wastewater)		
E_p	**For combined and industrial sewage** – (based on population equivalents (PE)[18])		
EE	**Total environmental effect = direct environmental effect (E) times weighted sum of points (∑ P x E)**		

[18] Population equivalent (PE) is calculated by dividing the total daily load of BOD_5 discharged into the system by the quantity of BOD_5 released by a single person per day (0.06 kg). PE is a way to "convert" industrial and non-residential wastewater into residential wastewater equivalents, as measured by BOD_5.

Financial/Economic Evaluation

While the environmental evaluation is being calculated, the Krakow Fund economic and financial staff conduct a financial analysis using data from Part C of the application. The result is an aggregated Net Present Value (NPV) indicator, which takes into account both the stream of costs and benefits of a loan/grant (NPV of the Fund) and the stream of costs and benefits from the investment itself. Projects that the Fund estimates to be "very profitable", i.e. those generating a positive NPV at a high discount rate (commercial rate of return), or those deemed "very unprofitable", i.e., those generating a negative NPV at a low discount rate (social rate of return) are excluded from consideration on the final ranking list.

Based on data in Part C of the application, the Fund estimates project effectiveness as well as the effectiveness of the financial support the Fund could provide to the project. The Fund discounts the streams of costs and benefits in order to calculate an aggregate indicator enabling the comparison of individual projects. Based on data provided by the applicant, the Fund estimates:

- **NPV indicator for the Fund's resources**

The indicator is estimated for an annual discount rate equal to the Central Bank re-discount rate. A loan or a grant (with instalments paid out over time) will be treated as an outflow of the Fund, whereas loan repayments as an inflow. While this indicator will always be negative, its magnitude will depend on the value of the Fund's co-financing of the project and the form of assistance (a grant provides no inflow to the Fund), as well as on the grace and repayment periods for loans (the shorter the repayment period, the higher the indicator).

- **NPV indicator for investment outlays**

This indicator is estimated using standard methods for appraisal of investment effectiveness. Inflows (revenues) and outflows (investment outlays; operating and maintenance costs less depreciation; interest; profit; etc.) will be taken into account. The Fund calculates NPV using two different discount rates, for example, 7 and 15% (10% and 20% before taxes). The choice of discount rates depends on the overall economic situation of the country. If the project generates a negative NPV at the lower discount rate, the investment may be rejected as too costly. This lower rate is sometimes called the "social discount rate", typically used for public investments. It is the lowest possible discount rate applied for projects in the public sector that yield high social benefits. This means that a project financed by the Fund should in principle have a positive NPV with the social discount rate. If the project generates a positive NPV at the higher discount rate, the investment may be rejected as well because it can easily be implemented using commercial sources of finance. This is the discount rate for commercial investments and is the lowest discount rate acceptable by commercial investors.

The two indicators are multiplied by appropriate weights (implied by current priorities and principles of the Fund) and constitute the aggregated NPV indicator.

Aggregated NPV = *k* * NPV of Fund resources engaged in the project + *n* * NPV of the investment

Where n+k=1

Note: The weighting of the n and k indicators is a matter of Fund policy.

Calculating the Environmental Effect

Once both the aggregated NPV indicator and the aggregated environmental effect have been calculated, Fund staff conduct a final appraisal for investment projects. The final scoring is conducted using a special scoring table attached to the application by the Fund and specially designed computer software. The outcome of this final appraisal is the "**Environmental Project Efficiency**" (EPE) indicator. The EPE is a type of cost-effectiveness indicator that is also the basis for ranking projects within their own categories (that is, wastewater treatment projects are compared with wastewater treatment projects). After an application is placed on the ranking list, one copy is sent to the Fund's contracted bank. The bank estimates the current financial solvency of the applicant and sends its opinion to the Fund within three weeks (for both grants and

loans). Once the projects have been ranked, the Fund generally finances the top projects, while remaining within its budget limits for the given type of projects. The formula for estimating environmental project efficiency (EPE) is as follows:

EPE = EE/aggregated NPV indicator

where EE refers to the aggregated and weighted environmental effect estimated in Part B of the application.

Projects that have the highest EPE value will be most likely to receive financial assistance from the Fund.

Ranking of Projects

Based on the estimated EPE indicators, a ranking list of projects is prepared. The selection of projects with the highest EPE values will allow the Fund to finance first and foremost projects that achieve a high environmental effect at low cost (both values take into account additional conditions, such as location, operating costs, etc.). Projects with lower EPE values may also be financed, though perhaps at a later time, depending on the availability of financial resources at the Fund.

In the last week of every quarter, the Fund establishes a ranking list of investment projects based on the final appraisal of applications and the bank opinions, and submits this list to the Fund's Management Board for acceptance. At the first meeting of the quarter, following submission of the recommendation list by the Management Board, the Fund's Supervisory Council makes the final decision as to which proposals shall be awarded financial support. If the Supervisory Council does not follow the recommendations of the Management Board, it must explain its rationale for doing so and provide this explanation in writing if so requested. This requirement may be waived in cases where such disclosure would infringe on the relevant laws on state or commercial confidentiality.

Below are examples of the Project Information Form (used for eligibility screening) and the full Application Form for investment wastewater management projects that are used by the Krakow Fund as a basis for appraising and selecting projects to be co-financed by the Fund.

A: Project Information Form

INVESTMENT PROJECT INFORMATION FORM
WASTEWATER MANAGEMENT

CODE (to be entered by the Fund) | |

A. GENERAL INFORMATION

A-1. Project title (one sentence, precisely defining the scope of the project)

Construction of trunk lines and connections of sanitary sewer lines (gravity and pressure) in the villages of X and Y

A-2. Project promoter

Name:	Town Hall of Sample City
Legal status:	Local self-government unit
Address:	00-000 Sample City; Sample Street
Person authorised for contacts with the Fund:	Mr. George Smith, Head of Investment Department, Communal Management and Environmental Protection
Phone:	+48-48-123-4567
Fax:	+48-48-123-4567

A-3. Administrative location of the project

Region malopolska, county: krakowski, municipality: Sample City, village X and Y

A-4. Major goals of the project

Protection of water intake and ensuring sanitation of water in the receiving body (Ruby River). Liquidation of individual cesspools and sewer tanks. Protection of the natural environment.

A-5. Major environmental effects expected

Ensuring purity of water in the Ruby River upstream from the drinking water intake for the Capital City (nearby major city). Connection of 117 lots and the Primary School in village X as well as 7 apartment blocks in village Y to the WWTP in village X.

A-6. Is the project promoter in compliance with legal obligations to pay pollution charges and non-compliance fees (that are the sources of revenue for Environmental Funds in Poland)?

Yes √ **No** □

B. TECHNICAL AND ENGINEERING PLAN - WASTE MANAGEMENT

B-1. Sewage network and wastewater mains

Already exist	**yes**/~~no~~
Will be built concurrently with the WWTP	~~yes/no~~
Other (please explain)	~~yes/no~~

B-2. Wastewater balance **0 – present state, 1- state after project completion**

Environmental Data	Units	0	1
Wastewater volume	m^3/y	0	40.981
Demand on WWTP	Population equivalents	0	564
COD	g / m^3	634	60
BOD_5	g / m^3	317	15
N total	g / m^3	58.7	30
P – total	g / m^3	11.7	1.5
Total suspended solids	g / m^3	317	25

B-3. Sludge management

Sludge amount after stabilisation and de-watering	m^3 / y	0.25
Volume of sand	m^3 / y	0.25
Sludge management - description	Sludge will be given to farmers or collected by firms specialised in incineration of sludge.	

B-4. Impact on receiving water **0 – present state, 1- state after project completion**

Environmental Data	Units	1
COD	g / m^3	8.22
BOD_5	g / m^3	4.12
N total	g / m^3	5.45
P total	g / m^3	0.14
Total suspended solids	g / m^3	20.04

B-5. Receiving body (name): ___ Ruby River _____

B-6. Information concerning the expansion of the sewage network

1. For villages and small towns	Number of households to be connected to the sewage network (provide the full list of addresses in the annex)
2. For larger agglomerations	Provide detailed wastewater balance according to the technical documentation (in the annex)

B-7. Legal status of the land for the WWTP (please describe): _____
Municipally-owned

B-8. Has the promoter received financing from the Fund previously? **NO**

Project Names and Codes	Amount and Disbursement Instrument	Date of Fund's Decision

C. FINANCIAL PLAN OF THE PROJECT

C-1. Financial plan

Sources of Financing	Total (currency)	Total Investment Outlays for the Project (Amounts from Year .....)		
		Including		
		Resources Already Disbursed	Resources Committed	Resources Planned
Own resources	USD 187 500		USD 187 500	
Credits and loans (sources) 1. ..... 2.	.....	.....	.....	.....
Grants (sources) 1. ..... 2.				
Disbursement mechanism applied for (circle those appropriate) - direct grant - interest subsidy - soft loan (maturity: 8 years) - equity investment	.... USD 312 500	....	....	.... USD 312 500
Total	**USD 500 000**		**USD 187 500**	**USD 312 500**

C-2. Estimated O&M costs in USD/year (in 2005 prices)	USD 30 000

C-3. Planned sources of debt servicing

Revenue Source	Share in %
Operating REVENUES (tariffs)	100%

C-4. Planned sources for financing O&M costs

Revenue Sources	Share in %
Operating REVENUES (tariffs)	100%

FUND'S COMMENTS

Declaration

I herewith declare that, to the best of my knowledge, all information contained in this Project Information Form is true and complete. Should the information provided herein be false or incomplete I agree to reimburse the Fund, upon its request, the full amount of the awarded subsidy as well as a contractual fine and all administrative costs connected with processing this application and the execution of the liabilities of the entity that I represent.

Name:	Date:	Signature:

APPRAISAL TABLE FOR PRE-SELECTION OF WASTEWATER MANAGEMENT INVESTMENT PROJECTS (To be filled out by the Fund)						
Criteria		**Questions in Project Information Form**	**Basis for appraisal**	**Is information complete? (YES/NO)**	**Appraisal (YES/NO)**	**Comments**
1	Are major goals and expected environmental effects consistent with the Fund's mission and eligibility criteria?	A-1; A-4; A-5	Environmental Protection Law, Fund’s Statute, Rules of Providing Grants and Loans			
2	Is the project promoter eligible for receiving assistance from the Fund?	A-2	Environmental Protection Law, Fund’s Statute, Rules of Providing Grants and Loans			
3	Is the project consistent with priorities and principles of regional and local environmental policy?	A-1; A-3; A-4; A-5	Statement of the Voivod Environmental Department and municipal authorities			
4	Does the project promoter fulfil obligations to pay pollution charges and non-compliance fees?	A-6	Statement of the Accounting Department in the Voivod Office			
5	Do sewer network and collectors exist (or is there a realistic implementation plan for them?)	B-1	Judgment of Fund's technical team			
6	Are sewage and basic pollution balanced?	B-2	Local Land Use Plan			
7	Are waste and sludge quantities specified? What techniques of waste and sludge utilisation were used?	B-3; B-4; B-5	Statement by municipal authorities and judgment by the Fund's technical team			
8	Does the property rights situation enable appropriate implementation and operation of the project?	B-7	Judgment by the Fund's staff			
10	Does the financing plan provide for financing investment outlays?	C-1, C-3	Judgment by the Fund's finance team			
11	Is there a sufficient contribution from the promoter's own resources?	C-1	Rules of Providing Grants and Loans			
12	Does the project provide for appropriate financing of debt servicing and O&M costs?	C-2, C-4	Judgment by the Fund's finance team			
13	Does the disbursement mechanism that the project promoter proposes comply with the provisions of the Fund's statute?	C-1	Environmental Protection Law, Fund’s Statute, Rules of Providing Grants and Loans			
14	Is the expected unit cost of achieving the environmental effect in line with the average value-for-money for similar projects?	B1 / C1, C2	Judgment by the Fund's experts			

Note: If the Fund, on the basis of this table, finds that the information provided by the applicant is incomplete, the applicant is asked to supplement the information. Once the information is complete, the decision is made as to whether compliance is met for each question (a “yes” response). If all responses are “yes”, the applicant is invited to submit a full application. If one “no” response is listed above, the application is rejected.

B: Full Project Application Form

INVESTMENT PROJECT APPLICATION FORM
WASTEWATER MANAGEMENT

(To be Completed by the Applicant)

PROJECT CODE (for Fund only)

The Application consists of three parts:

Part 'A' – general data
Part 'B' – technical-environmental data
Part 'C' – economic-financial data

INVESTMENT PROJECT APPLICATION FORM
WASTEWATER MANAGEMENT

PART 'A'

GENERAL DATA

PROJECT CODE (for Fund only)

A-1 Applicant Information		
A-1.1 Full name	Town Hall of Sample City	
A-1.2 Address	00-000 Sample City; Sample Street	
A-1.3 Telephone	+48-48-123-4567	
A-1.4 Fax	+48-48-123-4567	
A-1.5 Person responsible for contacts with the Fund	Mr. George Smith, Head of Investment Department, Communal Management and Environmental Protection	
A-1.6 Full names and functions of people responsible for the project	Ms. Ellen Curtis, Mayor of Sample City Mr. George Smith, Head of Investment Department, Communal Management and Environmental Protection	
A-1.7 Applicant's legal status	Local self-government unit	
A-1.8 Is the applicant's legal status or property regime likely to change:	Before project is implemented? NO	Before debts are paid? NO
A-1.9 If yes, what will be the future legal form?	Does not apply	
A-1.10 Value of applicant's assets (for municipalities – value of annual budget)	USD 13.2 mln	
A-1.11 Owners, major stakeholders:	Town Hall; Local government budget	
A-1.12 Institutions / firms jointly implementing the project	Woodrow, Joint Stock Company 00-000 Neighbour City; Neighbour Street	
A-1.13 What is the division of responsibilities?	The Contractor performs the work in accordance with contract no. [number of contract] of 10 February 2005	

A-2 Project Information			
A-2.1 Short description of the project and its status			
Construction of trunk lines and connections of sanitary sewer lines (gravity and pressure) in the villages of X and Y as follows: a) PVC sewers of diameter 250 mm, length = 535 m b) PVC sewers of diameter 200 mm, length = 4 276 m c) PVC sewers of diameter 160 mm, length = 3 080.5 m collectors d) Pressure mains made of polyethylene (PE) of diameter 63 mm, length = 618.5 m e) Wastewater pumping station (3) Construction of sewer lines will enable the collection of wastewater from 116 lots and from the Primary School in village X as well as from 7 apartment blocks in village Y. The wastewater will be transported to the WWTP in village X (capacity Q = 800 m^3/day).			
Origins and environmental effects of the project, project goals			
A-2.2 Description of factors that inspired the project	Protection of water intake and ensuring sanitation of water in the receiving body (Ruby River). Liquidation of individual cesspools and sewer tanks. Protection of the natural environment		
A-2.3 Major project goals	Management of wastewater in the villages of X and Y.		
A-2.4 Expected environmental effects	Ensuring purity of water in the Ruby River upstream from the drinking water intake for the Capital City (nearby major city). Connection of 117 lots and the Primary School in village X as well as 7 apartment blocks in village Y to the WWTP in village X.		
A-2.5 Impact on human health of the environmental effect (morbidity rate)	Improvement of the sanitation and epidemiological status of residents. Protection of water in the Ruby River and Diamond River watersheds (the latter is the major watershed in the country).		
A-2.6 Population affected by health impact	3 466 residents		
A-2.7 Implementation Schedule (stage)	Start Date	End Date	
Preparation and design	2000	26 February 2004	
Purchases/procurements	--	--	
Construction	10 February 2005	30 June 2005	
Start-up and staff training	1 July 2005	30 September 2005	
Operation	1 October 2005	30 June 2006	
Description of critical factors affecting project implementation: - No financing available apart from the local government budget			

A-2.8 Project status (describe activities and tasks completed to date):	Date
Construction design completed with construction permits	30 February 2004
Completed by 2004: - sanitary collector made of PVC pipe, diameter fi 200-315, l= 3 705 m - pressure collector made of PVC pipe, diameter fi 160-200, l= 981 m - wastewater pumping station (2 items) - WWTP in village X, capacity 800 m^3/day (1) – the start-up of the WWTP will take place by 30 September 2005	30 September 2004
Unrestricted tender procedure announced for the performance of works (sewers) in accordance with the Public Procurement Law	30 November 2004
Works contractor selected and contract signed	10 February 2005

A-2.9 Activities and tasks to be completed by the time the project is implemented	Deadline
Construction of a sanitary sewer system in accordance with the application	By 30 June 2005
Connection of 116 plots, the Primary School in village X and 7 apartment blocks in village Y to the sewer system	By 30 June 2005

PART 'B'
TECHNICAL-ENVIRONMENTAL DATA
WASTEWATER MANAGEMENT

PROJECT CODE (for Fund only)

Part 'B' for wastewater management consists of four parts (to be completed by the Applicant):

Part-1 Project area data

Part-2 Sewer system data

Part-3 Data on the proposed technology

Part-4 Data on forecasted environmental effects

Part-1 – Project Area Data

0 – present state, 1- state after project completion

U	Applicant Data	Units	0	1
U_1	Number of inhabitants (project area)	Persons	1 915	1 930
U_2	Number of inhabitants connected to the water supply system	Persons	1 816	1 840
U_3	Number of inhabitants connected to the sewer system	Persons	0	858
U_4	Water rate – industry	USD / m^3	0.59	0.59
U_5	Sewer rate – industry	USD / m^3	0.59	0.59
U_6	Percentage of the wastewater treated	%	0	46.6
U_7	Projected number of inhabitants according to the current land use plan	Persons	2 500	
U_8	Legal form of the sewer system (before and after)			
	Budget institution			
	Company with municipal participation		Yes	Yes
	Other (specify type?)			
U_9	Legal form of wastewater treatment plant (before and after)			
	Budget institution			
	Company with municipal participation		Yes	Yes
	Other (specify type?)			
U_{10}	Production of industry or enterprise (specify type of production and unit of production)			
	Type .....X „ .....Y „ .....Z	X/day Y/day Z/day		
U_{11}	Unit indicator for the amount of sewage			
$U_{11.1}$	Municipal needs, $1000*(k_5 \text{ or } k_6)/(U_3*365)$	l / resident	150	150
$U_{11.2}$	Industry, $1000*k_{6.2}/U_{10}$	l / unit		

Part-2 – Sewer System Applicant Data

0 – present state, 1- state after project completion

K	Sewer System Technical Data	Units	0	1
K_1	System length	Linear meters	3 705	11 597
$K_{1.1}$	Combined sewer part	%	--	--
$K_{1.2}$	Separated system – sanitary part or industrial part	%	100	100
K_2	Wastewater pumping station	Number	2	5
K_3	Total capacity of the pumping station	m^3 / sec	0.045	0.055
K_4	Pressure pipeline length	Linear meter	981	1 599
K_5	Amount of the effluent for the combined sewer system	'000 m^3 / year	--	--
$K_{5.1}$	- of which, storm water	%		
$K_{5.2}$	- of which, municipal sewage	%		
$K_{5.3}$	- of which, industrial sewage	%		
$K_{5.4}$	- other (specify)	%		
K_6	Amount of the effluent for the separate sewer system	'000 m^3 / year	0	40 981
$K_{6.1}$	- of which, municipal sewage	%	0	100
$K_{6.2}$	- of which, industrial sewage	%	--	--
$K_{6.3}$	- other (specify)	%	--	--

Part-3 – Data on Proposed Technology

0 – non-treated sewage, 1 – after treatment / stabilised sludge

T	Technical Data	Units	0	1
Separate sewer system				
T_1	Treated sewage effluents amount	'000 m^3 / year	0	40.981
$T_{1.1}$	of which, domestic sewage	%	0	100
$T_{1.2}$	of which, industrial sewage	%	--	--
$T_{1.3}$	of which, other sewage	%	--	--
T_2	Wastewater treatment plant capacity	m^3 / d	0	800
Combined sewer system:				
T_3	Wastewater treatment plant capacity	m^3 / d	--	--
$T_{3.1}$	Capacity of the mechanic portion (primary treatment) during periods of rain	m^3 / d		
$T_{3.2}$	Capacity of the biological portion (secondary treatment) during periods of rain	m^3 / d		
T_4	Sludge amount after stabilisation and de-watering	'000 m^3 / a	0	0.25
T_5	Delivered oxygen amount	kg O_2 / h	0	7.23
T_6	Electrical energy consumption	kWh / d	0	101
T_7	Energy consumption indicator T_6 / T_3	kWh / m^3	0	0.9
T_8	*Type and name of the technology*	*Description*		
$T_{8.1}$	Mechanic (primary) treatment system	Automatic drum filter. Anaerobic selector and settling tank		
$T_{8.2}$	Biological (secondary) treatment system	Oxygen-poor chamber (three-phase de-nitrification) of activated sludge		
$T_{8.3}$	Additional system (tertiary)	Dosing of ferric sulphate to precipitate out phosphorus compounds. Use of PIX (iron-based coagulant used to bind pollutants) and PEL (flocculant to help precipitate pollutants out of solution)		
$T_{8.4}$	Aeration system	Aeration chamber (nitrification). Aeration using ventilation		
$T_{8.5}$	Raw sludge thickening	Vertical secondary settling tanks (clarifier)		
$T_{8.6}$	Sludge stabilisation	Oxygenated chamber for stabilising sludge		
$T_{8.7}$	Stabilised sludge drainage	Filter press or aggregate. Area for storing sludge		
$T_{8.8}$	Final destination of sludge	Given to farmers or collected by firms specialised in incineration of sludge		
$T_{8.9}$	Automation	Full automation of the process		
T_9	Wastewater per person of sewage T_3 / U_3 or T_3 / U_{10}	m^3 / person (or unit. U_{10})	0	0.93

Part-4 – Data on Expected Environmental Effects

0 – present state, 1- state after project completion

E	Environmental Data	Units	0	1
Sewage quality				
E_1	Demand on WWTP	Population equivalents	0	564
E_2	COD	g / m^3	634	60
E_3	BOD_5	g / m^3	317	15
E_4	N total	g / m^3	58.7	30
E_5	$N - NH_4$	g / m^3	29.4	5
E_6	P – total	g / m^3	11.7	1.5
E_7	Total suspended solids	g / m^3	317	25
Sludge quality				
E_8	Organic substances	%	--	--
E_9	Dry mass	%	--	--
E_{10}	Heavy metal sum	g / ton	--	--
E_{11}	Toxic organic substances	g / ton	--	--
Receiving water (name):	Apple Creek – flows into Ruby River, Qavg (average flow) = 0.025 m^3/second			
E_{12}	Required purity class (1 is the highest)		1	1
E_{13}	Average low flow	m^3 / sec	0.0075	0.0088
E_{14}	Dilution level Q/ALF (volume divided by average low flow)		3.33	2.84
Flow into receiving water (increase of concentration after mixing)				
E_{15}	COD	g / m^3	8.0	8.22
E_{16}	BOD_5	g / m^3	4.0	4.12
E_{17}	N total	g / m^3	5.0	5.45
E_{18}	$N - NH_4$	g / m^3	1.0	1.31
E_{19}	P total	g / m^3	0.1	0.14
E_{20}	Total suspended solids	g / m^3	20.0	20.04

PART 'C'

FINANCIAL AND ECONOMIC DATA

(To be completed by the Applicant)

PROJECT CODE (for Fund only)

C.1 Investment outlays *(see Table C.7B)*

Total investment outlays (in USD):	507 688.50
Total outlays on fixed assets (in USD):	507 688.50

C.2 Loan or grant requested from the Fund *(see Tables C.6A and C.6B)*

Amount of grant applied for	0
Amount of loan applied for (in USD)	312 500
Grace period applied for	6 months
Loan maturity applied for	9 years
Interest rate on loan applied for	4%

C.3a) Proposed schedule for disbursement of loan/grant instalments (*delete inappropriate***)**

Value of the instalment (in USD)	Date of disbursing instalment (day, month, year)	What is to be financed by the Fund's instalment
109 375	By 30 April 2005	Construction of sanitary collectors and pumping station
156 250	By 30 May 2005	Construction of sanitary collectors and pumping station
46 875	By 30 June 2005	Construction of sanitary collectors and pumping station

C.3 b) Proposed schedule for loan repayment (*without interest***)**

#	Value of the repaid principal (in USD)	Date of payment of the principal to the Fund (day, month, year)
1	31 250	31 December 2005
2	31 250	31 December 2006
3	31 250	31 December 2007
4	31 250	31 December 2008
5	31 250	31 December 2009
6	31 250	31 December 2010
7	31 250	31 December 2011
8	31 250	31 December 2012
9	62 500	31 December 2013

C.4 Forecast of the operation costs of the new investment project ***(****see Tables C.9A and C.9B****)*** **- main items of operation costs** (*apply the energy price forecasts used by the Fund*)

Cost item	Unit	Unit price (in USD)	Annual use	Annual cost (in USD)
Fuels/energy carriers: Electricity used at the pumping station and in processes at the WWTP	KWh	0.15	3 6865	5 529.75
Materials and raw materials: a) purchase of chemicals - PIX (coagulant) - PEL (polyelectrolyte (flocculant) b) purchase of lime c) purchase of chlorinated lime	 t kg t t	 225.00 7.81 93.75 109.38	 2.4 28.9 1.4 1.1	 550.00 226.00 133.13 120.31
Labour costs (includes social security)	Full-time positions - 1	781.25	12 months	9 375.00
Repair of the pumping station				625.00
Transport of sludge				2 907.81
Overhead, taxes, insurance, other				3 750.00

C.5 Forecast of the revenue generated by the new investment project ***(****see Tables.C-9A and C.9B****)*** **- main items of revenues and savings** (*apply the energy price forecasts used by the Fund*)

Item of revenue or saving	Unit	Unit price (in USD)	Amount of annual sale or savings	Annual revenue (in USD)
Payment by residents for the collection of wastewater – households	m^3	0.9375	40 495 m^3	37 964.06
Savings from the removal and transport of wastewater from the Primary School	m^3	3.125	486 m^3	1 518.75 Total: 39 482.81

Sources of financing for current cash-flow deficits, if they occur ***(****see Tables C.10A and C.10B****):***

Does not apply

Proposed collateral

Promissory note or asset insurance (“mortgage”)

C.6A Schedule for the Fund's Grant Disbursement and Loan Disbursement and Repayment, Quarterly Basis (in USD)

	Specification	I	II	III	IV	TOTAL Year One	I	II	III	IV	TOTAL Year Two
I	Loan/grant value	109 375	203 125	0	0	312 500					
II	Debt outstanding at the beginning of the period	0	109 375	312 500	312 500	XXXXXX	281 250	281 250	281 250	281 250	XXXXXX
III	Repayment	1 093.75	3 125	3 125	34 375	41 718.75	2 812.5	2 812.5	2 812.5	34 062.5	42 500
1	Interest	1 093.75	3 125	3 125	3 125	10 468.75	2 812.5	2 812.5	2 812.5	2 812.5	11 250
2	Principal	0	0	0	31 250	31 250	0	0	0	31 250	31 250
IV	Debt outstanding at the end of the period	109 375	312 500	312 500	281 250	XXXXXX	281 250	281 250	281 250	250 000	XXXXXX

C.6B Schedule for the Fund's Grant Disbursement and Loan Disbursement and Repayment, Annual Basis (in USD)

	Specification	1	2	3	4	5	6	7	8	9	10	TOTAL
I	Loan/grant	31 2500	0	0	0	0	0	0	0	0	0	312 500
II	Debt outstanding at the beginning of the period	0	28 1250	250 000	218 750	187 500	125 000	93 750	62 500	62 500	0	XXXXXX
III	Repayment	41 718.75	42 500	41 250	40 000	38 750	37 500	36 250	35 000	65 000	0	377 968.80
1	Interest	10 468.75	11 250	10 000	8 750	7 500	6 250	5 000	3 750	2 500	0	65 468.75
2	Principal	3 1250	31 250	31 250	31 250	31 250	31 250	31 250	31 250	62 500	0	312 500
IV	Debt outstanding at the end of the period	28 1250	250 000	218 750	187 500	156 250	125 000	93 750	62 500	0	0	XXXXXX
V	NPV of the Fund's resources at a 7% discount rate (*to be calculated by the Fund*)											

N.B: In calculating the NPV of resources disbursed for the project, the Fund uses standard discounting methods. Loan or grant disbursement is treated as expenditure and loan repayment is treated as revenue.

C.7A Schedule of Investment Outlays, Quarterly Basis (in USD)

Financed from Fund resources:	
Total investment outlay:	

	Specification	I	II	III	IV	TOTAL Year One	I	II	III	IV	TOTAL Year Two
I	Preparation and design	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
II	Outlays (1+2+3+4)	109 375	203 125	0	0	312 500					0
		158 322.96	349 345.51	0	0	507 668.47					0
1	Purchase and preparation of land	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
2	Construction and assembly works	109 375	203 125	0	0	312 500					0
		158 322.96	349 345.51	0	0	507 668.47					0
3	Purchase of equipment and machines	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
4	Intangible assets	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
III	Start-up	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
IV	Contingencies	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
V	Increase in operating capital [(5+6)-7]	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
5	Net change in receivables (increase +, decrease -)	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
6	Net change in inventories (increase +, decrease -)	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
7	Net change in liabilities (increase +, decrease -)	0.00	0.00	0	0	0.00					0
		0.00	0.00	0	0	0.00					0
VI	Total investment expenditure (I+II+III+IV+V)	109 375	203 125	0	0	312 500					0
		158 322.96	349 345.51	0	0	507 668.47					0
VII	Investment expenditure in fixed assets (II+IV)	109 375	203 125	0	0	312 500					0
		158 322.96	349 345.51	0	0	507 668.47					0

C.7B Schedule of Investment Outlays, Annual Basis (in USD)

Financed from Fund resources:	
Total investment outlay:	

	Specification	1	2	3	4	5	6	7	8	9	10	TOTAL
I	Preparation and design	0.00	0									0.00
		0.00	0									0.00
II	Outlays (1+2+3+4)	312 500	0									312 500
		507 558.47	0									507 558.47
1	Purchase and preparation of land	0.00	0									0.00
		0.00	0									0.00
2	Construction and assembly works	312 500	0									312 500
		507 558.47	0									507 558.47
3	Equipment and machines	0.00	0									0.00
		0.00	0									0.00
4	Intangible assets	0.00	0									0.00
		0.00	0									0.00
III	Start-up	0.00	0									0.00
		0.00	0									0.00
IV	Reserves	0.00	0									0.00
		0.00	0									0.00
V	Increase in operating capital [(5+6)-7]	0.00	0									0.00
		0.00	0									0.00
5	Net change in receivables	0.00	0									0.00
	(increase +, decrease -)	0.00	0									0.00
6	Net change in inventories	0.00	0									0.00
	(increase +, decrease -)	0.00	0									0.00
7	Net change in liabilities	0.00	0									0.00
	(increase +, decrease -)	0.00	0									0.00
VI	Total investment expenditures (I+II+III+IV+V)	312 500	0									312 500
		507 558.47	0									507 558.47
VII	Investments in fixed assets (II+IV)	312 500	0									312 500
		507 558.47	0									507 558.47

C.8A Financing Sources, Quarterly Basis (in USD)

	Specification	I	II	III	IV	TOTAL Year One	I	II	III	IV	TOTAL Year Two
I	Financing from applicant's own resources	158 323.00	349 345.50	0.00	0.00	507 668.50	0.00	0.00	0.00	0.00	0.00
II	Financing by the Fund	109 375.00	203 125.00	0.00	0.00	312 500.00	0.00	0.00	0.00	0.00	0.00
III	Other loans/ grants	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	-										
	-										
	-										
	-										

C.8B Financing Sources, Annual Basis (in USD)

	Specification	1	2	3	4	5	6	7	8	9	10	TOTAL	%
I	Financing from applicant's own resources	195 168.47	0									195 168.47	38.44
II	Financing by the Fund	312 500.00	0									312 500.00	61.56
III	Other loans/grants	0.00	0									0.00	0.00
	-												
	-												
	-												
	-												

C.9A Revenue/Savings and Costs Forecast, Quarterly Basis (in USD)

	Specification	I	II	III	IV	TOTAL Year One	I	II	III	IV	TOTAL Year Two
I	Operating REVENUES (1+2)	0.0	0.0	0.0	9 870.6	**9 870.6**	10 383.3	10 383.3	10 383.3	10 383.3	**41 533.1**
1	Revenue from sales of goods/services	0.0	0.0	0.0	9 490.9	**9 490.9**	9 965.6	9 965.6	9 965.6	9 965.6	**39 862.5**
2	Other revenue and savings (e.g. reduction in the pollution charges burden, decrease in operating costs)	0.0	0.0	0.0	379.7	**379.7**	417.7	417.7	417.7	417.7	**1 670.6**
II	COSTS (3+4+5)	1 093.8	3 125.0	3 125.0	8 773.1	**16 166.9**	8 783.4	8 783.4	8 783.4	8 783.4	**35 133.8**
3	Operating costs of the new project (without depreciation and interest)	0.0	0.0	0.0	5 648.1	**5 648.1**	5 970.9	5 970.9	5 970.9	5 970.9	**23 883.8**
4	Depreciation of new assets	0.0	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0	**0.0**
5	Interest (on the loans used to finance this investment project)	1 093.8	3 125.0	3 125.0	3 125.0	**10 468.8**	2 812.5	2 812.5	2 812.5	2 812.5	**11 250.0**
III	Pre-tax income on investment (I-II)	-1 093.8	-3 125.0	-3 125.0	1 097.5	**-6 246.3**	1 599.8	1 599.8	1 599.8	1 599.8	**6 399.4**
6	Increase of the income tax and other profit charges	0.0	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0	**0.0**
IV	After tax income – net profit (III-6)	-1 093.8	-3 125.0	-3 125.0	1 097.5	**-6 246.3**	1 599.8	1 599.8	1 599.8	1 599.8	**6 399.4**

Description of assumptions, price forecasts etc. used for the calculations of particular categories of revenues and costs (if not described in C.5):

- **Revenues**: In 2005, for receipt of wastewater = 4 0495 m^3 x 0.9375 USD/m^3 = 3 7964.06 USD/y divided by 4 quarters = 9 490.9 USD/quarter (operations in the first accounting year).
- For reducing charges for wastewater removal from the Primary School = (486 m^3 x 3.125 USD/m^3) = 1 518.75 USD divided by 4 quarters = 379.7 USD/quarter.
- **Costs**: In 2005, from C.5. Electricity = (36 865 KWh x 0.15 USD/KWh = 5 529.7 USD / 4 quarters = 1 382.5 USD/quarter (no operations up to the IV quarter of the first accounting year).
- For purchase of materials, raw materials, repairs, servicing costs, taxes, insurance = (17 062.81 USD / 4 quarters) = 4 265.7 USD/quarter.
- **Revenues**: In 2006, for receipt of wastewater = 40 495 m^3 x 0.9843 USD/m^3 = 39 862.19 USD/y divided by 4 quarters = 9 965.55 USD/quarter.
- For reducing charges for wastewater removal from the Primary School = (486 m^3 x 3.125 USD/m^3 x 1.1) = 1 670.63 USD divided by 4 quarters = 417.66 USD/quarter.
- **Costs**: In 2006, from C.5. Electricity = (3 6865 KWh x 0.1619 USD/KWh = 5 967.5 USD / 4 quarters = 1 491.88 USD/quarter.
- For purchase of materials, raw materials, repairs, servicing costs, taxes, insurance = (17 062.81 USD x 1.05 / 4 quarters) = 4 479.06 USD/quarter.

Note: Operations will occur after the start-up of the WWTP in village X, that is in the fourth quarter of 2005.

C.9B Revenue/Savings and Costs Forecast, Annual Basis (in USD)

	Specification	1	2	3	4	5	6	7	8	9	10	TOTAL
I	Operating REVENUES (1+2)	9 870.6	41 533.1	43 597.8	46 312.7	48 413.3	50 533.8	52 676.6	54 843.9	56 405.3	0.0	404 187.0
1	Revenues from sales of goods/services	9 490.9	39 862.5	41 760.5	44 291.4	46 189.7	48 087.8	49 985.9	51 884.2	53 149.7	0.0	384 702.7
2	Other revenue and savings (e.g. reduction in the pollution charges burden, decrease in operating costs)	379.7	1 670.6	1 837.5	2 021.3	2 223.6	2 445.9	2 690.6	2 959.7	3 255.6	0.0	19 484.5
II	COSTS (3+4+5)	16 116.9	35 133.8	35 205.6	35 345.5	35 486.3	35 710.9	36 010.6	36 284.1	36 573.6	0.0	301 867.2
3	Operating costs of the new project (without depreciation and interest)	5 648.1	23 883.8	25 205.6	26 595.5	27 986.3	29 460.9	31 010.6	32 534.1	34 073.6	0.0	236 398.4
4	Depreciation of new assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
5	Interest (on the loans used to finance this investment project)	10 468.8	10 937.5	10 000.0	8 750.0	7 500.0	6 250.0	5 000.0	3 750.0	2 500.0	0.0	65 156.3
III	Pre-tax income on investment (I-II)	-6 246.3	6 399.4	8 392.3	10 967.2	12 927.0	14 822.8	16 665.9	18 559.8	19 831.7	0.0	102 320.0
6	Increase of the income tax and other profit charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
IV	After tax income (III-6)	-6 246.3	6 399.4	8 392.3	10 967.2	12 927.0	14 822.8	16 665.9	18 559.8	19 831.7	0.0	102 320.0

C.10A Cash-flow Forecast, Quarterly Basis (in USD)

	Specification	Source of Data	I	II	III	IV	TOTAL Year One	I	II	III	IV	TOTAL Year Two
I	INFLOWS		109 375	203 125	0	9 870.6	322 370.6	10 383.3	10 383.3	10 383.3	10 383.3	41 533.1
1	Operating revenue	C.9A.I	0.0	0.0	0.0	9 870.6	**9 870.6**	10 383.3	10 383.3	10 383.3	10 383.3	**41 533.1**
2	Increase of the promoter's capital assets											
3	Loans and grants											
	- From the Krakow Fund	C.8A.II	109 375	203 125	0.00	0.00	312 500	0.00	0.00	0.00	0.00	0.00
	- Other	C.8A.III										
4	Other revenue generated by the investment											
II	OUTFLOWS		160 510.5	355 595.5	6 250	43 148.1	565 504.1	11 595.9	11 595.9	11 595.9	42 845.9	77 633.8
5	Investments in fixed assets	C.7A.VII	158 322.96	349 345.51	0	0	507 668.47					
6	Change in the operating capital (growth +, decrease -)	C.7A.V										
7	Operating costs of the new investment project (without depreciation and interest)	C.9A.3	0.0	0.0	0.0	5 648.1	**5 648.1**	5 970.9	5 970.9	5 970.9	5 970.9	**23 883.8**
8	Repayment of loans and credits (principal)											
	- To the Krakow Fund	C.6A.2	0	0	0	31 250	31 250	0	0	0	31 250	31 250
9	Interest payments on the loans and credits	C.9A.5	1 093.8	3 125.0	3 125.0	3 125.0	**10 468.8**	2 812.5	2 812.5	2 812.5	2 812.5	**11 250.0**
	- To the Krakow Fund	C.6A.1	1 093.75	3 125	3 125	3 125	10 468.75	2 812.5	2 812.5	2 812.5	2 812.5	11 250
10	Growth in the income tax and other profit charges	C.9A.6	0.0	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0	**0.0**
11	Other outflows caused by the project (including dividends)											
III	NET CASH FLOW (I-II)		-51 135.51	-152 470.5	-6 250	-33 277.5	-243 133.5	-1 212.6	-1 212.6	-1 212.6	-32 462.6	-36 101
IV	ACCUMULATED CASH-FLOW BALANCE		-51 135.51	-203 606	-209 856	-243 133.5	XXXX	-244 346.1	-245 558.7	-246 771.3	-279 233.9	XXX

C.10B. Cash-Flow Forecast, Annual Basis (in USD)

	Specification	Source Tables for Data	1	2	3	4	5	6	7	8	9	10	TOTAL
I	INFLOWS		322 370.6	41 533.1	43 597.8	46 312.7	48 413.3	50 533.8	52 676.6	54 843.9	56 405.3	0	716 687
1	Operating revenue	C.9B.I	9 870.6	41 533.1	43 597.8	46 312.7	48 413.3	50 533.8	52 676.6	54 843.9	56 405.3	0.0	404 187.0
2	Increase of the promoter's capital assets												0
3	Loans, credits and grants	C.8B.III	312 500	0	0	0	0	0	0	0	0	0	312 500
4	- From the Krakow Fund	C.8B.II	0	0	0	0	0	0	0	0	0	0	0
	- Other												
5	Other revenue generated by the project												
II	OUTFLOWS		554 925.37	66 071.3	66 455.6	66 595.5	66 736.3	66 960.9	67 260.6	67 534.1	99 073.6	0	1 121 613
6	Investments in fixed assets	C.7B.VII	507 558.47	0	0	0	0	0	0	0	0	0	507 558.47
7	Change in operating capital (growth +, decrease -)	C.7B.V	0	0	0	0	0	0	0	0	0	0	0
8	Operating costs of the new investment project (without depreciation and interest)	C.9B.3	5 648.1	23 883.8	25 205.6	26 595.5	27 986.3	29 460.9	31 010.6	32 534.1	34 073.6	0.0	236 398.4
9	Repayment of loans and credits (principal)												
	- To the Krakow Fund	C.6B.2	31 250	31 250	31 250	31 250	31 250	31 250	31 250	31 250	62 500	0	312 500
10	Interest payments on the loans and credits	C.9B.5	10 468.8	10 937.5	10 000.0	8 750.0	7 500.0	6 250.0	5 000.0	3 750.0	2 500.0	0.0	65 156.3
	- To the Krakow Fund	C.6B.1	10 468.75	11 250	10 000	8 750	7 500	6 250	5 000	3 750	2 500	0	654 68.75
11	Growth in the income tax and other profit charges	C.9B.6	0	0	0	0	0	0	0	0	0	0	0
12	Other outflows caused by the project (including dividends)		0	0	0	0	0	0	0	0	0	0	0
III	NET CASH FLOW BALANCE (I-II)		-232 554.8	-24 538	-22 858	-20 283	-18 323	-16 427	-14 584	-12 690	-42 668	0	-404 926
IV	ACCUMULATED CASH-FLOW BALANCE		-232 554.77	-257 093	-279 951	-300 234	-318 557	-334 984	-349 568	-362 258	-404 926		-404 926

V	NPV of the investment at a 7% discount rate:	-336 593.78
VI	NPV of the investment at a 15% discount rate:	-285 373.84
VII	Internal Rate of Return after taxes (IRR AT):	--
VIII	Internal Rate of Return before taxes (IRR BT):	--

Checklist for Verifying the Correctness of Completing Part "C" of the Application Form

No	Questions	Basis for Judgment	Yes/No
1	Is the grant/loan amount acceptable to the Fund?	Decision of the Supervisory Board, Fund's Principles of Grant/Loan Financing	
2	Are maturity and grace periods consistent with the principles of the Fund?	Fund's Principles of Grant/Loan Financing	
3	Does the project promoter provide sufficient share of co-financing?	Fund's Principles of Grant/Loan Financing	
4	Is the source for financing the cash flow deficit credible?	Opinion of the Fund's financial team or the bank	
5	Have a credible business plan and a feasibility study been carried out?	Opinion of the Fund's financial team	
6	Have the assumptions used in financial analysis been revealed and are the methods used state-of-the-art?	Opinion of the Fund's financial team	
7	Are tables on grant/loan disbursement/repayment filled out correctly?	Opinion of the Fund's financial team	
8	Do tables C6-C10 contain data on the project only (i.e., not on the applicant/project promoter)?	Interview with project promoters	
9	Are data in the Application Form radically different from those in the Project Information Form?	Opinion of the Fund's financial team	

Summary Financial Indicators of the Project (Appraisal Summary of Part 'C' of the Application Form)

#	Measure of the NPV of the Project for Society	Source Table in Application Form	Value in PLN	Weight	Value × Weight
1	**NPV of Fund's resources committed to the project** (*)	C.6.B			
2	**NPV of the investment project itself** (**)	C.10.B			
3	**Aggregated NPV indicator**				

(*) - insert the absolute value of the indicator

(**) - If $NPV_{20\%} \leq 0$ then $NPV_{investment} = -NPV_{20\%}$

If $NPV_{20\%} > 0$ then $NPV_{investment} = NPV_{10\%}$

Note: NPV for both cases is calculated before taxes!

ANNEX V: CHECKLISTS FOR MEASURING COMPLIANCE WITH GOOD PRACTICES FOR PUBLIC ENVIRONMENTAL EXPENDITURE

These Checklists constitute an integral part of an OECD document "*Good Practices for Public Environmental Expenditure Management*" developed within the framework of the OECD EAP Task Force. They were presented at the Fifth "Environment for Europe" Ministerial Conference, held in May 2003 in Kiev, Ukraine (Kiev.Conf/2003/Inf/13). In addition, these Good Practices have been adopted as OECD Council Recommendation (C(2006)84) and are relevant for the OECD member states.

The Checklists below can be used to measure the performance of public environmental expenditure programmes against good practices. Each of the three Checklists contains five major principles, which are operationally described in the right-hand column of the checklist based on specific criteria. Performance auditors can assign the three following scores to each principle: "zero" if no good practices are applied; "one" if some but not all good practices are applied; and "two" if all good practices are applied. The scope of application of good practices is assessed by assigning a "yes", "no" or "partially-applied" judgement. In this way, any particular programme or its implementing agency can achieve a maximum of ten (10) points in each performance area. In order to visualise the results of the performance assessment, a performance triangle can be constructed by plotting the score in each area on the three axes of a radar chart, each axe showing the level of compliance with the Good Practices in terms of environmental effectiveness, fiscal prudence and management efficiency, respectively.

Checklist 1. Performance in Terms of Environmental Effectiveness

Principle	Good Practices
1. Additionality and consistency with other environmental policy instruments	• Public funds do not permanently substitute for weak environmental policies; they are not spent on achieving environmental objectives that could have been achieved with administrative or economic instruments or by eliminating environmentally-harmful subsidies. • Public funds are not used for environmental projects that would have been implemented anyway (e.g. that have high risk-adjusted financial rates of return and could have been financed privately). • Public environmental expenditures reinforce other policy instruments and are consistent with their stated objectives. • Regular running costs of environmental administration and enforcement agencies are financed through the regular budget process. Extra-budgetary or specialised expenditure programmes are normally focused on financing investment in fixed assets or precisely defined non-investment projects, which are not regular duties of administration. Financial assistance to running costs of non government entities is given only in exceptional circumstances, for a strictly limited period, during which the rate of assistance declines. • External auditors periodically review the environmental value-added of public expenditures; there are provisions to phase out public funds after they have fulfilled their role.
2. Sound and well-defined programming framework	• Public funds are spent within the framework of a written, publicly available expenditure programme document approved by appropriate authorities.

	• Expenditure programme has specific, measurable, agreed, realistic, time-bound objectives, eligible beneficiaries, specified financing needs, eligible project types and a set of written rules that guide the financing decisions that enable the objectives to be achieved at the least cost. • Expenditure programme is established as part of a wider environmental programme or policy, which is a stated priority and has been developed through a participatory political process. • Environmental expenditure programmes support sustainable development; wider economic, social and poverty reduction objectives, which (as appropriate) are integrated into the public environmental expenditure programme without undermining its environmental effectiveness.
3. Sound consideration of environmental effects	• Standard application forms are used to solicit quantitative and qualitative information on the environmental effects of the proposed projects. Once obtained, the accuracy and reliability of this information is verified. • Indicators of environmental effects are unambiguous and are used as essential criteria in project appraisal and selection. • Environmental effects are monitored throughout the project cycle and after implementation; project level environmental data are stored in a publicly available database that allows unambiguous ex-post verification and analysis. • If the project fails to achieve its predicted effects, as stated in the application form or financing contract, effective contractual sanctions on beneficiaries are enforced in proportion to the violation. • Meaningfully aggregated information on environmental effects achieved is periodically reported to governing bodies and to the public, reviewed by external auditors and used as a performance indicator.
4. Maximising environmental effect from available funds	• Quantitative information on the full lifetime costs (investment, operating and maintenance) of the project is requested from applicants in a standard application form and verified; project level cost data are tracked and stored in a database format in a way that allows unambiguous ex-post verification and analysis. • Project selection criteria ensure that limited public funds achieve the greatest environmental effect. An unambiguous cost-effectiveness indicator (unit lifetime cost of achieving environmental effects) and the rate of assistance from public funds form the core of the quantitative basis for appraisal, scoring, ranking and selecting of projects. • Quantitative information on cost-effectiveness is periodically reported to governing bodies and to the public and is subject to periodic external, independent reviews. Cost effectiveness is a key performance indicator.
5. Leveraging additional private and foreign finance for the environment	• Public funds cover less than 100% of project costs; co-financing by other sources or by the beneficiary's retained earnings is required as a principle. • Leverage of private and foreign finance is a formal requirement and a performance indicator. • Public funds do not distort competition in financial markets and do not obstruct the development of private financial institutions. Financial products used in environmental expenditure programmes do not compete with financial products offered by private financial institutions. • A full financial plan for the project is required; commitments for financing from other sources are verified. No disbursement is made until full financing for the project is adequately secured.

Checklist 2. Performance in Terms of Fiscal Prudence

Principle	Good Practices
1. Fiscal integrity of revenue	• All sources of revenue are clearly specified in the legislation. • If the revenues managed within the programme come directly or indirectly from compulsory transfer payments (taxes, charges, fees), they are treated as public funds in the meaning of the laws governing public finance, public procurement and state aid. As such, this money is subject to the usual fiscal discipline applied in the entire public finance sector, even if it is managed outside of the budget. • Revenues are recorded at treasury accounts before they are allocated to the environmental expenditure programme. • Only cash revenues are accepted.
2. Negative efficiency impacts of earmarking minimised	• Earmarked revenues are limited to specified periods of time. Effective provisions are in place to prevent the creation of vested interest groups and perpetuation of public expenditure programmes past their ability to provide value added. • Earmarking within earmarked schemes (e.g. sub-funds within earmarked environmental funds) is avoided as it further infringes on efficiency. If earmarking is unavoidable (e.g. for political reasons), safeguards that prevent inefficient resource allocation and perverse incentives are implemented.
3. High standards of fiscal discipline	• The implementation of environmental expenditure programmes does not cause unplanned fiscal deficits. In particular, contingent and implicit liabilities (such as loan guarantees) are not incurred without an explicit, prior approval from fiscal authorities. Medium-term financial forecasts, including contingent and implicit liabilities of all implementing agencies, are regularly prepared and disclosed in financial statements. • For all extra-budgetary funds and government-controlled agencies, an estimate of the revenue and the corresponding expenditures is provided in the state (or sub-national) budget, at least as an annex. Statements on debt and contingent liabilities, especially of all extra-budgetary environmental institutions, are presented along with the budget of the Ministry of Environment to the Ministry of Finance. • Mandatory internal and external independent financial audits are regularly carried out. • Ex-post reporting, according to a transparent expenditure classification system, is regularly conducted and publicly disclosed.
4. Accountability and transparency	• All individuals involved in managing expenditure programmes are held accountable for decisions to the Government, Parliament and the public within their clear and distinct lines of responsibility, on the basis of effective legal provisions ensuring transparency and meaningful information disclosure. • Public funds are guarded against corruption and fraud, e.g. through effective checks and balances on various interest groups in governing bodies. Any potential conflicts of interest are eliminated. • Ex-post reports on performance and results achieved (in terms of specified performance criteria) are periodically conducted and disclosed to the public.
5. Collection of revenues and public procurement separated from expenditure management	• Special agencies implementing environmental expenditure programmes focus on programme and project cycle management and project financing, rather than on collecting revenue or making direct procurement of equipment and construction services on behalf of the government. These other tasks are performed by regular government agencies. • Collection of revenue from fiscal or quasi-fiscal instruments is normally done by relevant fiscal authorities under the control of treasury services. • National or international public procurement rules apply for all purchases that are co-financed by public funds, even if the purchasing agent is a private entity.

Checklist 3. Performance in Terms of Management Efficiency

Principle	Good Practices
1. Sound governance	• Expenditure programme is governed by clear, written and agreed rules rather than by *ad hoc* discretion. • Terms and conditions of financing, decision-making and administrative procedures, internal policies and principles of project appraisal and selection are written and available to the public. They are coherent and consistent, do not change frequently and randomly, but are periodically reviewed in order to identify areas for improvement. • Governing bodies of environmental expenditure programmes represent the key stakeholders with appropriate checks and balances between different interest groups; non-environmental authorities, parliament and non-government organisations are duly represented. • Governing bodies are responsible for programming, priority-setting, establishing rules, performance evaluation, supervision and control. The political process is confined to programming and supervision. Political interference in the selection of individual projects for financing and beneficiaries is restricted and governed by rigid procedures.
2. Professional executive management	• Responsibilities for the day-to-day management and implementation of an environmental expenditure programme are clearly separated from responsibilities of governance bodies and clearly defined in statutory and operational documents. • The implementing agency has a written mandate based on a contract or the law. It is a professional executive management body with a fair degree of operational autonomy, but is subject to strict accountability for performance. Its responsibilities focus on project cycle management and, in particular, on impartial project appraisal and selection. • Executive managers are held accountable for performance and not judged by political affiliations. Performance indicators, established by governing bodies, are clearly written and used in regular performance management. International quality management systems (such as the ISO 9000 family) are considered as a performance benchmark for executive management. • Implementing agencies of large specialised environmental expenditure programmes have staff assigned exclusively to their management and are selected by executive managers. • Staff skills adequately match the technical requirements of a given expenditure programme. The recruitment and remuneration of managers and of staff are based strictly on merits. Remuneration is adequate to attract and maintain highly qualified people and to reward integrity and commitment.
3. Sound project cycle management	• The project cycle is subject to intelligible, transparent and written procedures, which are consistent and publicly available, in particularly to all potential beneficiaries; the project cycle manual is binding to staff and used in practice. • Project identification is proactive and follows from the environmental expenditure programme established by the governing bodies and from realistic analysis of market trends and of demand for financing in the environmental sector. • Applications for financing are accepted only in standard forms tailored to different project types and supported by clear, user-friendly instructions. Application forms are easily available to all potential applicants, preferably in an electronic version. • Project appraisal and selection criteria and procedures are objective, transparent and unambiguous. Discretionary, subjective elements of project appraisal and selection are subject to explicit, written procedures. Their records are kept in publicly available files. • Appraisal systems and procedures are tailored to the size and complexity of different project types. For large investment projects, a two-stage appraisal process is used (first stage - screening against eligibility criteria; second stage - ranking of eligible projects). • The appraisal system is relatively simple, based on impersonal rules as appropriate, and allows meaningful comparison of comparable projects against each other or against a benchmark. The appraisal system also allows for an ex-post verification of the selection process, including

	tracking personal responsibilities for important judgments and decisions. Appraisal reports are clear, unambiguous and publicly available.
4. Fair and unbiased relations with external stakeholders	• Relations with external stakeholders (beneficiaries, intermediaries, consultants) are handled in a transparent, fully unbiased, and arms-length manner. An effective communication policy ensures that all applicants have equal access to information on funding opportunities and equal opportunity to have their projects impartially reviewed on a merit basis. • Outsourcing of certain tasks in project cycle management is meaningfully applied through a competitive process without perverse incentives; conflicts of interest are prevented (e.g. the same consultants cannot both prepare projects and appraise them).
5. Effective management of financial products and related risks	• Only financial products allowed in the statute and approved by the governance body are used by the implementing agency. • Complexity of operations and the choice of financial products are proportional to the institutional capacity to manage the associated risks. Typically, grants are the first choice, as they are the most transparent and market-friendly form of subsidy. • Grants are designed and disbursed in a manner that maximises incentives for timely and cost-effective implementation of individual projects and of the entire portfolio of the implementing agency. Grants are designed to minimise misuse of public money by applicants. • As in-house capacity to manage financial risk increases, other financial products can be considered in order of increased risk, e.g. interest subsidies, loans through intermediaries, direct loans, leasing, equity investments and loan guarantees. Before a new financial product is applied, its feasibility is checked through an assessment of risks, market needs and is supported by a financial plan.

Assessment in each area forms a performance triangle, which is constructed by assigning scores to the checklists presented above. A high score in all dimensions indicates a programme or an implementing agency that performs well in terms of expenditure management. A lower score in any area implies a need for targeted institutional reform and strengthening, or even closing down, the expenditure programme. It is worth noting that this framework does not include the full evaluation of the performance of the revenue side of an environmental financing programme. This is because these Good Practices focus mainly on expenditure management. In a more comprehensive performance audit of a particular financing institution or programme, the radar chart should be expanded to include one more area reflecting assessment of the revenue side of the programme.

Results of the Assessment of the State Environmental Fund of Ukraine against the Good Practices of PEEM

Environmental Effectiveness

Principle	First Criterion	Second Criterion	Third Criterion	Fourth Criterion	Fifth Criterion	Sixth Criterion	Score of the Pronciple
Additionality and consistency with other policy instruments	0	0	1	0	1		0
Sound and well-defined programming framework	2	0	1	1			1
Sound consideration of environmental effects	0	0	0	0	0		0
Maximising environmental effect from available funds	0	0	0				0
Laveraging additional and foreign finance for the environment	2	1	2	0			1
Total:							**2**

Fiscal Prudence

Principle	First Criterion	Second Criterion	Third Criterion	Fourth Criterion	Fifth Criterion	Sixth Criterion	Score of the Pronciple
Fiscal integrity of revenue	2	2	2	2			2
Negative efficiency impacts of earmarking are minimised	0	0					0
High standards of fiscal discipline and transparency	1	2	2	1			1.5
Accountability and transparency	0	0	0				0
Collection of revenue and public procurement separated from expenditure management	1	2	1				1
Total:							**4.5**

Managerial Efficiency

Principle	First Criterion	Second Criterion	Third Criterion	Fourth Criterion	Fifth Criterion	Sixth Criterion	Score of the Pronciple
Sound governance	1	0	0	0			0
Professional executive management	0	0	0	0	1		0
Sound project cycle management	0	0	1	0	0	0	0
Fair and unbiased relations with external stakeholders	0	0					0
Effective management of financial products and related risks	2	1	0	0			1
Total:							**1**

ANNEX VI: LIST OF OFFICIALS/INSTITUTIONS INTERVIEWED DURING THE REVIEW MISSION IN MARCH 2006

Alexei SLENZAK, Operations Officer, Environment Sector, World Bank Residence Office.

Desmond O'MAONAIGH, Project Manager, Ukraine Banking Corporate Governance Project, IFC.

Elena VOLOSHINA, Head of IFC Operations in Ukraine, IFC.

Galina PRESTINSKAIA, Legal Advisor, Eco-Law Kiev NGO.

Larysa KHROMOVA, Lead Specialist, Sustainable Development Division, Ministry of Economy.

Luidmyla LUKASH, Deputy Head, Department of Financing of Agriculture and Environmental Protection, Head of Division for Financing of Water, Forestry and Environment, Ministry of Finance.

Mykola MOVCHAN, Head, Kiev City State Ecology and Natural Resources Department, Ministry of Environmental Protection.

Mykola PYLYPCHUK, Deputy Head, Department of Strategic Planning, Environmental Economics and Environmental Management, Ministry of Environmental Protection.

Mykola SASIUK, Head, Department of Strategic Planning, Environmental Economics and Environmental Management, Ministry of Environmental Protection.

Natalia MOVCHAN, Lead Consultant, Secretariat of the Parliamentary Committee on Environmental Policy, Nature Use and Elimination of the Chornobyl Catastrophe.

Oleg CHEKARAMIT, Director, Tripylska Thermo-Electric Power Plant, Town of Ukrainka.

Oleg KULIK, Head, Division of Environmental Economics, Ministry of Environmental Protection.

Oleksander GRIBAN, Chairman of the Supervisory Board, GreenCo-Center JSC.

Oleksander KLITKO, Project Manager, Environment, Delegation of the European Union.

Olena SHLUMUKOVA, Head Specialist, Department for Water Resources and Ecosystems, Ministry of Environmental Protection.

Tetyana TYMOSHKO, Director, Aarhus Information-Training Center, State Ecological Institute, Ministry of Environmental Protection.

Volodimir KOROTCHENKO, Deputy Head, State Department on Environment and Natural Resources, Kiev Oblast, Ministry of Environmental Protection.

Yevgen KHLOBYSTOV, Head, Department of Sustainable Development and Environmental Safety, National Academy of Science.