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PROGRAMME FOR CENTRAL AND EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA

**MOBILISING FINANCE FOR ENVIRONMENTAL PRIORITIES:
RECOMMENDATIONS FOR THE FUTURE**

Fifth joint meeting of the Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force) and the Project Preparation Committee (PPC)

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Delegates at the 4th Joint Meeting of the EAP Task Force and PPC agreed that this paper should be submitted to the Belgrade Ministerial Conference as a Category I document. The draft was approved in principle by the Executive Committee of the Ad Hoc Preparatory Working Group of Senior Officials for the Sixth Ministerial Conference "Environment for Europe" in Belgrade on 15 February. The outcomes of that discussion will be reported to the EAP Task Force and PPC at their 5th Joint Meeting on 15-16 March in Brussels.

ACTION REQUIRED: EAP Task Force/PPC delegates are invited to endorse this document, subject to written comments to be provided to the PPC Secretariat by 30 March 2007.

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Comité de Préparation des Projets

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EXECUTIVE SUMMARY

This paper argues that the sustained provision of adequate financial resources for the environment is a prerequisite for addressing environmental challenges in Eastern Europe, the Caucasus and Central Asia (EECCA) and South-Eastern Europe (SEE). It sets out options for how optimal use could be made of the various available sources of environmental finance, including domestic public expenditure, private sector participation and official development assistance. Recommendations are provided for Ministers on priority actions for ensuring that financial resources are made available for the environment. EECCA and SEE governments need to continue to prioritise the environment in policy and public expenditure frameworks, and make better use of incentive-based instruments. They also need to create a suitable climate for the private sector to participate in environmental financing. The international community must ensure that IFI loans for environmental investments are more accessible, especially for low-income countries, including by providing adequate grant co-financing. Finally, EECCA and SEE countries should strengthen their capacity to prepare environmental investment projects, with effective support from IFIs and donors.

I. ENVIRONMENTAL CHALLENGES AND OPPORTUNITIES IN EECCA AND SEE

A. Environmental challenges

1. Despite the progress that has been made across the region over the past fifteen years, the countries of Eastern Europe, the Caucasus and Central Asia and South-Eastern Europe still face significant environmental challenges. There is a risk that the environment-related Millennium Development Goals, including the reversal of the loss of environmental resources, halving the proportion of the population without access to safe water and sanitation, will not be reached in some EECCA and SEE countries. Access to safe water and sanitation is highly variable across the region, especially in rural areas and for the poorest and most vulnerable sections of the population. In urban areas, a relatively large share of the population is connected to centralised water and sanitation infrastructure, but a much lower proportion enjoys access to safe and sustainable services, as a consequence of neglect and under-investment. For example 37% of households in Georgia, 33% in Tajikistan, and 21% in Albania have access to safe and sustainable water supplies. For sustainable access to sanitation the picture is even starker. Less than 10% of the population in each of these three countries has access to reliable and safe sewage disposal (*Monitoring what Matters*, World Bank 2007). It is estimated that a doubling of current financing levels would be required to achieve the water-related MDGs, although current UN estimates significantly underestimate the scale of this challenge, with negative implications for the prioritisation of financial allocations at national and international levels. Environmental pollution is a persistent problem with serious impacts both on prospects for economic growth and public health, especially for the poor.

2. Reliable access to finance is essential for addressing these environmental challenges. This encompasses private and public financing for investments in environmental infrastructure, energy efficiency and renewable energy, pollution control, natural resource management and biodiversity. However, the reports on Trends in Environmental Expenditure in EECCA and SEE prepared respectively by the EAP Task Force and the REC for Central & Eastern Europe show that currently available expenditure, both public and private, is unevenly spread between sectors and does not closely match the region's environmental priorities. In EECCA countries overall, total environmental protection expenditure has increased, albeit slightly, in constant dollar terms since 2000. In some countries (e.g. Armenia, Azerbaijan, the Kyrgyz Republic and Moldova) the level of expenditure remains too low to attract any significant provider of environmental goods or services. Environmental expenditure per capita is below US\$5 per person per year. With the exception of Moldova, the share of public environmental expenditure in general government expenditure is marginal (below 0.5%). Investment represents less than 15% of environmental expenditure, with the exception of Armenia (35% in 2005, up from 7% in 2000). These

countries spend their meagre resources mainly in the wastewater sector; with very little expenditure reaching other sub-sectors. Environmental expenditure has enjoyed steady growth in the three major economies (the Russian Federation, Kazakhstan and Ukraine) since 2002. However, the volume of expenditure remains low compared to CEE countries, with the notable exception of Russia. In these bigger economies environmental expenditure has only partially benefited from the robust macroeconomic performance. Kazakhstan is the only country where environmental expenditure has risen as a share of GDP and as a share of public expenditure since 2000. Wastewater accounts for less than 50% of environmental expenditure; air, and to a lesser extent waste, represents a significant share. Kazakhstan has the most balanced pattern, with environmental expenditure split between air (37%), wastewater (27%), and waste (18%). In all EECCA countries the business sector and the government have contrasted investment patterns: the public sector concentrates on wastewater, whereas the primary focus of the private sector is air. Only in Russia, Belarus and Kazakhstan does the private sector allocate a substantive share of its expenditure on wastewater.

B. New opportunities for environmental financing

3. Since the last Environment for Europe Ministerial conference in Kiev in 2003 the context for the delivery of environmental finance in EECCA and SEE has evolved considerably. The expansion of the EU to include eight Central European countries in 2004 had a major impact, resulting in new opportunities for accessing environmental finance – both private and public – by the new EU member states. Progress has been made in strengthening national institutions, in part through the EU enlargement process.

4. EU expansion has shifted the focus of the Efe process ‘south and east’ towards EECCA and SEE. It is increasingly important to recognise the need for differentiated approaches to the different parts of the region. The new EU neighbourhood policy provides new opportunities for enhanced transboundary environmental cooperation. However, not all countries are equally able to benefit from these opportunities due to differences in their fiscal positions and levels of administrative capacity for environmental management. The international community can help by targeting assistance where it is most needed, by linking it more closely to the progress in reform processes, and by channelling additional finance which can play a catalytic role alongside domestic resources. The economic recovery of most EECCA countries since the financial crisis at the end of the 1990s has created the prospect of increased domestic financial resources for the environment. The EC has a dominant role in financing infrastructure in SEE due to the central importance of the EU accession process, which has broadened to encompass Croatia and FYR Macedonia since the Kiev conference. In oil and gas rich middle-income EECCA countries (Azerbaijan, Kazakhstan, Russia) significant budget surpluses caused by a sharp increase in oil prices have shifted the key challenge from increasing public funds to making efficient use of available resources in order to avoid an over-dependency on revenues from natural resources, diversify economies and lay a solid foundation for sustainable development. The low-income EECCA countries (i.e. the rest of the Caucasus and Central Asia) face specific challenges as they are often heavily indebted, with weaker governance and no EU accession incentive.

II. THE ROLE OF DOMESTIC FINANCE

A. Public domestic finance

5. Domestic finance, both public and private, will remain the major source of environmental finance in EECCA and SEE beyond 2007. Public finance will continue to play a vital role in providing environmental services that will bring significant public benefits, such as water resource management, biodiversity, or municipal environmental infrastructure. EECCA and SEE governments need to create appropriate

frameworks for optimising the use of available public environmental expenditure. A number of countries have followed the experience of OECD and CEE countries and have started to improve the efficiency of allocation of public budgets through formalising requirements for Medium Term Expenditure (or Budget) Frameworks (MTEFs or MTBFs) at the municipal level (e.g. Ukraine) or at the national level (e.g. Albania, Armenia, Kazakhstan, Kosovo, Moldova, Montenegro and Serbia). In SEE the mainstreaming of environmental expenditures into wider economic development strategies is happening as part of the EU accession project. For example in FYR Macedonia the Public Investment Programme for 2005-2007 includes environmental priorities. Processes such as these offer opportunities for environmental agencies to introduce strategic environmental investments into priorities supported by general budgets (see Box 1) and to ensure more predictable budget allocations for large-scale environmental investments, which require several years to prepare and implement. However, it also poses a challenge for environment ministries to compete effectively with other social sectors for limited fiscal space and cooperate effectively with Ministries of Finance. Environmental agencies can be competitive by improving their technical skills to prepare high quality investment programmes and convincingly prioritize projects within these programmes, taking into account environmental as well as social and wider economic benefits. The OECD Draft Council Recommendation on Good Practices for Public Environmental Expenditure Management (OECD, 2006) provides useful guidance in this respect. It is based on the basic principles of public expenditure management and environmental policy followed in member countries, and aims to make them compatible and mutually supportive. It operationalises these principles in several check-lists (environmental effectiveness, budgetary good practice and management efficiency) which can be used when designing, reviewing or reforming public environmental expenditure programmes. Some low income countries (e.g. Georgia) have successfully mainstreamed environment into national budget priorities through the national Poverty Reduction Strategy Paper (PRSP). Poverty Reduction Strategy Credits offer concrete implementation and funding arrangements for these priorities. In SEE the Priority Environmental Investment Programme for South Eastern Europe has been developed and is under implementation (*REC 2005, Targeting the Environmental Investment Challenge in the SEE*). This Programme has assisted Ministries of Environment in selecting priority environmental investments and in facilitating their financing. It also helped the donor community to target their financial assistance to the region more effectively.

Box 1: Mid-Term Budget (Expenditure) Frameworks

MTEF is an institutional mechanism that represents a complete logical chain linking policy formulations, planning and budgeting, and complements the short-term perspective of annual budget formulation. It contributes to greater fiscal discipline and efficiency in resource allocation and in operation. It ensures that budget allocations are consistent with government policy and strategic prioritization, given the availability of resources. It represents a fundamental shift away from ad hoc lists of project ideas towards a model which facilitates realistic and affordable investment programmes supported by strategic targeting of limited public funds.

MTEF in Armenia (supported by the UK's Department for International Development) gives prominence to sectors which are identified in the Poverty Reduction Strategy Paper, excluding environment. The OECD/EAP Task Force has nevertheless supported the efforts of the State Committee in charge of water to design a Financing Strategy for water supply and sanitation, and to integrate this into the new budget process. Major outcomes of the project are a consensus on realistic infrastructure targets, more objective discussion of tariff policy, reflection on realism of social and environmental objectives, an opportunity to improve dialogue with the Ministry of Finance, an opportunity to incorporate results into the MTEF and into PRSP. The World Bank has provided technical assistance and guidance to facilitate MTBFs in Tajikistan and Ukraine.

6. Central environmental agencies also face a challenge to support devolution of responsibilities for provision of local environmental infrastructure and management of environmental resources to local governments and to regional institutions. Devolving responsibilities to the local level must correspond with fair revenue sharing between central and local level and fiscal autonomy of local governments. It is in the interests of environment ministries to support these reforms, which facilitate predictable revenues and

access to adequate debt finance on private capital markets. National governments can also create incentives for local governments to allocate a fair share of local budgets for environmental investments. Box 2 illustrates some examples of environmental intergovernmental transfers from EECCA countries.

Box 2: Intergovernmental transfers to finance environmental investment - lessons from EECCA country case studies

Intergovernmental transfers are instruments that central governments can use to improve the performance and control of sub-national public expenditure, and to create incentives for better coherence between national and local public policies. Surveys in OECD countries confirm that the impact of intergovernmental grants on efficiency, fiscal discipline, and equity, largely depends on their design. Important lessons have also been learnt from EU accession countries where intergovernmental transfers are a key dimension of relations between levels of government and a major source of finance for local jurisdictions. EECCA countries mostly rely on inter-governmental transfers to bridge the financial gap that arises between the costs of local policies and services and the revenues to which local authorities have access. In EECCA countries, general purpose transfers, typically in the form of equalization schemes, are frequently used but can have negative consequences by enabling local budgets to increase their expenditure without raising additional tax revenues.

7. Most local governments in the region still have room to mobilise affordable financing from the users of environmental infrastructure. Water and sanitation services are, on average, affordable at present even in low income countries in the region. Among the countries studied by the World Bank (*Monitoring what Matters*, World Bank 2007) the average household's bill for these services exceeded 3% of its income only in Moldova and Kazakhstan. Average affordability indicators disregard income distribution, thereby concealing the affordability of water and sanitation to the poorest and most vulnerable groups. Unfortunately, data on water and sanitation service bills by income groups are not easily available. Affordability is based on current, low service levels, and there is a vicious circle of low prices and low quality services. Although the room for affordable tariff increase is much larger than commonly believed, the costs of investment needed to bring water and sanitation services up to the level of sustainable access is likely to pose a burden on household budgets, especially poorer ones. For several years to come, notwithstanding rising incomes, there will be a case for the international community to continue to fund part of the investment costs of improved water and sanitation on concessional terms, so long as systems are well managed and local populations pay for the operation and maintenance costs. Tariffs for environment-related utilities such as water and sanitation need to be set at levels commensurate with service delivery, and which ensure affordability and financial sustainability. The most vulnerable population groups who cannot afford the services must be identified and covered by effective but cost-efficient social safety nets. These reforms require sophisticated institutions and strong fiscal systems to provide reliable social protection. They are sometimes blocked politically because some local governments are not willing to charge people even if the people are willing to pay more for better services. The country studies supported jointly by Denmark and the EAP Task Force showed how smart investment planning and financing strategies can address fiscal and poverty constraints to infrastructure investments (OECD 2003). Affordability constraints could also be addressed through economies of scale by developing larger, regional investments instead of large numbers of small, localized infrastructure projects.

8. Perhaps the most profound environmental impact since the Kiev ministerial conference has been caused by the dramatic increase in the price of fossil fuels, mainly internationally traded oil and gas. Augmented by the political dimension of international energy trade, this has put energy efficiency and renewable energy sources at the top of government and business agendas. Environment agencies have a great opportunity to support these new priorities with concrete measures, such as national support schemes for renewable energy sources that have been set up in EU Member States (see Box 3).

Box 3: EU experience with support schemes for renewable energy sources

In EU Member States five main forms of national support schemes for renewable energy sources can be identified:

- i) guaranteed feed-in tariffs and mandatory buy-back obligations;*
- ii) renewables certificates, usually coupled with take-in obligations;*
- iii) public-bidding systems;*
- iv) tax relief or exemptions; and*
- v) direct support to investments.*

The RES-E (Renewable Energy Sources) Directive sets criteria on national support schemes. They must be compatible with the internal market, take into account the different characteristics of RES, be efficient and simple and include sufficient transitional regimes to maintain investors' confidence. They should also be affordable to users and public funds. Compensation levels should decrease over time, support should not continue in the long term. Full transparency is encouraged as far as possible, leaving the final decision to the market, including normal market risks. Different schemes have shown to have different performance by the above criteria. Feed-in-tariffs give more predictable prices than amounts, which are determined by the market. For certificate trading it is the opposite. Feed-in schemes can take into account efficiency, if properly used. Certificates may not give enough security for investment, while prices may be volatile.

9. The Kyoto Protocol to the Convention on Climate Change provides a range of opportunities to finance the abatement of greenhouse gas (GHG) emissions. Flexible, project-based mechanisms, such as the Joint Implementation (JI) and Clean Development Mechanism (CDM), channel foreign funds directly into GHG reducing projects. Host enterprises acquire the necessary funds partly upfront to undertake projects and partly after verified emissions reductions are achieved, while an investor receives the resulting GHG reduction credits, in the form of Emission Reduction Units (ERU) from JI and Certified Emission Reductions (CER) from CDM. These project based mechanisms already have well established global markets. However, projects often encounter financing difficulties due to unfavourable investment climates in sectors that could generate emission reductions and unpredictable procedures for host country approval. In addition, there is a lack of certainty about the climate change regulatory framework after 2012 when the first commitment period of the Kyoto Protocol ends. The short time left to develop projects that could generate significant amounts of emission reduction credits by 2012 is resulting in diminishing interest among potential project developers.

Box 4: International Emissions Trading (IET) and Green Investment Scheme (GIS)

International Emissions Trading under article 17 of the Kyoto Protocol could generate large amounts of additional public revenues for countries where GHG emissions will be lower than their Assigned Amount Units (AAUs) under the Kyoto Protocol. This market is still emerging. Some concerned voices were initially raised that the IET could undermine the environmental integrity of the Kyoto Protocol, if AAU transfers are not associated with actual emission reductions. The idea of green investment schemes emerged as a response to these concerns. Under these schemes AAU revenues will be earmarked to GHG reducing projects and programmes, or used to support policies and measures, which lead indirectly to emission reductions as well as capacity building. Although not a legal requirement under the Kyoto Protocol, credible and transparent mechanisms ensuring that AAU revenue are used to achieve verifiable environmental effects are standard buyers' requirement. Therefore, GIS are being developed in Latvia, Romania and Ukraine and are being considered by Bulgaria, the Czech Republic, Poland and the Russian Federation.

10. A new and, for some countries, potentially vast source of funds for GHG abatement and other environmental improvements is being made available through International Emission Trading under Article 17 of the Kyoto Protocol (see Box 4). Under this mechanism the governments of the CEE and EECCA countries listed in Annex B of the Kyoto Protocol can sell a part of their Kyoto quotas in the form

of Assigned Amount Units (AAUs). The proceeds from the sale of AAUs can be utilized to finance the GHG abating projects and other environmental programmes subject to agreement between sellers and buyers.

B. The role of the private sector

11. At the 2003 Kiev conference Ministers recognised the potentially important role of the private sector in mobilising finance for environmental objectives. As public sources of finance alone cannot meet the environmental investment needs in EECCA and SEE countries, private sector finance is essential. There is a wide range of different types of private sector actors that could potentially play a role in environmental financing. These include users of environmental infrastructure, domestic operators of environmental infrastructure services, polluting industries, property developers and, last but not least, financial intermediaries including banks, investment funds, insurance companies, pension funds and other carriers of long-term finance.

12. Effective public policies can play an important role in mobilising private environmental expenditure. In mature democracies and markets government financial support for polluters to reduce pollution to legally binding standards has proven to be bad for the environment and the economy in the long run. Therefore the 'polluter pays' principle was widely agreed as the cornerstone of environmental policies in OECD and EU countries. As EECCA and SEE develop modern political and market systems, public expenditure will play a decreasing role in achieving environmental improvements, except in providing environmental infrastructure and in managing common natural resources. The experience of industrialised OECD countries and the more recent experience of new EU members show that many environmental objectives can be effectively and efficiently achieved without placing a burden on public budgets. These include aligning environmental standards (both quality and emissions) with good international practice, and reforming environmental permitting to make it more effective and enforceable (but also fair and investment-friendly). The European regulatory system can serve as a reference for environmental permits that are integrated and derived from environmental performance benchmarks. These permits are less cumbersome and more transparent to issue, and easier to enforce than post-Soviet permits. They also encourage continuous improvement of environmental performance by enterprises and prevent or minimize pollution. Economic instruments such as environmental taxes or emissions trading can be applied to alter the behaviour of polluters (see Box 5). Ministries of Environment, especially in EECCA, will face difficult challenges in decreasing the present excessive reliance on the use of economic instruments (mainly pollution fees) and non-compliance fines for revenue raising purposes. A continuation of the present situation would be damaging to the image of environmental agencies which would be perceived as rent seekers rather than providers of public goods. It would also divert scarce institutional capacity away from much needed reform of core environmental policy instruments, such as permits.

13. According to international good practice, public funds can provide efficient financial incentives to enterprises if they are used to encourage the improvement of environmental performance beyond legal minimum standards and beyond standard business practice in industry. Governments can also provide cost-effective support to pollution abatement by focussing on investment aid to collective treatment infrastructure (e.g. collective waste and wastewater treatment facilities), in particular to small and medium sized enterprises (SMEs). Operational and maintenance and, ideally, investment costs need to be recovered from users of such infrastructure in order to ensure its sustainability.

14. Since the Kiev conference, the experience of the EBRD and World Bank has shown that the main contribution of the private sector to environmental infrastructure such as water and sanitation in EECCA and SEE countries has been more efficient operation rather than capital. Finance and expertise from the private sector will only flow freely where the climate is attractive and investment costs can be recovered, and where the regulatory framework is predictable. Investors have a low appetite for high risk ventures

where higher, often unaffordable, insurance premiums will be required. Governments should improve the climate for private sector involvement, including by developing a clear legal basis and procedures for establishing and managing public-private partnerships, drawing from good and bad lessons learned so far. The experience of CEE countries also shows that municipal infrastructure can be efficiently managed by public utilities providing that they are corporatised and financially and operationally autonomous.

Box 5: Lessons learned from the use of economic instruments of environmental policy

In EECCA countries environmental fees are not fulfilling their functions properly. There are too many fee titles (e.g. 1,217 air, and 1,345 water pollutants in Kazakhstan alone) to be managed efficiently and calculated properly. In OECD countries incentive pollution fees are usually targeted at one or two pollutants and rarely earmarked for environmental funds (e.g. NO_x and SO₂ taxes in Scandinavian countries). A recent World Bank study in Kazakhstan showed that, notwithstanding relatively high rates, the fees do not provide incentives to reduce pollution. Calculation of payments due is non-transparent and discretionary. These features turn environmental fees primarily into a tool for government officials to extract rents from industry. Enterprises perceive them as such and as an opportunity for corruption. They are an inefficient fiscal instrument to raise insignificant revenues for local budgets and need to be drastically streamlined. Most of the several thousand emissions fees could be abolished without any serious damage to the environment or to public revenue.

Selected pollution fee rates in Kazakhstan and OECD countries

Indicator	Kazakhstan rates, US\$ per ton (2001)	Reference rates in OECD countries, US\$ per ton
SO ₂ from stationary sources	22 – 70 Av 38.5	2,046 (Sweden) 105 (Poland) 20-30 (US)
NO _x from stationary sources	Av. 17	5,900 (Sweden) 105 (Poland) 20-30 (US)
Discharges of polluting substances into water bodies (BOD)	24.4	896 (Poland) n.a. (Sweden) Variable (US)
Least hazardous solid waste (least hazardous)	0.9	390 (Sweden) 2-7 (Poland)
Most hazardous solid waste (most hazardous)	28.2	21 (US- on average) 32-47 (Poland)

15. State/donor intervention and assistance can also support private sector participation by facilitating access to credit. This can be done through credit enhancement schemes, support for specialised municipal relationship banking, well designed lines of credit or co-financing schemes. Options for making use of local capital markets to finance environmental infrastructure also include enabling the proponents of small projects, for example small municipalities and community groups, to bundle their projects in order to be more palatable to capital markets. Some further examples are elaborated in Boxes 6 and 7.

16. There are significant opportunities in EECCA and SEE countries to follow successful examples from around the world of harnessing private sector finance to provide certain public environmental goods and services, such as watershed and biodiversity protection. In order to realise these opportunities governments must create conditions for the private sector actors to capture private gains (business case) of protecting public environmental resources. Government regulatory interventions can trigger revenues to private sector from biodiversity-friendly agriculture, tourism (particularly in coastal areas), or managing wetlands to protect quantity and quality of water bodies used for recreation, or drinking. Innovative, low cost solutions to environmental problems, for example non-conventional technologies for wastewater

treatment through ecosystem management, should be given due consideration also by the donor funded environmental investment support facilities, especially in low-income countries, where extensive infrastructure (e.g. pipes, pumps and waste water treatment plants) may be unaffordable.

Box 6: Harnessing local capital markets to finance environmental infrastructure - lessons from EECCA country case studies

As part of the process of fiscal decentralization, the policy and institutional obstacles that prevent the financial sector from playing a greater role in financing environmental projects should be removed; incentives for such an involvement include the right for local authorities to incur debt, support to the development of carriers of long-term savings (insurance companies, banks), regulation of the portfolio of these institutions (and the share that they are allowed to invest in local jurisdictions), etc. Experience from other regions could be applied in EECCA countries to enable local capital and financial markets to play a greater role in financing environmentally-related infrastructure.

Local capital and financial markets cannot develop without the appropriate legal framework. This legal framework has to be supplemented by mechanisms that reduce risk to lenders. Any strategy concerning the development of local capital and financial markets must be compatible with the existing system on which other sources of finance are based, in particular intergovernmental transfers and fiscal autonomy. The objective should be to diminish uncertainties about the resources available to sub-national authorities, to generate stable streams of revenues for these jurisdictions, and to allow these authorities to adapt their revenues to their needs and financing strategies. In addition, action taken by central governments on the reform of the WSS sector in EECCA should be implemented in parallel with actions taken at the local level. Here, the focus is on the overall scheme of decentralisation and on the institutional capacity of local authorities.

Box 7: Energy Service Companies: a mechanism to harness private sector expertise to boost energy efficiency

Governments can also facilitate development of specialised project management companies such as energy service companies (ESCOs) in order to enhance the bankability and technical feasibility of energy efficiency projects owned by inexperienced and small project owners. ESCOs have been widely supported by the World Bank as a business model for bridging the gap between end-users and financing. It involves private sector participation and financing, allows technical risks to be transferred away from end-users and financiers, and includes inherent business incentives for ESCOs to develop projects proactively. ESCOs can also specialize in packaging smaller energy efficiency projects, bundling procurement of goods across several projects and taking on project performance and credit risks. Thus ESCOs can be seen as a mechanism to remove many of the commonly cited barriers to energy efficiency investments. Of about 24 World Bank operations worldwide to develop ESCO markets in client countries, some included development of utility-based ESCOs, while others supported the development of an ESCO industry. Despite promising attributes, creating strong and credible ESCOs, not to mention full ESCO markets, has proven very challenging. Countries often lack the legal and financial infrastructure to adapt to and support such business models. New ESCOs often lack the proper skills (corporate management, financial management and credit assessments, risk mitigation and management, sales) and thus have limited credibility to potential customers and financiers. EECCA and SEE countries often have limited equity markets and investors willing to create new companies and test new business types.

17. OECD and CEE industrialised countries offer a number of positive experiences with using policy incentives to involve private enterprises, specifically polluting industries, in improving environmental performance including clean-up of environmental legacies as part of privatisation (see Box 8).

Box 8: Policy incentives to encourage brownfield clean-up and recycling and to facilitating ongoing pollution abatement by industry

Contaminated sites deter investors from land development because of the associated cleanup costs. Developers may shy away from properties believed to be contaminated for fear of *future* liability and because *immediate* cleanup costs may prove too high for the development project to be viable. Lenders may also withhold financing for brownfield projects to avoid involvement in liability at the site, and/or undervalue the property as collateral for the loan. In particular, the privatization of state owned enterprises is more efficient if liabilities for past pollution are known to both parties, and responsibility for clean-up clearly specified and allocated. Once it is done, policies to encourage the financing of brownfield remediation may consist of (a) liability relief, (b) direct financial incentives, (c) and regulatory relief, in the form of fast-track approvals of plans and flexible cleanup standards, and (d) insurance against liability. There are several options now available to insurers that will allow them to effectively cap or contractually transfer their liabilities for known environmental matters. Remediation cost cap policies, guaranteed cost to closure, blended finite risk policies, and contractual transfer of liabilities are some of the options currently available to property sellers and buyers.

18. While accumulated industrial pollution is often a public liability (due to former state ownership of most industrial sites, unclear privatization arrangements, and abandonment of sites), ongoing pollution, in contrast, is mostly perceived as a responsibility of the private sector. Governments face the challenge of enforcing this responsibility from rapidly growing industries amid opposition of powerful interest groups including those concerned about social impacts such as short-term job losses. Innovation and courage will be needed from environmental agencies to design and implement policies which effectively protect the environment, while being neutral to public budgets and friendly to investments and markets. Polluters will reduce ongoing pollution without subsidies only if induced by environmental policy instruments, by public pressures or by trade partners. For example a recent study showed that under the present regulatory environment in Kazakhstan investors have no incentives to apply best available techniques (BAT) that would avoid and minimize the impacts of a rapidly growing petrochemical industry on the environment as a whole. Correcting the incentive structure would require the modernization of the regulatory framework. Environmental permitting would need to move to an approach based on BAT, improvements in monitoring, including self-monitoring, a modern environmental liability regime, financial sanctions that are streamlined and fair, but deterrent and tightly enforced, and a number of environmental fees need to be drastically reduced with parallel strengthening of their incentive functions. In CEE the Environmental Compliance and Enforcement Network for Accession (ECENA) has played an important role in facilitating the process of enforcement. It is an informal network of environmental authorities from the pre-candidate, candidate and acceding countries. Its main objective is to support its members in strengthening environmental compliance and enforcement in line with the EU accession obligations and, where relevant, obligations under the Stabilisation and Association Process. Through ECENA multi-annual work programmes, member countries have increased their capacity for the implementation of EU legislation.

19. Domestic private investment can be boosted by foreign direct investment (FDI). FDI can help to improve the environmental performance of industrial enterprises. Guidance in this area has been developed by the OECD, for example the environment chapter of the Multinational Enterprises Guidelines, and the analysis of technology transfer schemes. EECCA and SEE countries can also help to improve the climate for private investment in the environment through adopting appropriate regulatory frameworks.

III. THE ROLE OF INTERNATIONAL FINANCE

A. The need for sustained official development assistance for the environment

20. There are strong reasons for continuing international financial assistance for the environment in EECCA and SEE. Official development assistance can play a catalytic role in the overall provision of environmental finance. There is a strong link between the environment and poverty reduction agendas, for example through the Millennium Development Goals and the environment-health nexus. The emergence of a new European neighbourhood policy is creating new opportunities for effective transboundary environmental cooperation beyond the borders of the EU, and for more cost-effective approaches to regional and global environmental problems through cooperation with EECCA and SEE countries. The state of the environment is also highly relevant to the regional security agenda through a range of issues including environmental migrants and transboundary environmental hazards.

21. The priorities and approaches of donors and IFIs in the EECCA and SEE regions have evolved somewhat since the Kiev conference in 2003. Bilateral donors are progressively scaling down their programmes in the region, and consequently the EC is assuming a more prominent role as the main provider of environmental grant assistance. Donors have also made important progress in developing more coordinated and strategic ways of working together, for example through multi-donor initiatives such as the EBRD's Early Transition Countries Initiative. Some of these have an explicit environmental focus, for example the Northern Dimension Environmental Partnership (NDEP) and the Danube and Black Sea Task Force (DABLAS). In SEE the Regional Environmental Reconstruction Programme (REReP) has played an important role in facilitating donor assistance based on the needs of SEE countries. Donors are also using a range of new aid instruments, including budgetary support, in addition to the more traditional project-based approach. The shift towards budgetary support has implications for the how international aid is channelled into the environment sector as recipients countries have more say in how aid expenditure is allocated between sectors. Therefore it is especially important to ensure that environmental priorities are clearly reflected in national expenditure frameworks in such cases, as discussed in paragraph 5 of this paper.

B. Optimizing the use of international assistance

22. There needs to be better coherence between national environmental expenditure and international environmental assistance. One option is the use of Poverty Reduction Strategy Papers, and associated Medium-Term Expenditure Frameworks to provide this coherence by enabling donors and IFIs to plan their assistance around country-led approaches that explicitly set out national priorities, including the environment. Under the new EC assistance instruments, such as the Instruments of Pre-Accession (IPA), European Neighbourhood Partnership Instrument (ENPI) and the Development Cooperation and Economic Cooperation Instrument (DCECI), EC environmental assistance will increasingly be channelled through national programmes, so environmental investment projects will need to be linked to national priorities in order to access EC grant financing. Alongside the alignment of international assistance with national expenditure priorities, international assistance can also be used to provide incentives for environmental improvements and reforms (see Box 9). For example, the World Bank has developed client-executed grants and lending instruments with results-oriented disbursements, including Development Policy Loans with environmental performance indicators and Poverty Reduction Support Credits (PRSCs). Similarly, the EU's Stabilisation and Association process and the associated assistance packages such as IPA in the non-accession countries of SEE have provided powerful incentives for reforms and environmental improvements.

Box 9: Output-based aid

Output-based aid (OBA) is the use of explicit, performance-based subsidies to complement or replace user fees. It involves the contracting out of basic service provision (e.g., infrastructure, health, education) to a third party — such as private companies, non-governmental organizations (NGOs), community-based organizations (CBOs), and possibly even a public service provider — with subsidy payments tied to the delivery of previously specified outputs (e.g. per network connection, or per kilometer of road constructed or maintained). Governments can also be beneficiaries and receive aid in instalments upon achieving specific milestones or targets.

Examples of possible OBA applications include payment of subsidies tied to:

- Number of new connections made, when the goal is to expand access to network services;
- Verified household consumption, equivalent to the difference between a life-line tariff (paid for by the household) and the full tariff;
- Achievement of positive externalities (e.g. subsidies for sanitation disbursed against the achievement of specific environmental targets).

23. In addition to traditional donor grants and IFIs loans, EECCA and SEE countries require assistance in making the most efficient use of all available sources of international financial assistance for the environment, including multi-donor initiatives such as the Global Environmental Fund and the Northern Dimension Environmental Partnership.

C. Improving conditions for external borrowing for environmental improvements

24. In low-income countries in EECCA and SEE, IFI loans for environmental improvements need to be made more accessible and affordable. In order to achieve this, sustained grant co-financing is necessary. At the moment the ratio of grants to loans in EECCA and SEE is in the range of 10:90, but this needs to increase to 40:60 in low-income countries. As the eventual repayment of IFI loans will come from EECCA and SEE countries' domestic resources, it is important to ensure that investments are phased realistically in a way that takes into account affordability and fiscal constraints. This is particularly important in low-income countries which have caps on sovereign borrowing set by the International Monetary Fund (IMF).

25. In middle-income countries in EECCA and SEE national authorities need to be able to prioritise projects that are appropriate for IFI investment. It is important to bring in technical expertise as part of IFI packages, including support to build local capacity for understanding IFI requirements. For example, it may be necessary to undertake institutional and sector reforms in order to make investments feasible and sustainable. In some cases central governments could consider revising procedures for obtaining sub-sovereign guarantees so that municipalities could, where appropriate, have more direct access to international finance for environmental investments.

26. Further work is needed to find ways of attracting international finance for small projects, including those with a particular developmental or poverty reduction focus. Some options could include developing new opportunities for on-lending arrangements and sub-national borrowing. IFIs should also work with local commercial banks in order to launch credit lines for smaller infrastructure projects. Lessons should be learned from the experiences of the World Bank and EBRD with the use of credit lines and financial intermediaries, municipal funds and energy service companies (see Box 10).

Box 10: Lessons learned from the World Bank experience with targeted credit lines

The use of lines of credit (LOC) by the World Bank has declined sharply over the FY93-03 period, accounting for only 2% of total World Bank investment lending by FY03. The decline has been across all regions and all sectors. Cancellation of original commitments has been high, and outcomes of closed LOC have been poor. Given this difficult history, the need for credit lines targeted at environmental investments should be carefully considered on a case by case basis. If deemed necessary to achieve specific environmental objectives, they should be carefully designed taking into account lessons learned from international experience. Better outcomes of LOCs are associated with stable macroeconomic conditions in a country, stronger financial sectors, and limited state ownership of financial institutions, use of clear eligibility criteria in the selection of financial intermediaries, and use of only private sector financial intermediaries.

There is also a challenge for donors to coordinate terms and conditions of their support to the credit lines. IFIs and donors should assess the extent to which there are differences in guidelines governing LOC and to work towards harmonizing them to the extent possible. Better efforts at in-country coordination are also needed. (Source: OED Review of Bank Lending for Lines of Credit, World Bank 2004).

IV. THE NEED FOR EFFECTIVE PROJECT PREPARATION

27. The availability of well-developed, viable environmental project concepts can be a bottleneck to environmental investment, even when finance is available. For example, feasibility studies are often focused on technical aspects of projects while financial and economic analyses are underdeveloped, which ultimately reduces the likelihood of developing a bankable project. Effective project preparation is essential for accessing environmental finance from public, private and international sources, and for ensuring that the supply and demand of finance are balanced. The burden of project preparation, particularly on lower-income countries, should be reduced by implementing lower-cost and more streamlined approaches that are appropriate to the needs of EECCA and SEE countries, while maintaining quality standards. Project design should avoid oversized investment proposals and unrealistic business models. Greater attention is needed to develop cost-effective project preparation for smaller projects. Options could include innovative project design, pooling smaller projects into larger projects, and cross-sectoral organisation. Smaller projects and local low-tech solutions may often provide the first steps on the economic growth ladder for low-income countries, as opposed to ambitiously high performance specifications based on standard Western private sector practice.

28. Strengthening capacity for project preparation in EECCA and SEE is a priority. Project proponents, including national and sub-national authorities and the private sector, need to be able to coordinate and prioritise the identification and development of environmental investment projects. The Municipal Development Fund in Georgia provides a good example of how this can be achieved. In Croatia capacity for project preparation has been enhanced by development of the ISPA strategy and IPA lists. The Croatian national ISPA environmental strategy includes priority projects for ISPA co-financing in waste, water and air pollution management. The list of projects was prioritised and selected projects were identified as those requiring early implementation. International support for environmental project preparation will continue to be necessary, especially in the lower-income countries of the Caucasus, Central Asia and Western Balkans. Capacity building should be a primary objective of this support. International assistance should be delivered in a way that is responsive to the needs of EECCA and SEE countries and donor support should complement the varying approaches and working methods of the different IFIs. Lessons should be learned from experiences with the EC's Joint Environment Programme (JEP) I and II, and from the current suite of Investment Support Facilities (ISFs) also funded by the EC. There are important opportunities to harness the transition experience and technical capacity of the new EU member states and apply these in EECCA

and SEE countries. The Environment for Europe process could continue to play an important role in coordinating international assistance for project preparation beyond 2007.

29. Foreign assistance alone will not strengthen local capacity for project preparation. Support for institutional reforms, effective project design and implementation and innovative, performance based forms of assistance should all be considered. Priorities for supporting effective project preparation could include the following:

i) *Encouraging appropriate institutional reforms.* For example, in the water and sanitation sectors it may be appropriate to create financially viable public utilities that are autonomous of municipal authorities. In this way utilities are subject to more rigorous fiscal discipline and are incentivised to develop specialised technical expertise and project management capabilities. The roles of different ministries (for example Ministries of Environment, Ministries of Finance, etc.) with respect to project preparation should be made clear.

ii) *Building capacity for project preparation through client involvement in project design and implementation.* Rather than being regarded as a stand-alone activity, capacity building should be mainstreamed into the process of developing and implementing environmental investment projects. Technical assistance and support for institutional reforms should be integrated into the project process so that client institutions are left with enhanced technical expertise and project management capabilities that will enable them to take forward further environmental projects in the future. For example, EBRD routinely includes Corporate Development Support Programmes for water utilities as part of its investment projects in the water and sanitation sector.

iii) *Building up the pool of local consultancy capacity.* Capacity for project preparation does not only need to exist in the public sector – an experienced and appropriately skilled local private sector, able to provide high-quality consultancy services, is also important. IFIs and donors should make full use of available local expertise by involving local consultants in the project process where appropriate, thereby enabling the transfer of expertise and exposing local consultants to international best practice. An example of how international support can boost local consultancy capacity is provided by some of the EC's ISFs. For example, the EC Tacis-funded Water Investment Support Facility has made extensive use of local consultants in feasibility studies for a number of water and sanitation investment projects.

V. CONCLUSIONS AND RECOMMENDATIONS

30. At the Sixth "Environment for Europe" Ministerial Conference in Belgrade, Ministers may wish to consider the following recommendations for the mobilisation of environmental finance in EECCA and SEE beyond 2007:

(a) Better use should be made of increased domestic public financial resources.

- i) EECCA and SEE countries should increase the level of public environmental expenditure as a percentage of GDP to the levels of CEE countries net of EU assistance and focus them on national priorities.
- ii) Governments should introduce mid-term expenditure frameworks for predictable budget support of priority large scale public investments. Ministries in charge of environment should ensure the prioritisation of environmental expenditure in public expenditure frameworks by preparing result oriented and economically sound environmental programmes, including high-quality investment proposals and financing strategies for their implementation. Donors should

align their national assistance plans with these domestic investment priorities. The design and implementation of public environmental expenditure frameworks should be guided by the OECD Council Recommendation.

- iii) Governments should mobilise additional domestic resources in order to achieve the MDG targets of access to municipal environmental infrastructure measured by complementary indicators of quality, safety and sustainability of infrastructure services. In particular, governments should encourage the financial autonomy of utilities and appropriate tariff reforms so that operation and maintenance, and in the longer run investments, can be financed primarily through user charges while ensuring that poorer users receive adequate social protection.
- iv) Countries listed in Annex B to the Kyoto Protocol should immediately implement procedures for the approval of JI projects and promptly meet conditions and implement green investment schemes in order to harness the potentially significant additional public revenues for the environment from international emissions trading.

(b) National authorities in EECCA and SEE countries should create more suitable climates for private sector participation in environmental improvements.

- i) The role of governments is essential for creating the appropriate framework to attract financial and capital markets to finance environmental services, in particular in energy efficiency, renewable energy sources, agriculture, tourism, forestry and water resource management.
- ii) The regulatory climate for private sector participation in environmental infrastructure investments should be strengthened.
- iii) Post-Soviet environmental permitting and compliance instruments should be reformed in line with EU practices in order to encourage industries and private enterprises to invest in improving ongoing environmental performance and cleaning-up past environmental liabilities. The Guidelines and Guiding Principles for Integrated Environmental Permitting developed by the EAP Task Force could be helpful in this regard.
- iv) Economic instruments should be used primarily to provide incentives to polluters instead of generating government revenues.
- v) The international community can provide guidance for policy reforms, technical experience and catalytic financial support.

(c) Adequate levels of international environmental assistance to the region should be sustained and should support national environmental priorities.

- i) IFI lending for environmental investments needs to be made accessible for low-income countries through the provision of adequate donor grant co-financing.
- ii) Middle-income countries need to be able to prioritise projects for IFI investments and undertake appropriate institutional and sector reforms in order to improve access to international finance at sub-national levels.
- iii) IFIs and donors should assist EECCA and SEE countries in taking advantage of alternative financing mechanisms such as carbon financing.
- iv) IFIs and donors should consider the use of performance-based aid instruments to create incentives for environmental improvements and reforms.

(d) EECCA and SEE countries should build their capacity for project preparation.

- i) National and sub-national authorities need to be able to identify priority environmental investments and help project owners, in particular utilities, to prepare viable environmental investment projects.

- ii) Governments, IFIs and donors can contribute towards this by supporting appropriate institutional reforms, building capacity through client involvements in the process of designing and implementing investment projects and building up the pool of local consultancy capacity for project preparation.

