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REPORT FROM THE COMMISSION

Annual Report of the Instrument for Structural Policy for Pre-Accession (ISPA) 2006

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1. INTRODUCTION

This report is presented in accordance with Article 12 of the ISPA Regulation. It is the 7th Annual Report covering the ISPA activities during 2006. In addition to Bulgaria and Romania, which are receiving ISPA assistance since the launch of this instrument in 2000, the present report also covers Croatia, which became an ISPA beneficiary country following the June 2004 European Council decision to award her the status of candidate country.

For all these countries, 2006 entailed various challenges. Whereas for Croatia the major goal was to fully commit its ISPA allocation, Bulgaria and Romania had to accelerate and improve further implementation of ISPA funds while at the same time they had to start preparing future projects for the Cohesion and Structural funds to which they are entitled upon accession. The report analyses progress in project funding, management and implementation and contribution to EU policies, concluding that 2006 has seen important progress. As 2006 was the last year of ISPA assistance, except for Croatia, the concluding section also offers an assessment of the lessons learned over its seven years of implementation.

2. ISPA BUDGET

In the Commission budget for 2006, €585 million was allocated to the ISPA instrument. The appropriations covered all expenses for co-financing projects (measures) in the field of environment and transport, as well as for providing technical assistance (TA), irrespective whether the TA measures were initiated by the beneficiary countries or by the Commission.

Table 1: ISPA budget in 2006 – in Euro

Budget line	Commitment appropriations	Commitments consumed	Payments implemented
Functional budget line B13.01.04.02	4,500,000	2,338,712	2,154,419
Operational budget line B13.05.01.01	580,500,000	580,350,000	175,579,778
Total	585,000,000	582,688,712	177,734,197

3. PROJECT FUNDING

3.1. New ISPA projects

In 2006, the Commission approved 11 new ISPA measures. The total ISPA contribution for the year amounted to €89.9 million, representing an average grant rate of 82.8% of a total eligible project cost of €134.5 million. Commitments

totalling €89.96 million were used for the new projects and €490.3 million was used for ongoing projects.

Of the 11 new ISPA projects for 2006, 4 concerned environmental protection - 1 project for water and waste water, including treatment and 1 solid waste project, as well as 2 horizontal environmental measures for the preparation of future Cohesion Fund and IPA projects.

There were 5 new projects in the transport sector – 1 for improvements to navigation on the Danube River and 4 horizontal transport projects were approved for preparing future IPA and Cohesion fund projects in the transport sector covering, strengthening institutional capacity and providing technical assistance with railway modernisation measures.

Finally, 2 technical assistance projects provided support the National ISPA Coordinator in Croatia and ISPA Monitoring Committee meetings in Romania. Nearly 64.5% of the total ISPA contribution was awarded to the environment sector.

Table 2: New projects approved in 2006 – in Euro

	Project decisions n°	Eligible cost	ISPA contribution	Grant rate %	Commitments
Environment	4	81,540,109	58,097,883	71.5	58,097,883
Transport	5	52,732,558	31,557,040	77	31,557,040
Horizontal TA	2	312,335	312,335	100	312,335
Total	11	134,585,002	89,967,258	82.8	89,967,258

3.2. Projects funded during 2000-2006

Between 2000 and 2006, the Commission co-financed 107 projects submitted by Bulgaria, Croatia and Romania: 69 in the environment sector, 33 in the transport sector, and 5 horizontal TA measures (one for achieving decentralised implementation (*EDIS*) and four for organising monitoring committees and supporting implementing agencies). These projects represent a total project cost of €4.81 billion, of which €4.43 billion are eligible for ISPA funding. ISPA funds contributed 67.36%, or €2.98 billion, to these eligible investment costs. A strict balance between both sectors was maintained.

By the end of 2006, more than €2.981 billion of ISPA funds had been allocated for the three beneficiary countries for the period 2000–2006. Out of this amount 100% has been committed.

Table 3: Projects approved in 2000-2006 – in Euro

Sector	Project decisions n°	Eligible cost	ISPA contribution	Average grant rate %	Commitments
Environment	69	2,079,790,226	1,497,166,495	71.99	1,497,166,495
Transport	33	2,344,434,543	1,482,548,029	63.24	1,482,548,029
Horizontal TA	5	1,945,643	1,945,643	100	1,945,643
Total	107	4,426,170,412	2,981,660,167	67.3	2,981,660,167

3.3. Payments

Between 2000 and 2006, €2.981bn was committed for a total of 107 projects in the three beneficiary countries. Payments at the end of 2006 equate to 24.6% (amounting to €733 mln) of the total ISPA funds allocated, consequently, €2.248 bn still remain to be paid out in the years to come. The development of payments in 2004, 2005 and 2006 was €132.3 mln in 2004 and €229.1 mln in 2005, but payments declined to €174.3 mln in 2006. Reflecting the substantial acceleration of payments between 2004 and 2005, all payment credits initially foreseen in the Commission's 2005 budget were absorbed. The decline of payments to 2006 resulted in unused payment appropriations of about € 46 mln.

The reason why payments for Bulgaria and Romania decreased in the 2005/06 period in relation to those made in the 2004/05 period is that projects had not progressed sufficiently to give rise to significant intermediate payments. Payments in the period up to 2004/05 were boosted by some large first instalments of the advances. Thereafter, the second instalments depend on contracts being signed while the first intermediate payments depend on actual expenditure on the ground. For Croatia, which joined the ISPA family in 2005, the first payments (first advances) were made in 2006.

Table 4: Payments – in Euro

Sector	2000-2005	2006	Total
Environment	255,243,502.98	87,328,724.24	342,572,227.22
Transport	302,711,402.35	86,490,276.60	389,201,678.95
TA	987,324.40	482,691.08	1,470,015.48
Total	558,942,229.73	174,301,691.92	733,243,921.65

4. TECHNICAL ASSISTANCE

4.1. Technical assistance on the initiative of the beneficiary country

TA measures for *project preparation* have to ensure that beneficiary countries present a sufficient number of quality projects in time for funding, incl. for future

funding from the Cohesion Fund and IPA. Similarly, TA measures for *institutional strengthening* aim at enhancing the capacity of the beneficiary's administration to manage and monitor the implementation of large-scale infrastructure investments.

In 2006, 4 applications concerning project preparation in the transport sector and two applications concerning project preparation in the environment sector were approved. A further 2 TA projects were approved for institutional capacity building.

When considering the period 2000-2006, ISPA awarded over €149 million to more than 29 projects concerning institutional building or the preparation of projects.

**Table 5: Technical assistance on the initiative of the beneficiary country
2000-2006 - in Euro**

Sector	N° of projects	Eligible cost	ISPA contribution
Environment	9	87,791,848	64,434,542
Transport	15	99,493,298	82,833,250
Horizontal TA	5	1,945,643	1,945,643
Total	29	189,230,789	149,213,435

4.2. Technical assistance (TA) on the initiative of the Commission

TA at the Commission's initiative essentially provides for funds either to Commission services for performing essential control and programme management functions, or directly to beneficiaries for certain critical horizontal services. The activities fall into three categories:

- local technical *intra-muros* assistance (to cover salaries for contracted staff in EC Delegations in Bulgaria, Romania and Croatia, as well as their overhead costs);
- *extra-muros* support to EC Delegations (essentially to cover contracted expertise necessary for performing *ex-ante* control tasks on procurement documents, and to cover training activities); and
- Service contracts and grants for project appraisal assistance, policy development, strategic analysis, advisory services, monitoring and similar implementation activities.

**Table 6: Technical assistance on the initiative of the Commission 2006
in Euro**

Activity	Commitments consumed	Payments¹
Intra-muros support	1,880,800	1,478,984
Extra-muros support	457,912	675,435
Service contracts and grants ²	80,000	1,278,086
Total	2,418,712	3,432,505

(1) include all payments made in 2006, of which some relate to commitments predating 2006

(2) Including some activities relating to ISPA beneficiary countries which became Member state in 2004

5. MANAGEMENT AND IMPLEMENTATION

5.1. Project monitoring

After EDIS, which was granted to Romanian implementing agencies in summer 2006, the Delegation continued to monitor tendering and contracting activities until accession. Apart from exerting the Commission powers for endorsing tendering and contracting (prior to EDIS), it is best placed to ensure progress on the ground and liaise with national authorities and final beneficiaries on any problem that may arise.

While for Bulgaria and Romania the first ISPA projects were approved by the Commission in 2000, implementation of these projects started at best in 2001, generally, by tendering the service contracts for supervision of the implementation. However, due to delays in the tendering and contracting process, the first actual works contracts were not signed until 2002. Progress on the ground has slowly gained pace since then, which is witnessed by the progress in the payments made by the Commission to the national authorities of these two acceding countries.

With regard to Croatia, by the end of 2006 implementation had not yet commenced on any project. However, the first two tenders for service contracts were announced in January 2007.

5.2. Financial management and control – incl. EDIS

The principal requirements for both the financial management and control and the treatment of irregularities are governed by the provisions of the ISPA Regulation and of Annex III of the Financing Memoranda, as applicable under the regime of ex ante control by the Commission. The key elements relate to the establishment of internal financial control systems and procedures that can ensure transparent and non-discriminatory procurement procedures, the accuracy of declared expenditure, adequate internal audit capability, sufficient audit trail and appropriate treatment of irregularities.

In 2006, four audit missions were carried out in Romania and Bulgaria in the context of the EDIS process where the final stage consists of a verification audit by the

Commission auditors with the objective to assess the readiness of the acceding countries to assume full responsibility for tendering and contracting by waiving the ex-ante controls made by the EC delegations.

In parallel with EDIS, a number of project audits were carried out in Romania in order to verify the legality and regularity of the expenditure declarations submitted to the Commission and the related payments. The main issues in this respect concerned ineligible expenditure certified to the Commission, lack of supporting documents, verification of eligibility of expenditure which was incompletely or not adequately documented, addenda to contracts not correctly processed and publicity and information measures not fully complied with.

A number of project audits were also carried out in Bulgaria. In general, the main findings were reflecting the shortcomings identified during the system audits, namely the insufficient quality of tendering and contracting dossiers, particularly in relation to modifications of contracts, the need to improve the verification of expenditure declarations and the incomplete adherence to publicity and information requirements. Due to very slow progress of ISPA projects in Croatia in 2006, the audit work consisted of desk work in relation to issues outstanding after the system audits which were carried out during the second half of 2005 and which effectively supported the Commission's decision to grant DIS to Croatia in February 2006. The main outstanding deficiency relates to the development of an effective and coherent staff retention policy.

5.3. European Court of Auditors findings

The Court of Auditors performed a limited review at the Commission involving mainly an examination of Commission activities concerning management and control systems in one of the candidate countries (Croatia) and in the accession countries (Bulgaria and Romania), including an examination of the progress of EDIS for the latter countries.

The conclusion of the Court was that, overall, taking into account the audit scope, the transactions audited were not materially affected by error. While the Court noted improvements in the supervisory and control systems at the level of the Commission, important weaknesses were noted at national level. In the case of ISPA projects, the relatively high frequency of these weaknesses was compensated by corrective action resulting from the Delegation's *ex-ante* controls.

5.4. Co-financing partners – EIB, EBRD and KfW

Given their expertise in project preparation and implementation, the Commission regularly met these lending institutions and, where possible, organised joint project identification and appraisal missions for projects for which loan financing was sought. In 2006 one loan was provided for a project by the EIB.

6. CONTRIBUTION TO COMMUNITY POLICIES

6.1. Public procurement

The fulfilment of legal requirements for sound, fair and transparent public procurement as enshrined in the PRAG (Practical Guide to contract procedures for EC external actions) has proved to be a major challenge for the acceding beneficiary countries. This results from the fact that the qualifications of staff in these countries are not always up to the level of skills required to manage complex infrastructure projects, in particular as far as tendering and contracting are concerned. Because of the difficulties encountered in this area, the Commission has put many efforts into developing technical assistance activities which focused on strengthening recipients' procurement skills, systems and procedures. Amongst others, it continued to organise various seminars and training sessions, including the dissemination of manuals and practical guides.

6.2. Environment policy

By providing direct assistance to priority projects for environment, ISPA facilitates the implementation of environmental policy and compliance with EU standards in the beneficiary countries. In particular, administrative capacity has been strengthened in regard to environmental investment planning and prioritization, and steady progress has also been made in proper implementation of the EIA directive, including aspects related to public consultation. However, problems in relation to the difficulties of the environmental authorities in obtaining adequate funding and staffing as well as the lack of co-ordination between policy fields and of strategic planning need to be addressed further by these countries.

6.3. Transport policy

The transport networks in the beneficiary countries, in the case of Bulgaria and Romania, agreed in accordance with TINA (*Transport Infrastructure Needs Assessment*), were constructed around the framework of pan-European corridors. These networks are used as the planning basis for the national transport strategies for ISPA purposes, i.e. concern the construction or rehabilitation of a section, nodal point or access relating to the networks. Six of the afore-mentioned corridors run across the territory of Bulgaria, Croatia and Romania. Under the new Community guidelines for the development of the trans-European transport network (TEN-T), three of the network's priority projects (*motorway axis Igoumenitsa/Patra-Athina-Sofia-Budapest, inland waterway axis Rhine/Meuse-Main-Danube and railway axis Athina-Sofia-Budapest-Wien-Praha-Nürnberg/Dresden*) concern axes which include Bulgaria and Romania, and one includes Croatia (*railway axis Lyon-Trieste-Divaca/Koper-Divaca-Ljubljana-Budapest-Ukrainian border*). In the case of Croatia, which was not included in the TINA Study, transport infrastructure needs have been established in accordance with the priorities identified in the REBIS (Regional Balkans Infrastructure Study – Transport) study. Accordingly an additional railway axis (*Salzburg - Ljubljana - Zagreb - Beograd - Nis - Skopje – Thessaloniki*) has been identified as a priority project.

7. CO-ORDINATION AMONG PRE-ACCESSION INSTRUMENTS

As required by the Coordination Regulation, the Commission ensures close co-ordination between the three pre-accession instruments PHARE, SAPARD and ISPA. The Regulation carefully specifies the fields to which each instrument provides assistance, thereby minimising potential overlaps between the different instruments.

The PHARE Management Committee ensures co-ordination among these three instruments, whereas further co-ordination is implemented through the (PHARE) Joint Monitoring Committee, the inter-services Co-ordination Committee and periodic meetings with the EC Delegations in the beneficiary countries.

8. SEVEN YEARS OF ISPA: SOME LESSONS LEARNED

Since 2006 was the last year for ISPA – at least for the vast majority of the projects and beneficiary countries (only the 6 Croatian projects will be continued to be implemented under the ISPA Council Regulation) – it is appropriate to draw a few lessons from the experience gained over the last 7 years.

ISPA was conceived in 1999 with the view to provide funding for infrastructure upgrading and to prepare the Eastern and Central European Candidate Countries for the absorption of Cohesion policy instruments, more precisely the Cohesion Fund for which less developed Member States are eligible. Consequently, the ISPA Council Regulation was closely tailored after the Cohesion Fund Regulation as far as areas of eligibility (environment and transport) and the management and control system are concerned. Regarding the latter, it must be noted that differences in the management system mainly relate to the fact that certain essential provisions for public procurement and financial control need to comply with external aid rules.

ISPA provided grant **funding of key infrastructure on an unprecedented scale**. For Romania, Bulgaria and Croatia alone, 107 projects are being financed, benefiting from Community grants of €3 billion and mobilising €4.8 billion of total funds.

Beneficiary countries were requested to prepare ISPA investment strategies covering seven years. These were national documents, but their contents and quality needed to be accepted by the Commission service prior to financing. As such, ISPA introduced **strategic planning** for obtaining Community funds in two sectors which are key for fostering economic development and cohesion.

Strategic planning and project implementation are an invaluable "**learning by doing**" experience which will help beneficiary countries to become better prepared for absorbing Structural and Cohesion Funds upon accession and – in the case of Croatia – IPA.

Over the years, beneficiary countries generally improved the quality of project preparation, reducing the time – and resources – necessary for the Commission to approve projects for funding. With the assistance of the Commission - and international consultants – beneficiary countries learned to **comply with essential EU law**, like the EIA Directives or other relevant environmental norms and *acquis*,

or public procurement; they developed capabilities for project preparation like financial analysis, technical studies, design, tendering and contracting, as well as for project implementation. ISPA helped beneficiary countries to become better acquainted with new ways of financing (e.g. public-private partnerships), modern planning principles (e.g. sustainable development, environmental impact assessment including public consultation), sector policies (e.g. integrated water sector investment), or modified national law in areas essential for project implementation (e.g. land acquisition).

Under ISPA, beneficiary countries – and the Commission – developed a **close relationship with International Financial Institutions (IFIs)**, in particular the EIB. A significant number of ISPA projects are co-financed with IFIs; IFIs also participated, where appropriate, in programming and appraisal missions. Bilateral donors provide assistance, in particular in the early years of ISPA, both for project preparation and for investment financing. The synergies developed with IFIs under ISPA contributed to the Commission's decision to set up JASPERS as an instrument to assist new Member States in project preparation.

ISPA provided significant amounts of **funds for technical assistance (TA) for project preparation, administrative capacity** building and strategic studies. TA played a particularly important role in providing funds for the preparation of Cohesion Fund projects for new Member States, as well as for IPA in the case of Croatia.

Most of the ISPA projects in new Member States will be completed under Cohesion Fund rules. The similarities of ISPA rules with those of the Cohesion Fund allowed beneficiary countries who became Member States in 2004 and 2007, to **transfer without any difficulties from ISPA to the Cohesion Fund**.

Experience gained under ISPA was also taken on board when the Commission drafted the IPA Council Regulation and related implementing provisions. The Regional Development Component of IPA unifies those areas of funding which in the 2000- 2006 period were programmed under different instruments (ISPA and Phare) and managed by different Directorate-Generals and puts responsibility with the Directorate General for Regional Policy. Strategic planning, project preparation methodologies, TA assistance, capacity building were features developed successfully under ISPA and which are now introduced in IPA.

Last but not least the very active **role of Member States** in the ISPA Management Committee and the competence of their experts was an important factor for enhancing the quality of ISPA projects. It underlined the cooperative approach developed during ISPA between Member States and Candidate countries.

On the downside, actual **implementation progress on the ground is far behind** (initial) expectations. Given the unprecedented scale and scope of ISPA – as well as the weakness of the national administrations, it could not have been expected that ISPA would have an easy start. But the fact is that Bulgaria and Romania need more than 4 years to pay out the financial commitment of year "n"; and that Croatia, after more than 2 years of ISPA, needs yet to sign the first works contract. By the end of 2006, only one quarter of the funds that were committed during the whole ISPA period have been paid out. In essence, these implementation delays are a result of a

lack of adequate capacity, as manifested by poorly prepared projects, non-compliance with relevant EU norms like EIA or public procurement, poor contract management, unclear landownership and delayed land acquisition.

While EDIS was granted to Romanian Implementing Agencies in June 2006 (the largest portfolio ever EDIS-ised before accession) and to some agencies in Bulgaria in November 2006, **EDIS nevertheless came rather late**. Fully decentralised management before accession is a valuable benchmark for assessing the readiness of beneficiary countries to absorb funds and comply with financial management requirements, in particular on public procurement.

While systems and structures for programming and implementation are important and essential, it is staffing at an adequate level and competence that makes them operate efficiently. **Absence of sustainability of public administration** dealing with ISPA was a serious concern for a significant number of implementing bodies. Training and project management experience acquired "on the job" made experts attractive for the private sector, thus leading to high staff turnover and continuous concern about vacancies and adequate recruitment ("training for leaving syndrome").

Preparation for and implementation of **ISPA relied heavily on external assistance**. International consultants were required to prepare projects of adequate quality, international consultants and external advisors were needed to assist in complex tender evaluations and implementation supervision, the ex-ante role of the delegation was an essential safety net to ensure compliance with procurement rules. This reliance on external assistance and advice reduces ownership by and accountability of the national authorities and local bodies, which are an essential prerequisite for successful programming and implementation.