

**OECD/EAP Task Force Secretariat
and EU PHARE Programme**

- Support to Central and Eastern Europe (CEE) EcoFunds -

Review of the Slovenian Environmental Development Fund

Final Report

April 2000

TABLE OF CONTENTS

ABBREVIATIONS AND ACRONYMS	i
EXCHANGE RATES	ii
EXECUTIVE SUMMARY	iii
1 INTRODUCTION	1
1.1 Background	1
1.2 Objectives of the Review	1
1.3 Methodology	1
2 POLICY & INSTITUTIONAL FRAMEWORK	2
2.1 Background and Objectives of the Fund	2
2.2 Policy and Legal Framework	3
2.2.1 Environmental Protection Act 1993	3
2.2.2 Fund Statute	4
2.2.3 Fund Mission Statement	5
2.3 Institutional Framework	5
2.3.1 Supervisory Board	5
2.3.2 Administrative Board	6
2.3.3 Fund Director	6
2.4 Fund Organisation	6
2.5 Comments, Conclusions and Recommendations	7
3 FUND OPERATIONS	10
3.1 Fund Revenues	10
3.2 Programming / Planning	11
3.3 Fund Expenditures / Disbursements	12
3.4 Project Cycle Management	17
3.4.1 Standard Project Cycle	18
3.4.2 Project Cycle – Air Pollution Abatement Programme	20
3.4.3 Loans Transferred from the MEPP	20

3.5	Credit Assessment & Approval	20
3.6	Loan Portfolio Management & Control	22
3.6.1	Loan Portfolio Management	22
3.6.2	Loan Portfolio Control	22
3.7	Relations & Co-operation with the Commercial Banking Sector	23
3.8	External Relations & Communications	24
3.9	Fund Management Systems & Procedures	25
3.9.1	Operational Management & Reporting Systems	25
3.9.2	Financial Management & Reporting Systems	26
3.10	Comments, Conclusions and Recommendations	27
4	FUTURE DEVELOPMENT OF THE FUND	30
4.1	Future Requirements for Environmental Financing in Slovenia	30
4.1.1	Public Sector	30
4.1.2	Private Sector	32
4.2	Options for Strategic Development of the Fund	32
ANNEX I:	List of People Interviewed	34
ANNEX II:	List of Documents Reviewed	36

ABBREVIATIONS AND ACRONYMS

APA	Air Pollution Abatement (Programme)
CEE	Central and Eastern Europe
DEM	Deutsche Marks
EAP	Environmental Action Programme for Central and Eastern Europe
ECS	Environmental Credit Scheme (supported by PHARE)
EPA	Environmental Protection Act 1993
EU	European Union
GDP	Gross Domestic Product
GEF	Global Environmental Facility
IBRD	International Bank for Re-construction and Development
IFI	International Financing Institution
ISPA	Instrument for Structural Policies Pre-Accession
LIBOR	London Inter-Bank Overnight Rate
MEPP	Ministry of Environment and Physical Planning
NEAP	National Environmental Action Plan
OECD	Organisation for Economic Co-operation and Development
PHARE	The European Union's Assistance Programme for Central and Eastern Europe
PR	Public Relations
SEDF	Slovenian Environmental Development Fund
SIT	Slovenian Tolars
USD	United States Dollars
WB	World Bank
WWW	World Wide Web (Internet)

EXCHANGE RATES

The financial data presented in this report are given in the currencies in which they were quoted in the original source.

Annual average exchange rates for the Slovene Tolar against the other currencies quoted in the report are shown below:

Year	1 USD	1 ECU / EURO	1 DEM
1994	128.8	152.4	79.4
1995	118.5	153.1	82.7
1996	135.4	169.5	89.9
1997	159.7	180.4	92.1
1998	166.1	186.3	94.4

EXECUTIVE SUMMARY

BACKGROUND AND OBJECTIVES OF THE REVIEW

The EAP Task Force is engaged in a series of voluntary reviews of environmental funds in Central and Eastern Europe (CEE) under the aegis of the *CEE Environmental 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 Environmental Funds Network, held in Riga, May 1998, the Director of the Slovenian Environmental Development Fund (SEDF) requested that such a review be conducted of the Slovenian Fund.

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 this Review were to:

- evaluate the organisation, operations and performance of the Slovenian Environmental Development 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.

THE SLOVENIAN ENVIRONMENTAL DEVELOPMENT FUND

The Slovenian Environmental Development Fund (SEDF) was established in 1993 as a legal public entity under the Environmental Protection Act 1993. It was constituted as a non-profit, joint stock company with a start-up capital of SIT 10 million allocated from the state budget. The Fund Statute was initially issued in the middle of 1994, and subsequently amended in 1996 and 1997. The Fund is currently 100% owned by the Republic of Slovenia.

The Fund's objectives are generally guided by the principles laid down in the Environmental Protection Act 1993, national priorities identified by the MEPP in the National Environmental Action Plan, and other policy documents. The main goal of the Fund is *to provide loans on preferential terms for environmental investments from its own capital and from capital obtained from other sources*. The interest rate charged on loans must ensure the maintenance of the real value of the Fund's capital, and the coverage of its running costs without profit (the real value of the Fund's capital is maintained by capital revaluation adjustments using the retail price index). The Fund provides loans on the basis of public announcements i.e. tendering procedures for purposes defined in the Environmental Protection Act and the National Environmental Action Plan. The Fund's governing bodies are the Supervisory Board, comprising a President and nine members appointed by the National Assembly, an Administrative Board consisting of a President (currently the State Secretary of Environment) and four members appointed by the Government, and the Fund Director.

The main revenues / assets of the Fund are derived from part of the proceeds generated by the privatisation of state enterprises, claims (receivables) on outstanding debts transferred to the Fund on the date of its establishment by the Ministry of Environment and Physical Planning (MEPP), transfers from the state budget, loan repayments and interest on loans, and from grants and loans provided by foreign donors and IFIs. By comparison, revenues received from environmental taxes and penalties levied under the Environmental Protection Act provide only a minor part of the Fund's financial resources. The Fund's financial support has been focused hitherto primarily on projects concerned with air pollution abatement, water supply and waste water management.

KEY CONCLUSIONS AND RECOMMENDATIONS

Policy and Institutional Framework

The main *practical* consequences and effects of the Fund's existing mandate and institutional framework are:

- the Fund currently operates as a 'quasi-bank', and has therefore developed a strong banking culture i.e. careful, risk averse, disciplined and focused *primarily* on the financial risks and performance of its lending activities;
- the *environmental dimension* of the Fund's mandate tends to be of only secondary importance within the context of its existing activities and operational procedures. In general, as long as an applicant for loan finance can demonstrate that the proposed investment will generate environmental benefits in line with the priorities set by the MEPP, and can satisfy the Fund's strict requirements on credit worthiness and loan collateral, the loan is granted.
- as the Fund is restricted to providing loans for projects which are financially 'bankable' and where the borrower is able in every case to satisfy the Fund's strict credit risk and collateral requirements, the Fund in many instances *effectively competes with the commercial banks for business* especially from the private sector. For some types of projects, the Fund's current mandate and lending policies may breach the European Commission's competition rules and guidelines on state aid. With the view of better preparing the Fund for the post-accession period, it would be worthwhile to carefully analyse Fund's compatibility with the EU law on state aid and competition and if it is found to be incompatible it may be necessary to reconsider the modality in which the Fund may contribute to financing the implementation of the major and the most burdensome EU environment-related Directives.
- as a consequence, the Fund in many cases does not achieve any 'additionality' from its lending activities (i.e. it is not currently able to act as a lender of last resort for environmentally essential or desirable projects which cannot be financed from any other source), and its ability to leverage other, particularly private sector, financial resources for environmental investments is limited.
- without the ability to offer direct grants and other forms of subsidy from its own resources, the Fund is unable to perform a pivotal role in mobilising and channelling other financial resources into environmental investments, or promoting some of the other changes and developments necessary to fulfil national environmental priorities and achieve compliance with EU environmental requirements.
- compared with the commercial banks, the Fund's principal advantages in the market for environmental financing are that:
 - it can provide soft loans at lower interest rates than prevailing commercial market rates (loans provided by the Fund are typically priced at the prevailing inflation rate plus 50% of current commercial bank interest rates);

- it is able to lend for significantly longer periods than commercial banks (up to 15 years to borrowers from the public infrastructure sector, and up to 7 years to borrowers from the industry sector, depending on the nature and life cycle of the project).
- because *inter alia* of the legal requirement to maintain the real value of its capital assets, the loan terms generally offered by the Fund, while more attractive than those typically offered by commercial banks, are not particularly advantageous to borrowers compared, for example, with the terms offered by some other funds in the CEE region. The subsidy element of the financial assistance programmes operated by the Fund is relatively small, against which must be set the considerable financial and other costs incurred by prospective borrowers in applying for loans.
- the Fund has, until recently, experienced difficulties in lending the funds which have been allocated for private sector projects, primarily because the terms and conditions offered by the Fund in tenders issued under the ‘Cleaner Industries Programme’ were perceived by many prospective borrowers as unattractive compared with other sources of finance.
- even if additional financial resources were made available to the Fund, under its present restrictive mandate, it would find it difficult to increase substantially its overall volume of lending.
- the present requirement to offer financial assistance through a public tendering procedure creates significant peaks and troughs in the Fund’s workload, and may have the effect of deterring some developers of environmentally-worthwhile projects from seeking assistance from the Fund.

Thus, a fundamental conclusion of the Review is that, under its present mandate, *the Fund is not in a position to make a major contribution towards mobilising and targeting the large volume of additional financial resources which will be required for Slovenia to make rapid and substantial progress towards meeting national environmental objectives and achieving compliance with EU environmental requirements.*

The Review Team therefore *recommends that the MEPP, in close consultation with other relevant institutions (in particular the Ministry of Finance), undertake a formal review of the present mandate and institutional framework of the Fund with a view to providing the legal and policy foundations which will enable the Fund to make a major contribution towards meeting the future needs and requirements for environmental financing in Slovenia.*

In particular, the Team *recommends that consideration be given to making the following changes to the Fund’s existing mandate:*

- making the financing of investment and (potentially) other projects, which are essential for achieving compliance with EU environmental requirements, *an explicit and high priority* of the Fund;
- *clarifying the role and functions of the Fund* so that it does not compete with commercial banks and other financing institutions;
- *requiring the Fund to give greater emphasis to the prospective environmental benefits of all projects which it supports* by, for example, making the cost-effectiveness of potential investments in achieving their intended environmental objectives a prime criterion for project selection and support;
- removing the requirement to maintain the real value of the Fund’s capital assets;
- requiring the Fund, subject to certain clearly-defined priorities and criteria, to focus on providing financial support to those projects which offer high prospective environmental benefits *but which cannot (or are unlikely to) attract financing from other sources;*

- empowering the Fund, subject to clearly-defined priorities and criteria, to be able *to offer direct grants and other forms of subsidy from its own resources*;
- empowering the Fund, subject to clearly-defined priorities and criteria, to be able *to offer long-term project financing to the private sector*;
- empowering the Fund, subject to clearly-defined priorities and criteria, to be able *to accept and consider applications for financial support outside of the confines of a public tender*.

If the Fund's existing mandate is changed in the manner suggested above, then it will be necessary for the Fund's financial resources to be significantly expanded, and also replenished on a regular basis. This could be achieved in a variety of ways, for example, through:

- further transfers from the State budget;
- allocating part of the revenues generated by existing or new economic instruments (e.g. pollution or product charges);
- seeking further financial resources from foreign donors and IFIs.

Given the need to increase very substantially the volume of funds available for financing the environmental investments required for EU accession, it is in any event essential that the government gives consideration to different ways and means of generating additional financial resources in order to meet these requirements, and the mechanisms for their allocation and disbursement.

Fund Operations

Based on its review of the Fund's operations, the Review Team concludes that *the Fund operates effectively and efficiently in fulfilling its official mandate*. The following positive features and strengths of the Fund are especially commendable:

- the formulation and implementation of comprehensive operational policies and procedures that are well-suited to meeting the Fund's objectives;
- very competent and highly committed staff, working closely together as a team;
- an absence of undue political influence, and a very high degree, of accountability and transparency, in decision-making, thus satisfying the major criteria a public financial institution should be subject to;
- rigorous, highly developed financial management practices, particularly in the areas of credit risk assessment and loan administration;
- extensive and effective relations with commercial banks as service providers;
- well-established relations and communications with key stakeholders;
- the use of targeted, competitive tenders to focus its resources in selected investment areas;
- a proven track record in administering financial resources on behalf of international institutions.

Moreover, since its foundation, the Fund has successfully disbursed or otherwise been involved in the provision of well over 4000 loans for environmental projects and maintained the real value of its capital in accordance with its mandate. While the Review Team has very few criticisms of the way in which the Fund is currently managed and operated, the Team offers the following comments and suggestions for improving the operation of the Fund:

The Fund, in conjunction with the MEPP and the Ministry of Finance, should seek to diversify and strengthen the Fund's domestic revenue sources. If, as recommended, the Fund's existing mandate is changed in order to expand the Fund's role in financing priority environmental investments, it would be essential to increase substantially its assured revenues. Unlike most environmental funds in other CEE countries, the Slovenian Fund does not receive any substantial revenues from earmarked economic instruments such as pollution charges and fines. The only assured, reasonably predictable source of revenue the Fund has is from interest payments and the repayment of loans issued by it. The level of loan repayments is affected by a number of factors, including the skill of the Fund staff in assessing and managing credit risks and the evolution of the market for environmental finance. Such factors contribute to the Fund's strongly "risk averse" approach to selecting and financing projects which in turn constrains its ability to select projects offering major environmental benefits. Though revenue from loan repayments is gradually increasing, it remains at less than USD 10 million per annum. The Fund's most significant source of domestic revenues to date – part of the proceeds from privatisation – is expected to diminish rapidly as the privatisation process in Slovenia approaches completion. Additional revenue sources, particularly of a type which would be fairly predictable and reliable year after year (e.g. product charges, CO₂ tax), would help the Fund to maintain a minimum level of assured revenue, balance the Fund's roles as administrator of domestic and foreign resources, and provide a more stable basis for financial planning (e.g. beyond the current one year time horizon).

The Fund should continue its important role as an administrator of foreign/international environmental finance, and expand its role in managing EU environmental financial assistance. The Fund has already proven itself to be a reliable and effective partner for foreign donors and international financing institutions interested in financing environmental protection in Slovenia. Such interest is likely to continue in the future and, with regard to Slovenia's accession to the EU, should increase. The Fund already enjoys close co-operation with the EU Phare Programme. It would therefore seem appropriate for the Slovenian and EU authorities to utilise and build upon the Fund's existing expertise and capabilities in order to manage the substantial EU financial assistance which is expected to be made available to help Slovenia meet accession-related environmental requirements (e.g. ISPA funds). However, this would require the Fund to strengthen its expertise and procedures for appraising the environmental effects of projects, and for managing grant programmes.

*The Fund should formulate and pursue longer-term financing strategies based on an amended mandate and more clearly defined environmental objectives. The Fund's planning has thus far been based almost entirely on annual cycles. This is likely due, *inter alia*, to weakly defined environmental objectives, the previous lack of a NEAP specifying longer-term national environmental objectives, and the lack of predictable, reliable domestic revenue sources. Without longer-term financing strategies (e.g. 2-5 years), periodically reviewed and updated as needed, the Fund's role vis-à-vis other environmental policy tools and sources of finance becomes difficult to discern and manage, and the Fund loses some of its comparative advantages as a strategic, flexible extra-budgetary financing mechanism. Moreover, the timeline for Slovenia's accession to the EU provides an important point on the longer-term planning horizon for the Fund, both in terms of pre- and post-accession environmental investment needs and evolving opportunities for the Fund's future development.*

*The Fund's expenditure/disbursement policies and procedures should be made more flexible so as to enable it to fulfil stated environmental objectives and facilitate greater involvement of the private sector in financing environmental protection more effectively and efficiently. This would principally involve empowering the Fund to employ other financing mechanisms (i.e. grants and interest rate subsidies) and to provide finance on more flexible terms with the aim of *maximising environmental benefits and the leveraging effect* of the Fund's financial support. The Fund's currently very strict requirements for loan security and the marginally soft nature of its finance restrict it to a rather small market niche and, in some instances, compel it to compete for business with the commercial banks. Unless the Fund changes its financing approach to one which focuses more on meeting environmental needs in the most cost-effective manner, rather than on minimising financial risk and maximising*

financial performance, the Fund may find that it ceases to have “value-added” and has missed an excellent opportunity to make a unique and valuable contribution to environmental improvement in Slovenia.

The Fund should strengthen its project appraisal and selection procedures in order to increase the environmental benefits and cost-effectiveness of the projects which it finances. The Fund has not been systematically subjecting project proposals to rigorous environmental appraisal, or routinely assessing whether they represent “least-cost” options for achieving the desired environmental results. Only two project applications have so far been rejected for non-compliance with environmental criteria. Article 19 of the Fund’s statute refers to the environmental “contribution” of projects to be financed by the Fund, as well as to the comparison of costs, but the wording is vague and without concrete guidance on how the Fund should give effect to such goals. Even if demand for the Fund’s resources remains erratic, the Fund should appraise the environmental components of applications more rigorously in order at least to be able to suggest changes in the project’s design, technology or methodology which would generate greater environmental benefits. Similarly, comparison of project costs among similar projects submitted to the Fund, or against standard benchmarks, would enable the Fund to identify and suggest more cost-effective project design or implementation options. If, as recommended, the Fund were to become engaged in the provision of grant support, the demand for the Fund’s resources may be expected to rise considerably, making sound project appraisal and selection procedures all the more important.

The Fund has recognised and accepted the need to strengthen project monitoring and post-implementation evaluation efforts. As the number of projects financed by the Fund rises, and those projects reach the implementation and post-implementation stages, the Fund should allocate greater resources to project monitoring and evaluation. Regular monitoring of projects under implementation can help avoid and/or minimise problems; evaluation of projects after implementation is important to verify environmental effects as well as to take stock of “lessons learned” which can provide helpful feedback for Fund planning and reform measures.

Future Development of the Fund

Future development of the Fund needs to recognise and take into account a number of factors, in particular:

- the future requirements for environmental financing in Slovenia, and the main related issues that need to be addressed;
- the role that the Fund has played to date and the skills, capabilities and track-record which it has developed;
- how these attributes can be used and further developed to help meet environmental financing needs in Slovenia.

In this context, the Review Team identified and considered four basic options for the future status / development of the Fund:

- A) No change in the existing mandate and operations of the Fund (i.e. “do nothing”);
- B) Close the Fund down, and transfer its assets and resources to Central Government;
- C) Amend the Fund’s legal and policy foundations, changing the role of Fund so that it in effect becomes a specialist agency managing environmental subsidies on behalf of the State, with a clear mandate to focus on the provision of support to, and realisation of, priority environmental investments (particularly those related to EU accession), and to leveraging other sources of finance into such priority investments;

D) Privatisise the Fund i.e. convert the Fund into a privately-owned, specialised investment bank.

For the reasons explained in this Report, the Review Team *recommends that Option C be actively pursued by the Fund and the MEPP over the short-to-medium term, and that Option D be retained as a possibility to be considered after Slovenia has joined the European Union.*

1 INTRODUCTION

1.1 BACKGROUND

The EAP Task Force is engaged in a series of voluntary reviews of environmental funds in Central and Eastern Europe (CEE) under the aegis of the *CEE Environmental 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 Environmental Funds Network, held in Riga, May 1998, the Director of the Slovenian Environmental Development Fund (SEDF) requested that such a review be conducted of the Slovenian 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 Slovenian Environmental Development 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, an appraisal mission, and preparation of the Review Report. A comprehensive set of background documents concerning, and relevant to, the Fund were examined by the review team (the "Team") both prior to and after the appraisal mission (see Annex 2). The appraisal mission was undertaken over the period 22 – 26 March 1999. During this period, the team engaged in extensive discussions with Fund staff, officials of the Ministry of Environment and Physical Planning (MEPP) and Ministry of Finance, Fund clients and other organisations (see Annex 1). The full co-operation of these parties is gratefully acknowledged.

The review team consisted of the following members: Dr. Wolfgang Hackl, Dr. Rob Wylie, Mr. Lubomir Paroha, Ms. Nelly Petkova and Mr. Michael Betts (Head of Mission).

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 POLICY & INSTITUTIONAL FRAMEWORK

2.1 BACKGROUND AND OBJECTIVES OF THE FUND

The Environmental Development Fund of the Republic of Slovenia (hereinafter: the Fund) was established on 2 July 1993 as a legal public entity under the Environmental Protection Act 1993. It was constituted as a non-profit, joint stock company with a start-up capital of SIT 10 million allocated from the state budget. The Fund Statute was initially issued in the middle of 1994, and subsequently amended in 1996 and 1997. The Fund is currently 100% owned by the Republic of Slovenia. However, pursuant to the Statute of the Fund (Article 14), other legal entities and individuals may become shareholders provided their aggregate share-holding does not exceed 33% of the capital stock of the Fund. Such shares are defined as registered shares, and any holders would not have any voting rights or be entitled to earn interest/receive dividends on their shares, but they would have the right to obtain loans from the Fund on more favourable terms than others. The shares of the Fund are in non-material form and cannot be quoted on the stock exchange. The Fund's share structure as at the end of 1998 is shown in **Table 1**.

Table 1 : Share Structure of the Fund as at 31.12.98

Number of shares	72 722
Nominal value	7 272 200 000.00 SIT
Revaluation	1 423 675 000.00 SIT
Total value of shares	8 695 875 000.00 SIT
Shares to be issued *	57 829.00 SIT
Total value as at 31.12.1998	8 695 932 829.00 SIT

Source: *Fund's own calculations.*

* *Shares are issued 3-4 times a year, at a price per share of 100 000 SIT*

The Fund actually commenced operations at the end of 1994/beginning of 1995 when the first staff were recruited. In 1995, the Standing Orders for the Procedures and Conditions of the Disbursement of Funds were published in the Official Gazette. The Fund's capital resources have been increased in subsequent years through transfers of outstanding debts (receivables) on loans granted to final beneficiaries by the Ministry of the Environment and Physical Planning (MEPP).

The Fund is legally and administratively an independent non-profit company operating both on its own behalf, and on behalf and for the account of third parties. The Fund can engage in financing environmental investments in both the public and private sectors. The Fund maintains close institutional and operational links with the MEPP.

The Fund's objectives are generally guided by the principles laid down in the Environmental Protection Act 1993, national priorities identified by the MEPP in the National Environmental Action Plan, and other policy documents. The main goal of the Fund is *to provide loans on preferential terms for environmental investments from its own capital and from capital obtained from other sources*. The interest rate charged on loans should ensure the maintenance of the real value of the Fund's capital, and the coverage of its running costs without profit (the real value of the Fund's capital is maintained by capital revaluation adjustments using the retail price index). The Fund provides loans on the basis of public announcements i.e. tendering procedures for purposes defined in the Environmental Protection Act and the National Environmental Action Plan.

An overview of the Fund's financial performance from 1994 to 1998 is given in **Table 2**.

Table 2: Overview of Financial Flows through the Fund, 1994 - 1998 (in SIT millions)

	1994	1995	1996	1997	1998
Start of year balance	0	241.320	1328.140	1812.349	2010.887
Annual revenues	260.078	1228.441	2050.576	3273.891	5181.902
Total disposable resources ¹	260.078	1469.761	3378.716	5086.240	7192.789
Environmental expenditure	0	70.746	1427.019	2854.402	2484.478
Overhead/administrative costs	18.663	69.513	129.688	151.333	135.045
Other ²	0.095	1.362	9.660	69.618	96.922
Total expenditures ¹	18.758	141.621	1566.367	3075.353	2716.445
End of year balance ³	241.320	1328.140	1812.349	2010.887	4476.344

Source: *Fund's own calculations.*

Notes: 1) Total disposable resources = Start of year balance + Annual revenues. Total expenditures = Environmental expenditure + Overhead /administrative costs. 2) "Other" includes interest on the World Bank loan managed by the Fund as well as bank service fees paid by the Fund to banks in outsourcing some of the Fund's activities. However, from the data provided by the Fund, it is not clear what is the portion spent on such fees which should normally be considered as part of the Fund's administrative costs. 3) End of year balance = Total disposable resources - total expenditures.

2.2 POLICY AND LEGAL FRAMEWORK

The policy and legal framework of the Fund derives from three principal sources:

- Environmental Protection Act 1993;
- The Fund Statute;
- The Fund Mission Statement.

The main elements of these policy/legal instruments are summarised below.

2.2.1 Environmental Protection Act 1993

A key concept established in the Environmental Protection Act 1993 (EPA) is that of "public services in the field of environmental protection" of which two types are defined - State Public Services and Mandatory Local Public Services.

State public services are described in Article 25 of the Act as services for:

- the protection of forests, farmland, waters and water regulation;
- the protection of the sea and the underground world;
- the protection of natural national assets, stock and flow resources;
- the protection of non-expendable natural resources;
- soil and karst protection, emergency protection and rescue services;
- as well as public services in other areas of environmental protection.

Mandatory local public services are defined in Article 26 of the Act as:

- Supply of drinking water;
- Draining and treatment of municipal waste and rain water;
- Municipal waste treatment and disposal;
- Dumping of the remains of municipal waste;
- Public hygiene and cleaning of public areas;
- Maintenance of public ways, walking and green areas;
- Examination, control and cleaning of firing equipment and installation, smoke flues and vents with a view to air protection.

The same Article further states that if a local authority fails to provide the mandatory local public services, the state is obliged to do so at its expenses. Articles 84 through 88 of the Act relate specifically to the Fund:

- *Article 84* states that the Fund shall be established as a financial institution for the purpose of providing loans at favourable interest rates for investments in the field of environmental protection.
- *Article 85* stipulates the arrangements for administration and supervision of the Fund.
- *Article 86* sets out the manner in which the basic rules of the Fund shall be specified and adopted.
- *Article 87* defines the basis upon which the financial resources of the Fund shall be derived.
- *Article 88* stipulates that the financial resources of the Fund shall be used to provide loans for investments in:
 - state public services for environmental protection;
 - mandatory local public services for environmental protection;
 - facilities and technologies intended for environmental protection;
 - environmentally sound technologies and products; and
 - the implementation of rehabilitation programs of the parties responsible for environmental strain.

2.2.2 Fund Statute

The Fund Statute elaborates the status of the Fund, and the rules governing the organisation and operation of the Fund.

Article 9 of the Statute defines the *basic and other activities* of the Fund as follows:

- the basic activity is to provide loans from the Fund's own capital stock at an interest rate which ensures the maintenance of the real value of the capital stock and the coverage of operating costs;
- the Fund may also acquire and channel loans for providing loans for investments at an interest rate ensuring the costs of the acquired loans as well as operating cost will be covered;

- the Fund may carry out financial intermediation activities for individual environmental investment projects, provided this does not conflict with the activities described above;
- the Fund may also perform supplementary activities that are necessary for its existence (e.g. consultancy work conducted by the Fund's staff) but which do not fall within the scope of its basic activities;
- with a special contract, the Fund may delegate individual tasks to other entities.

Article 19 of the Statute extends the scope for use of the Fund's funds to include:

- provision of loans for investments of the Republic associated with obligatory measures;
- providing lacking funds for the implementation of the National Environmental Action Plan;
- issuing guarantees and insurances for the investments referred to in Article 88 of the Environmental Protection Act 1993.

Article 20 of the Statute requires the Fund to approve loans on the basis of a public tender procedure.

2.2.3 Fund Mission Statement

In its 1997 Annual Report, the Fund describes its corporate mission as being to “offer favourable crediting of environmental investments”, and its vision for the future as being to:

- extend the Fund's activities to all environmental protection fields;
- become a leading Slovene financial institution engaged in the financing of environmental projects;
- increase the amount of financial resources available to the Fund;
- manage EU funds designated for investments in projects designed to achieve compliance with EU environmental requirements;
- after Slovenia joins the European Union, transform the Fund into a specialised environmental bank.

2.3 INSTITUTIONAL FRAMEWORK

In accordance with Article 85 of the Environmental Protection Act 1993 and Article 24 of the Fund Statute, the governing bodies of the Fund comprise:

- the Supervisory Board
- the Administrative Board
- the Fund Director

2.3.1 Supervisory Board

The work of the Fund is supervised by the Supervisory Board which is currently made up of a President and 9 members drawn from various institutions. They are appointed by the National Assembly (the Parliament) and serve for a period of 4 years. The Supervisory Board reports to the National Assembly at least once a year or whenever so required.

2.3.2 Administrative Board

The Administrative Board consists of a President (currently the State Secretary of Environment) and four members appointed/dismissed by the Government of Slovenia (currently representatives of the MEPP, Ministry of Finance, the Chamber of Commerce/Economy and a water utility). The Board conducts its operations in accordance with the adopted Standing Rules and has a quorum if a majority of the Board members participate during a Board session. Each member has one vote and the Board's decisions are adopted by a majority of all votes. The main responsibilities of the Administrative Board are to:

- adopt the Fund Statute and submit it to the Government for approval;
- adopt annual programmes along with financial plans and investment policy and submit them to the Government for approval;
- adopt business reports and annual balance sheets and submit them to the Government for approval;
- adopt standing orders, standing rules and other Fund documents;
- make decisions on tenders and complaints submitted against loan allocations;
- appoint and dismiss the Director of the Fund, and submit its proposals to the Government for approval;
- issue guidelines and instructions for the Director;
- propose to the Government conditions for issuing new shares and other issues relating to them.

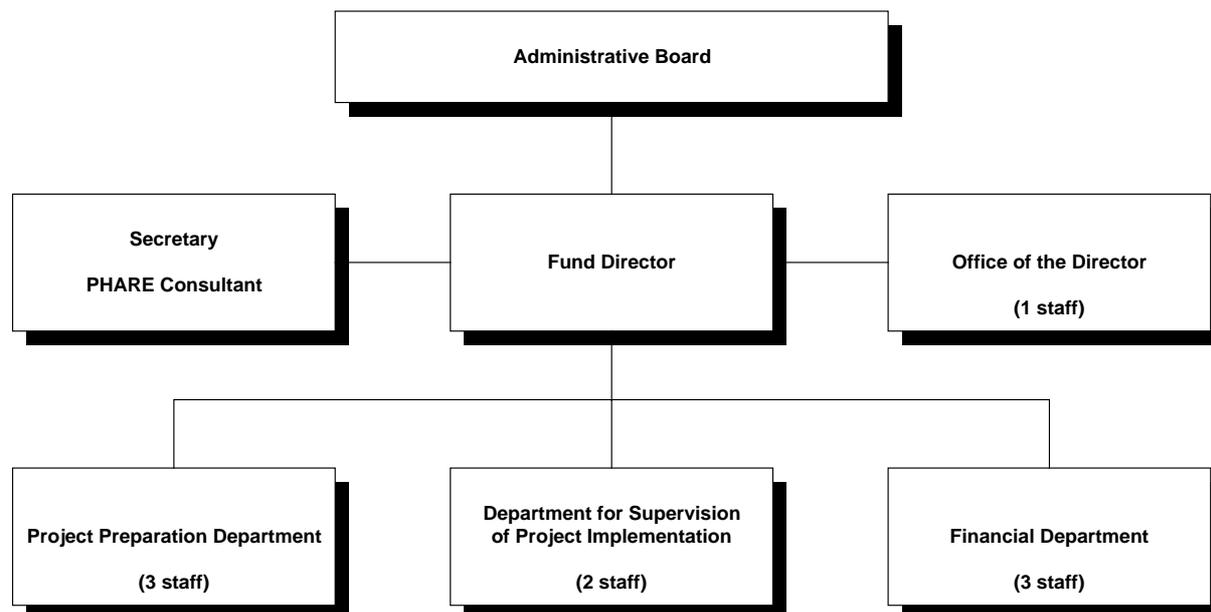
2.3.3 Fund Director

The Director represents the Fund and heads its business operations. The working relationships and responsibilities of the Director are determined in a contract made between the President of the Administrative Board and the Director, based on a decision of the Board. The term of office is four years, following which the Director may be re-appointed subject to the approval of the Board.

2.4 FUND ORGANISATION

Currently, the Fund employs 11 staff, organised into four units: the Office of the Director, including legal affairs, the Project Preparation and Evaluation Department, the Department for Supervision of Project Implementation and the Finance Department (see **Figure 1**). An additional, Phare long-term technical expert has been assigned to the Fund and is now fully integrated into the Fund's staff.

Figure 1: Fund Organisational Structure



2.5 COMMENTS, CONCLUSIONS AND RECOMMENDATIONS

In several respects, the SEDF is unique in the CEE region in that it is the only Fund in the region which:

- is established as a joint stock company;
- is engaged solely in the provision of loan finance on preferential terms (the Fund's mandate does not allow it to offer grants from its own resources);
- operates virtually like a specialised development bank;
- requires high quality collateral from its borrowers (e.g. a guarantee from a commercial bank) who must also be able to demonstrate a high level of credit worthiness;
- fully revolves; and
- maintains the *real* value of its capital assets.

The main *practical* consequences and effects of the Fund's existing mandate and institutional framework are:

- the Fund currently operates as a 'quasi-bank', and has therefore developed a strong banking culture i.e. careful, risk averse, disciplined and focused *primarily* on the financial risks and performance of its lending activities;
- the *environmental dimension* of the Fund's mandate tends to be of only secondary importance within the context of its existing activities and operational procedures. In general, as long as an applicant for loan finance can demonstrate that the proposed investment will generate environmental benefits in line with the priorities set by the MEPP, and can satisfy the Fund's strict requirements on credit worthiness and loan collateral, the loan is granted.

- as the Fund is restricted to providing loans for projects which are financially 'bankable' and where the borrower is able in every case to satisfy the Fund's strict credit risk and collateral requirements, the Fund in many instances effectively competes with the commercial banks for business especially from the private sector. For some types of project, the Fund's current mandate and lending policies would be likely to breach the European Commission's competition rules and guidelines on state aid.
- as a consequence, the Fund in many cases does not achieve any 'additionality' from its lending activities (i.e. it is not currently able to act as a lender of last resort for environmentally essential or desirable projects which cannot be financed from any other source), and its ability to leverage other, particularly private sector, financial resources for environmental investments is limited.
- without the ability to offer direct grants and other forms of subsidy from its own resources, the Fund is unable to perform a pivotal role in mobilising and channelling other financial resources into environmental investments, or promoting some of the other changes and developments necessary to fulfil national environmental priorities and achieve compliance with EU environmental requirements.
- because *inter alia* of the legal requirement to maintain the real value of its capital assets, the loan terms generally offered by the Fund, while more attractive than those typically offered by commercial banks, are not particularly advantageous to borrowers compared, for example, with the terms offered by some other funds in the CEE region. The subsidy element of the financial assistance programmes operated by the Fund is relatively small, against which must be set the considerable financial and other costs incurred by prospective borrowers in applying for loans. Compared with the commercial banks, the Fund's principal advantages in the market for environmental financing are that:
 - it can provide soft loans at lower interest rates than prevailing commercial market rates (loans provided by the Fund are typically priced at the prevailing inflation rate plus 50% of current commercial bank interest rates);
 - it is able to lend for significantly longer periods than commercial banks (up to 15 years to borrowers from the public infrastructure sector, and up to 7 years to borrowers from the industry sector, depending on the nature and life cycle of the project).
- the Fund has thus, until recently, experienced difficulties in lending the funds which have been allocated for private sector projects, primarily because the terms and conditions offered by the Fund in tenders issued under the 'Cleaner Industries Programme' (see section 3.3) were perceived by many prospective borrowers as unattractive compared with other sources of finance.
- even if additional financial resources were made available to the Fund, under its present restrictive mandate, it would find it difficult to increase substantially its overall volume of lending.
- the present requirement to offer financial assistance through a public tendering procedure creates significant peaks and troughs in the Fund's workload, and may have the effect of deterring some developers of environmentally-worthwhile projects from seeking assistance from the Fund.

Thus, a fundamental conclusion of the Review is that, under its present mandate, *the Fund is not in a position to make a major contribution towards mobilising and targeting the large volume of additional financial resources which will be required for Slovenia to make rapid and substantial progress towards meeting national environmental objectives and achieving compliance with EU environmental requirements.*

The Review Team therefore *recommends that the MEPP, in close consultation with other relevant institutions (in particular the Ministry of Finance), undertake a formal review of the present mandate and institutional framework of the Fund with a view to providing the legal and policy foundations which will enable the Fund to make a major contribution towards meeting the future needs and requirements for environmental financing in Slovenia.*

In particular, the Team *recommends that consideration be given to making the following changes to the Fund's existing mandate:*

- making the financing of investment and (potentially) other projects, which are essential for achieving compliance with EU environmental requirements, an explicit and high priority of the Fund;
- clarifying the role and functions of the Fund so that it does not compete with commercial banks and other financing institutions;
- requiring the Fund to give greater emphasis to the prospective environmental benefits of all projects which it supports by, for example, making the cost-effectiveness of potential investments in achieving their intended environmental objectives a prime criterion for project selection and support (see section 3.9);
- removing the requirement to maintain the real value of the Fund's capital assets;
- requiring the Fund, subject to certain clearly-defined priorities and criteria, to focus on providing financial support to those projects which offer high prospective environmental benefits but which cannot (or are unlikely to) attract financing from other sources;
- empowering the Fund, subject to clearly-defined priorities and criteria, to be able to offer direct grants and other forms of subsidy from its own resources;
- empowering the Fund, subject to clearly-defined priorities and criteria, to be able to offer long-term project financing to the private sector;
- empowering the Fund, subject to clearly-defined priorities and criteria, to be able to accept and consider applications for financial support outside of the confines of a public tender.

If the Fund's existing mandate is changed in the manner suggested above, then it will be necessary for the Fund's financial resources to be significantly expanded, and also replenished on a regular basis. This could be achieved in a variety of ways, for example, through:

- further transfers from the State budget;
- allocating part of the revenues generated by existing or new economic instruments (e.g. pollution or product charges);
- seeking further financial resources from foreign donors and IFIs.

Given the need to increase very substantially the volume of funds available for financing the environmental investments required for EU accession, it is in any event essential that the government gives consideration to different ways and means of generating additional financial resources in order to meet these requirements, and the mechanisms for their allocation and disbursement (see also section 3.9).

3 FUND OPERATIONS

3.1 FUND REVENUES

The main revenues / assets of the Fund to date are derived from:

- an initial capital allocation from the state budget (founding capital) - DEM 150 000 (SIT 10 million);
- claims of the MEPP on outstanding debts transferred to the Fund on the date of its establishment – DEM 30 million;
- 8.5% of the revenue generated from the privatisation of enterprises under the Privatisation Act - approximately DEM 33 million;
- taxes and penalties collected through the enforcement of the Environmental Protection Act - approximately DEM 100 000 quarterly;
- transfers from the State budget - approximately DEM 9 million;
- loan repayments and interest on loans;
- revenues from financial operations/bank interest;
- grants and loans from foreign donors and IFIs.

The Fund may also acquire revenues from concessions for public waste management services and from domestic grants and loans, but has not yet received any revenue from these sources.

Since 1996, the Fund has been on-lending to final beneficiaries a DEM 30 million World Bank loan aimed at reducing air pollution from household heating systems and urban boiler houses. Also since 1996, the Fund has received EU Phare grants totalling Euro 4 million towards a scheme for the co-financing (on a 50:50 basis) of projects under the Fund's industrial pollution reduction programme. In 1995, the Global Environment Facility (GEF) provided a USD 6.2 million grant to the Republic of Slovenia for a scheme to phase-out ozone depleting substances in industry, for which the Fund was responsible for procurement and disbursement procedures and monitoring of project implementation. These schemes are described further in section 3.3 below.

Revenues received by the Fund for the years 1994 – 1998 are shown in **Table 3**.

Table 3: Fund Revenues, 1994 - 1998 (SIT millions)

Type of Revenue	1994	1995	1996	1997	1998
Initial capital	10.000				
Revenue from privatisation		708.229	775.693	1322.677	1265.262
Other revenue from MEPP	33.888				890
Loan repayment (without interest)	173.205	377.755	549.567	756.913	1222.237
Interest	21.586	94.137	254.882	268.694	756.739
Revenue from provisions		2.049	15.079	21.173	22.679
Land use penalties	21.399	46.271	33.999	26.315	19.969
World Bank (IBRD) loan			363.980	878.119	634.746
Phare grant			57.376		370.270
Total	260.078	1228.441	2050.576	3273.891	5181.902

Source: *Fund's own information.*

Note: Revenue from provisions include: commission for processing loan applications, commission for loan monitoring, commission for the sale of tender documents, commission for early repayment of loans, commission for financial intermediation.

3.2 PROGRAMMING / PLANNING

The Fund's operational programming and planning are primarily undertaken through the preparation of annual Investment Policies and related Financial Plans.

The main purpose of the annual Investment Policy is to outline the type and structure of all assets of the Fund to be deployed for the implementation of the tasks set forth in the Environmental Protection Act, and for meeting all liabilities of the Fund. It describes in broad terms the financial resources that are expected to be available for disbursement, how the Fund proposes to allocate these resources, and the public tenders which are planned to be launched during the year.

The financial implications and requirements of the Investment Policy are elaborated in greater detail in the associated annual Financial Plan, including projections of:

- loan repayments;
- new loans;
- revenues;
- short-term deposits of the Fund;
- grants made to the Fund (e.g. from Phare);
- Fund operating costs and expenses;
- fixed assets;
- cash flows, balance sheet and profit-and-loss account.

The Financial Plan also presents a forecast of the overall financial performance of the Fund for the following year.

The annual Investment Policy and Financial Plan are adopted by the Administrative Board and submitted to the Government for approval. The official basis for the Fund's spending priorities are those defined in the Environmental Protection Act and Fund Statute (as noted in section 2.2). The Fund's annual spending priorities are defined in close co-operation with the MEPP and take into consideration the funds expected to be available for the subject year. The Fund's main investment priorities for 1999 remained unchanged from previous years: wastewater treatment, solid waste management, reduction of air pollution and new environmental technologies and products.

Since its creation in 1994, the Fund has either initiated and managed, or been otherwise involved in executing, the following specific financial assistance programmes:

- loans for municipal infrastructure investments;
- loans for investments for the reduction of pollution in industry (since 1998, with support from the Phare programme);
- loans for air pollution abatement (with support from the World Bank);
- grants for the phasing-out of ozone depleting substances (with support from the Global Environmental Facility);
- loans transferred from the MEPP in accordance with Article 108 (4) of the Environmental Protection Act;
- the MEPP grants programme.

The role of the Fund in each of these financial assistance programmes is summarised in **Table 4**.

Table 4: Role of the Fund in Existing Financial Assistance Programmes

Programme	Role of the Fund			
	Programming & Preparation	Appraisal & Selection	Contracting & Disbursement	Repayment & Monitoring
1. Municipal Infrastructure	✓	✓	✓	✓
2. Cleaner Industries	✓	✓	✓	✓
3. Air Pollution Abatement	✓			
4. Ozone Depleting Substances			✓	✓ ¹
5. Loans Transferred from MEPP				✓
6. MEPP Grants Programme	✓	✓		

Notes: 1) There is no repayment component in this programme.

3.3 FUND EXPENDITURES / DISBURSEMENTS

The Environmental Protection Act of 1993 and the Fund Statute restrict the use of the Fund's own financial resources to the provision of loans for environmental investments at preferential interest rates (currently, the rate of inflation + 2 %). The Fund is not empowered to use its own resources in order to provide grants. Interest rates charged by the Fund currently lie 3.5 – 7 % below commercial

rates (loans provided by the Fund are typically priced at the prevailing inflation rate plus 50% of current commercial bank interest rates). All loans approved by the Fund must be secured by a commercial bank guarantee or other suitable form of insurance. The Fund is also legally empowered to issue loan guarantees, but has not yet done so.

In accordance with regulations governing public financial entities (of which the Fund is one), the Fund is obliged to invest not less than 30% of its uncommitted financial resources in securities or bonds guaranteed by the Republic of Slovenia. The Fund may invest available working capital in short-term deposits at banks.

The Fund's expenditures by environmental sector and by type of recipient for the years 1996 – 1998 are shown in **Table 5** and **Table 6**.

Table 5: Fund Expenditures by Environmental Sector, 1996 - 1998 (SIT millions)

Environmental Sector	1996	1997	1998
Air (total)	829.020	2097.630	1833.013
incl. - energy production / heating sector	778.214	1742.672	1061.519
- industry sector (excluding energy / heating)	50.806		265.488
- transport		354.959	506.006
- other expenditure related to air pollution			
Water (total)	404.234	620.664	571.080
incl. - water supply	170.855	208.153	236.411
- waste water treatment / sewage	233.379	412.511	196.619
- other expenditure related to water protection and supply			138.050
Waste disposal	193.765	136.108	80.383
TOTAL	1427.019	2854.402	2484.476

Source: *Fund's own information.*

Table 6: Fund Expenditures by Type of Recipient, 1996 -1998 (SIT millions)

Type of Recipient	1996	1997	1998
Enterprises (total)	336.326	998.231	1587.821
including.- publicly-owned ¹	182.325	309.100	862.727
- privately-owned	154.001	95.131	725.094
Municipal / local administration	449.261	536.644	241.589
Public institutions, schools, universities, hospitals, etc.		50.238	20.470
Private persons	641.432	1265.771	14.875
Other		3.518	619.721
TOTAL	1427.019	2854.402	2484.476

Source: *Fund's own information.*

Note: 1) Publicly-owned enterprises are enterprises owned more than 50% by the State or Municipalities.

As noted earlier, the Fund disburses money through a variety of financial assistance programmes. The sources of the financial resources disbursed under the various programmes are indicated in **Table 7**; the programmes themselves are then briefly described below.

Table 7: Sources of Financial Resources for Existing Financial Assistance Programmes

Programme	Source of Financial Resources		
	Fund	State	Other
1. Municipal Infrastructure	100%		
2. Cleaner Industries	100%		Phare ¹
3. Air Pollution Abatement	25%		75% (WB)
4. Ozone Depletion			100% (GEF)
5. Loans Transferred from MEPP		100% (MEPP)	
6. MEPP Grants Program		100% (MEPP)	

Note: 1) Tender "IN98A" in 1998 was co-financed through the Phare Environment Credit Scheme.

Municipal Infrastructure: Each year since 1995, the Fund has invited municipalities and municipal service companies to apply for loans for financing investments in sewage/wastewater treatment systems, solid waste disposal, drinking water pipelines, gas pipelines and local transportation. Approximately USD 7-10 million annually is offered through competitive tenders and the amounts requested in the applications frequently exceed the available resources. There is a huge need for investments in municipal infrastructure but, since August 1998, there are strict legal limitations on how much municipalities can borrow (10% of budget revenues), preventing them from applying for more loans. The terms and conditions of such loans are as follows:

- loans can cover up to 70% of the total investment cost, which is the amount usually requested; the remaining costs are usually covered from municipal budgets;
- individual loans are usually in the range from 10 to 100 million SIT (~ USD 50 000 to 550 000) - so far, the two biggest loans provided by the Fund for municipal environmental infrastructure are: a 300 000 000 SIT loan for environmentally-friendly buses for public transportation, and a 100 000 000 SIT loan for a potable water treatment plant;
- the repayment period is up to 15 years, with no grace period, but repayments (in quarterly instalments) commence only after completion of the investment;
- interest rate: official yearly average inflation rate + 2% p.a. (with first class collateral);
- collateral: adequate insurance by the State, bank guarantee, or a mortgage on commercially viable real estate having a value of at least 3 times the loan amount.

A summary of the tenders issued to date under the Municipal Infrastructure programme is presented in **Table 8**.

Table 8: Municipal Infrastructure Programme - Summary of Tenders Issued

Tender	Resources in SIT million		% Committed
	Total	Committed	
LI95	710	710	100 %
LI96	1 200	758	63 %
LI97A	1 200	1 200	100 %
LI98A ¹	1 500	450	30 %
LI99A ²	3 600	N/A	N/A

Notes: 1) In 1998, the Ministry of Finance issued a decree requiring that overall debt service for any municipality shall not exceed 10% of its annual budget revenues. As a result, the number of municipalities able to apply for Fund support decreased in 1998. 2) This tender was not closed and/or complete data for the tender were not available at the time of the review.

Reduction of Pollution in Industry ('Cleaner Industries'): In June 1996, the Fund invited industrial companies to take loans for financing projects for pollution reduction in the air, water and solid waste sectors, and the phase-out of ozone depleting substances. A USD 7.3 million loan facility was offered, but the response of industrial companies was relatively low - approximately USD 2 million were disbursed. Another tender with similar purposes was launched at the end of 1996 in the amount of approximately USD 5 million of which only about USD 300 000 was disbursed. In 1997, a new tender for industrial companies was issued with a much wider scope of projects covered. Besides end-of-pipe technologies, new environmentally-friendly technologies and products were also included, as well as industrial rehabilitation programmes originating from the privatisation process of Slovenian industry. Again, however, the response of industrial companies was relatively low. Up until 1998, the terms and conditions of such loans were as follows:

- up to 50% of the total investment amount - companies typically apply for the upper limit - the remainder is financed by companies' own funds or commercial bank loan;
- individual loans are usually in the range from 10 to 100 million SIT- so far, the two biggest loans provided by the Fund to industry are: a 360 000 000 SIT loan for environmentally-friendly buses, and a 276 000 000 SIT loan for a powder coating plant;
- the repayment period is up to five years (with possible exceptions), with no grace period, but repayments (in quarterly instalments) start only after completion of the investment;
- interest rate: official yearly average inflation rate + 4% p.a. (with first class collateral);
- collateral: adequate insurance by the State or bank guarantee.

In the 1998 invitation for tender to industry, projects were co-financed by a EU Phare Euro 4 million grant (the so-called "Environmental Credit Scheme") where the Fund participates with up to 70% in the financing of eligible investment projects. Blending of the resources provided by Phare together with those of the Fund has allowed the Fund to soften further its lending conditions and reduce the effective interest rate charged to borrowers down to the official inflation rate + 2%. As a result, the take-up of loans by industrial borrowers increased substantially (to almost 100%).

A summary of the tenders issued to date under the 'Cleaner Industries' programme is presented in **Table 9**.

Table 9: Cleaner Industries Programme - Summary of Tenders Issued

Tender	Resources in SIT million		% Committed
	Total	Committed	
IN96A	1 000	286	29 %
IN96B	710	39	5 %
IN97A	1 500	152	10 %
IN98A ¹	1 500	1 469	98 %
IN98B ²	1 200	N/A	N/A

Notes: 1) Tender IN98A was co-financed by the Phare 'Environmental Credit Scheme' and thus offered a lower interest rate than previous tenders. 2) This tender was not closed and/or the complete data for the tender were not available at the time of the review.

Air Pollution Abatement Programme: The Fund signed a loan agreement with the World Bank (IBRD) for DEM 30 million in June 1996 to finance conversions to cleaner heating systems. After the project's pilot phase in Maribor in 1995, it was gradually expanded to cover the entire territory of Slovenia. In 1997, approximately SIT 1500 million were disbursed to approximately 2000 borrowers. The Fund contributes to this programme with its own resources (equal to 25% of the World Bank loan). Projects financed under this facility can be supported up to 80% of total investment costs. Most investors apply for the highest percentage possible. The terms and conditions of such loans are as follows:

- the maximum loan amount for a legal entity is SIT 55 million; for individuals SIT 1.1 million;
- the repayment period is up to 10 years with quarterly instalments for a legal entity, and up to 6 years with monthly instalments for individuals;
- interest rate: the World Bank interest rate is determined as a 6 month LIBOR for DEM + 2% (in first half of year 1998, this was about 6.03 % p.a.), and it is adjusted twice a year.

At the end of 1997, loans under this facility amounting to SIT 1274 million had been approved, and SIT 1176 million disbursed for the financing of 3245 conversions to cleaner heating systems.

Phase-Out of Ozone Depleting Substances (ODS): The Republic of Slovenia was awarded a grant in the amount of USD 6.2 million by the Global Environment Facility Trust Fund (GEF). The grant agreement was signed in November 1995 with the IBRD acting as the implementing agency on behalf of the GEF. The grant was approved for disbursement to six Slovenian companies for financing six investment projects aimed at phasing-out ozone depleting substances. According to the grant agreement, the Fund was to act as the financial intermediary for the project, responsible for procurement and disbursement procedures and monitoring of project implementation. GEF funds were disbursed through the State Budget account (i.e. not through the Fund). The project was completed in 1998.

MEPP Grants: Since 1998, the MEPP has been providing grants (subsidies) from the state budget for environmental improvement measures. The grants programme is implemented by the MEPP through

specific tenders (one per year). The Fund has been contracted by the MEPP to provide assistance with administering the programme, in particular:

- drafting tender documents;
- developing criteria and methods for the evaluation of applications;
- evaluating the applications received.

In 1998, when the grants programme was very small, the Fund had complete responsibility for administering the programme. In 1999 (as is also proposed for 2000), the Fund's role has been limited to the provision of human resource support to the MEPP.

The environmental sectors eligible for grants are:

- waste management;
- waste water treatment;
- sewage systems;
- protection of drinking water sources.

There are no geographical restrictions for the projects. The grants can be provided up to 50 % of the project cost. The amounts of financial resources earmarked for the grants programme in 1999 and 2000 are given in **Table 10**.

Table 10: Financial Resources Allocated for the MEPP Grants Programme

Environmental Sector	Allocation in SIT million	
	1999	2000 ¹
Waste Management	300	300
Waste Water Treatment	300	300
Sewage	215	200
Protection of Drinking Water Sources	215	200
Total	1 030	1 000

Note: 1) Proposed amounts.

3.4 PROJECT CYCLE MANAGEMENT

After a thorough analysis of the Fund's loan approval procedures, conducted in 1996 and 1997 within the framework of the EU Phare-financed project, the Fund's procedures were significantly simplified. The current procedures, as adopted by the Administrative Board in December 1997, are described in the Standing Orders for the Procedures and Conditions of the Disbursement of Funds. The Fund provides loans on the basis of public tender procedures in a manner and in accordance with the procedure set in the Standing Orders.

3.4.1 Standard Project Cycle

The procedures adopted by the Fund for project cycle management vary according to the particular programme. The standard project cycle applied for managing the municipal infrastructure and cleaner industries programmes is summarised below.

Tendering:

Tenders are prepared by the Fund on the basis of the approved annual Investment Policy and Financial Plan. The Administrative Board appoints a 'Committee for Public Tender Implementation', which is composed of at least three members, including at least one representative of the MEPP. The Committee is ultimately responsible for overseeing the entire tender preparation and loan-approval process, including:

- defining the subject of the tender (i.e. type of projects eligible for financing);
- determining the amount of funds to be made available under the tender;
- specifying the conditions for loan provision;
- specifying the requirements for loan insurance (i.e. collateral);
- specifying contents of the application to be submitted by applicants;
- communicating relevant information to applicants;
- establishing the time limit and manner of submitting applications;
- specifying criteria for the evaluation of applications;
- specifying procedures for opening, evaluating, and selecting applications;
- specifying appeals procedures;
- setting the time limit during which applicants will be informed about the outcome.

An approved tender announcement is published in the Official Gazette, on the Fund's internet web site (since the beginning of 1999), in national newspapers and in other media. Respondents can obtain the application document either in person or by mail upon payment of a fee of SIT 15 000.

A period of at least two months is normally allowed for submission of tender applications. Upon receipt, applications are opened by the Committee, checked for completeness and given a registration number. Incomplete applications are rejected.

Appraisal & Selection:

The evaluation of applications is undertaken by the Fund's Project Preparation Department. The Fund generally endeavours to complete the evaluation of tender applications within 60 days from the date of submission. The evaluation procedure comprises the following main elements:

- verification of the data/information given in the application;
- evaluation of the creditworthiness / collateral of the applicant;
- confirmation of the positive environmental effects of the proposed investment.

As specified in the Fund's statute, the following principles are used to guide the Fund's provision of loans:

- “the investments will make an important contribution to the preservation and improvement of the living and natural environment;
- the investments themselves will be less environmentally harmful;
- the investments will be more effective in comparison with costs;
- the borrower shall be capable of repaying the acquired loan.”

Due to a shortage of applications for most tenders, no attempt is usually made to compare proposed projects, nor are proposed projects assessed against any standard benchmarks. To date, only two applications have been rejected for not meeting environmental criteria/requirements.

For each application, a standardised summary evaluation sheet is prepared. This sheet:

- contains only facts and information;
- does not contain any recommendations;
- does not indicate the name(s) of the person(s) who performed the evaluation;
- is not signed.

The Committee considers all of the evaluated applications on the basis of the summary evaluation sheets, and reaches a decision in each case. A written summary record of the Committee’s decisions is prepared and signed by each Committee member.

Based upon the signed record of the Committee’s decisions, the Office of the Director prepares a formal notification of the results of the tender which is sent to all applicants. Unsuccessful applicants then have 15 days within which to lodge an appeal.

Implementation:

Successful applications are passed to the Department for Supervision of Project Implementation which is responsible for preparation of loan agreements. The applicant then has a period of 60-90 days (depending on the particular tender) in which to submit all the documentation required for the conclusion of the loan agreement. Should an applicant fail to do so, the Fund is no longer under an obligation to enter into a loan agreement.

Loans are disbursed according to the conditions and schedule contained in the loan agreement. Funds are generally either transferred to the account of the borrower up to the value already expended on the project, or paid directly to suppliers of goods and providers of services, on the basis of monthly reports furnished by the borrower (see also section 3.6 below).

Currently, project monitoring is undertaken by one staff member in the Department for Supervision of Project Implementation. As at the end of 1998, 87 site inspections had been carried out for a total of 161 projects. The Fund plans to change and strengthen the system for project monitoring in the near future.

In general, a project is considered to have been completed after 3 years of operation. This period may, however, be shorter for some types of projects. The recipient of a loan is obliged to submit a final report confirming that the environmental benefits stated in his application have been achieved. If a project fails to realise the stated environmental benefits, sanctions may be imposed according to the terms of the loan agreement.

3.4.2 Project Cycle – Air Pollution Abatement Programme

The Fund's role in respect of the Air Pollution Abatement (APA) Programme is one of strategic programme management. Implementation of this Programme is managed by Nova Kreditna Banka Maribor. In terms of project cycle management the Fund prepares and publishes tenders for the Programme and provides application forms. The forms are simplified in comparison to those used for the Fund's standard project cycle. Application forms are free for businesses – natural persons are charged 1000 SIT.

Project appraisal, selection, contracting, disbursement as well as monitoring is conducted by Nova Kreditna Banka Maribor, with the exception of collateral evaluation for legal entities. There is a processing fee of DEM 75, plus an annual administration fee of DEM 55 over the life of the loan.

The only environmental criteria are those contained in the definition of eligibility i.e. conversion from coal burning to cleaner fuels, such as light oil, natural gas or renewable energy sources.

At the beginning of the APA Programme, the projects were geographically limited to the Maribor area (based upon poor air ambient quality). Since 1997, as a result of a Fund proposal, the eligible geographic area has been extended to the whole of Slovenia.

Due to the large number of individual projects under this Programme, project monitoring is reduced more-or-less to an automated verification of project completion. The project is considered to be completed after the client submits supporting documentation, such as a contract with a gas supplier, in the case of conversion to natural gas, or technical certificate (operational license) in the case of conversion to propane.

3.4.3 Loans Transferred from the MEPP

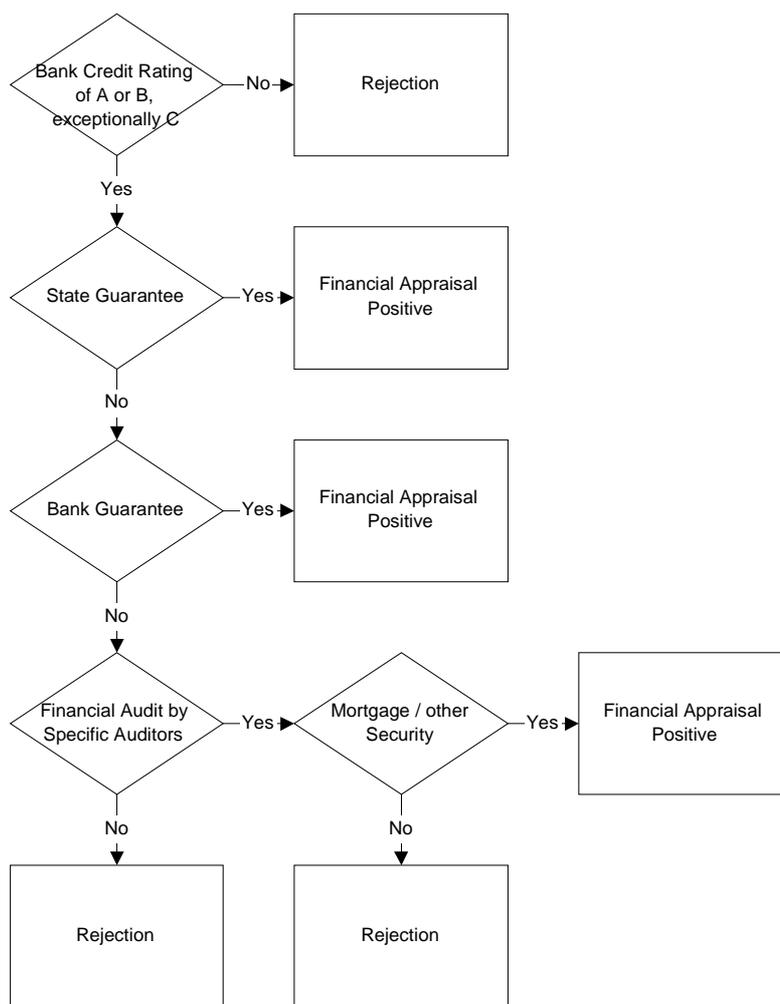
The Fund's role in respect of loans transferred from the MEPP is confined to that of monitoring implementation and verifying completion. This task is performed by the Department for Supervision of Project Implementation. As at the end of 1998, 103 projects had been inspected out of total of 280 projects under this Programme. Of these 280 projects, the Fund estimates that around 15% constitute bad loans.

3.5 CREDIT ASSESSMENT & APPROVAL

Because of the restrictions contained in its Statute, the Fund is obliged to follow a very strict credit assessment policy. The financial criteria for approval of credits are defined in the Fund Statute on the one hand, and in the conditions set for each tender on the other. The standard assessment procedure is illustrated in **Figure 2**.

In cases where an applicant is seeking a loan and intends to offer collateral other than a bank guarantee (e.g. a mortgage), then he is required to complete a detailed questionnaire and undergo a financial audit by one of four approved commercial auditors, the costs of which have to be borne by the applicant.

Figure 2 : Standard Credit Assessment Procedure



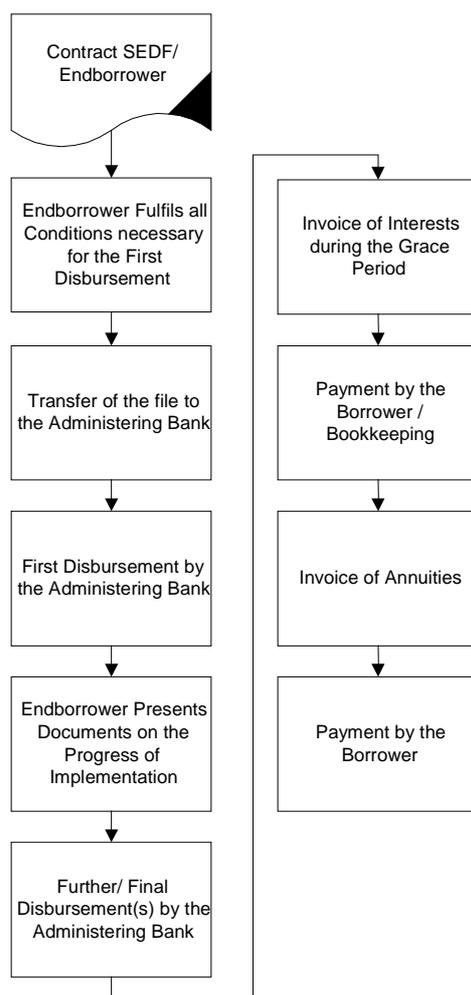
3.6 Loan Portfolio Management & Control

3.6.1 Loan Portfolio Management

Once the loan agreement has been completed by the Fund, and all conditions required prior to the commencement of disbursement have been fulfilled, further administration of the loan is assigned to an administering bank (the Bank Koper).

The procedure generally adopted by the administering bank for the administration of loans is summarised in **Figure 3**.

Figure 3: Loan Administration Procedure



3.6.2 Loan Portfolio Control

This task currently involves the control of:

- “old loans” - loans, which were disbursed directly by the MEPP before the establishment of the Fund. Currently, 70 % of the total volume of these loans has been written-off;
- “normal loans” - loans which are repaid in accordance with the loan agreement; and

- “bad loans” - loans, which are not repaid in accordance with the loan agreement.

A summary credit risk analysis of the Fund’s existing loan portfolio is shown in **Table 11**.

Table 11: Credit Risk Analysis of the Fund’s Existing Loan Portfolio (SIT millions)

Risk Category	Loan Balance as at 31/12/98	%	Loan Balance as at 31/12/97	%	Ratio 98/97 %
A	7 680.044	93	5 884.466	88	131
B	295.773	4	269.795	4	110
C	82.612	1	326.168	5	25
D	21.441		45.683	1	47
E	150.676	2	126.248	2	119
Totals	8 230.546	100	6 652.361	100	124

Source: *Fund Annual Report, 1998*.

Under its service contract, the administering bank is obliged to provide regular loan status reports, which enable the Fund to evaluate the efficiency of the monitoring system of the administering bank. The Fund regularly reviews these reports and advises the administering bank on how to proceed if payments are overdue.

When payments become overdue, an escalation procedure is applied as follows:

1. Delay in payment;
2. Request for payment by the administering bank;
3. Intervention by the Fund;
4. Request for payment by the Fund;
5. Involvement of a law firm;
6. Filling in and presentation of the blank payment order;
7. In case of security by a state or a bank guarantee: information on the provider of the guarantee and / or (partly) drawing of the guarantee;
8. Bringing a legal action against the borrower;
9. Realisation of other securities, especially mortgages;
10. Execution of the verdict of the court.

Currently, only 8 to 10 borrowers require close observation, and these relate only to “old loans”.

3.7 RELATIONS & CO-OPERATION WITH THE COMMERCIAL BANKING SECTOR

Currently, the relations and co-operation of the Fund with commercial banks cover the following fields:

- *Commercial banks as administering banks (as loan administrator).* Based on a service contract, the selected commercial bank carries out all the administrative work associated with the administration of loans.
- *Commercial banks acting as a financial intermediary for specific Fund programmes.* In some cases, commercial banks operate in specific programmes as a financial intermediary for the Fund (e.g. in the Air Pollution Abatement Programme). This concept was chosen primarily because of the large number of potential applicants, the geographical coverage of the Programme and the relatively small size of individual loans.
- *Commercial banks as sub-contractors:* The Fund acts as a financial intermediary for the Global Environment Facility Trust Fund Grant Agreement. In order to ensure rapid disbursement of the GEF grant, the Fund appointed the Nova Ljubljanska Banka as sub-contractor.
- *Commercial banks as a broker for the Fund.* In accordance with a decree issued by the Ministry of Finance applying to all state-owned funds, liquid funds have to be invested in bonds or securities issued by the Slovenian State. Factor Banka, which was selected through a public tendering procedure, manages the liquid long-term funds of the Fund.
- *Commercial banks receiving short-term deposits from the Fund.* According to a decision of the Administrative Board, six commercial banks are currently eligible to receive short-term deposits from the Fund.

3.8 EXTERNAL RELATIONS & COMMUNICATIONS

The Fund has established a variety of mechanisms for managing its external relations and communications. As part of the Phare project “Technical Assistance to the Environmental Credit Scheme (ECS) Slovenia”, a significant amount of resources (Euro 600 000) was allocated to prepare the infrastructure for implementing the scheme, for capacity-building of the Fund’s staff, and for developing the Fund’s overall public relations (PR) and marketing strategy. To help implement the project, a Phare long-term expert was assigned to the Fund, who is now fully integrated into the Fund’s staff (the project is for a duration of 18 months). Activities promoted and undertaken as part of this project include:

- Organisation of a workshop to introduce the ECS PR strategy and the marketing agency SPEM (a Slovenian consulting firm which assists the Fund in developing and implementing its Market Strategy);
- Media (advertising) campaign – An extensive media campaign was conducted in the period June - October 1998 to support and promote the Air Pollution Abatement Programme and ECS. This included press conferences, regular monthly press releases (advertisements in specialised managers magazines and national newspapers), radio and television interviews, special media actions and direct contacts with specific journalists. An assessment of the media campaign indicates that most of the media messages, concerning the Fund, are positive;
- Training of the Fund’s staff on the basics of public and media relations – a number of training courses on this topic have been organised for the Fund’s staff and a draft manual on the same topic has been completed;
- “EcoNews” – the Fund’s EcoNews newsletter, which appeared for the first time in November 1998. The first issue provided a detailed description of the structure of the Fund, the calls for tenders and the loan arrangements. It was widely distributed among target audiences both in Slovenia and abroad (it was mailed to 4 000 addresses, including industry, municipalities, governmental bodies, NGOs, embassies, etc.). The second issue features successful projects financed by the Fund as well as projects co-financed under the ECS. At the time of writing of

the report, 5 issues of the newsletter have been prepared. These newsletters are planned to be placed on the Fund's internet web-site;

- Development and maintenance of an Internet Web-site – the Fund's web-site is already a reality - it can be found at the following address: www.ekosklad.si. The web-site provides information on the Fund's activities, investment objectives, costs of financing, contact persons, WWW links (e.g. the Fund's Calendar of Events), etc. For the time being, the Fund's web-site page exists in Slovenian only but the Fund is considering its translation into English as well. The Fund is also considering the possibility of placing basic application forms on the web-site so that they can be downloaded by potential applicants;
- The Fund's 1997 and 1998 Annual Reports – although this activity was not originally within the scope of the project, it was later included as part of the Fund's Marketing Strategy. The reports are available in English;
- Regular Press Conferences – on average, such conferences are held every 2 – 3 months when a new event, activity or report is to be advertised;
- Fact Sheets/Folders about the Fund and its activities, with leaflets containing information on various case studies of projects financed by the Fund;
- Market research – potential clients have been interviewed with respect to their investment plans and intentions. Based on the information from such research, the Fund will be in a better position to target its efforts and approach at the right people. One such study has already been completed (September 1998) and two more are planned;
- Preparation of a generic press kit;
- Development of an environmental journalists database;
- Compilation of press conference clippings and weekly compilation of press clippings on the activities and the impact of the Fund and the ECS project.

The Fund is also considering the possibility of establishing a hotline to answer questions and provide rapid information to potential clients.

3.9 FUND MANAGEMENT SYSTEMS & PROCEDURES

3.9.1 Operational Management & Reporting Systems

The existing operational management and reporting systems of the Fund are generally well-developed and have evolved to reflect both the legal provisions and administrative rules governing the Fund, and the scope of the Fund's operations. In some cases, existing operational management procedures need to be properly documented and formalised. One area where there would appear to be significant scope for improving existing operational management practices concerns the *environmental* evaluation of tender applications, and the *environmental* assessment and monitoring of project implementation.

Currently there are two computer databases being used within the Fund:

- A database created for the purpose of project supervision within the Department for Supervision of Project Implementation;
- A database created under the auspices of Phare ECS technical assistance to support the activities of the Financial Department.

At the time of the review, the databases were not linked or integrated nor did they cover the whole range of Fund requirements for computerised systems. These drawbacks will be overcome in the near future through further development of the database system within the framework of the technical assistance being provided by Phare.

As a public institution, the Fund's performance is closely monitored and evaluated by the Government of the Republic of Slovenia. The Government is responsible for appointing and dismissing the members of the Administrative Board, approves the Statute, the annual financial plan and investment policy of the Fund, approves its annual accounts and reports on the Fund's operations. It also approves the appointment of the Fund Director as well as adopts decisions on the issuing of shares, loss-coverage methods, etc.

The operations of the Fund are also monitored by the Supervisory Board. The Supervisory Board reports to the National Assembly on the performance of the Fund at least once a year or whenever so required.

The Fund's performance is also subject to periodic scrutiny by Phare and the other international agencies with which it has established relationships.

3.9.2 Financial Management & Reporting Systems

The responsibility for financial management and reporting lies primarily with the Financial Department. Many of the routine financial management tasks are out-sourced to external bodies, so that the work of the staff in this Department is mainly concentrated on monitoring the results of the services performed by external experts.

The tasks which are out-sourced to external bodies are:

- accounting - the Fund submits all necessary information to an accounting agency which carries out all work related to accounting;
- securities are managed by Factor Banka as a broker (see section 3.6 above);
- administration of overdue loans is delegated to a law firm;
- administration of normally performing loans is performed by a commercial bank.

Because of the Fund's methodology for carrying out the financial assessment of tender applications (it is more or less confined to a series of formal questions such as: is the bank risk rating confirmed and sufficiently documented; is the wording of the bank guarantee and the issuing bank acceptable; does the auditor clearly confirm the creditworthiness of the applicant), one could also consider the financial assessment as being substantially out-sourced.

Financial reporting is carried out on a regular basis. It is a task of the Financial Department to collect and review the reports from the various partners of the Fund:

- the administering bank submits a monthly report on the development of the administered loans and a special report on overdue loans;
- the accounting agency presents a monthly statement of accounts and prepares the financial part of the Annual Report of the Fund;
- the Factor Banka, as a broker for securities, regularly submits a report on the development of such securities.

In accordance with Article 33 of the Fund Statute, the Fund is audited by an authorised financial auditing organisation. KPMG Slovenia was recently re-appointed as financial auditor. In addition, the financial status and operations of the Fund are audited regularly by the Court of Audit.

3.10 COMMENTS, CONCLUSIONS AND RECOMMENDATIONS

Based on its review of the Fund's operations, the *Review Team concludes that the Fund operates effectively and efficiently in fulfilling its official mandate.* The following positive features and strengths of the Fund are especially commendable:

- the formulation and implementation of comprehensive operational policies and procedures that are well-suited to meeting the Fund's objectives;
- very competent and highly committed staff, working closely together as a team;
- an absence of undue political influence, and a high degree of accountability and transparency, in decision-making;
- rigorous, highly developed financial management practices, particularly in the areas of credit risk assessment and loan administration;
- extensive and effective relations with commercial banks as service providers;
- well-established relations and communications with key stakeholders;
- the use of targeted, competitive tenders to focus its resources in selected investment areas;
- a proven track record in administering financial resources on behalf of international institutions.

Moreover, since its foundation, the Fund has successfully disbursed or otherwise been involved in the provision of well over 4000 loans for environmental projects, maintained the real value of its capital and progressively improved its administrative efficiency (i.e. reduced its administrative costs per employee). However, the administrative costs of the Fund are still relatively high compared with the administrative costs of other national environmental funds in the region. This can be explained mainly by the fact that the Fund applies rigorous, and therefore costly, procedures for credit analysis, and by the competitive salaries which the Fund offers, enabling it to employ and retain highly qualified and experienced staff.

While the Review Team has very few criticisms of the way in which the Fund is currently managed and operated, the Team offers the following comments and suggestions for improving the operation of the Fund:

The Fund, in conjunction with the MEPP and the Ministry of Finance, should seek to diversify and strengthen the Fund's domestic revenue sources. If, as recommended in section 2.5, the Fund's existing mandate is changed in order to expand the Fund's role in financing priority environmental investments, it would be essential to increase substantially its assured revenues. Unlike most environmental funds in other CEE countries, the Slovenian Fund does not receive any substantial revenues from earmarked economic instruments such as pollution charges and fines. The only assured, reasonably predictable source of income the Fund has is from interest payments and the repayment of loans issued by it. The level of loan repayments is affected by a number of factors, including the skill of the Fund staff in assessing and managing credit risks and the evolution of the market for environmental finance. Such factors contribute to the Fund's strongly "risk averse" approach to selecting and financing projects which in turn constrains its ability to select projects offering major environmental benefits. Though revenue from loan repayments is gradually increasing, it remains at less than USD 10 million per annum. The Fund's most significant source of domestic revenues to date – part of the proceeds from privatisation – is expected to diminish rapidly

as the privatisation process in Slovenia approaches completion. Additional revenue sources, particularly of a type which would be fairly predictable and reliable year after year (e.g. product charges, CO₂ tax), would help the Fund to maintain a minimum level of assured revenue, balance the Fund's roles as administrator of domestic and foreign resources, and provide a more stable basis for financial planning (e.g. beyond the current one year time horizon).

The Fund should continue its important role as an administrator of foreign/international environmental finance, and expand its role in managing EU environmental financial assistance. The Fund has already proven itself to be a reliable and effective partner for foreign donors and international financing institutions interested in financing environmental protection in Slovenia. Such interest is likely to continue in the future and, with regard to Slovenia's accession to the EU, should increase. The Fund already enjoys close co-operation with the EU Phare Programme. It would therefore seem appropriate for the Slovenian and EU authorities to utilise and build upon the Fund's existing expertise and capabilities in order to manage the substantial EU financial assistance which is expected to be made available to help Slovenia meet accession-related environmental requirements (e.g. ISPA funds). However, this would require the Fund to strengthen its expertise and procedures for appraising the environmental effects of projects, and for managing grant programmes (see below).

The Fund should formulate and pursue longer-term financing strategies based on an amended mandate and more clearly defined environmental objectives. The Fund's planning has thus far been based almost entirely on annual cycles. This is likely due, *inter alia*, to weakly defined environmental objectives, the previous lack of a NEAP specifying longer-term national environmental objectives, and the lack of predictable, reliable domestic revenue sources. Without longer-term financing strategies (e.g. 2-5 years), periodically reviewed and updated as needed, the Fund's role vis-à-vis other environmental policy tools and sources of finance becomes difficult to discern and manage, and the Fund loses some of its comparative advantages as a strategic, flexible extra-budgetary financing mechanism. Moreover, the timeline for Slovenia's accession to the EU provides an important point on the longer-term planning horizon for the Fund, both in terms of pre- and post-accession environmental investment needs and evolving opportunities for the Fund's future development.

The Fund's expenditure/disbursement policies and procedures should be made more flexible so as to enable it to fulfil stated environmental objectives and facilitate greater involvement of the private sector in financing environmental protection more effectively and efficiently. In line with the conclusions and recommendations in section 2.5, this would principally involve empowering the Fund to employ other financing mechanisms (i.e. grants and interest rate subsidies) and to provide finance on more flexible terms with the aim of **maximising environmental benefits and the leveraging effect** of the Fund's financial support. The Fund's currently very strict requirements for loan security and the marginally soft nature of its finance restrict it to a rather small market niche within which to operate and, in some instances, compel it to compete for business with the commercial banks creating the risk of crowding them out from the environment sector and preventing the development of environmental expertise with the banks. Unless the Fund changes its financing approach to one which focuses more on meeting environmental needs in the most cost-effective manner, rather than on minimising financial risk and maximising financial performance, the Fund may find that it ceases to have "value-added" and has missed an excellent opportunity to make a unique and valuable contribution to environmental improvement in Slovenia.

The Fund should strengthen its project appraisal and selection procedures in order to increase the environmental benefits and cost-effectiveness of the projects which it finances. Reflecting the erratic pattern of the demand for the Fund's financial resources (see section 3.3), the Fund has not been systematically subjecting project proposals to rigorous environmental appraisal, or routinely assessing whether they represent "least-cost" options for achieving the desired environmental results. Only two project applications have so far been rejected for non-compliance with environmental criteria. Article 19 of the Fund's statute refers to the environmental "contribution" of projects to be financed by the

Fund, as well as to the comparison of costs, but the wording is vague and without concrete guidance on how the Fund should give effect to such goals. Even if demand for the Fund's resources remains erratic, the Fund should appraise the environmental components of applications more rigorously in order at least to be able to suggest changes in the project's design, technology or methodology which would generate greater environmental benefits. Similarly, comparison of project costs among similar projects submitted to the Fund, or against standard benchmarks, would enable the Fund to identify and suggest more cost-effective project design or implementation options. If, as recommended, the Fund were to become engaged in the provision of grant support, the demand for the Fund's resources may be expected to rise considerably, making sound project appraisal and selection procedures all the more important.

The Fund has recognised and accepted the need to strengthen project monitoring and post-implementation evaluation efforts. As the number of projects financed by the Fund rises, and those projects reach the implementation and post-implementation stages, the Fund should allocate greater resources to project monitoring and evaluation. Regular monitoring of projects under implementation can help avoid and/or minimise problems; evaluation of projects after implementation is important to verify environmental effects as well as to take stock of "lessons learned" which can provide helpful feedback for Fund planning and reform measures.

4 FUTURE DEVELOPMENT OF THE FUND

Potential options for the future development of the Fund need to recognise and take into account a number of factors, in particular:

- the future requirements for environmental financing in Slovenia, and the main related issues that need to be addressed;
- the role that the Fund has played to date and the skills, capabilities and track-record which it has developed;
- how these attributes can be used and further developed to help meet environmental financing needs in Slovenia.

The broad future requirements for environmental financing in Slovenia are discussed briefly in the following section.

4.1 FUTURE REQUIREMENTS FOR ENVIRONMENTAL FINANCING IN SLOVENIA

4.1.1 Public Sector

The investments needed in order to comply with EU environmental requirements are expected to amount to over Euro 1 billion over the next 5 years. The largest requirement, at almost Euro 300 million, is for wastewater collection and treatment facilities, which are the responsibility of local communities. In contrast, responsibility for solid waste management is shared between central government and municipalities. The former is responsible for waste incinerator plants, two being planned over the next 10 years at a cost of between DEM 200-300 million each, the latter being responsible for all other aspects of solid waste management with the closure of existing landfill sites incurring the heaviest investment burden.

Over 60% of current investment is obtained from local budgetary sources, with state contributions and communal service providers providing between 15-18%. The Fund, whose contribution is still rather low at 5%, is gaining in importance, while commercial bank credit represents about 11%.

The main reasons for the lack of investment is the shortage of financially viable projects, which is largely due to uneconomic charging policies, and constraints on public sector borrowing. Expected price liberalisation is viewed by the local communities as the single most important factor in improving the economic viability of service providers and, in turn, attracting private investment. For local communities, especially for smaller ones with relatively poor creditworthiness, raising long-term credit, essential for infrastructure projects, is a major obstacle hindering investment.

Over the next 5-year period, communal infrastructure investments are planned to be on average 3 times higher than achieved in recent years, at around SIT 200 billion, with a shift in emphasis from water supply to, in particular, wastewater treatment.

The main driving forces behind the ambitious investment plans of local communities are the growing demand for environmental services and facilities, and the requirement to achieve compliance with EU standards. They also expect that the state budget and commercial banks will play a larger role in financing the necessary investments. However, the expectation that the commercial banks will play an increasing role in municipal environmental financing is based on the widely-held assumptions that the current strict borrowing limits will eventually be relaxed and that there will be a liberalisation of price controls.

Whilst there is interest in being able to offer concessions as a means of attracting funding, there is a realisation that, for this to work, numerous issues have to be resolved. These include problems of ownership, inappropriate legislation, lack of business interest due to poor cost recovery and, on the part of the communities, a lack of understanding as to how this form of operation can work.

According to a recent study¹, an increase in expenditure by the public sector equivalent to 0.5-0.6 % of projected GDP will be required in order to achieve compliance with EU standards, which is more than twice the investments foreseen for this sector in the country's macro-economic projections. In order to go anyway towards meeting this "financing gap", the main change that has to be implemented is to develop a more commercial approach to communal infrastructure development and provision. Without an increase in non-budgetary sources of financing (and this requires significant economic policy changes), investment in communal infrastructure will continue to be depressed and could become a major obstacle to EU accession.

Any price liberalisation would have to be accompanied by policy measures designed to protect vulnerable sections of the population. This would therefore entail a shift from the provision of blanket indirect subsidies to targeted direct subsidies.

Therefore, in summary, a possible route would be to:

- charge real prices but with targeted social subsidies;
- create a climate conducive for private sector involvement;
- increase competition; and
- regionalise municipal investment projects in order to achieve economies of scale.

An important component to help accomplish the above would be the presence in Slovenia of a public financial institution specialising in the leveraging of private and foreign financing of environmental projects. This institution would use a range of financial instruments, be able to assess project risk and arrange structured financing packages from a variety of sources, have access to and manage funding from international sources and have close links with Government as an organisation involved in helping to implement state environmental policy. In short, the Fund could play such a key role.

However, EU accession will undoubtedly affect the Fund's post-accession role as a mechanism for channelling state aid for environmental projects. In the European Union, the Member States are legally required to notify the EU Commission in advance about any significant subsidy schemes (subject to the *minimis* rule), to be granted in any form by public sector institutions to commercial (private and public) enterprises for environmental protection. Such schemes go through a scrupulous procedure of prior approval by the Commission in order to determine if they pose threats on competition or trade. In this context and with the view of better preparing the Fund for the post-accession period, it would be worthwhile to carefully analyse Fund's compatibility with the EU law on state aid and competition.

Pursuant to this law, the European Commission may find that the Fund falls under Article 87 (1) of the EC Treaty, which defines state aid, that is incompatible with the common market. Such aid:

- is granted by a State or through State resources in any form whatsoever;

¹ Mojmir Mrak, *Communal Infrastructure in Slovenia in View of its Accession to the EU: Sector Review, Investment Needs and Policy Priorities*, Working Papers Series, No. 83, Research Center of the Faculty of Economics, ISSN, 1999

- distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods;
- affects trade between Member States.

Even if the Fund is judged a state aid measure in the meaning of Article 87 (1) of the EC Treaty, a temporary derogation under one of the exceptions of Article 87 (3) can be sought. In considering countries' applications for membership, the European Commission uses as a guiding document, among others, the "Guidelines on State Aid for Environmental Protection" published in 1994 (94/C 72/03), and being revised when this report was produced. Moreover, the Commission is preparing "special guidelines" on state aid to environmental protection in Accession Countries. It is crucial that in the accession period, the government of Slovenia should seek to clarify the EU Commission's position on the Fund and obtain authorisation to keep the Fund as a mechanism for providing state aid, as unless such an authorisation is granted, the operation of the Fund will be considered illegal after Slovenia becomes a EU member.

It seems particularly justified for the Slovenian government to apply for a temporary approval by the Commission for state aid in the form of an environmental fund, exclusively for the support for investments required to implement environmental standards imposed by the most costly EU environmental legal acts. Such a request for a transitional period could be justified in terms of exceptions under Article 87 (3) (b) or (c) of the EU Treaty. It would constitute an integral element of Slovenia's programme of compliance with the EU acquis, and could significantly shorten the necessary adjustment period for the existing plants to adjust to new, much stricter EU mandatory environmental standards. Providing necessary adjustments are made in the legal basis and operations of the Fund, such state aid should also be made consistent with the EU guidelines and the historical records of decisions made by the EU Commission and the European Court of Justice. However, such state aid should be well justified through clearly established goals, precise scope and beneficiaries, and a timeframe matching the transition periods for the implementation of individual EU directives.

4.1.2 Private Sector

Over 70% of the Slovenian economy is dependent upon exports. Companies that have an export focus have incentives to make environmental investments. Environmental enforcement pressures on other companies have evidently not been sufficient to stimulate strong demand for environmental investment finance, as evidenced by the relatively poor response to the Fund's financial assistance programmes targeted at the private sector (at least prior to the softening of the Fund's finance by the Phare-supported Environmental Credit Scheme; see section 3.3).

The banking sector still exhibits a reluctance to offer long-term loans to private companies. Those companies with a relatively low credit risk rating cannot obtain preferential interest rates as they are regarded as presenting too high a credit risk.

4.2 OPTIONS FOR STRATEGIC DEVELOPMENT OF THE FUND

The time is opportune for the Fund management and the MEPP to consider the future role of the Fund: it is nearing the limits of its current market niche, given its strict requirements on loan security and the marginally-soft nature of its finance; draft legislation which could fundamentally affect the existence and function of the Fund is being prepared by the Government; EU accession, and the associated major demands for environmental investment, is steadily approaching.

In this context, the Review Team has identified and considered four basic options for the future status / development of the Fund:

- A) No change in the existing mandate and operations of the Fund (i.e. “do nothing”);
- B) Close the Fund down, and transfer its assets and resources to Central Government;
- C) Amend the Fund’s legal and policy foundations, changing the role of Fund so that it in effect becomes a specialist agency managing environmental subsidies on behalf of the State, with a clear mandate to focus on the provision of support to, and realisation of, priority environmental investments (particularly those related to EU accession), and to leveraging other sources of finance into such priority investments;
- D) Privatisise the Fund i.e. convert the Fund into a privately-owned, specialised investment bank.

In the Team’s opinion, option A would fail to exploit and develop the skills and capabilities which already exist in the Fund, and leave the Fund languishing in a rather narrow market niche with little prospect of further growth and development, or of being able to make a major contribution towards meeting the environmental financing needs associated with EU accession.

Option B has been included only because it is the Team’s understanding that closure of the Fund is currently being advocated, or at least considered, within certain Government circles. In the Team’s view, closing down the Fund would represent an unwarranted destruction of an effective and successful public institution, and a waste of a valuable asset, particularly in view of the major challenges and demands posed by EU accession.

Option C is the Team’s preferred option. This would entail fundamental revisions to the current role and mandate of the Fund, along the lines suggested elsewhere in this Report, with a view to the Fund becoming more flexible and able to respond to changing needs and demands for environmental financing in Slovenia, taking on a broader range of responsibilities and tasks on behalf of the State, and playing a much greater role in mobilising and channelling financial resources into the investments necessary to meet EU environmental requirements. In the latter context, *the Team considers that the Fund has the potential, with appropriate institutional strengthening (as recommended in section 3.9 above), to act as an effective Implementing Agency for future EU financial assistance (e.g. ISPA), and therefore recommends that this possibility be given serious consideration by the MEPP and the Ministry of Finance.*

In the Team’s opinion, Option D is a possibility only in the longer term – indeed, the Fund’s vision set out in its 1997 Annual Report envisages transforming the Fund into an “Eco-Bank” only after Slovenia accedes to the European Union. Moreover, the Team considers that the Fund would need to be developed further, and some key commercial issues thoroughly addressed, before this option could be considered seriously. In particular, the Fund would need to assess whether it would be able to compete successfully against the commercial banks and other financing institutions in the market for environmental financing, and to secure contracts tendered by the State for managing State financing / subsidy programmes. Nevertheless, examples exist of investment banks specialising in the municipal / environmental sectors in EU member states, and this option should be kept in mind for the longer term.

Accordingly, *the Team recommends that Option C be actively pursued by the Fund and the MEPP over the short-to-medium term, and that Option D be retained as a possibility to be considered after Slovenia has joined the European Union.*

ANNEX I: LIST OF PEOPLE INTERVIEWED

Ministry of Environment and Physical Planning

Mr. Marko Slokar
State Secretary and President of the Administrative Board of the Fund

Mr. Janko Žerjav
Former member of the Administrative Board

Ms. Irena Brcko-Kogoj
Counsellor

Ms. Nives Nared, MBA
Economic Adviser, Department for European Affairs

Mr. David Cabot
Project Manager, EC Phare Environmental Programme Slovenia

Environmental Development Fund

Dr. Anton Gantar dipl. ing. chem.
President of the Supervisory Board

Mr. Ljubo Žužek dipl.ing., dipl. oec.
Director

Ms. Vesna Vidič dipl. oec.
Assistant Director, Project Supervision

Ms. Maja Verbek dipl.iur.
Assistant Director, Fund Management

Mr. Janko Kramžar dipl. oec.
Assistant Director, Finance

Mr. Darko Koporčič dipl.ing.
Assistant Director, Project Managing

Ms. Irena Bolje - Karlovšek dipl.oec.
Senior Financial Advisor

Mag. Igor Čehovin dipl.ing.
Senior Advisor, Project Supervision

Mag. Damir Stančič dipl.ing.
PHARE Long Term Consultant

Other Institutions

Mr. Gianluca Grippa

Counsellor, Delegation of the European Commission, Ljubljana

Mr. Bojan Suvorov

Economic Attaché, Delegation of the European Commission, Ljubljana

Mr. Milan Cvikl

State Secretary of the Ministry of Finance

Ms. Andreja Jerina, MBA

State Under-secretary, Foreign Assistance Sector, Government Office for European Affairs

Ms. Zdenka Vidovič

Member of the Court of Audit

Ms. Janja Leban

Senior Consultant, Chamber of Commerce and Industry, Technology Development Department

Mr. Mojmir Mrak

Associate Professor, Faculty of Economics, University of Ljubljana

Dr. Marko Karlovšek

Senior Manager, Nova Ljubljanska Banka d.d., Ljubljana

Mr. Matjaž Južnič

Nova Kreditna Banka Maribor

Mr. Tomaž Sihur

Representative of the Municipality of Hrastnik

Mr. Julijan Šorli

Mayor of the Municipality of Tolmin

Mr. Andrej Benkovič

Deputy Director on Economic Affairs, KOTO Ltd., Ljubljana

ANNEX II: LIST OF DOCUMENTS REVIEWED

1. The Environmental Protection Act, June 1993
2. Statute of the Environmental Development Fund of the Republic of Slovenia, Joint-Stock Company, 1993
3. Law on the Ownership Transformation of Enterprises, 1994
4. Environmental Report 1995, Ministry of the Environment and Physical Planning, June 1996
5. Environmental Performance Reviews, Slovenia, UN/ECE, 1997
6. Environmental Development Fund of the Republic of Slovenia - Annual Report 1997
7. Environmental Development Fund of the Republic of Slovenia - Annual Report 1998
8. National Environmental Action Programme, Draft, Ministry of the Environment and Physical Planning, December 1998
9. Environmental Pre-accession Support - A Strategy of Slovenia (Final Version) including Country Operational Programme for Environment 1997 and Environmental Development Fund of Slovenia (Eco-Fund), Co-Financing Scheme, Ministry of the Environment and Physical Planning, January 1997
10. Environmental Development Fund of the Republic of Slovenia (Eco-Fund), Co-Financing Scheme (Annex to COP 97 Request and Environmental Pre-Accession Support Strategy), Ministry of the Environment and Physical Planning, January 1997
11. Technical Assistance for Project Preparation and Institutional Strengthening for the Ministry of the Environment and Physical Planning and the Environmental Development Fund of the Republic of Slovenia - Inception Report, February 1997
12. Environmental Credit Scheme EcoFund/EU Phare - Market Survey, Draft Report, February 1997
13. Environmental Pre-accession Strategy of Slovenia for Integration with the European Union, Ministry of the Environment and Physical Planning, October 1997
14. Environmental Credit Scheme Review Report - Technical Assistance to the Environmental Credit Scheme Slovenia, by Dames & Moore, October 1998
15. Technical Assistance to the Environmental Credit Scheme Slovenia, 98-0245.00 - First Quarterly Report, by Dames & Moore, January 1999
16. Phare / Eco-Fund Slovenia - Environmental Credit Scheme, Bojan Suvorov, EC Delegation in Slovenia, March 1999
17. Various Internal Documents of the Fund, including:
 - Investment Policy for the Year 1998
 - Investment Policy for the Year 1999

 - Financial Plan for the Year 1997

- Financial Plan for the Year 1998
 - Financial Plan for the Year 1999

 - Audit Report of Financial Statements for the Financial Year 1994, KPMG Slovenija d.o.o., March 1994
 - Audit Report on the Financial Statements for the Financial Year Ended 31 December 1995, KPMG Slovenija d.o.o.
 - Audit Report of Rectified Financial Statements for the Financial Year Ended 31 December 1994, KPMG Slovenija d.o.o., December 1995
 - Audit Report of Financial Statements for the Financial Year Ended 31 December 1996, KPMG Slovenija d.o.o.
 - Audit Report of Financial Statements for the Financial Year Ended 31 December 1997, KPMG Slovenija d.o.o.

 - Annual Report for the Period from January 1, 1997 till December 31, 1997 for the Air Pollution Program

 - Public Invitation to Tender for the Award of Loans for Environmental Investments of Companies 13IN98A
 - Public Invitation to Tender for the Awards of Loans for Environmental Investments of Companies 13IN98A (OJ RS no. 43/98) - Application for the Award of the Loan

 - Public Tender of the Environmental Development Fund of the Republic of Slovenia, joint-stock company, Ljubljana, for Granting Loans for Investments in Local Infrastructure, 1996
 - The Standing Orders of the Environmental Development Fund of the Republic of Slovenia, joint-stock company, Ljubljana, on Public Tender Procedures for Granting Loans, 1996
18. European Community Guidelines on State Aid for Environmental Protection (1994)
 19. St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy (OECD, 1995)
 20. Pollution Abatement and Control Expenditure in Central and Eastern Europe, OECD, 1998
 21. Mojmir Mrak, Communal Infrastructure in Slovenia in View of its Accession to the EU: Sector Review, Investment Needs and Policy Priorities, Working Papers Series, No. 83, Research Center of the Faculty of Economics, ISSN, 1999
 22. Survey of Economic Instruments for Environmental Policy in Slovenia in "Sourcebook on Economic Instruments for Environmental Policy" (REC, 1999, Ed. Jürg Klarer, Jim McNicholas, Eva-Maria Knaus)
 23. Survey of the Slovenian Environmental Development Fund in "Sourcebook on Environmental Funds in Economies in Transition" (OECD/EU Phare, 1999, Ed. Patrick Francis, Jürg Klarer, Nelly Petkova)