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7 Prospective Applications of Environmental Financing Strategies

Relevance of the modelling approach

The structured modelling approach to financing strategies has proved to have a number of comparative advantages over traditional project based plans, in particular for large countries and regions and for large, long term investment programmes. Unlike long project-specific pipelines, the formal models:

- Aggregate large numbers of programmes and projects into a systematic, transparent framework.
- Enable quick and apparent “what-if” simulations with different assumptions.
- Reveal consequences of choices immediately and transparently.
- Support strategic allocation of public funds.
- Guide choices of policies and instruments needed to stimulate leverage of private and foreign financing.
- Facilitate the shift from an approach based on “needs” to one of “affordability”.
- Make trade-offs between different commitments explicit and thereby forces discussions about real priorities and cost-effectiveness.

Accumulated experience has already revealed the most promising extensions of the application of the FEASIBLE approach to environmental financing strategies. Some of the areas where it could be most usefully applied include:

Integrated and realistic planning of environmentally related infrastructure

Experience with the environmental financing strategy concept to date has shown that it is a useful tool for realistic strategic planning in urban water supply, wastewater and solid waste sectors. But the major feature of the FEASIBLE approach to financing strategies has still to be demonstrated, i.e. integrated strategic financial planning for several municipal infrastructure sectors at the same time. In reality households must pay for all municipal services from one expenditure “basket”. National and regional authorities also face trade-offs between

supporting various infrastructure services from consolidated budgets. The FEASIBLE model was originally designed with the intention to facilitate realistic management of such difficult trade-offs. But the practical applications have started in a bottom-up way, from analysis of individual sectors separately. In future it is expected that countries will build upon this experience and use FEASIBLE 2 for more integrated planning of all environmentally-related infrastructure.

Policy dialogue between environmental/technical and financial authorities

So far one of the key values of the country applications of the environmental financing methodology was that they provided sector managers with a tool to demonstrate to the ministries of finance that environmental infrastructure development programmes are not just the random lists of idealistic wishes, but that they can be prioritised and systematically incorporated into the public investments and budget process. Development of financing strategies facilitated the dialogue in a credible language of specific targets, concrete measures and realistic resource availability. Authorities responsible for environmental and infrastructure management in transition economies are expected to continue using the FEASIBLE approach to support analysis and presentation of their programmes in terms that are convincing to the authorities responsible for economic development and public finance.

Monitoring of implementation of infrastructure development programmes in transition countries

The countries that have conducted analysis for a specific sector can easily use its results and a computer tool for monitoring progress of infrastructure development in this sector and for identification of corrective measures that might be needed to achieve intended objectives. These countries already have a computer model with data bases from previous years and with simulations of alternative scenarios. Using FEASIBLE for checking whether the programme is implemented according to the schedule is relatively straightforward, cheap and requires much less data than the original analysis.

IFIs and donor countries

The availability of a transparent, approved financing strategy, based on solid analysis can facilitate an effective dialogue with IFIs and donor countries about programming and priorities. The modelling tool itself can serve all parties to support country assistance strategies, project identification and reduce the risks to project pipelines. Potential trade-offs and crowding out can be detected in ad-

vance and preventive measures agreed between domestic and foreign parties. Targets and investment priorities can be formalised and balanced against realistic local co-financing commitments from users and budgets.

EU accession countries

The environmental financing strategy concept and the FEASIBLE 2 model are well suited to assist in development of implementation and financing plans, which are needed during the transitional periods. For those EU accession countries, which face particularly large gaps between the present level of environmental expenditures and official cost estimates, the FEASIBLE model could be used to update and verify expenditure needs assessment and identify the crucial measures that can effectively bridge all possible financing deficits. FEASIBLE can be very useful to develop a programming framework for project pipelines for ISPA and later, for cohesion and structural funds.

Developing countries

Although the environmental financing strategy methodology and FEASIBLE were originally developed in a CEE/EECCA context, they are equally applicable in developing countries where their application could contribute greatly to structuring the policy dialogue and bring about financially sustainable down-to-earth implementation programmes that take into account what the economy and the households can afford. With developing countries needs in mind, the FEASIBLE 2 model was enhanced with the generic cost function for rural water supply and sanitation technologies commonly used in developing countries.

Other environmental sectors

Finally, there is scope for application of the EFS methodology in the energy sector which faces a major challenge in balancing the cost of the technical measures needed to meet service requirements (e.g. change in fuel sources, efficiency improvements, cleaner technologies) while complying with stated pollution reduction targets of both local and global nature, on the one hand, with the available funding (from traditional sources and revenues from the flexible mechanisms under the Kyoto Protocol), on the other. The model based approach with generic cost functions for standardised technology modules and iterative scenario building could greatly facilitate this process.

Limitations on applicability

It should, however, always be kept in mind that the EFS concept and the FEASIBLE model cannot substitute for:

- Feasibility studies.
- Willingness-to-pay and ability-to-pay analysis.
- Cost-effectiveness optimisation.
- Priority setting between sectors/programmes.
- Legal approximation plans.
- Good policy making and effective implementation.

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Introductory Statement

**by Mr. Hans Christian Schmidt,
Minister of the Environment, Denmark**

During the 1990's National Environmental Action Plans (NEAPs) and strategies were developed in most Eastern European countries to address the challenges of reforming the environmental sector along with the transition from planned to market economies. While providing good overviews of the environmental problems and needs in the region, the first generation NEAPs did not reflect the limitations of scarce resources and the need for structural reforms of the environmental sectors. As a response to the limitations of the NEAPs, Denmark and other donor countries have during the last four years supported work in the OECD to develop Environmental Financing Strategies (EFSs), to help countries plan better for environmental improvements and secure long term sustainability of the planned infrastructure investments. The environmental financing strategy is a methodology used to organise information and to balance environmental policies and targets with available resources.

It is well documented today that the municipal infrastructure sector, not least in the water sector, is in a very critical state. This is especially true in countries of the former Soviet Union, the EECCA countries (Eastern Europe Caucasus and Central Asia), where accession to and support from the EU have so far not been driving forces. The current status of public infrastructure in the EECCA region is one of severe under-investment, huge losses of water and energy and a high accident rate. Preventive maintenance has given way to accident management and damage repair, costing several times more than that of regular maintenance. The needs by far exceed the available financial resources, and therefore, governments and service providers must prioritise and seek ways of increasing the financial flow to the sector as well as reducing the costs of providing the services.

The environmental financing strategy is, thus, a methodology to organise information and to balance environmental policies and targets with available resources. Up to now, Denmark has financed the development of a computerised decision support tool, the so-called FEASIBLE model, which facilitates the balancing of needs with available financing. The tool has been tested on a number of country and regional studies in the water sector (Georgia, Moldova, Kazakhstan, Ukraine and three regions in Russia, viz. Novgorod, Pskov and Kalinin-grad), and lately it has been extended to include the waste sector. The waste model has been tested in Novgorod and in Latvia. The first reports (Georgia,

Moldova and Novgorod) were submitted to the Almaty Conference in the year 2000. In response to the “Guiding Principles for Reform of the Urban Water Supply and Sanitation Sector in the NIS” adopted by Ministers in Almaty, additional studies have now been completed, and the FEASIBLE model has been reprogrammed in a more user-friendly second version. This model is available for free to subscribers.

I am pleased to learn that recently other donors, such as the EU TACIS and Germany, have used the methodology and model developed to support EFSs in other regions in Russia and in Armenia. Furthermore, the methodology has been applied without the use of the FEASIBLE model but as a project based prioritisation tool that is particularly relevant in smaller countries and as a next step when overall policies and targets are set.

This report presents an overview of the EFS methodology and, in particular, the FEASIBLE model, and it provides a synthesis of the results achieved so far by applying the methodology. I will not give a summary of the report here but just point to a few key conclusions:

- The studies show that in the EECCA region the financial resources available today are hardly sufficient to cover operating costs of the existing deteriorating water infrastructure.
- User charges have reached affordability levels in some countries like Kazakhstan and Moldova. There is, however, still room for increasing tariffs in other regions, such as Russia and the Ukraine.
- There is scope for reducing operating costs through energy and water saving measures that should also be taken into account when dimensioning and designing new infrastructure or upgrading existing facilities.
- There is no doubt that public budgets as well as international financial support and partnerships will still have to play a substantial role in the future financing of strongly needed capital investments in improved environmental infrastructure. And this support must be linked with continued institutional and economic reforms.

The FEASIBLE model has proven its applicability, not only in EECCA countries but also in accession countries, and I believe that the cost-effectiveness of

Danish environmental investments could also be improved by applying the methodology more actively in Denmark. Lately, the OECD has demonstrated the applicability of the FEASIBLE model in developing countries by developing a financing strategy for the wastewater sector in the Chinese province of Sichuan.

We see the EFS methodology and the FEASIBLE model as important building blocks for the Strategic Partnership on Water for Sustainable Development, which was launched at the World Summit on Sustainable Development in Johannesburg in September 2002. It is my hope that this publication and the EFS methodology including the FEASIBLE model will be of interest to many new user groups (municipal investment planners, regional and national administrations, international financing institutions, consultants, etc.). I wish to thank those institutions, regions and countries, which have actively participated in developing the EFS methodology and the FEASIBLE tool and made valuable information available for the environmental financing strategies in general and for this publication in particular.

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List of Abbreviations and Acronyms

C&D	Construction and demolition
CIS	Commonwealth of Independent States (of the former Soviet Union)
DANCEE	Danish Cooperation for Environment in Eastern Europe
DEPA	Danish Environmental Protection Agency
EAP	Environmental Action Programme
EECCA	Eastern Europe, Caucasus and Central Asia, comprises countries of the former Soviet Union except the EU accession countries (Estonia, Latvia and Lithuania)
EFS	Environmental financing strategy
EU	European Union
EUR	Euro
FDI	Foreign Direct Investments
FEASIBLE	<u>F</u> inancing for <u>E</u> nvironmental, <u>A</u> ffordable and <u>S</u> trategic <u>I</u> nvestments that <u>B</u> ring on <u>L</u> arge-scale <u>E</u> xpenditure
GDP	Gross domestic product
GEL	Georgian lari
HH	Household
HHW	Hazardous household waste
IFI	International financing institution

ISPA	Instruments for Structural Policy Adjustment
LCD	Litre per capita per day
MRF	Materials recycling facility
MSW	Municipal solid waste
NEAP	National environmental action programme
NIS	Newly Independent States (of the former Soviet Union)
O&M	Operation and maintenance
OECD	Organisation for Economic Co-operation and Development
SMART	Specific, measurable, agreed, realistic and time-bound (targets)
USD	United States dollar
WEEE	Waste electrical and electronic equipment
WS	Water supply
WW	Wastewater
WWT	Wastewater treatment

Executive Summary

An important obstacle to achieving environmental goals in many countries has been the failure to adequately address the associated financial issues: the costs of achieving environmental goals; how those costs could be minimised; and the challenge of matching costs with available resources. This volume presents an approach for addressing these issues, particularly for investment-heavy environmental infrastructure, such as urban water supply, wastewater collection and treatment and municipal solid waste. Its main message is that a systematic modelling approach to investment and financial management can improve decision-making and ensure a better use of scarce resources. The main ideas underlying this approach are the importance of realism, affordability and cost-effective use of resources in achieving environmental goals.

A computerised decision support tool – FEASIBLE – was developed by OECD and Denmark to help develop financing strategies, mostly in the countries of Eastern Europe, Caucasus and Central Asia (EECCA), but also in EU accession countries and China. It currently may be applied in the water supply, waste water and solid waste management sectors, and the goal is to extend it to energy-related infrastructure. FEASIBLE is freely available and can be obtained through the web pages of OECD, the Danish Environmental Protection Agency and COWI, the Danish consulting firm that developed the model.

The basic approach underlying FEASIBLE is to take public policy targets in areas like water supply and sanitation, determine the costs and timetables of achieving them, and to compare the schedule of these expenditure needs with available sources of finance. This analysis generally reveals “finance gaps” during planned implementation. FEASIBLE can then develop various scenarios to determine how these gaps could be closed. This could be by: identifying policy reforms that could help achieve the targets at lower cost; identifying ways of mobilising additional finance; adjusting the ambition level of the targets; or extending the time period for achieving the targets.

An important feature of FEASIBLE is the emphasis on realism and affordability. The model can assess the levels of finance (public, private, domestic, foreign) that might be available under different macro-economic conditions. In this way it provides a check on what public budgets might realistically be expected to contribute. It can also help to assess the potential social implications of increasing tariffs by determining the impacts of such price increases on household income. By focussing on these issues, the application of FEASIBLE is more than a tech-

nical exercise: it also supports a process of dialogue and consensus building among the key stakeholders involved in financing environmentally-related infrastructure. In this way it can build a bridge between policy development and implementation.

The analyses prepared to date for EECCA countries have shown that the percentage of the urban population with access to water supply, wastewater treatment and solid waste management services is higher than in countries at a similar income level, but that these services are inefficiently designed and very costly to operate and maintain. At the same time, the existing arrangements for providing these services are financially unsustainable. Thus, in most EECCA countries there is a chronic shortage of funds for proper operation and maintenance of infrastructure, such as small repairs, replacement of worn-out parts, small capital repairs and essential rehabilitation. This has resulted in the rapid loss of the economic and technical value of assets. If corrective action is not taken, it may eventually lead to the physical collapse of the infrastructure, with severe consequences for human health, the environment and economic activity.

The grave situation in EECCA calls for a fundamental reform in the approach to financing environmentally-related infrastructure and the associated policy and institutional arrangements. Overly ambitious plans to extend the coverage and level of infrastructure services need to be replaced by more realistic, modest capital improvement programmes, tailored at providing essential repairs and rehabilitation of critical elements of infrastructure in order to maximise efficiency gains (mainly reduction of energy costs) within the limits of what households and public budgets can afford.

Even achieving these more modest objectives represents a major challenge for EECCA countries. *User charges* will be the most important long-term source of finance for operation and maintenance expenditure, though the low income in many EECCA countries represents an important affordability constraint. *Public budgets* will have an essential role in the short and medium term in financing rehabilitation and capital investments, in providing social protection and in facilitating access to credit. However, infrastructure programmes have to compete with other pressing social priorities. Thus, scarce *public funds and donor grants* need to be strategically prioritised; they will need to be increased in many

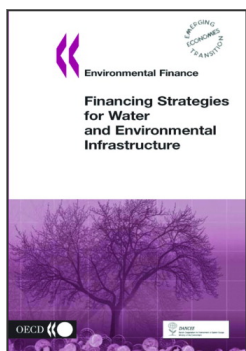
EECCA if the Millennium Development Goals are to be achieved¹. The importance of *domestic financial and capital markets* will grow over time. *International financial institutions (IFI)* will continue to have an important role in capital investments and promoting financial and management discipline. The role of the *private sector* will for many years be more important in providing managerial know-how than finance.

Even though the development of environmental financing strategies (EFS) has only been undertaken in the last few years, it has already triggered some significant policy changes in EECCA countries. *In Novgorod Oblast (Russia)*, the EFS for the water sector was officially adopted by Regional Government and used to identify a portfolio of projects co-financed by the Oblast and international donors. The municipal waste EFS for *the Novgorod and Yaroslavl Oblasts* led to a revision of the waste management plans that involved the identification of more cost-effective regional solutions. *In Moldova*, the EFS was adopted as an official policy document and supported a draft government resolution relaxing unrealistically stringent wastewater effluent standards. *In Kaliningrad (Russia)*, the EFS was used to identify a portfolio of projects co-financed by the Oblast and international donors. *In Ukraine*, the EFS was used to support a comprehensive water sector strategy. *In Pskov (Russia)*, the EFS stimulated a policy debate about infrastructure development targets that were revealed as being financially unsustainable and unrealistic. *In Georgia and Kazakhstan*, the EFS has provided a revealing “reality check” on possible co-financing arrangements with IFIs and donors.

The experience accumulated to date suggests that the environmental financing strategy methodology can be useful tool for governments in developing realistic plans to achieve nationally or internationally agreed targets. The underlying assumption is that governments should not finance all or most expenditure, or sponsor all or most projects. Relying on the public budget to finance operational and maintenance costs of collective infrastructure, for example, is not a sustainable solution. The main role of government in relation to finance is to establish the policy, regulatory and institutional framework within which resources from users, financial markets, capital markets, local budgets and enterprises can be

¹ As one of the Millennium Development Goals, by 2015 all United Nations Member States have pledged to reduce by half the proportion of people without sustainable access to safe drinking water. At the Johannesburg Earth Summit it was further agreed, by 2015 to reduce by half the proportion of people without access to basic sanitation

mobilised in a complementary way, and applied as cost-effectively as possible to achieve agreed goals. Hence, the financing strategies can be useful not only to help plan the government budget, but also in suggesting how policy instruments that affect the capacities and decisions of other public and private financial agents might be reformed.



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