OECD/EAP Task Force Secretariat and EU Phare Programme

*Review of the Czech State Environment Fund*

March 15, 1999

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### ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>Bln</td>
<td>Billion</td>
</tr>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
</tr>
<tr>
<td>CZK</td>
<td>Czech Crowns</td>
</tr>
<tr>
<td>EAP</td>
<td>Environmental Action Programme for Central and Eastern Europe</td>
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<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IT</td>
<td>Information Technology</td>
</tr>
<tr>
<td>Mln</td>
<td>Million</td>
</tr>
<tr>
<td>MoE</td>
<td>Ministry of Environment</td>
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<tr>
<td>NGO</td>
<td>Non-governmental Organisation</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PHARE</td>
<td>EU Technical Assistance Programme for Central and Eastern Europe</td>
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<td>SEP</td>
<td>State Environmental Policy</td>
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<tr>
<td>SFZP</td>
<td>State Environment Fund of the Czech Republic</td>
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<tr>
<td>USD</td>
<td>United States Dollars</td>
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EXECUTIVE SUMMARY

BACKGROUND AND OBJECTIVES OF REVIEW

The EAP Task Force is engaged on a series of voluntary reviews of environmental funds in Central and Eastern Europe (CEE) under the aegis of the Funds Network, which is supported in CEE by the European Union’s (EU) Phare Programme. Each review examines the operations of a specific fund and identifies institutional strengthening measures that would enhance fund effectiveness and efficiency. Reviews generally cover the major areas addressed by the St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy (OECD, 1995). At the third meeting of the CEE Funds Network, held in Riga, May 1998, the Director of the Czech State Environment Fund requested that such a review be conducted of the Czech Fund.

THE CZECH STATE ENVIRONMENTAL FUND

The State Environment Fund of the Czech Republic (“SFZP” or the “Fund”) was established by Czech National Council Act in 1991 as a “State Institution”, in effect merging and replacing the pre-existing State Air Fund and State Water Fund. The chief objective behind establishment of the Fund was to create a comprehensive and flexible financial instrument for implementing state environmental policy. The Fund, which began its operations in 1992, is a separate legal entity administered by the Ministry of Environment (MoE), with the Minister ultimately responsible for the allocation and use of the Fund’s resources. The Minister is advised in the use of the Fund’s resources by the Fund Council, whose 12 members and Chairperson are appointed by the Minister. The Fund’s mandate is implemented through the work of the Fund Office, whose Director is appointed by the Minister and currently has a staff of over 70 people.

The Fund’s principal sources of revenue are pollution charges and fines, proceeds from privatisation, and loan repayments. In 1997 revenues amounted to about 167 mln USD. The Fund’s current environmental investment priorities are: air pollution abatement; water pollution abatement; minimisation of waste, especially hazardous waste; support for “clean” technologies, and; protection of nature and landscape. Environmental expenditures of the Fund totalled approximately 104 mln USD in 1997. The majority of the Fund’s financial support has been awarded either as grants or soft loans, though the Fund may also offer loan guarantees and interest rate subsidies for loans extended by commercial banks.

KEY CONCLUSIONS AND RECOMMENDATIONS

The Fund has undergone considerable improvements over the last two years. It plays a significant role in financing environmental protection and improvement in the Czech Republic and substantial environmental benefits have resulted from the Fund’s activities. A window of opportunity for further improving the Fund now exists as a result of the country’s preparations for accession to the European Union. One of the objectives of the review is to help the Fund assess its strengths and weaknesses and identify possible measures for continued institutional strengthening.

Principal Strengths

- Professional, competent staff, with forward-thinking management;
- Sound cashflow management procedures;
- Fairly robust and well defined project cycle management procedures, (particularly in the areas of project appraisal and ranking), which broadly conform with best practice in the region;
- Project cycle procedures and criteria (with the critical exception of final project selection), appear to be objective, transparent, reasonably-well documented and publicly available;
• The relatively recent introduction and use of interest rate subsidies as a financing instrument;
• Positive steps toward managing the heavy demand for the Fund’s resources, including:
  – reduction of the share of total project costs that the Fund can cover (generally from 80 to 60%); tightening the eligibility criteria for the receipt of grants; and moving from “interest-free” to interest bearing loans for municipalities;
  – exploratory use of project financial appraisal and internal rate of return, which could help the Fund to identify projects with greatest cost-benefit ratios and to determine true financial needs of applicants;
  – development of ideas for two-stage project appraisal procedures to process applications more efficiently;
• Fund Directors recognise the need for internal management systems which conform with international quality assurance norms and have begun to address this need;
• The management structure of SFZP is straightforward and suited to the size of the organisation;
• There is evidence of a documented, systematic approach to Fund activities;

Main Areas for Improvement

Some of the key challenges facing the Fund are related to the external policy and institutional framework in which the Fund must operate, whereas other areas for improvement are more integral to the internal operations of the Fund. It is recognised that the Fund management is likely to have less influence in addressing the external factors than in strengthening the internal operations of the Fund. Nevertheless, for the Fund to continue to make substantial improvements, and to take advantage of new opportunities, for example associated with the EU accession process, the external constraints on its effectiveness and efficiency will have to be diminished, if not eliminated. The main challenges, both external and internal, and proposed measures for addressing them are as follows:

• The Fund and Ministry of Environment (MoE) should work closely together in defining a new medium term (2-5 years) strategy for the Fund. The strategic role currently being played by the Fund vis-à-vis other policy instruments for implementing the State Environmental Policy (SEP) is unclear. The SEP reviewed by the Review Team only very briefly mentions the Fund and the official “Strategy of the State Environmental Fund in the Years 1997-2000” appears to be more of an emergency response to crises suffered by the Fund in 1995-1996 than a pro-active vision for the Fund’s future. The Fund’s role seems to be defined largely by past and present client demand (which far exceeds supply). If possible, a new strategic role for the Fund should be more fully elaborated in the new SEP. In any case, a new strategy should be developed and approved at the level of the Government. Any new Fund strategy should, as a minimum, give serious consideration to the “value-added” by the Fund vis-à-vis other instruments available to the State for implementing the SEP and special requirements facing the State as a result of EU accession.

• Final decision-making authority for the selection of individual projects should be vested in a collective body (i.e. a reformed Council) representing the Fund’s key stakeholders (i.e. MoE, Ministry of Finance, Parliament, Ministry of Regional Development, municipal authorities, business community, financial sector, and citizen environmental movement). Currently the Minister of Environment has final decision-making authority in selecting projects and need not follow the recommendations of the Fund Office or Council. Whether or not the Minister exercises this authority, its effect is a decision-making process which has been perceived as subject to influence by political interests rather than a balance of policy, environmental and economic goals. Undoubtedly, the Minister and MoE have an essential role to play in identifying environmental priorities and in setting the necessary policy and institutional framework to guide the Fund’s activities. However, both the St. Petersburg Guidelines and best practice in the region suggest that this authority should not extend to decisions on the financing of specific individual projects. The MoE’s interests in ensuring that the Fund focuses on
priorities set in the SEP could be maintained, inter alia, through the appointment of MoE representatives to a reformed Council. Accountability and transparency could be enhanced by an appeals process and the introduction of periodic audits. Such a change should also reduce applicants’ perceived need for lobbying in the application process, allowing resources of both applicants and officials to be used more efficiently.

• **A reformed Council should be given greater authority and responsibility, including final decision-making on project selection.** The “value-added” by the Fund Council as it currently functions appears to be minimal: it does not have the expertise nor time to substitute for the role of Fund staff in project appraisal (nor should it try to); and its advice on project selection need not be followed by the Minister. The St. Petersburg Guidelines and best practice at other funds in Central Europe suggest the following main functions for the Council: it would take the lead in formulating the Fund’s strategy for implementing the SEP; it would have final decision-making authority, and the related responsibility, for determining which projects receive financial support from the Fund; it would appoint the Fund Director; it would approve annual investment priorities (a subset of the environmental priorities identified by the MoE) and criteria used for project appraisal and ranking; and, it would approve of the Fund’s annual budget and performance reports, before submitting them to the MoE.

• **The composition of the Fund Council should be diversified to better represent the interests of key stakeholders, while maintaining the Council size at a reasonable number.** The current composition of the Council renders it vulnerable to real or perceived “capture” by certain interest groups (i.e. state civil servants or Members of Parliament) and fails to adequately include the interests of some of the Fund’s most important stakeholders, namely clients (e.g. municipalities, business community, environmental NGOs). This lack of representation can undermine the public legitimacy of the Council. Care should be taken, however, not to increase the size of the Council substantially. Experience shows that the larger such bodies become, the less efficiently they operate. While there is some room for flexibility, the optimum size is likely to be between 9-13.

• **The Fund should adopt a stronger, pro-active annual programming process in which relative priorities for spending are explicitly stated (in an indicative manner) among the various project categories or environmental media.** The annual Annexes, despite becoming more specific in the past two years, remain broad and give little indication, either to the Fund or potential applicants, as to real spending priorities. There appears to be no process through which the Fund’s spending priorities are pro-actively, ex-ante, determined. Rather, it appears that, for any given year, the Fund’s spending priorities are determined largely by historical and expected demand as expressed by applicants. Such an approach to programming undermines the Fund’s ability to allocate its resources in a focused, strategic, cost-effective manner. The lack of any indicative prioritisation among the many project categories listed in the annual Annex (over 20 in 1998) can create the perception that the Fund has an equal capacity and interest in supporting virtually any kind of environmental project, which may in turn contribute to the large volume of requests for support from the Fund. A new programming process should be explicitly defined, documented and made known to all interested parties, including potential applicants. The process should, as a minimum, fully involve key Fund staff, the Fund Council and Ministry of Environment.

**Other Options for Improvement**

The above recommendations, in the opinion of the Review Team, address the most important obstacles to substantially improving the effectiveness and efficiency of the Fund. The resolution of additional challenges, discussed briefly below, while also improving the operations of the Fund, should be seen as important but less critical.

• **The Fund should examine how its activities may accelerate the involvement of private sector finance in environmental investments.** Commercial sources of finance (e.g. certain banks) are
becoming more involved in the financing of environmental investments in the Czech Republic, (albeit on less attractive terms to borrowers than those offered by the Fund). As capital markets develop, and the need for subsidised finance among the Fund’s clients diminishes, the Fund should assess the effect its different disbursement forms have with respect to maximising environmental benefits and facilitating the development of more market-based financing mechanisms for environmental protection. In line with this, the Fund should consider expanding its use of interest rate subsidies as an effective mechanism for promoting the involvement of commercial banks in the financing of environmental investments.

- A two-stage project appraisal process should help the Fund process the extremely high number of applications it receives more efficiently. The Fund is flooded with far more eligible project proposals than it can possibly finance, partly because the annual Annex sets such broad “priorities” and does not indicate relative importance among them. As most of the applications received by the Fund are “eligible” under the broad guidelines set in the Annex, Fund staff are obliged to appraise the proposals fully, regardless of their chances for eventual approval by the Minister. This results in a highly inefficient allocation of staff resources and an often unnecessary drain on the resources of unsuccessful applicants. A two-stage project appraisal process could be an effective means for quickly and efficiently screening out relatively weak proposals and for tentatively ranking the remaining proposals which would later undergo full appraisal in a second stage. In order to maintain transparency and objectivity, however, it is essential that the Fund clearly specifies the criteria used to determine which proposals reach the second stage and which do not.

- Another option for reducing the project appraisal workload on Fund staff is to create a simplified, one-stage appraisal process for small projects requesting financial support below some given threshold. Additionally, the final decision-making workload on the Fund Council (or Minister, in the current situation) could be lightened by delegating authority for approval of small projects to the Fund management, with appropriate provisions to ensure transparency and accountability in project selection. Currently, all projects, regardless of how small, must be formally considered and recommended by the Fund Council, and then approved by the Minister.

- Any revisions or amendments to the Fund’s Act or Statute, (which surely will be required to implement the fundamental reforms suggested above), should include provisions allowing non-“fundamental” reforms to be made either upon approval of the MoE or by a strengthened Fund Council. The Fund’s Parliamentary Act and Statute provide a strong legal basis for its activities. However, the language of these documents appears to require either Parliamentary or Governmental approval for all but the most simple internal changes at the Fund, which presents an obstacle to implementing some important reforms which do not affect the fundamental mission or governance of the Fund. Operating within a framework of rules and procedures ensuring accountability and transparency, a stronger, more meaningful role for the Fund Council could allow some reforms to be made without approval of the full Government and/or Parliament. “Fundamental” reforms might include: changes in the Fund’s basic mission; unforeseen changes in the Fund’s revenue sources; major changes in the structure and/or function of the Fund’s governing bodies.

- The Review Team understands that the annual Annex for 1999 was to be presented to the Council before the start of the new 1999 funding cycle. This practice should become the norm for the future. In past years, the annual Annex was evidently not presented to the Council until the first session of the year. As a result, many applications could be received by the Fund in the early part of the year which might not have met the priorities established by the Annex.

- The Fund’s policy for selecting banks to manage its assets should be clearly defined, documented and made publicly available upon request. The Team understands that a number of banks have been selected to manage the Fund’s financial resources based upon State involvement in certain banks, the knowledge of the Fund Director and agreement between the
Fund and the Minister of Environment. However, to the Team’s knowledge this “policy” is not clearly documented or known outside the Fund. Such an approach to bank selection could leave the Fund open to criticism for not being objective or transparent in its decision-making. In the future, selection of banks for cooperation should be done in a competitive manner, with the criteria for selection clearly defined and made known to interested banks.

- Either the Fund Act or, perhaps more appropriately, the Statute, should clearly require the Fund to develop and implement professional project cycle procedures based on principles of objectivity, transparency and accountability. Current legal requirements on the Fund to develop and implement professional project cycle procedures and criteria for appraising and ranking project proposals are weak. The Fund’s Act states that: “The fundamental principle shall be an unbiased evaluation of the application from the point of view of its economic assets and collective interests”. The Statute merely requires “skilful evaluation” by the Fund. Neither document explicitly requires professional project cycle procedures based on principles of objectivity, transparency and accountability, nor do they mention key criteria for project ranking, such as environmental benefits or cost-effectiveness. While the Fund management has made considerable progress in these areas in recent years, the legal requirement for them to do so remains weak.

- The Fund has recognised the need for quality assurance procedures in its management, however, the documentation of these and mechanisms for regularly evaluating and revising them should be strengthened. The Fund has already begun to put quality assurance procedures in place to manage its operations. Some of these procedures, however, have not been sufficiently documented. Additionally, mechanisms for regularly evaluating and revising these procedures should be developed and put into practice.

- The Fund should periodically conduct internal audits of its management systems. Ideally, the Fund’s statute would require such audits, specify the competent bodies for conducting them and their frequency. As it stands at the threshold of an opportunity, the Fund should also consider having its management systems audited by an internationally recognised institution. Through such an assessment, the Fund could take a fresh look at all its management systems and embark on a course that would take it, step by step, towards the ultimate goal of certification to recognised international standards.
1 INTRODUCTION

1.1 BACKGROUND

The EAP Task Force is engaged on a series of voluntary reviews of environmental funds in Central and Eastern Europe (CEE) under the aegis of the Funds Network, which is supported in CEE by the European Union’s (EU) Phare Programme. Each review examines the operations of a specific Fund and identifies institutional strengthening measures that would enhance fund effectiveness and efficiency. Reviews generally cover the major areas addressed by the St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy (OECD, 1995). At the third meeting of the CEE Funds Network, held in Riga, May 1998, the Director of the Czech State Environment Fund requested that such a review be conducted at the Czech Fund.

1.2 OBJECTIVES OF THE REVIEW

The overall objectives of the Fund reviews are: to help Environmental Funds in CEECs achieve the greatest environmental benefits possible with the scarce financial resources available to them and; to enable Funds to become more effective instruments for facilitating the evolution and application of market-based mechanisms for financing environmental investments.

More specifically, the objectives of the review were to:

- evaluate the organisation, operations and performance of the Czech State Environment Fund against inter alia the guidelines and criteria contained in the St. Petersburg Guidelines;
- identify and recommend changes/measures, both short and long-term, for strengthening and improving the effectiveness and efficiency of the Fund as a public environmental financing institution;
- assess the institutional, organisational, technical and financial capacities and potential of the Fund to act as an Implementing Agency for EU and other potential foreign sources of finance;

1.3 METHODOLOGY

The review involved three stages: preparatory activities, appraisal 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 (the “Team”) prior to the appraisal mission (see Annex 2). The appraisal and drafting mission was undertaken over the period 17 - 21 August 1998. During this time the team engaged in extensive discussions with Fund staff and Council members, officials of the Ministries of Environment and Finance, Fund clients and other organisations (see Annex 3). The full co-operation of these parties is gratefully acknowledged.

The review team consisted of the following members: Mr. Glen Anderson, Mr. Ian McIver, Mr. Daniel Siddy and Mr. Patrick Francis (Head of Mission). The team was assisted by a local expert, Mr. Lubomir Paroha and an interpreter, Mrs. Dagmar Rejchrtova.

The views expressed in this report are those of the Review Team members and do not necessarily reflect those of the European Union, the OECD, the EAP Task Force or their Member countries.
2 THE CZECH STATE ENVIRONMENT FUND

2.1 BACKGROUND AND OBJECTIVES OF THE FUND

The State Environment Fund of the Czech Republic was established by National Council Act No. 388 in 1991, with the legal status of a “State Institution”, in effect merging and replacing the pre-existing State Air Fund and State Water Fund. This Act includes the Fund’s Statute, related Regulations, and the Directive on the Provision of Financial Resources from the Fund. The Directive, issued by the Ministry of Environment, is supplemented each year through annual Annexes issued by the MoE following close consultations with the Fund Office. Recent Annexes have been guided by the “Strategy of the State Environment Fund in the Years 1997-2000”, which was approved at a meeting of the economic Ministers of the Government of Czech Republic on January 13, 1997.

The chief motivation for establishment of the Fund was the aim to create a comprehensive and flexible financial instrument of environmental policy that would:

- be based on the system of payments for activities affecting the environment (fees, charges, and fines for the use of the environment);
- replace other existing specialised funds (the State Water Management Fund\(^1\) and the Air Protection Fund\(^2\));
- allow for the mobilisation of financial means for environmental protection;
- allow for a sufficiently flexible reaction to evolving priorities in environmental protection;
- allow for a yearly carry-over of financial resources.

The “Strategy of the State Environment Fund in the Years 1997-2000” is based on the State Environmental Policy adopted in 1995. The most important elements of this strategy include:

I. Setting priorities:
   - air pollution abatement (especially from medium-sized sources, i.e. 0.2-5 MW\(_t\));
   - water pollution abatement (especially from medium-sized sources, i.e. 5-10 thousand equivalent inhabitants);
   - minimisation of waste, especially hazardous waste;
   - support for “clean” (low waste, low emission and low energy consumption) technologies, especially for small and medium-sized enterprises;
   - protection of nature and landscape (with emphasis on increased retention capacity of the landscape and the flood prevention effect of measures).

II. Introduction of five specialised assistance programmes corresponding to the above listed priorities for the period 1998-2000.

III. Setting the criteria (and their relative importance) for assessing applications within the five programmes:
   - health risk minimisation;
   - environmental damage within given locality;
   - compliance with international treaties;

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\(^1\) The State Water Management Fund was established in 1967 as part of the Ministry of Forest and Water Management.  
\(^2\) The Air Protection Fund was established in 1977, also as part of the Ministry of Forest and Water Management.
− emphasis on preventive measures;
− abatement cost per unit of pollution;
− share of the Fund assistance on the project cost.

The role of the Fund in total environmental expenditures in the Czech Republic is illustrated in the table below, which indicates the main State sources of annual environmental expenditures in the country from 1990 - 1997.

Table 1: The structure of total annual expenditures on environmental protection in the Czech Republic, 1990-1997 (in bln CZK; current values).

<table>
<thead>
<tr>
<th>Year</th>
<th>State Government Sources</th>
<th>Total from State Government</th>
<th>Total Environmental Investments</th>
<th>Investments as a % of GDP</th>
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<tr>
<td></td>
<td>State Budget</td>
<td>SFZP</td>
<td>National Property Fund</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>3.2</td>
<td>1.9</td>
<td>-</td>
<td>5.1</td>
</tr>
<tr>
<td>1991</td>
<td>7.5</td>
<td>1.5</td>
<td>-</td>
<td>9.0</td>
</tr>
<tr>
<td>1992</td>
<td>10.7</td>
<td>1.5</td>
<td>-</td>
<td>12.2</td>
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<tr>
<td>1993</td>
<td>9.1</td>
<td>2.9</td>
<td>-</td>
<td>12.0</td>
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<td>1994</td>
<td>10.0</td>
<td>3.6</td>
<td>0.1</td>
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<tr>
<td>1995</td>
<td>9.2</td>
<td>4.9</td>
<td>0.8</td>
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<td>1996</td>
<td>8.2</td>
<td>4.6</td>
<td>1.1</td>
<td>13.9</td>
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<tr>
<td>1997</td>
<td>8.0</td>
<td>3.3</td>
<td>1.4</td>
<td>12.7</td>
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</table>

Source: Ministry of Environment of the Czech Republic.
Notes: “n.a.” = not available. National Property Fund expenditures include expenditures for drinking water. “Total Investments” represents statistically monitored expenditures on environmental protection investments based on the methodology applied by the Czech Statistical Office. (This methodology, which excludes expenditures on drinking water, conforms with EU methodology). Municipal environmental protection expenditures are estimated at the amount of approximately 2.0 billion CZK per year.

Another reflection of the scale of the Fund’s activities since 1993 is given in Table 2 below, which illustrates its total annual revenues and expenditures.

Table 2: Total revenues and expenditures of the SFZP (mln USD; current values based on annual average exchange rates).

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<td>Annual revenues</td>
<td>94.943</td>
<td>155.926</td>
<td>186.869</td>
<td>197.212</td>
<td>167.148</td>
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<td>Environmental expenditures</td>
<td>98.408</td>
<td>123.105</td>
<td>183.843</td>
<td>169.551</td>
<td>103.968</td>
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<td>Overhead / administration costs</td>
<td>0.889</td>
<td>1.389</td>
<td>1.458</td>
<td>1.525</td>
<td>2.158</td>
</tr>
<tr>
<td>Total expenditures(^1)</td>
<td>99.297</td>
<td>124.495</td>
<td>185.301</td>
<td>171.076</td>
<td>106.126</td>
</tr>
</tbody>
</table>

Notes: Totals might not equal the sums of individual sub-components due to rounding. The Fund carries over unspent money from one year to another, thus, total disposable resources for environmental expenditure in any given year may be higher than the amounts indicated under “annual revenues”.
1) “Total expenditures” = “Environmental expenditures” + “Overhead / administrative costs”.

- -11
2.2 MANAGEMENT AND ADMINISTRATION

The Fund is a state agency, subordinated to the Minister of Environment, without any direct link to the State Budget. Its scope of work is defined by the Statute of the Fund, which was approved by the Czech Government in February 1992. The Administrator of the Fund is the MoE, with the Minister holding ultimate responsibility for the use of the Fund’s resources.

The Fund Council acts as the Minister’s advisory body; its decisions are submitted to the Minister as recommendations. Regular Members and the Chairperson of the Council are appointed and discharged by the Minister of Environment. The Members of the Council include:

- six representatives of the following ministries: MoE, Ministry of Finance, Ministry of Regional Development, Ministry of Agriculture, Ministry of Industry and Trade, and the Ministry of Health;
- six members of the lower chamber of the Czech Parliament, from the following committees: Committee for the Environment and Regional Development, Committee for the Budget, and, Committee for the National Economy;
- one representative of the Union of Towns and Municipalities.

The activities of the Fund are executed by the Fund Office. In accordance with the Fund Statute, the Fund Office performs the following main activities:

- draws up budgets and final accounts of the Fund;
- receives applications from those interested in obtaining support from the Fund;
- ensures skilful evaluation of the applications;
- prepares the background materials necessary for the Council to render its recommendations;
- prepares proposals for projects to be financed and submits them to the Minister;
- on the basis of the resolution of the Minister, the Fund Office is authorised to enter into contracts with successful applicants;
- administers the bank accounts of the Fund and executes all payments;
- carries out analyses of the use of the Fund's resources and submits these to the Council, the Ministry of Finance and the Czech Parliament;
- regularly informs the public about the Fund’s activities.

The Fund Director is appointed and discharged by the Minister of Environment. The other senior managers are the Technical and Financial Directors, who are appointed by the Fund Director. The Fund currently has 74 employees in three divisions:

<table>
<thead>
<tr>
<th>Division of the Director:</th>
<th>18 employees</th>
<th>(13 with university degree)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Division:</td>
<td>26 employees</td>
<td>(12 with university degree)</td>
</tr>
<tr>
<td>Technical Division:</td>
<td>30 employees</td>
<td>(26 with university degree)</td>
</tr>
</tbody>
</table>

A particularly important institutional partner for the Fund is the Czech Environmental Inspectorate, which establishes and monitors the pollution charges and fines which represent the largest part of the Fund’s revenues.

The composition of the respective divisions (as of mid-1998) is shown in the Fund’s organigram (Figure 1).
2.3 Revenues

The standard incomes of the Fund include:
- charges on the discharge of waste water into surface waters;
- charges on the use of ground water;
- charges on the emission of harmful substances into the air;
- charges pursuant to the Waste Law;
- payments for the conversion of agricultural land from agricultural production;
- charges on the production and import of substances damaging the Earth’s ozone layer;
- fines imposed by the Czech Environmental Inspectorate;
- repayments of loans principal and interest;
- transfers from the National Property Fund under the “Air Revitalisation Programme” (a total of 6.1 bln CZK from 1994-1997).

According to the Fund’s founding law, revenues may also come from:
- fines on the misuse of financial support provided by the Fund;
- transfers from the State Budget;
- taxes;
- loans from legal entities;
- contributions made by domestic and foreign legal entities.
Over the period 1992-1997, the revenue of the Fund totalled 25.29 billion CZK (nearly 900 million USD). The largest sources of revenue in that period were air pollution charges (28.2%), transfers from the National Property Fund (23%), wastewater charges (22%), and, payments for the conversion of agricultural land (9.2%). The annual revenues of the Fund from 1993-1997, with a break down of major sources, is shown in Table 3.

Table 3: Fund revenues (mln USD; current values based on annual average exchange rates).

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Air pollution charges</td>
<td>28.09</td>
<td>44.72</td>
<td>43.84</td>
<td>46.70</td>
<td>50.45</td>
</tr>
<tr>
<td>Water use charges</td>
<td>1.43</td>
<td>1.49</td>
<td>1.06</td>
<td>1.33</td>
<td>1.15</td>
</tr>
<tr>
<td>Wastewater charges</td>
<td>37.01</td>
<td>28.94</td>
<td>24.65</td>
<td>20.90</td>
<td>15.74</td>
</tr>
<tr>
<td>Waste disposal charges</td>
<td>12.23</td>
<td>14.79</td>
<td>22.52</td>
<td>9.72</td>
<td>1.74</td>
</tr>
<tr>
<td>Soil/land use charges</td>
<td>11.12</td>
<td>17.04</td>
<td>13.14</td>
<td>16.10</td>
<td>14.48</td>
</tr>
<tr>
<td>Air pollution fines</td>
<td>0.35</td>
<td>0.31</td>
<td>0.32</td>
<td>0.40</td>
<td>0.64</td>
</tr>
<tr>
<td>Wastewater fines</td>
<td>0.62</td>
<td>0.39</td>
<td>0.38</td>
<td>0.31</td>
<td>0.30</td>
</tr>
<tr>
<td>Waste disposal fines</td>
<td>0.05</td>
<td>0.41</td>
<td>0.64</td>
<td>0.36</td>
<td>0.27</td>
</tr>
<tr>
<td>Soil/land use fines</td>
<td>0.06</td>
<td>0.09</td>
<td>0.12</td>
<td>0.14</td>
<td>0.09</td>
</tr>
<tr>
<td>Product charge on CFCs</td>
<td>-</td>
<td>1.93</td>
<td>1.90</td>
<td>1.43</td>
<td>1.29</td>
</tr>
<tr>
<td>Loan repayment (including interest)</td>
<td>1.44</td>
<td>8.46</td>
<td>14.59</td>
<td>21.63</td>
<td>24.81</td>
</tr>
<tr>
<td>Revenue from privatisation (Air Quality Program)</td>
<td>-</td>
<td>34.73</td>
<td>60.29</td>
<td>73.67</td>
<td>47.32</td>
</tr>
<tr>
<td>Revenue from financial operations and interest on bank deposits</td>
<td>2.55</td>
<td>2.62</td>
<td>3.44</td>
<td>4.54</td>
<td>10.15</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.41</td>
</tr>
<tr>
<td>TOTAL revenues</td>
<td>94.94</td>
<td>155.93</td>
<td>186.87</td>
<td>197.21</td>
<td>167.15</td>
</tr>
</tbody>
</table>


Notes: Totals might not equal the sums of individual sub-components due to rounding.

In order to have a longer term perspective, the Fund (together with Czech Environmental Inspectorate and other institutions) has carried out a study on the trends in pollution charges for the period 1998-2002. Only wastewater charges are expected to rise (as a result of the new clean water act); payments for the conversion of agricultural land are expected to remain at about the same levels while waste disposal and air pollution charges will decrease in near future. The share of loan repayments in total revenues is also expected to rise, as has been the case in recent years.

The Fund does not set, collect, or claim the charges; it is only the recipient of the revenue. The general scheme for collecting pollution charges is as follows:

- the level of pollution charges for each polluter is set by Czech Environmental Inspectorate;
- the polluter makes the actual payment to the tax authority;
- the tax authority channels the payment to the Fund.

Each year, when preparing the next year’s annual budget, the Fund receives forecasts from the Czech Environmental Inspectorate on the expected levels of revenue. The difference between these estimates and actual revenues is typically not significant, as may be seen from the following table (a notable exception being wastes charges):
Table 4: Forecast and actual revenues from pollution charges to the Fund in 1997.

<table>
<thead>
<tr>
<th>Media</th>
<th>Forecast (mln CZK)</th>
<th>Actual revenue (mln CZK)</th>
<th>Actual/forecast (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water</td>
<td>630.0</td>
<td>554.2</td>
<td>88.0</td>
</tr>
<tr>
<td>Air</td>
<td>1490.0</td>
<td>1638.6</td>
<td>110.0</td>
</tr>
<tr>
<td>Waste</td>
<td>20.0</td>
<td>70.2</td>
<td>351.0</td>
</tr>
<tr>
<td>Soil</td>
<td>400.0</td>
<td>461.9</td>
<td>115.5</td>
</tr>
<tr>
<td>Total</td>
<td>2540.0</td>
<td>2724.9</td>
<td>107.3</td>
</tr>
</tbody>
</table>


2.4 SPENDING STRATEGIES

The long term spending strategy of the Fund is based upon State Environmental Policy goals and the financial means available to the Fund. The Fund’s long-term spending priorities, as specified by the MoE in the “Strategy of the State Environmental Fund in the Years 1997-2000”, are listed earlier in this chapter. The Fund also has an annual spending plan, the priorities of which are again set by the MoE. The top priorities for 1998 are:

- air protection - focused on medium size pollution sources;
- water protection - focused on medium size pollution sources;
- use of renewable energy sources.

2.5 EXPENDITURES

Since 1993 (inclusive), the Fund has spent approximately 686 mln USD on environmental protection. The major fields of this expenditure are indicated in Table 5, which readily shows that the large majority of support has gone to the air and water sectors.

Table 5: Expenditures by environmental sector (mln USD; current values based on annual average exchange rates).

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Air (total)</td>
<td>32.13</td>
<td>42.65</td>
<td>89.65</td>
<td>83.97</td>
<td>37.99</td>
</tr>
<tr>
<td>Water (total)</td>
<td>57.37</td>
<td>69.25</td>
<td>81.51</td>
<td>71.68</td>
<td>59.67</td>
</tr>
<tr>
<td>Waste (total)</td>
<td>7.35</td>
<td>6.19</td>
<td>9.37</td>
<td>5.35</td>
<td>1.91</td>
</tr>
<tr>
<td>incl.:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>incineration</td>
<td>3.42</td>
<td>1.28</td>
<td>0</td>
<td>0.71</td>
<td>0.17</td>
</tr>
<tr>
<td>Nature protection / conservation</td>
<td>1.55</td>
<td>5.02</td>
<td>3.31</td>
<td>8.55</td>
<td>4.40</td>
</tr>
<tr>
<td>TOTAL</td>
<td>98.41</td>
<td>123.11</td>
<td>183.84</td>
<td>169.55</td>
<td>103.97</td>
</tr>
</tbody>
</table>


Note: The figures listed for “Nature protection and conservation” include projects focused on soil and landscape protection.

The Fund categorises its assistance as either direct or indirect. Direct forms of assistance include:

- grants (only to non-commercial entities);
- loans to non-commercial entities with an interest rate of 3% (as of 1998; previously, such loans were interest-free), and;
- loans to commercial entities with an interest rate of 7%.

Indirect forms of assistance include:
• guarantees for loans, to an amount of 50 mln CZK for a period of 10 years, and;
• subsidies to offset the interest rate of loans extended by commercial banks (up to an amount of 7%) for a maximum period of 5 years.

As suggested above, the Fund differentiates between two types of applicants: 1) municipalities and other non-commercial entities; 2) commercial entities. For either type of beneficiary, the Fund does not combine direct and indirect forms of assistance, nor interest subsidies and guarantees for loans. The terms associated with the different forms of support provided by the Fund differ according to specific assistance programme category and type of applicant. (In 1998, the Fund had six programmes of assistance with 21 detailed subprogrammes.) The maximum loan repayment period is 7 years (including up to 3 years of grace period), starting the year after the last disbursement is made by the Fund. The Fund may cover a maximum of 80% of total project costs, though commercial entities may typically receive support amounting up to 50%. Non-commercial entities may receive a combination of both grants and soft loans, while commercial entities are typically eligible for soft loans only. The Fund does not support projects already supported from the state budget.

Support from the Fund is typically provided to municipalities. In 1997, municipalities received 84.9% of the total environmental expenditures of the Fund while 12.2% was received by commercial entities, and 2.9% by other non-commercial entities. Water management joint stock companies where municipalities own at least 90% of the shares are treated by the Fund as municipalities.

As can be seen in Table 6 below, the vast majority of the Fund’s financial support is provided in the form of grants or soft loans. Since the early 1990’s, there has been a trend toward reducing the share of total support provided as grants and increasing the share provided as soft loans.

Table 6: Environmental expenditures by type of disbursement mechanism (mln USD; current values based on annual average exchange rates).

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Grants</td>
<td>61.05</td>
<td>72.83</td>
<td>95.75</td>
<td>94.82</td>
<td>57.61</td>
</tr>
<tr>
<td>Soft and interest free loans</td>
<td>37.36</td>
<td>50.27</td>
<td>88.09</td>
<td>74.73</td>
<td>45.65</td>
</tr>
<tr>
<td>Interest subsidies</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.68</td>
</tr>
<tr>
<td>Loan guarantee</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.04</td>
</tr>
<tr>
<td>TOTAL environmental expenditures</td>
<td>98.41</td>
<td>123.11</td>
<td>183.84</td>
<td>169.55</td>
<td>103.97</td>
</tr>
</tbody>
</table>


Notes: The Fund began to provide loan guarantees in 1996. The total amount guaranteed by the Fund in that year was 1471.5 mln CZK (~ 54 mln USD), however, it was not called upon to pay any of those guarantees. In 1997, the Fund extended loan guarantees worth 1410.8 mln CZK (~ 47 mln USD), and was required to make payments of 1.2 mln CZK (~ 0.04 USD), which do not appear in the above table due to the proportionally low amount.

Amounts which the Fund might be required to pay as a result of its loan guarantees, are covered by the maintenance of a financial reserve. The reserve held by the Fund fluctuates during the year according to changes in the risks related to Fund's financial situation.

2.6 FUNDING CYCLE

For each calendar year, the Fund’s priorities, and assistance programmes designed to address those priorities, are published at the end of the previous year by the MoE as an Annex to the Directive on the Provision of Financial Resources from the State Environmental Fund. The Annex is widely distributed as a special brochure, published in several newspapers and is also available on the Fund’s Internet page (http://www.sfzp.cz).
The funding cycle applied by the Fund includes the following steps:

- The applicant submits an application to the Fund Office on the Fund’s standard form, together with the required annexes.
- The application is briefly checked by Fund staff for its completeness. A complete application is then officially registered.
- A registered application is passed on to the relevant experts at the Fund for appraisal of its technical, environmental and financial merits. A number of criteria - specific for each assistance programme - are applied in the appraisal process (see Box 1 below for a description of criteria applied in the air programme). Following appraisal, the Fund ranks project proposals and recommends to the Fund Council which projects should be funded. During its session, the Council reviews the opinion of the Fund Office, and makes its own recommendation on whether the project should be approved or disapproved, which is then submitted to the Minister of Environment. The Minister then issues a resolution specifying which projects are to receive financial support from the Fund.
- If a project is approved in the Minister’s resolution, a “Decree” is issued by the MoE to the Fund Office with detailed instructions and conditions for entering into a contract with the applicant. This Decree must be forwarded on to the applicant within 15 days after the Fund receives it from MoE.
- The applicant must then submit to the Fund Office any additional information necessary for the preparation and signing of a Contract for Provision of Financial Support.
- If a loan is a part of the financial support package, it must be secured with suitable collateral. The most common form of collateral is real estate, (in which case the value of the collateral is required to be greater than the loan itself), however, other kinds of collateral are also acceptable. Loan disbursement does not begin until the loan is fully secured by collateral. In order to secure a loan with real estate as collateral, the borrower must register a “collateral right” with the relevant regional territorial registry in the name of the lender. Loan disbursements may be made only after proof of this “right”, in the form of an abstract made available by the registry, is submitted to the Fund. Once a borrower repays his or her loan, the Fund releases its “collateral right” to the real estate.
- Once all required additional information (including collateral in the case of a loan) is submitted to and approved by the Fund, the contract is signed.
- Payments are made according to the schedule agreed upon in the contract. The Fund withholds 10% of the support until the project is completed and a final evaluation is conducted. If the project is found to have met all the targets and benefits stated in the application, the remaining 10% is paid.

**Box 1: Appraisal Criteria Used in the Air Programme**

Formally complete applications submitted in the field of air protection are evaluated on the basis of the following criteria:

1. The level of concentrations of the main pollutants at the given locality. This criterion is established on the basis of the air ambient and emission conditions at the given location and is expressed in terms of air ambient and emission orders of municipalities as drawn up by the state administration.

2. The importance of the project in regional environmental policy. This criterion is employed to reflect the prioritisation assigned to individual projects by the pertinent territorial department of the Ministry of the Environment.

3. A preference for measures which maximise pollution reduction. This factor is determined as a percentage of the value of the emission limits for the chief and possibly other pollutants as set down in the Measure of the State Committee for the Environment Law No. 17/1997.

4. The costs for implementing the project and the amount of support requested from the Fund, related to a unit of pollution abatement. A pollution unit abatement cost is calculated; the value of pollution charges and fines reduced as a result of the project are also considered in the cost calculations.

5. Consideration of the requirements of environmentally burdened areas. This criterion is expressed in terms of a point value of the total sum of all the evaluation factors carried out in the framework of the project “Delimitation of Environmentally Burdened Areas in the Czech Republic”.

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The applicant must receive a notification (positive or negative) within six months after his or her application was registered.

In 1997, the Fund received 462 applications for assistance, out of which the Minister approved:
- 83 projects within the air programme;
- 27 projects within the water programme;
- 10 projects within the waste programme;
- 4 projects within the clean technologies programme;
- 67 projects within the nature protection programme.

2.7 EVALUATION, REPORTING AND PUBLIC INFORMATION

Each year the Fund prepares a report on its activities and submits it to the MoE. At the Ministry, the report is evaluated by the relevant departments and then submitted to other ministries for their comments. Consequently it is submitted to the Czech Government. The Fund also submits special reports annually to the Czech Parliament and the Ministry of Finance.

The Fund undergoes a financial audit annually, conducted by certified companies. The audit is done in accordance with Czech laws but the auditing companies selected have experience and practice in working according to EU standards. In 1997, the Fund underwent an additional special audit concerning its loan portfolio.

Information about the Fund is disseminated publicly through its annual report, articles in the Bulletin of the MoE, specialised journals and in response to specific requests. Another, recently opened forum for disseminating information is the Fund’s new web page on the Internet.

2.8 MAJOR ACHIEVEMENTS

From 1992-1997, the Fund helped finance:
- 469 wastewater treatment plants and sewer systems;
- 96 projects to remedy flood damage (resulting from the floods in July of 1997);
- 1197 general conversions from more polluting fuels to gas in municipalities;
- 457 projects to protect nature and landscapes.

Over the period of its operations, the Fund has financed activities in the water sector leading to a decrease in water pollution by 54 004 tonnes of BOD₅ and also by 75 516 tonnes of insoluble substances. For comparison: in 1996, a total of 49 744 tonnes of BOD₅ and 84 102 tonnes of insoluble substances was produced in the Czech Republic.

In the sphere of air protection, a decrease in pollution (dust, sulphur dioxide, nitrogen oxide, carbon oxide and hydrocarbons) of 316 236 tonnes per year was achieved in the years 1992-1997. For comparison: in 1996, a total of about 628 500 tonnes of the chief pollutants was emitted into the air by small and medium-sized pollution sources.

The fact that the greatest percentage of expenditures from the Fund so far have been directed towards the protection of air and water is in accordance with the priorities laid down in the State Environmental Policy for the short-term (1995-1998). The dominant character of projects supported thus far by the Fund - construction of small wastewater treatment plants and installation of connections to sewer systems, general conversion to gas in towns and municipalities - corresponds to the needs of the communal sector and also to the financial capabilities of the Fund.
3 POLICY AND INSTITUTIONAL FRAMEWORK

3.1 STRATEGIC ROLE OF THE FUND

Environmental funds have served a number of functions in the economies in transition of Central and Eastern Europe. While CEE countries recognise and support the polluter pays principle, their ability to invoke this principle has been hindered by a number of factors, including: weaknesses in their systems of environmental policy and management, severe financial constraints among regulated facilities, weak capital markets and banking sectors, ongoing privatisation. During the transition period, environmental funds have emerged as an important tool of environmental policy, supporting environmental investments and enabling CEE countries to overcome the barriers elaborated above and make progress in reducing environmental problems.

To maximise their strategic value as policy instruments and to make efficient use of their scarce resources, environmental funds must develop a strategic plan and vision that serves as a framework for priority setting, disbursement policies, and annual programming of resources. While disbursements by the SFZP have been, and remain, an important source of environmental finance in the Czech Republic, the Review Team believes that the Fund’s contribution has been guided more by past and present client demand than a well-defined, pro-active and co-ordinated strategy. The existing State Environmental Policy (SEP), dated August 1995, makes only very brief mention of the Fund. The SEP: recognises the Fund as an important source of environmental finance; notes its past expenditures; envisions a role for the Fund in expanding resources for environmental investment through the leveraging of Fund resources to attract other domestic and donor finance; and directs the Fund to provide “guarantees for commercial credits and interest reductions in order to mobilise financial resources for the protection of the environment . . .” The official “Strategy of the State Environmental Fund in the Years 1997-2000” does not go much further in elaborating the strategic value of the Fund and appears to be more of an emergency response to crises suffered by the Fund in 1995-1996 than a pro-active vision of the Fund’s future.

With the Fund’s expenditures seemingly being determined mainly by client demand, questions arise concerning their efficiency and effectiveness. Is the Fund addressing the “right” problems? Is the Fund using the most efficient financing mechanisms to achieve its goals? Is the Fund to be a financier of “first” or “last” resort? How should the Fund maximise its leveraging effect vis a vis other domestic and foreign sources of finance? How should the Fund adapt to changing needs for subsidised finance in the environmental sector? To fully assess the Fund’s performance, answers to these questions (or at least clear guidance) should be found in the SEP and more fully elaborated upon in the Fund’s official Strategy. In the Review Team’s opinion, however, this is not sufficiently the case at present.

### BOX 2: RECOMMENDATIONS

- The Fund and MoE should work closely together in defining a new medium term (2-5 years) strategy for the Fund. Ideally, the strategic role of the Fund (i.e. its special niche) would be more fully elaborated in the new SEP and/or the Fund’s official Strategy for 1997-2000. In any case, the Fund and MoE should collaborate in the formulation of a new strategy, perhaps for the years 1999-2004, which would be approved at the level of Government. This new strategy should:
  - give serious consideration to the “value-added” by the Fund vis a vis other instruments available to the State for implementing the SEP;
  - give attention to the special requirements facing the State as a result of EU accession;
  - examine issues such as long term revenue generation, changing staff requirements (such as
expanding external relations capabilities), options for improving the leveraging of Fund resources, development of policies on “additionality”, and marketing the Fund as an implementing agency for the State;

- be developed in close consultation with the Fund Council, representatives of other Ministries and regional governments, Fund clients and external experts, before being submitted for approval at the Government level.

3.2 GOVERNING BODIES OF THE FUND

3.2.1 Role of the Minister and Ministry of Environment

As currently prescribed in the Parliamentary Act and Statute of the Fund, the ultimate responsibility for all policy-setting and decision-making is vested with the Minister of Environment as Administrator of the Fund. This authority enables the Minister to overrule recommendations submitted by the Fund Council and the Office of the Fund. Since the period of central planning, the vesting of such decision-making authority with Ministers has been a common practice in the Czech Republic where extra-budgetary funds are concerned.

In considering the roles being played by the Fund’s governing bodies, it is important to distinguish between overall policy setting and operational decision-making. To the extent that the Fund’s expenditures should be consistent with, and reinforce, the Government’s national environmental policies and priorities, there is a clear role for the Minister and MoE departments to articulate these priorities. Such a policy setting role for the Ministry provides information which enables the Fund and its Council to develop eligibility and selection criteria and provides a basis for evaluating the Fund’s performance. The Ministry has an important role to play in providing guidance on types of projects which the Fund should support and the approximate proportion of resources that should be devoted to different project categories (see Section 3.3). Ministries of Environment play such a policy setting role for many CEE Funds.

The Review Team’s larger concern relates to the Fund’s resource allocation decision-making process - i.e. the Minister’s role in deciding which individual projects receive funding. This role represents a potentially deep involvement in the activities of the Fund, which has financed over 2,000 projects during its lifetime. At present, the Minister need not follow the expertise of the Fund Office in elaborating and applying selection criteria as well as the advice of the Fund Council in rendering decisions on disbursements. Whether or not the Minister exercises this authority, its effect is a decision-making process which could be perceived to be influenced more by political objectives than a balance of policy, environmental and economic goals. Even though the Fund has developed fairly robust environmental and economic project selection criteria, thus promoting accountability, transparency and efficiency, the way in which resource allocation decision-making authority is currently structured could negate the Fund’s progress in these areas and affect its credibility.

While the Review Team heard of problems in the past resulting from the Ministerial decision-making authority, no evidence was presented to suggest that political interference at that level has been a problem in recent years. (This conclusion is supported by a review of the results of the 31st session of the Fund Council, May 1998, which show that the Minister approved over 90% of projects recommended by the Fund Office.) In addition, none of the Fund’s Directors, staff or Council members interviewed by the Team identified political interference in project selection as a major concern at the present time, though they acknowledged that it was an issue in the past. Some of the Fund’s applicants interviewed by the Review Team, however, did express the view that the application process involves both the preparation of the technical and financial application as well as some level of political lobbying of local and Ministry officials. Given the large number of applications submitted to the Fund, such efforts imply added financial and time costs for applicants
and officials. Those applicants interviewed indicated they would favor a selection process which would minimise their perceived need to garner political support for their proposals.

**BOX 3: RECOMMENDATIONS**

- **Final decision-making authority for the selection of individual projects should be vested in a collective body (i.e. a reformed Council) representing the Fund’s key stakeholders (i.e. MoE, Ministry of Finance, Parliament, Ministry of Regional Development, municipal authorities, business community, financial sector, and citizen environmental movement).** The MoE has an essential role to play in identifying environmental priorities and in setting the necessary policy and institutional framework to guide the Fund’s activities. However, both the St. Petersburg Guidelines and best practice in the region suggest that this authority should not extend to decisions on the financing of specific individual projects. The MoE’s interests in ensuring that the Fund focuses on priorities set in the SEP could be maintained, *inter alia*, through the appointment of MoE representatives to a reformed Council. Accountability and transparency could be enhanced by an appeals process and the introduction of periodic audits. Additionally, with the elimination of applicants’ perceived need for lobbying in the application process, resources of both applicants and officials could be used more efficiently.

**3.2.2 Role of the Fund Council**

Following the issues and recommendations elaborated above, it is necessary to re-examine the role currently being played by the Fund Council. The Council, whose members are appointed and dismissed by the Minister, serves as an “advisory” body. Apart from providing its suggestions to the Minister on the ranking of individual projects as originally appraised and submitted by the Fund Office, the Council appears to have little real authority or responsibilities. Indeed, the “value-added” by the Fund Council as it currently functions appears to be minimal, making poor use of the collective wisdom such a body could offer. It does not have the expertise nor time to meaningfully substitute for the role of the Fund Office in project appraisal (nor should it try to), and its advice on project selection need not be followed by the Minister. While the Council Members interviewed by the Review Team exhibited a high degree of interest and commitment in their duties to the Fund, they expressed some dissatisfaction in not being able to play a more meaningful role in its guidance and supervision.

Furthermore, the current composition of the Council renders it vulnerable to real or perceived “capture” by two interest groups: state civil servants and Members of Parliament. Presently six of 13 Council members are representatives of national ministries and another six are Members of Parliament. (The last member being a representative of the Union of Towns and Municipalities.) While such a composition may thoroughly promote the interests of the national authorities, it does not adequately include the interests of some of the Fund’s most important stakeholders, namely clients (e.g. municipalities, business community, environmental citizens organizations). This lack of representation can undermine the public legitimacy of the Council.

**BOX 4: RECOMMENDATIONS**

- **The Council should be given greater authority and responsibilities, including final decision-making on project selection.** The St. Petersburg Guidelines and best practice at other funds in Central Europe suggest the following main functions for the Council:
  - in consultation with senior management at the Fund Office and MoE, it would take the lead in formulating the Fund’s overall strategic role in implementing the SEP;
– it would have final decision-making authority, and the related responsibility, for determining which projects receive financial support from the Fund (though provisions may be made for this authority to be delegated to senior management at the Fund Office for small projects);

– it would appoint the Fund Director;

– it would approve annual investment priorities and criteria used for project appraisal and ranking;

– it would approve the Fund’s annual budget and performance reports, before submitting them to the MoE.

• The composition of the Fund Council should be diversified to represent better the interests of key stakeholders, while maintaining the Council size at about the same number. The Council should be changed to better represent other key stakeholders, namely Fund clients (e.g. municipalities, business community, environmental NGOs). Such a change would broaden the collective wisdom of the Council, strengthen its representative character and likely increase the Fund’s public credibility. Care should be taken, however, not to increase substantially the size of the Council. Experience shows that the larger such bodies become, the less efficiently they operate. While there is some room for flexibility, the optimum size is likely between 9-13. Simple arithmetic indicates that in order to diversify the Council composition and maintain a reasonable size, the two main blocks of members (state civil servants or Members of Parliament) would have to be reduced.

If final decision-making authority for project selection is shifted from the Minister to a collective decision-making body (i.e. the Council), such new responsibilities would make changes in the Council composition even more important. (However, even if the Council were to continue to play only its currently very limited, advisory role, its composition should be reformed to include a broader array of stakeholders in the Fund.)

3.3 ANNUAL PROGRAMMING

Currently, programming of the Fund’s resources involves two major activities: preparation of the Fund’s budget and preparation of the annual Annex to the Fund Directive. The key elements of the budgeting process are projecting revenues, administrative costs and resources available for supporting environmental projects.

Provisions for annual programming of Fund resources are elaborated in the Directive and annual Annexes to the Directive. The Directive issued by the MoE describes the application process, the types of applications that are eligible for funding, and the mechanisms that will be used to disburse the resources of the Fund. The Directive describes projects and selection criteria in general terms. For each annual funding cycle, the MoE issues an Annex to the Directive that includes a description of programme priorities and criteria that will be used to evaluate applications in each programme area. The Annex also indicates the forms of financing (e.g. grants, loans) and maximum co-financing share the Fund is prepared to provide. Generally, these two parameters vary according to the type of applicant (commercial, non-commercial) and programme category (in 1998, the Annex described 21 programmes in six categories).

According to Fund staff (and corroborated by others interviewed), the Annexes have, in recent years, become more detailed in line with the Fund’s efforts to improve the focus of project identification and efficiency of its appraisal process. Nevertheless, the annual Annexes remain rather broad and do not indicate anticipated levels of funding for each “priority”, thus giving little guidance, either to the Fund or potential applicants, as to real spending priorities.

There appears to be no process through which the Fund’s spending priorities are pro-actively, ex-ante, determined. Rather, it appears that, for any given year, the Fund’s spending priorities are determined
largely by past and expected demand. Such an approach undermines the Fund’s ability to allocate its resources in a focused, strategic manner. The lack of any indicative prioritisation among the many (over 20 in 1998) project categories listed in the annual Annex creates the perception that the Fund has an equal capacity and interest in supporting virtually any kind of environmental project. This contributes to the annual flood of applications whose demands far exceed the Fund’s resources and perpetuates a practice of annual resubmission of previously rejected applications. Moreover, because many applications formally meet the broad eligibility criteria laid out in the Annex, the Fund staff are obliged to fully process and appraise them, even if they have virtually no chance of being financed by the Fund. This makes for a highly inefficient use of valuable resources (time, energy and money) of both the Fund and applicants.

In previous years, the Annex was not submitted to the Fund Council until the first meeting of the year. As a result, the Fund received a large number of applications at the beginning of the year which could not benefit from the (albeit limited) guidance provided in the Annex. Fund officials stated that the Annex for 1999 was to be submitted to the Minister, and presumably then issued by the MoE, in advance of the new calendar (and funding) year. This should allow applicants who intend to submit their applications early in the year to ensure that their applications are consistent with the instructions in the Annex.

**Box 5: Recommendations**

- **Any newly defined strategic role for the Fund should envision a stronger, pro-active annual programming process in which relative priorities for spending would be indicated among the various project categories or environmental media.** This programming process should be explicitly defined, documented and made known to all interested parties, including potential applicants. The process should fully involve key Fund staff, the Fund Council and MoE as a minimum. It would be advisable to open up this process even further, by involving potential applicants, perhaps through public consultations organised jointly by the Fund and MoE to discuss priorities within given sectors or media. Ultimately, the annual Annex, which is currently issued by the MoE and serves as the main tool for annual programming, should be more precise and explicit in listing the Fund’s spending priorities for the given year. (Spending goals should be indicative and allow flexibility to shift resources between categories depending on the number and quality of applications received and opportunities for the most cost-effective investments.) This would help shape a more visible strategic role for the Fund and also reduce the excessive flood of applications which currently inundate the Fund and drain its resources and those of applicants.

- **Submission of the annual Annex to the Council before the start of each funding year, as occurred for 1999, should become standard practice in the future.**
4 FUND OPERATIONS

4.1 REVENUES
The SFZP has relied on four major sources of revenue. Environmental charges and fines for air, water, waste, and soil accounted for 51.5 percent of revenues in 1997, followed in importance by transfers from the National Property Fund for the Programme for a Healthier Atmosphere (28.3 percent), income from loan repayments (13.9 percent), and interest on the Fund’s bank accounts (6.3 percent). The Fund can also receive revenues from the State budget and from foreign sources such as the European Union. The Fund has no direct role in the collection of charges and fines or the amount transferred from the National Property Fund. Thus, the largest proportion of the Fund’s revenue is determined outside the Fund.

The revenue base for the Fund is expected to be diminished by the termination of transfers from the National Property Fund and declining environmental charge revenues. Barring increases in rates applied to environmental charges, these revenues can be expected to decline over time as facilities make investments and reduce pollution emissions. MoE officials stated that the country has been particularly successful in reducing air emissions, with concomitant reduction in charges for air pollution. Increases in water charge rates have provided some compensation for the reduction in air charges.

Even though the Fund does not have a direct hand in determining charge rates or collections, improved accountability and transparency in the Fund’s selection of projects should help build acceptance for increases in charge rates. If polluting facilities perceive the selection process as being fair and competitive, designed to reward those projects which achieve significant environmental benefits at lowest cost, there should generally be greater support for increases in rates that either maintain or increase the amount of finance flowing to the Fund and being made available for projects.

The understands that the MoE routinely requests state budget support for the Fund, but has been unsuccessful in effecting such transfers. The state budget is the largest source of finance for environmental expenditures in the Czech Republic (followed by facilities’ own resources and the SFZP). These resources are allocated to environmental projects by a number of state and local government institutions. An interesting question arises regarding the capabilities of these other government institutions, relative to those of the SFZP, in evaluating projects and efficiently allocating resources. For certain types of environmental investment projects, the Fund may be better positioned to evaluate projects in terms of technical, economic, and financial criteria than other government bodies. Given the Fund’s accumulated experience and expertise, it could play a role in encouraging better project design and more cost-effective use of state resources.

**Box 6: Recommendations**

- The MoE, and Czech Government more generally, may wish to assess the relative strengths and weaknesses of the various programmes and institutions which are currently administering national, public finances for environmental investments. Given the Fund’s accumulated experience and expertise, it is likely to have a comparative advantage in encouraging better project design and ensuring cost-effectiveness, at least for certain types of projects.

The two sources of income for which the Fund has greater control are interest earnings and repayment of loans. The Review Team was informed about previous problems the Fund encountered as a result of deposits in banks that subsequently failed or suffered severe financial difficulties. The Fund’s current senior management team has evidently developed an informal policy which guides the Fund in
selecting banks. The Fund’s income is deposited in five banks, all of which are characterised by state participation. While these banks do not provide the highest interest rates available in the Czech Republic, they are considered less risky. To the Team’s knowledge, this “policy” is not clearly documented or known outside the Fund. Such an approach to bank selection could leave the Fund open to criticism for not being objective or transparent in its decision-making.

**BOX 7: RECOMMENDATIONS**

- The Fund’s policy for selecting banks to manage its assets should be clearly defined, documented and made publicly available upon request. The policy should be prepared by the Fund and presented to the Fund Council and Ministry for approval. In the future, selection of banks for cooperation should be done in a competitive manner, with the criteria for selection clearly defined and made known to interested banks.

The repayment of loans is the major income category for which future growth may be expected to offset reductions in pollution charges and fines. The level of income from repayment of loans depends on four factors: 1) share of disbursements in the form of loans; 2) interest rates on the loans; 3) duration of the repayment period (including any allowance for a grace period); and 4) the repayment rate. The real value of the repayments will also be affected by inflation.

Approximately 45% of the Fund’s disbursements are in the form of soft loans, which have more favourable conditions (i.e. interest rates, grace and payback periods) than commercially available loans. The Fund charges interest rates of 3 and 7 percent for soft loans to public sector and private sector applicants, respectively. Previously, the Fund provided interest-free loans to public sector applicants. The shift to interest-bearing loans should increase income from loan repayments. According to one applicant, the interest rate for private sector borrowers is approximately ½ the commercial rate. Even though the applicant requested a soft loan to cover only 6-7 percent of project costs, he felt the interest rate offered by the Fund justified the time and expense of preparing the application.

Soft loans provided by the Fund often include grace periods of up to three years (which vary according to the amount of time required to implement the project) and repayment periods of up to seven years. While the longer payback periods reduce the level of income to the Fund, they may be justified on the grounds that many environmental projects entail significant construction time and do not yield profits, necessitating repayment from sources of income unrelated to the investment. Loans with such conditions as offered by the Fund, especially considering the country’s inflation rate (~10%), therefore contain a substantial element of subsidy.

The rate of default on loans is a critical determinant of the revenue potential of loan repayments. In 1997, repayment of loans was 79 percent of projected repayments, with a large proportion of defaulted payments due to the unprecedented summer floods. Private sector applicants have received 15 percent of soft loans but account for 85 percent of defaults. (A quick, rough calculation by the Review Team suggested that the Fund’s loan default rate is comparable to that found among commercial banks in the country.) As discussed elsewhere in this report, the Fund has a comprehensive strategy for addressing late payments and defaults. Since public funds are involved, the Fund is empowered to attach a non-payment penalty equal to 1/1000 of the unpaid amount per day. One obstacle to more effective collection of defaulted loans is the Czech Republic’s law on collateral. While the SFZP requires collateral on loans, many Czech banks have been unable to obtain support from the courts in transferring collateral as compensation for defaulted loans.

In meetings with the Fund and MoE, the only potentially new revenue sources discussed were state budget revenues and the EU. The Team understands that the Czech Parliament is considering a new carbon tax, partial proceeds from which might be directed to the Fund. Other environmental funds in
the CEE region have introduced new sources, such as product charges, to complement existing pollution charges and other revenue sources. Typically, product charges are levied on goods which contribute to pollution (such as fuels) or result in waste products which are costly to manage (e.g., tires, car batteries, packaging materials). Product charges may simultaneously raise revenue and provide incentives for reduced resource use.

**Box 8: Recommendations**

- The Fund is encouraged to assess the debt servicing capacity of each new loan applicant to be able to set the most appropriate conditions on its soft loans. As the economic situation for municipalities and firms improves, so too should their ability to borrow on more stringent (i.e. less soft) conditions. Provided borrowers could cope with such conditions, higher interest rates and shorter grace and payback periods would yield greater revenues for the Fund.

- In the process of developing a multi-year strategy for the Fund, options for expanding its revenue base should be explored and discussed with the Fund Council, the MoE, and other key ministries. An examination of these options should consider new sources, restructuring of existing sources such as pollution charges, and take account of the likely effects of any shifts in the relative use of different disbursement mechanisms (i.e. grants vs. loans).

### 4.2 Project Cycle Management

#### 4.2.1 Overview

The procedures for identifying, preparing and deciding on projects can be described as the project cycle. This typically has six main steps:

i. identification;

ii. preparation and design;

iii. appraisal;

iv. selection, negotiations and financial award (including contracting);

v. monitoring of implementation and operation of the project;

vi. evaluation.

The project cycle procedures of public sector financial institutions should be based on principles of objectivity, accountability and transparency. Moreover, these procedures, including criteria used for project appraisal and selection, should be clearly specified, documented and made available to all potential applicants and the general public upon request.

The main legal instrument governing the Fund’s project cycle is the MoE’s Directive on the Provision of Financial Resources from the Fund. Article 3 stipulates that applications shall be subject to expert appraisal by the Fund in accordance with the criteria set out by the Ministry each year in the Annex to the Directive. Based on the Fund’s appraisal, the Fund Council makes its recommendations to the Minister. The Directive also provides detailed instructions on application procedures, document requirements, basic eligibility and appraisal criteria, contractual requirements and disbursement management. (More details on the Fund’s project cycle can be found in Chapter 2.)

The Review Team finds the Fund’s project cycle to be professional and clearly defined, consisting of a formal sequence of discrete steps. These broadly conform with best practice, although there is scope for improvement in some areas (see following sections). With the critical exception of project selection (see Sections 3.2 and 4.2.5), project cycle procedures and criteria appear to be objective and transparent. Procedures and criteria are reasonably-well documented and publicly available.
Recommendations on improvements to written operational procedures are discussed in more detail in Chapter 5.

Nevertheless, the legal requirement for the Fund to develop and apply professional project cycle procedures based on objectivity, accountability and transparency is relatively weak. The Fund’s Act states that: “The fundamental principle shall be an unbiased evaluation of the application from the point of view of its economic assets and collective interests”. The Fund Statute merely requires “skillful evaluation” by the Fund. Neither document explicitly requires professional project cycle procedures based on principles of objectivity, transparency and accountability, nor do they mention key criteria for project ranking, such as environmental benefits or cost-effectiveness. While the Fund management has made considerable progress in these areas in recent years, the legal requirement for such standards should be put in place.

**Box 9: Recommendations**

- Either the Fund Act or, perhaps more appropriately, the Statute, should clearly require the Fund to develop and implement professional project cycle procedures based on principles of objectivity, transparency and accountability. It is important that the Fund’s legal framework provides a strong foundation for appropriate project cycle management procedures and criteria. In order to complete this framework, the Act and/or the Statute on the Fund should be amended to clearly state:
  - that the Fund must have formal arrangements for project cycle management in accordance with established best practice principles;
  - how decision-making authority and responsibility (and therefore accountability) for elaborating, authorising and applying such procedures and criteria are allocated.

### 4.2.2 Identification

The Fund has an active and sustained pipeline of project applications. This appears to be due in large part to the pro-active efforts of potential clients. In addition, the Fund actively encourages and identifies projects through a variety of measures including:

- publicising the existence of the Fund and its annual spending priorities and eligibility criteria (as set out in the annual Annex) using a variety of media including the national and local press, an Internet Web page, and free information packs;
- holding client seminars;
- providing weekly ‘client days’ when applicants may visit the main office of the Fund in Prague and meet with relevant staff members to discuss their projects or project concepts;
- formal and informal communications between Fund technical staff (particularly those in the Air Section) and their counterpart colleagues in the Ministries of Environment, Energy, etc.

Information on the Fund and application forms are also available from regional offices of the MoE and from municipalities.

The Fund appears to have an effective and professional approach to project identification, albeit within a rather unfocused programming framework (as discussed in the previous chapter).

The Fund’s project pipeline is significantly over-supplied. The Team was not presented statistics on unsuccessful project applications. However, Fund staff indicated that the number of applications is around four times greater than the number of approved projects. In some sectors, such as air, the Fund has been able to support only 1 in 10 applications because of the high demand. This excessive demand causes inefficiencies in subsequent stages of the project cycle due to the volume of applications that must be processed.
Box 10: Recommendations

- Project identification could benefit from a more focused approach (e.g. regional or sectoral). Options for improvement could include:
  - information campaigns aimed at specific regions or at soliciting very specific types of projects;
  - establishing stronger and more formal links between the Fund and regional/municipal governments;
  - increasing the number of regional Fund representatives;
  - running quarterly ‘roadshows’ in those regions furthest from Prague to compliment the weekly ‘client days’ held at the Fund’s head office.

- The volume of the project pipeline (i.e. the number of projects coming forward) should be reduced in order to improve efficiency. The root causes and principal solutions to this problem are the inter-related issues of programming and project appraisal. Project identification needs to be more selective and focused, based on more tightly-targeted spending priorities and more stringent eligibility and evaluation criteria.

- A complementary approach to reduce the number of applications being submitted would involve the adoption of tactical steps aimed at influencing and managing demand. Careful public relations work would be required. Options could include:
  - provision to potential applicants of basic statistical information on the number and success rate of applications, in order to give them a realistic idea of the chances of success;
  - advising applicants to think carefully about the strengths and weaknesses of their project concepts, and about alternative sources of financing, before committing time and resources to preparing and submitting an application to the Fund;
  - reducing the frequency of ‘client days’ (to, say, once every two weeks) and/or changing these days so that prospective clients will be seen by prior appointment only on a first-come, first-served basis;
  - introducing a nominal application processing fee.

4.2.3 Preparation and Design

Clients submit formal applications directly to the Fund using standard application forms. Application requirements and procedures are clearly explained in the accompanying guidance notes. The application form consists of the following sections:

- basic information on the applicant’s name, address, etc.;
- the location and type of area (industrial, residential, etc.) in which the project will be constructed;
- description of the project and quantitative data on its anticipated environmental benefits;
- implementation and financing plan;
- current and prospective financial situation of the applicant (different information requirements for enterprises and municipalities);
• instructions on additional documents required depending on the type of applicant (municipality, private enterprise, etc.) and the programme (air, water, etc.) under which the application is submitted.

Applications must include, *inter alia*, a statement by the district authority regarding the environmental effect of the project and recommendation on its approval. This has both advantages and disadvantages:

• district authority endorsement should mean, in theory, that projects match local environmental priorities;
• local political or other interests could influence the district authority’s decision as to whether to support a project or not.

Each of the three sections of the Technical Department has a dedicated Applications Reception and Registration Unit which checks that application forms and their supporting documentation are administratively correct, and registered before passing it to the relevant technical specialist. We understand that Fund management proposes to combine these units into a single Applications Reception Department, which should provide some improvements in operational efficiency.

### BOX 11: RECOMMENDATIONS

<table>
<thead>
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<th>Recommendation</th>
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<tr>
<td>The Fund should retain the right, under certain circumstances, to approve projects even if they do not have the recommendation of the district authority.</td>
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<tr>
<td>There may be benefits in introducing less detailed application forms for smaller projects (projects where the Fund’s financial contribution is below a certain limit), as part of a streamlined, single-stage appraisal process (see also the following section).</td>
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### 4.2.4 Project Appraisal

**Current Practice**

The Fund’s existing project appraisal system, (also described in Chapter 2), consists of:

• a technical appraisal; and
• a financial/credit appraisal.

The Fund’s Technical Department evaluates each application according to pre-defined, published criteria. Scores for each criterion are weighted and the aggregate score is used to rank applications listed for consideration at each Fund Council meeting. For example, the Air Section of the Technical Division uses criteria organised under the following headings:

• environmental (including ambient and emission pollutant load; 30% weighting)
• economic (including cost per unit of pollution abatement, and level of subsidy requested; 30%)
• regional (urgency of implementation as defined by regional environmental priorities; 20%)
• technical (priority attached to the technical level of the proposed solution; 20%)

The Fund introduced new credit procedures in 1997. The Fund’s Finance Division undertakes a financial assessment of the client prior to submission of the application to the Fund Council. Previously, the financial assessment was conducted only after the Minister had given his approval for a project. The new evaluation procedures are also more detailed than before. The Review Team understands that the procedure applies to grant applications as well as to loans. In the case of loan requests, the credit-worthiness of applicants is also examined. Clients must submit required financial information with their project applications. This information includes financial statements, balance sheets, profit/loss accounts, key ratios, etc. and is systematically evaluated according to pre-defined rules in order to derive an overall credit classification, which may be one of the following:
category 1 – essentially ‘problem-free’
category 2 – ‘potential for problems’
category 3 – ‘atypical’.

At the same time, the Financial Division evaluates collateral offered in the case of loan applications. The Fund’s collateral policy is documented in its internal regulations. The Fund requires the value of collateral to be at least 100% the amount of the requested loan. Eligible collateral items include liens on property, third party or bank guarantees, promissory notes and charges over listed stocks and shares.

In general, the Fund Office’s procedures for technical and financial/credit appraisal of applications are objective, transparent and robust.

Once applications have undergone technical and financial appraisal, they are ranked in order of preference and presented to the Fund Council with the Fund Office’s recommendations. The Fund Council reviews this information and prepares its own list of recommendations for submission to the Minister. Up to 300 applications may be considered by the Council at any one meeting.

Weaknesses in the System

As mentioned earlier, the efficiency of the project cycle is severely undermined by the fact that the Fund receives far more eligible applications than it can possibly finance, but is nonetheless obliged by its current statute and regulations to appraise them all, including those which have little or no chance of being funded. Applicants must invest significant time and resources into preparing project proposals which, even if they are of good quality, may have only a slim chance of success due to the fierce competition for the Fund’s resources. By the same token, Fund staff find it very difficult to carry out full technical and economic appraisal of the large number of applications. The number of applications presented to the Fund Council for consideration means that Council members are burdened with paperwork and can give very little attention to individual projects. The added-value of the Fund Council’s involvement in the appraisal process is therefore questionable (as discussed in Chapter 3).

The Fund’s senior management recognise this problem and outlined to the Review Team their preliminary proposals for a two-stage appraisal process. In Stage 1, applicants would complete a simplified and less-detailed application form which would be rapidly evaluated on the basis of specified technical and financial criteria. Applications would be scored and ranked by the Fund Office, and a certain proportion of the top-ranked projects would pass into Stage 2 for full appraisal. In Stage 2, short-listed applicants would then be required to provide more detailed information to allow verification of technical and financial/credit assumptions made in Stage 1. These applications would then be ranked by the Fund Office and presented with recommendations to the Fund Council for consideration prior to submission to the Minister for final decision.

Box 12: Recommendations

- The efficiency of the appraisal process would be greatly enhanced by more explicit and focused descriptions of the Fund’s spending priorities and selection criteria in the Annual Annexes.
- A two-stage project appraisal process could be an effective means for fairly quickly and efficiently screening out relatively weak proposals and for tentatively ranking the remaining proposals which would then undergo full appraisal in the second stage. However, in order to maintain transparency and objectivity, it is essential that the Fund clearly specifies the criteria which will be used to determine which proposals reach the second stage and which do not.
- Furthermore, it would be important to maintain the valid decision-making role envisioned for
a reformed Fund Council in final project selection, and to provide a high level of confidence that the “best” projects have been put forward by the Fund. To achieve this, the total amount of finance requested by projects that pass into Stage 2 should be greater than the total amount of money which is available under the spending window for that session of the Fund Council. For example, those projects at the top of the preliminary ranking list whose total requested financial support equals 1.5 x the anticipated amount available for that sector, could be passed to Stage 2 for full appraisal.

- Another option for reducing the project appraisal workload on Fund staff is to create a much simplified, one-stage appraisal process for small projects requesting financial support below some given threshold.

4.2.5 Selection, Negotiations and Financial Award

Final selection of projects is undertaken by the Minister on the basis of the list of recommended applications submitted by Fund Council. All projects, regardless of size, must be approved by the Minister. The Minister’s approval of an application is formalised by issuing a ‘Decree’. This is sent to the Fund Office and the applicant, and requires the Fund Office to contact the applicant within 15 days to open contract negotiations. Signing of the contract is subject to certain detailed conditions on, for example, satisfactory assignment of collateral or submission of detailed financial or other information. The Fund Office has the power to rescind the Minister’s Decree if the conditions precedent are not fulfilled. This creates an important problem, in that the Fund Director appears to be personally responsible and legally liable for all contracts entered into by the Fund, but has very limited contractual authority, as this is vested in the Minister. This creates the potential for a situation whereby the Minister may commit the Fund to enter into an unsatisfactory or inappropriate contract, and the Fund Director may be held legally liable for the consequences.

One of the conditions that must be met before the contract can be signed is that the applicant must ‘prove unequivocally’ that the project will lead to the environmental improvements specified in the application. To do this, the client must submit an ‘expert statement’ from an independent environmental expert (usually a consulting firm or specialist institute). Until recently, this statement was submitted along with the other required documentation at the beginning of the application process. However, in an effort to reduce the excessive appraisal workload carried by the Fund and also demands on applicants, the submission of such a statement is now required only after Ministerial approval and prior to contract signature.

A standard contract is used. This is a detailed legal document and appears to provide a satisfactory contractual basis. Key provisions of the standard contract include:

- the client must open a special bank account which will receive all payments from the Fund;
- if the cost of the project is higher than envisaged at the time of contract signature, the Fund’s support will be limited to the original amount;
- if the cost of the project is less than envisaged, the Fund’s contribution will be reduced so that the percentage level of support remains the same;
- the amount and form of financial support are clearly specified, and eligible and ineligible project costs are clearly defined;
- the client is obliged to meet specified milestone dates in implementing the project, and must submit periodic progress reports as well as a final report on the project including final project accounts and representations on technical and environmental fulfilment of the project;
• grant/loan disbursement milestones and pre-conditions are specified (disbursements are normally made quarterly on the basis of proof of expenditure, checked by the Financial Department and authorised by the Technical Department);

• the contract also sets out the legal remedies and the Fund’s powers in case of the client’s default or violation of contractual conditions.

It appears that unsuccessful applicants are not told what score or ranking their projects received, and do not learn why their projects were not approved. The Fund Office sends them a letter advising them that their application will be ‘registered for consideration in the next round’ or simply that ‘the Minister has rejected your application’.

**Box 13: Recommendations**

- **The Fund, as a legal entity, should be legally liable for contracts entered into with successful applicants - not the individual person of the Fund Director.** Final project selection decisions, whether made by the Minister or Council, should have the effect of authorising the Fund to enter into a contract with the applicant. While the Director of the Fund, or any other duly designated member of the Fund’s management, may be authorised to sign and execute contracts with applicants, the Fund, as a legal entity, should remain liable for contractual obligations. If the Fund Director or other Fund officials are found to insufficiently fulfil their duties, they may be held subject to disciplinary action by the Fund’s governing bodies, as provided for in the Fund’s Act, Statute or other relevant laws and regulations.

- **Any issues which fundamentally affect the environmental, technical, or financial viability of a project should, to the extent possible, be resolved by the Fund Office before project proposals are submitted to the Council (or Minister, in the current situation) for final approval, rather than after such approval.** For example, if “unequivocal proof” of a project’s environmental effect is required from applicants in the form of an independent expert’s statement, such “proof” should be required much earlier in the project cycle as part of the standard appraisal process for all project types. (More appropriate measures for reducing the appraisal workload on the Fund staff are suggested elsewhere in this report; see sections 3.3 and 4.2.4.)

- The Review Team understands that, for some Fund programmes at least (e.g. under the Air Sector), this expert statement is now required as part of the original application, which the Team believes to be a more logical and efficient sequence.

- **The workload carried by the Fund Council (or Minister, in the current situation) in final decision-making on project selection could be lightened by delegating authority for approval of small projects to the Fund management, with appropriate provisions to ensure transparency and accountability in project selection.** Currently, all projects, regardless of how small, must be formally considered and recommended by the Fund Council, and then approved by the Minister.

- **Unsuccessful applicants should be given more detailed information on the reasons why their projects were not selected for funding.**

- **New procedures should be introduced to reduce the number of unsuccessful applications being routinely carried over to the next session, in order to minimise the backlog of projects.** Requiring a nominal application fee each time an application is submitted would likely reduce automatic re-submissions and discourage less persistent applicants. Other steps might include the classification of unsuccessful proposals as follows:
  - **well prepared and promising:** would include proposals which received a positive appraisal, but did not receive funding because of a lack of resources. Depending on the original ranking of the project and levels of finance expected to be available at the next Council session, the Fund might re-submit the proposal to the Council or encourage the
applicant to re-submit the proposal to the Fund, including any revisions that might be necessary to reflect elapsed time.

- **promising but not sufficiently prepared**: would include proposals for projects which closely match the Fund’s priorities and offer potentially high environmental benefits at reasonable costs, but require additional preparatory work. The Fund could specify how the proposal should be developed further and encourage the applicant to re-submit it at such time as those conditions are met.

- **unpromising**: would include project proposals that do not closely match the priorities of the Fund and are unlikely to in the future without very substantial changes in the project or the Fund’s priorities. The Fund should point out the proposals’ principal deficiencies and advise the applicant to check the next year’s Annex for any changes in the Fund’s priorities.

### 4.2.6 Monitoring of Project Implementation

Project implementation and operation is monitored by both the Technical and the Financial Departments. It was unclear to what extent monitoring activities are covered by written procedures. The main basis for monitoring appears to be desk-review of the financial and technical progress reports which clients are required to submit at regular intervals. These include information on fulfilment of project milestones required for disbursement purposes. The Financial Department closely monitors loan repayments.

In addition, site visits are undertaken by the Fund’s technical specialists. Due to limited resources, not all projects are subject to site visits at the same frequency. In the Air Section (which has the greatest number of projects), for example, about 20% of projects are subject to detailed monitoring. These are selected by the Head of the Air Section and agreed in advance with the Technical Director. In other sections, such as Water, monitoring appears to be more frequent (for example, one client reported that the Head of the Water section visited their project – a small sewerage and sewage treatment scheme - every two months).

Monitoring information is combined into regular internal management reports covering both the financial and technical progress of projects. The Fund has professional management information software systems to support project monitoring. Information flows appear to support key management activities such as disbursement authorisation and, where required, corrective action. Formal procedures exist for dealing with loan defaults and debt restructuring.

The Team did not review the Fund’s policies on procurement by beneficiaries, however, we understand that the Fund follows Czech national law, which requires purchases in excess of 1 million Czech Koruna (~ 30 000 USD) made with public funds to follow competitive tendering procedures. Upon notifying a successful applicant of the Minister’s decision to support his or her project, the Fund informs the applicant that he or she must:

- ensure that all procurement procedures are in compliance with national law;
- notify the Fund in advance about the wording of the announcement of the request for proposals for tendering equipment as well as about the date when the proposals will be evaluated;
- include a representative of the Fund into the committee which will evaluate and select the bids, if the Fund requests such representation.

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**BOX 14: RECOMMENDATIONS**

- Technical and financial monitoring procedures should be formalised and documented, as discussed more fully in the following chapter.

- If the Fund is to become more involved in providing medium- and long-term loans, it is
probable that procedures and institutional capacity for credit monitoring will need to be improved. In particular, the Fund should re-evaluate the credit rating and overall debt position of clients with loans on an annual basis. Collateral should also be re-appraised on an annual basis. Alternatively, it may be wiser for the Fund to sub-contract some or all these financial/credit monitoring tasks, together with bad debt management and recovery, to commercial banks, as is done by funds in some other CEE countries.

- **As the portfolio of the Fund increases over time, it may be useful to separate monitoring functions from project appraisal/preparation functions**, in line with standard practice at most commercial financial institutions. The creation of a Credit Portfolio Review Department or equivalent would provide an additional level of assurance of good fiscal management.

- **As it is possible that the Fund will serve as an implementing agency for EU financial assistance it should start to familiarise itself with the special procurement requirements of the EU.** The Fund’s standard form of contract and its monitoring procedures should be expanded to reflect Czech and, when appropriate, EU procurement requirements.

### 4.2.7 Evaluation

All projects are subject to final evaluation by the Technical and Financial Departments based on the final report that clients are required to submit. This report must include:

- a statement from the client warranting that the project has been completed and conditions have been fulfilled;
- ‘certified statements’ from local environmental authorities and/or expert consultants on the achievement of the specific environmental objectives of the project, as referenced in the application and the contract;
- copies of relevant operating permits and certificates issued by third parties;
- a financial report and accounts;
- evidence of fulfilment of other conditions.

In most cases, the Fund will also make a site visit to the project. If the final report is satisfactory, the Fund will release the final payment to the client.

Evaluation of the actual environmental benefits of a project is dependent on disclosure of information by the client and his/her consultants. The Fund itself does not actively conduct detailed **ex post** evaluation of projects. In addition, the Fund’s assistance programmes do not appear to be subject to any form of **ex post** evaluation.

**Box 15: Recommendations**

- **As a medium-term goal, the Fund should establish procedures and institutional capacity for conducting detailed ex post evaluation of a certain proportion of projects (i.e. not all) under each programme or spending priority.** While existing project evaluation procedures are generally adequate for the purposes of verifying that final payment may be made to the client, they are not intended to systematically provide more detailed information on the strengths and weaknesses of a project and its management. Such “lessons learned” could provide valuable input into management and policy changes.

- **For the same reason, and closely linked to this, the Fund should also introduce ex post evaluation of individual programmes or spending areas.** The Fund should consider creating
a dedicated ‘Project/Programme Evaluation Department’ (or equivalent), probably reporting directly to the Fund Director, to conduct independent ex post reviews of projects and programmes. Alternatively, independent consultants may be periodically employed to fulfil this function.

- The results of such evaluations should be circulated, discussed and acted upon internally, and maintained for future reference in a database. Information should also be made publicly available (with due regard to the need to restrict names and certain other information for confidentiality reasons). This will provide the Fund with valuable feedback on its performance and areas for further improvement, and will also be a very useful external relations tool in raising political and public awareness of the Fund’s contribution to environmental improvement in the Czech Republic.

4.3 EXPENDITURES/DISBURSEMENTS

4.3.1 Forms of Disbursement

The SFZP utilises an extensive range of disbursement mechanisms, notably:

- direct grants;
- soft loans;
- interest rate subsidies on commercial loans;
- and loan guarantees.

Direct grants are the most attractive mechanism to applicants because there is no requirement for repayment. They are also administratively simple for the Fund to manage and involve little financial risk. When used in a very selective and targeted manner, direct grants can also be effective in leveraging other sources of finance (assuming other sources exist). The major drawback of issuing direct grants, at least from the Fund’s perspective, is that no portion of the resources return to the Fund. As illustrated in Chapter 2, a bit more than half of the Fund’s disbursements are in the form of direct grant.

Soft loans enable the fund to recoup some of its expenditures and thus to “revolve” over time. Loan repayments are expected by the Fund’s managers to become an increasingly important source of revenue for the Fund, provided defaults are not excessive. As discussed in Section 4.1, the Fund has developed an aggressive program to recover loan principal and interest, and is prepared to pursue both contractual and legal sanctions, if necessary. A bit less than half of the Fund’s disbursements are in the form of soft loan.

As both direct grants and soft loans are forms of subsidised finance (to a lesser or greater extent), a key question is therefore how best to subsidise projects in order to maximise environmental benefits from the limited resources available to the Fund. The key advantages of direct grants were noted above. Soft loans, in addition to promising a financial return to the Fund, may encourage financial discipline on the part of borrowers, and reduce the ‘moral hazards’ associated with providing subsidies in non-repayable forms. However, soft loans do raise certain concerns: the risk of default; the real value of repayments may be eroded by inflation; the scope for leveraging other (especially commercial) sources of finance is likely to be less than with grants; the administrative costs of making and managing repayable loans are considerable, and usually significantly higher than those associated with grant provision.
**Box 16: Recommendations**

- Given that commercial sources of finance (e.g. certain banks) are becoming more involved in the financing of environmental investments in the Czech Republic, (albeit on less attractive terms than those offered by the Fund), *the Fund should examine how its activities may accelerate such involvement*. As capital markets develop, and the need for subsidised finance among the Fund’s clients diminishes, the Fund should assess the effect its different disbursement forms have with respect to maximising environmental benefits and facilitating the development of market-based financing mechanisms for environmental protection.

Interest rate subsidies were introduced by the Fund two years ago and are considered “indirect” forms of assistance, as are loan guarantees. These indirect forms require the applicant to secure other, commercial forms of financing before the Fund will provide its support. From the perspective of the commercial lender, a loan guarantee is quite attractive since the default risk is shifted to the Fund. The interest rate subsidy is more attractive to the borrower and less attractive to the bank; the bank receives commercial rates, but assumes the default risk. Both of these financing mechanisms allow leveraging of the Fund’s resources and provide stimulation for private sector participation in environmental financing. The issuance of loan guarantees, however, particularly by public institutions during periods of economic transition, should be considered financially risky; the Fund has already been required to pay off one defaulted loan. Apart from the risk associated with loan guarantees, the major disadvantage of these forms of support is that they do not yield future revenues for the Fund in terms of repayments. However, when properly used they can enable the Fund to support a larger number of projects than could be supported using soft loans or direct grants.

The Fund allows applicants to request a combination of grant and soft loan support. However, indirect forms cannot be combined nor will the Fund provide a grant or loan in addition to one of the indirect forms.

**Box 17: Recommendations**

- *The Review Team encourages the use of interest rate subsidies*. While recognising that such subsidies are in effect grants, and do not generate future revenues for the Fund, they are relatively risk free to the Fund, and can be very effective mechanisms for facilitating commercial bank involvement in the financing of environmental investments. *The Team urges the Fund to use great caution, however, in the consideration of extending loan guarantees*. Given the financial risk involved and the fact that the Fund has already had bad experience with this form of disbursement, the Fund could do well to forego them for the foreseeable future.

- *The Review Team would encourage the Fund to evaluate the rationale behind the restriction on “blending” direct (grants and loans) and indirect (interest subsidies and loan guarantees) forms of support*. There seems to be little difference between requesting a grant and an interest subsidy (which is essentially a grant) as opposed to a grant and soft loan. Allowing applicants to combine grants and interest subsidies could be quite attractive, while also providing additional leverage in comparison to the combination of grants and soft loans.
4.3.2 Additionality and Leveraging

Two of the most important principles that should guide the Fund’s disbursements are additionality and leveraging. The concept of additionality focuses on the role that the Fund’s resources play in overall financing of a project. The Fund’s financial support can be viewed as “additional” if the applicant would be unable to finance the project in the absence of the Fund’s support. In practice, it is difficult to make this determination on an ex ante basis. The Fund must consider both the overall financial situation of the applicant and its perception of the availability of other sources of “soft” and commercial finance. As a general rule, unless applicants are under pressure to make compliance investments, they may have adequate time to “shop” for the best deal; in other words, attempt to secure as much soft financing as possible.

Generally, additionality criteria are easiest to apply for non-investment projects such as research, environmental education, and nature protection programmes. The greater difficulty is encountered for investment projects. Financial analysis of projects, as is now being conducted by a few funds in the region, can be helpful in this regard. If a project yields a positive financial rate of return, it presumable could be financed from commercial or own sources, and would not warrant financial support from the Fund unless the project offered exceptional benefits (e.g demonstration value). Such additionality criteria should be applied within specific project categories (i.e., types of investment projects), rather than across categories. The Review Team understands that SFZP is considering the introduction of project financial analysis, which could improve its ability to assess additionality.

One of the most challenging issues the Fund faces is trying to optimise the level of support for projects. When the Fund provides guidance on the share of project costs it will finance, applicants tend to request the maximum share. The concept of leveraging focuses on the Fund’s ability to catalyse project proponents to mobilise other sources of finance, such that the Fund commits a minimum amount of public resources to each project. Thus, if the Fund simply limits its co-financing share of project costs to a small percentage, the Fund’s ability to leverage other resources will be maximised. However, arbitrary rules which do not account for the financial situation of applicants, type of project or availability of other sources of finance may simply eliminate demand. Thus, to optimise leveraging, the Fund must identify a level of co-financing that is just high enough to allow applicants to finance projects, thereby satisfying the additionality criteria as well.

**Box 18: Recommendations**

- The review Team strongly endorses the Fund’s experimentation with project financial analysis and encourages the Fund to develop and apply this approach more fully.

- To increase the leveraging of the Fund’s resources, several approaches could be utilised:
  - First, the Fund can simply reduce the share of project costs it is willing to finance.
  - Second, the Fund can consider the share requested as a selection criterion, rewarding applications that request less financial support relative to other applications. The drawback of both of these options is that some projects for which the Fund’s contribution is truly additional may not receive funding, while projects which could be financed from other sources simply request smaller amounts from the Fund. For this latter group of projects, any level of subsidised finance is attractive, compared to alternatives.
  - A third approach the Fund might consider to reduce the level of support on a per project basis would involve follow-up correspondence with all applicants informing them that the Fund’s resources are not adequate to support all good projects, offering them an opportunity to improve their prospects for financing by reducing the share requested and/or altering the form of financing requested. Such an approach could engender some “gaming” on the part of applicants, but might enable the Fund to support more projects.
4.4 Auditing and Reporting

The Act, Statute and Regulations on the Fund do not provide a firm or clear basis for regular auditing and reporting. Nevertheless, under the current Director, the Fund appears to have made considerable progress in this area.

The Fund prepares an annual report on its activities and submits it to the MoE, where it is reviewed by the relevant departments and then submitted to other ministries for comment. It is subsequently submitted to the Czech Government. The Fund also annually submits special reports to the Czech Parliament and the Ministry of Finance, and the Fund Director and his two Deputies also appear before various Parliamentary Sub-Committees on a regular basis. The annual report contains full financial statements on revenues, disbursements, assets and liabilities, and a breakdown of supported projects by sector.

In recent years, the Fund’s financial accounts have been audited by independent chartered accountants in accordance with the applicable Czech accounting standards. The auditors in 1997 were BDO CS s.r.o. In 1997, the Fund underwent an additional audit concerning its loan portfolio. The auditors are appointed by, and report to, the Fund Director.

The above-mentioned reports are publicly available on request from various official sources, but are not routinely circulated to a wide audience. The Fund has voluntarily developed a summary annual report (in both Czech and English) for public distribution. This contains a description of the Fund’s main priorities and achievements for the year, together with summary tables of revenues and disbursements. The report also contains BDO’s one-page financial auditors statement, but does not include formal financial statements.

Prior to this review, the Fund has never been subject to independent performance audits by external bodies, and there is no requirement in law for such reviews to be undertaken.

**Box 19: Recommendations**

- **In preparation for EU accession, in future years the Fund’s financial audit should be conducted according to relevant EU and international standards.** It would also be more appropriate for the financial auditors to be appointed by, and report to, the Fund Council rather than the Fund Director. Consideration should be given to using an international accountancy firm which is well known and respected, due to the fact that such firms provide additional credibility with the international community.

- **Detailed performance audits should be undertaken at regular intervals (say, every three years) by independent experts appointed by the Fund Council.** Such audits should look at issues like environmental contribution, operational efficiency, corporate governance, employee remuneration, etc. as well as the financial health of the Fund. Alternatively, such audits could be undertaken by the appropriate State auditing body. The report should be submitted to Government and to Parliament and be made available (preferably in English as well) to the public.

- **The Fund’s Act, Statute, Regulations and internal procedures should be updated so that they clearly specify what financial and other auditing requirements must be met.**
4.5 RELATIONS AND COOPERATION WITH THE COMMERCIAL BANKING SECTOR

The Fund co-operates with commercial banks in a number of direct and indirect ways. These principally include:

- banks hold and manage the Fund’s accounts;
- the Fund provides either interest rate subsidies or guarantees for loans extended by banks;
- banks co-finance projects also supported by the Fund;
- banks may provide guarantees on loans extended by the Fund.

The Fund’s role in the latter three forms of cooperation is rather passive, that is, such indirect cooperation comes about as a result of the initiative of the Fund’s beneficiaries rather than a purposeful strategy of the Fund. The Fund’s level of pro-active cooperation with commercial banks can be characterised as quite limited, especially in comparison with environmental funds in some other CEE countries. Given the fact that the Fund has suffered losses in the past due to banking failures and that some degree of instability remains in the Czech banking sector (which is consolidating and privatising), this cautious approach may be justified. The Team was also informed that there are some legal restrictions preventing certain forms of cooperation with banks, namely extending credit-lines through them. Another potential opportunity for cooperation between the Fund and a commercial bank arises from the EU PHARE sponsored “Business-Environment Programme”, in which a Czech commercial bank is to administer a soft loan programme aimed at supporting environmentally beneficial investments in the business sector. The Review Team understands that the Fund is to have a position on the steering committee of this programme, which has recently become operational.

**BOX 20: RECOMMENDATIONS**

- The Fund should more fully utilise its potential to facilitate the involvement of commercial banks in the financing of environmental investments. While acknowledging the need for caution and the existence of possible legal restrictions on the Fund, the Team believes that the Fund could be much more pro-active in its cooperation with the banking sector. The Fund’s mandate to pursue such cooperation, and more generally its role as a facilitator of private sector finance for environmental protection, should be renewed and strengthened either in the new SEP or, at the very least, in a new Fund strategy. Options for enhancing cooperation with commercial banks could include:
  - more active provision of interest rate subsidies on commercial loans, perhaps through special cooperation programmes with competitively selected banks;
  - awareness raising efforts aimed at informing banks of the possible investment opportunities in the environmental sector, with the added goal of greater, more targeted collaboration in the co-financing of projects;
  - taking full advantage of the “Business-Environment Programme” and participating actively on the programme’s steering committee. Besides offering the chance for closer cooperation with that particular bank, the Fund’s involvement on the committee should allow it to identify opportunities for environmental investments in the private sector which might be attractive to both the Fund and commercial banks.

4.6 EXTERNAL RELATIONS AND COMMUNICATIONS

The two key elements of the Fund’s current external relations program are the publication of the Annual Report and the annual Annex. The Annual Report summarises the financial operations of the
Fund for the previous year and selected trend information. The Annual Report also provides a brief description of the Fund. The Fund involves a number of ministries and other government entities in the development of the annual Annex, and consults them on project priorities. With EU enlargement approaching, the Fund is expected to play an important role as an implementing agency for EU financial assistance for environmental projects, which would also involve increased external relations with the EU.

The Fund has developed a variety of mechanisms for enhancing communications with applicants. The annual Annex is distributed as a special brochure, published in several newspapers, and is available on the Fund’s own, and the MoE’s internet web sites. The Annex provides information on project categories, selection criteria, and instructions for potential applicants. The Fund uses acceptance and rejection letters to notify applicants. In addition, the Fund has a “Client Day” each week during which the Fund staff are available to answer questions clients may have about the application process or their specific applications.

**Box 21: Recommendations**

- The Fund should formulate, document and implement a clear policy on external relations/public information. Much closer cooperation with the EU and member states is envisioned and the Fund needs to establish procedures for conducting effective relations with these foreign partners. As a minimum, this is likely to involve enhanced English language capacities. The Team commends the Fund’s recent development of its own internet web site. (Previously, the Fund made limited use of the MoE’s web site.) In addition to being helpful for disseminating a variety of information and documents, the web page could also be used to solicit applicant questions, which might save time and expense as compared to trips to Prague on Client Day.
5 MANAGEMENT SYSTEMS AND PROCEDURES

Management systems and procedures help an institution provide a transparent, competent and consistent level of service/performance to its ‘clients’. The purpose of this segment of the review was to evaluate how the Fund monitors and controls its activities and how the Fund’s performance in this regard compares with the principles of Quality Management and Business Excellence.

The opportunity to conduct an in-depth analysis of the documentation of the Fund’s management systems was limited in this review. However, discussions throughout the mission period and the specific interviews which were undertaken combined to indicate that the senior management of the Fund have already prepared a number of controlling procedures and that they understand and accept the need for keeping these up-to-date. Senior Fund management also recognise that records of work activities and an audit programme intended to demonstrate compliance with the management system requirements will be necessary.

With some improvements (which should not be difficult to achieve given the understanding and acceptance mentioned above) the Fund’s management systems would be relatively easy to bring up to a standard that would benefit the organisation’s effectiveness and efficiency and, if so desired, gain independent recognition.

5.1 ORGANISATIONAL STRUCTURE

The organisation diagram provided by SFZP (shown in Chapter 2) demonstrates a classical and straightforward management structure based upon disciplines and skills. It is the Review Team’s impression that this structure has served, and probably will continue to serve the organisation well. Nevertheless, the Fund should consider the following issues as it seeks to continue its development:

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<th>BOX 22: RECOMMENDATIONS</th>
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<td>• If the SFZP is to seek greater funding and the associated increase in workloads and broadening of project areas, the capacity of the current management structure to accommodate such changes should be assessed. Overall, the modular approach adopted by the Fund allows for a relatively comfortable integration of further project areas. However, specialist disciplines that currently support specific activities within the Fund may require managers who specialise in that work area (e.g. Information Technology).</td>
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<td>• It is noted that the responsibility for Human Resource matters is currently assigned to the Financial Director. Human Resources is clearly not a financial management activity (except with regard to payment of salaries). Such cross-discipline and cross-departmental functions may be better grouped under a central support function, with the salaries issue being an interface or input from the Human Resources function to the Financial Management function.</td>
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<td>• A solution to both above issues may be to appoint a Support Functions Manager to take responsibility for matters pertaining to all departments, e.g. Human Resources, IT, Housekeeping, Library, etc. Such a course may also relieve the Fund Director of mundane matters and leave him or her more time for dealing with external liaison, Fund promotion, etc.</td>
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5.2 OPERATIONAL MANAGEMENT, CONTROL AND REPORTING

The need for formal procedures and controls in any organisation is well established. The benefits of such procedures and controls include:

- consistency of action, giving transparency and predictability in dealing with clients;
- continuity following personnel changes;
- benchmarking for performance evaluation;
- basis for training;
- audit criteria for independent (external) assessment;
- evidence (records) for defending claims;
- confidence among stakeholders of proper work practices.

In addition, a formal management system provides a certain means for implementing change (removing the potential for error associated with verbal instructions or a series of memos) and a feedback system whereby records are reviewed to produce data upon which system improvements may be based.

During the review, it was deduced that the Fund operates in an effective manner, although there are opportunities for improvement in the management systems to allow full compliance with the accepted norms of Quality Management and Business Excellence principles.

Operating methods within the Fund appear to be based upon original, non-updated procedures supplemented by periodic memoranda plus good personal working relationships in close physical proximity. The effectiveness of such working methods will decrease rapidly in a number of circumstances:

- personnel changes;
- increased workload resulting from growth in size of the Fund or expansion of areas of activity ('product' range);
- proliferation of operational locations (branch offices, etc.).

**BOX 23: RECOMMENDATIONS**

- The Fund should update and formalise existing procedures and controls within its management system, and introduce certain elements which are currently lacking. (Specific areas for change are highlighted below.) The ad hoc system currently employed throughout the Fund for updating and amending original, documented procedures, should be replaced with a more formal, systematic approach which clearly documents the agreed changes and allows for monitoring of their implementation.

- Given the future changes the Fund is likely to undergo as a result of its probable involvement in managing EU accession assistance, the introduction of formal systems at this time would be especially helpful as it is always advantageous to manage growth or change from the outset rather than later when changes are already underway.

5.2.1 Activities under the Direct Responsibility of the Fund Director

The Fund Director has direct responsibility for a number of business activities as well as being the Chief Executive Officer. The business areas appear to be well organised and disciplined. It was not possible to fully evaluate the extent of documentation of procedures for all these areas; however, the
detailed interview with the IT Manager revealed a good level of documentation and control and recording systems with only minor observations for improvements in practice.

5.2.2 Activities under the Direct Responsibility of the Technical Director

In general, the functioning of the Technical Department appeared to be highly professional and effective, although heavily overloaded with work as noted earlier in this report. In common with other functions of the Fund, the original documented procedures have become outdated in parts and have been superseded by a series of ad hoc memoranda from members of senior management; the contents of these memoranda are verbally relayed to the operational personnel with the accompanying risk of differing interpretations. As noted above, this method of amending of procedures needs improvement.

A very limited review of the system utilised to record and track projects, which makes use of a computer database, suggests that the system is fairly effective.

A matter of concern was the lack of evidence of the skills/qualifications/experience of the persons forming the ‘Panel of Experts’ used to provide some technical input to the project appraisal process. The well-intentioned decision not to specify individual experts has led to a situation that appears to be inadequately controlled.

**Box 24: Recommendations**

- The process for forming the approved “Panel of Experts” should be reformed so as to ensure sufficient qualifications on the part of the experts and to allow applicants greater flexibility in choosing the expert.

5.2.3 Activities under the Direct Responsibility of the Financial Director

The Financial Division is responsible for the fiscal activities of the Fund itself and disbursements made to beneficiaries. The Division gave the impression of being competent and efficient. Existing procedures do not have a formal updating method and therefore, in common with other functions, the use of ad-hoc memos has developed.

As noted previously, the Human Resources function seems slightly out of place here (with the exception of Payroll management).

A heavy reliance is placed on IT systems (as would be expected for financial activities) to ease the burden of manipulating large volumes of data. This will need to continue and be made more efficient if further expansion is to occur.

**Box 25: Recommendations**

- The responsibilities of the Financial Director with regard to Human Resource management should be revised, as noted earlier.

- An expansion of the Fund’s operations, in volume or range of services, such as might occur if the Fund were to manage EU accession assistance, would warrant a review and probably upgrade of the IT systems used by the Finance Division.
5.2.4 Further Recommendations relating to Management Systems

**Box 26: Recommendations**

**Systems Documentation**

Following the observations regarding documentation of procedures in each business area, it is suggested that a thorough review be undertaken to compare:

- original procedures;
- all memos which amend the procedures;
- current real life operating methods;
- potential improvements.

Such a review should ensure that the system encompasses all business activities and the full range of projects encountered. Following the review, a new set of documented procedures should be produced and discussed in detail with all relevant personnel. The update and review mechanism for all documents should be made clear and an unequivocal policy agreed with all to ensure that the ‘memo’ style does not return. Procedures should be issued under a formal control mechanism (see below).

**Databases**

- It is suggested that an integrated database package available to all personnel via one comprehensive network, but with password-controlled access, be implemented at the earliest possible opportunity. At present, it appears that a number of different database software packages are utilised for projects, with some overlap among them. The investment in time involved in establishing an integrated system could be expected to pay large dividends, especially if the SFZP expands. Otherwise, the Fund’s computer system’s hardware and software were mostly of premium quality.
- The risk of data loss as a result of fire or theft could be minimised by use of a proper fire safe or a discipline of storing the back-ups at a different location.

**Computerised Documentation Management**

- Whilst considering the above observations, it may be an opportune time to reduce the volume of paper used in the management control system by utilising a document management facet within the Fund’s IT system. Besides reducing paper waste, such an initiative would ease the updating of management methods and maintenance of the system.

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5.3 Personnel Policies and Procedures

The basic tenets of Human Resource management should become part of the documented management system. The system should address:

- selection;
- induction;
- training;
- training review;
- performance appraisal;
- and record keeping.

SFZP clearly places great emphasis and importance on the competence of personnel. Whilst it is not suggested that formal independent approval of the personnel management system is sought at this stage, a sound basis upon which to model this element of the system would be the “Investors in People” standard. The Investors in People philosophy involves the whole organisation and provides management with a powerful tool which examines fundamental issues relating to management of
people, such as motivation and inter-personnel relationships. The Investors in People philosophy has 4 principles and 23 indicators to judge an organisation’s Human Resources management performance and is based on a continuing personal development principle.

5.4 INTERNAL AUDITING OF MANAGEMENT SYSTEMS

For any management system to be useful, an appraisal of its application and effectiveness must be made. The results of such appraisals can be used as feedback to provide management with the information required to institute new methods, retraining schemes, amendments to practice, adoption of new technologies, etc. Audits are a fact-finding exercise, not a fault-finding exercise, and should be designed to be completely objective and impersonal.

All formal management systems require a comprehensive programme of Internal Systems Audits. Such audits should be: conducted by trained personnel, knowledgeable but independent of the function or activity to be audited; carried out against the documented standards; properly reported and followed up on; and have the results reviewed by top management.

A special type of management systems audit – a Third Party Audit – is used if external certification of the management system is being sought. Such an audit would be carried out by a Nationally Accredited Assessment and Certifying Body. To the Review Team’s knowledge, the Fund’s management systems do not currently undergo periodic independent audits.

5.5 MODELS FOR BUSINESS MANAGEMENT

A number of models exist which offer guidance for management systems and the option of independent Third Party Certification for organisations adopting them and being able to prove their successful implementation and maintenance.

Notable amongst these are:

- ISO 9000 series
- ISO 14000
- Investors in People

Whilst ISO 9000 has been in vogue for many years, current thinking suggests that it is but one aspect of a comprehensive management system – indeed that it is probably the bare minimum. Recognition is given nowadays to the importance of human resources, health and safety of employees and consumers, product reliability, environmental performance, World-Class philosophies, Total Quality Management, etc. The European Foundation for Quality Management has also produced a Business Excellence Model by which an organisation can fashion and judge its performance across the full range of its activities.

**Box 27: Recommendations**

- The Fund should periodically conduct internal audits of its management systems. Ideally, the Fund’s statute would require such audits, specify the competent bodies for conducting them and their frequency.

- As it stands at the threshold of an opportunity, the Fund should consider having its management systems audited by an internationally recognised institution. Through such an assessment, the Fund could take a fresh look at all its management systems and embark on a course that would take it, step by step, towards the ultimate goal of internationally recognised certification.
6 IMPLICATIONS OF EU ACCESSION

6.1 INTRODUCTION

The Czech Republic’s goal of acceding to the European Union has a number of important implications for its environmental policy and investment activities. While estimates of the total environmental costs of qualifying for accession vary and cannot be precise, the figure is certainly very substantial. The principal implications of EU accession for the Fund are:

- the role to be played by the Fund in mobilising and directing domestic financial resources for the financing of investments important for meeting EU environmental standards;
- the possible role of the Fund as an implementing agency for EU financial assistance aimed at accession related environmental investments, and;
- the compliance of the Fund and its activities with the Union’s “Guidelines on State aid for environmental protection”.

Without intending to understate the importance of the third point, (a copy of the guidelines can be obtained from the European Commission), the Review Team is not in a position to address it here, other than to suggest that the appropriate people at the MoE, the Fund Council and Fund Office should familiarise themselves thoroughly with the guidelines as they may necessitate changes for the Fund once the Czech Republic accedes to the Union. As the first two points are closely related, they are addressed jointly below.

6.2 THE FUND AS A MECHANISM FOR CHANELLING DOMESTIC AND EU SOURCES OF FINANCE FOR ENVIRONMENTAL INVESTMENTS IMPORTANT FOR ACCESSION

As discussed earlier in this report, the strategic role of the Fund as an instrument for implementing state environmental policy, including those aspects particularly related to EU accession, is not clearly defined. Nevertheless, the Team learned that the MoE does indeed envision the Fund as playing a special role in supporting environmental investments important for EU accession; the MoE expects that the Fund will administer the EU’s “ISPA” programme, which is to provide pre-accession financial assistance for environmental investments. Both the MoE and Fund are preparing themselves for the eventual start of this programme, and some assistance for that preparation is being made available through the EU’s PHARE programme.

This review of the SFZP was conducted using the St. Petersburg Guidelines as a benchmark of performance. Though the St. Petersberg Guidelines do not specifically consider the role to be played by environmental funds vis-a-vis EU accession, the Team believes that the essential principles and recommendations set forth in the Guidelines remain a valid reference point. Though the EU has not formalised and published its requirements for implementing agencies to receive and administer accession related financial assistance, it is likely that such organisations will be expected to:

- be properly constituted and registered as a recognisable type of legal entity in accordance with sound public/corporate laws, with clear separation of supervisory, management and auditing functions;
- operate independently of government ministries, and be free from real and perceived political interference;
- have a management structure, internal procedures and appropriately qualified staff (including financing and environmental experts) so as to enable it to undertake most key functions in-house, including strategy and programme development, project appraisal and preparation, and financial management;
• operate transparent project selection criteria and processes, and be subject to external scrutiny through regular external financial and performance audits and self-disclosure of relevant information e.g. via external reports;

• operate sound financial management systems including robust procedures for project financial appraisal (including credit appraisal), project monitoring and disbursement.

**BOX 28: CONCLUSIONS & RECOMMENDATIONS**

• Judged against most of the key criteria set out in the St. Petersburg Guidelines, the SFZP is fairly well positioned and prepared to undertake the responsibilities associated with administering domestic and foreign (namely EU) sources of finance in support of EU accession. The principal weaknesses of the Fund, as identified earlier, lie in the external policy and decision-making framework. Most areas for improvement have already been recognised by senior Fund management and changes are either being implemented or considered.

• If final decision-making authority in project selection is not shifted to some collective body (i.e. a reformed Council) as suggested, the Fund may be required to establish a special “window” for managing and allocating EU financial assistance for accession related projects. Such a window would likely be governed by special criteria, procedures and reporting standards, defined in cooperation with the EU.

• In addition to continued conformance with the basic standards and principles set out in the St. Petersburg Guidelines, the Fund is likely to be expected to meet further requirements specific to the EU and its assistance programmes (i.e. PHARE). Some of the more important of these will include:
  
  − project eligibility, appraisal and selection criteria, (e.g. certain EU Directives, and therefore certain types of projects, will be of higher priority than others; project size and the participation of other co-financiers may be crucial);
  
  − competitive procurement procedures;

  − accounting, financial management and audits;

  − reporting to EU authorities (which also implies enhanced external relations and language capacities).
ANNEX I: LIST OF PEOPLE INTERVIEWED FOR THE REVIEW OF THE CZECH STATE ENVIRONMENT FUND

MINISTRY OF ENVIRONMENT
Ing. Erik Geuss, CSc
   Deputy Minister
Ing. Miroslav Hájek, CSc
   Director, Department of Environmental Economics
Prof. Bedrich Moldán, CSs
   Commissioner for EU Accession
Ing. Alexandra Orliková, CSc
   Director, Department of Foreign Relations
Ing. Radka Bucilová
   Head, Section of Macroeconomic Relations, Department of Environmental Economics

STATE ENVIRONMENT FUND
Ing. Aleš Vychodil
   Director
Ing. Václav Chytil
   Technical Director
Ing. Miloš Rybicka
   Financial Director
Ing. Jan Kuzel
   Head, Air Protection Department
Ing. Jirí Borecký
   Head, Economic Assessments Department
Ing. Pavel Cablk
   Head, Waste Management, Nature Protection, Clean Technologies and Renewable Resources Department
Ing. Jana Holasová
   Head, Financing Department
Mrs. Růžena Linhartová
   Head, Accounting Department

STATE ENVIRONMENT FUND COUNCIL
RNDr. Libor Ambrozek
   Member of the Fund Council; Member of the Czech Parliament
Mr. Jan Bláha
   Member of the Fund Council; Member of the Czech Parliament
MUDr. Jana Foltínová
   Member of the Fund Council; Department Director, Ministry of Health
Ing. Vladimír Kulhánek
Member of the Fund Council; Deputy Director, Department for Entrepreneurship, Ministry of Finance

OTHER INSTITUTIONS

Mr. Stephen Collins
   Head, Investment Section, PHARE, Delegation of the European Commission, Prague

Ing. Milena Horěcová, CSc
   Director, Department for Financial Policies, Ministry of Finance

Ing. Zdeněk Chaluš
   Consultant to Ministry for Regional Development

RNDr. Jan Jerábek
   Department for Regional and Municipal Policy, Ministry for Regional Development

Ing. Eva Příšová
   Director, Department of EU Integration, Ministry for Regional Development
ANNEX II: LIST OF DOCUMENTS REVIEWED

5. Application for Support from the Fund
10. The National Program of Preparation for Accession to the EU in the Environmental Sector
11. Preliminary Estimate of EU Accession Cost Invoked by Approximation of Environmental Law
14. Various Internal documents of the Czech State Environment Fund, including:
   - Guidelines for the evaluation of air pollution related projects;
   - Guidelines for the evaluation of water pollution related projects
   - Auditor’s report for the year 1997;
   - Conditions for collateral on loans offered by the Fund;
   - Sample contract for financial support provided by the Fund;
16. Survey of Economic Instruments for Environmental Policy in the Czech Republic (1998; to be published by the Regional Environmental Center)