

***Bulgarian
Ministry of
Finance***
Ex-ante
Assessment of
Financial
Instruments for
the Operational
Programme
‘Regions in
Growth’

15 October 2014

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Executive Summary

Context and objective of the study

Financial Instruments (FIs) are expected to play a much stronger role in regional development projects in the 2014-2020 programming period. Besides the advantages of recycling funds over the long term, Financial Instruments related to regional development will help to mobilise additional private co-investments in order to address market failures in line with the Europe 2020 Strategy and Cohesion Policy priorities

The **objective** of the present study is to perform an ex-ante assessment of Financial instruments (FIs) for Operational Programme 'Regions in Growth' for the programming period 2014-2020. The scope of the study is defined in an agreement between PricewaterhouseCoopers Bulgaria EOOD (PwC) and the Ministry of Finance of Republic of Bulgaria (MoF) from 21 May 2014.

This assessment consists of an analysis of the potential use of Financial Instruments in Bulgaria during the 2014-2020 programming period. Its focus is to determine what/how FIs can facilitate and amplify investments in the field of regional development and to formulate evidence-based recommendations for the implementation of such instruments. As required by the Common Provision Regulation (CPR, Article 37), this ex ante assessment aims at improving the quality of the design of the new operational programme through a clearly defined investment strategy for the implementation of FIs. The ultimate goal of an ex-ante assessment according to article 37 is to determine the best use of financial instruments on the basis of market failures and to ensure that it will contribute to the achievement of program objectives from funds under the Common Strategic Framework (CSF).

The **structure of the report** is based on the ex-ante assessment methodology for Financial Instruments developed by PwC for the European Commission and the EIB Group for the 2014-2020 programming period and modified to respond to an individual approach for the Bulgarian market. The study first focuses on the outline of the used methodology. The study proceeds with an analysis of the regulatory and planning documents on regional development and then considers the analysis of the Bulgarian regions' development, as well as the macroeconomic context in the country to the extent it is relevant to OPRG. The results of the implementation of the 2007-2013 ERDF Operational Programme are also taken into account in order to acknowledge the lessons learnt for the future programming period. The report also presents a description of the regional development market from the demand side through an analysis of the demand for funding, the identification of market segments and the analysis of the supply with the identification of the potential sources of funding for regional development. Based on the above, market failures and suboptimal investment situations on the market are defined both from qualitative and quantitative perspective as much as possible (due to the lack of information on the market¹). These serve as an initial identification step for provision of lessons learnt and relevant potential solutions for the upcoming programming period 2014-2020. The report proceeds with the conclusions and the recommendations in terms of potential value added of FIs, their structuring and investment strategies for FIs dedicated to regional development in Bulgaria. The final section proposes an action plan and monitoring and evaluation framework for the establishment of such instruments.

¹ Refer to section 6 of the report for limitations of the analysis.

Methodology

In April 2014, the European Commission issued the ex-ante methodological guidelines² that provide a template for the preparation of such studies. The present report follows the specific methodology. However, it has to be noted that the methodology is used only as an overall framework and road map in order to better take into consideration the country specifics.

The report first depicts in detail the methodology focus and rationale, including the following main aspects:

- *Supply side analysis*, an overview of the financial sector is provided in order to set the framework of the available financing in the market;
- *Demand side analysis* through a review of the project pipeline, conducted survey of municipalities and review of strategic documents;
- Based on the analysis of the supply and demand, an indication of *the gaps and resulting market failures* is provided along with an indication of sub-optimal investment situations in order to identify the need for the use of FIs;
- Based on this analysis, an *investment strategy with potential management structures for the proposed FIs* is also provided.

The three major tools for data collection are: interviews with stakeholders, survey to municipalities and literature review & desktop research. Further details of the applied methodology are presented in Section 2 'Methodology of the study'.

Analysis

Policy overview for the 2014-2020 period

This section provides a summary of the policy context relevant to the implementation of future Financial Instruments for the 2014-2020 programming period. It starts with a presentation of the content of the Partnership Agreement and the consistency between national policy and the selected Thematic Objectives, and ultimately outlines how this will impact the Operational Programme for 'Regions in Growth'. The Partnership Agreement is of particular relevance, given that it sets out the overall policy as to the use of European funds. No particular limitations for the use of financial engineering techniques are identified in the analysis of the Partnership Agreement.

Further analysis of the Operational Programme (OPRG) 2014-2020 is performed including important areas such as its different Priority Axes, their Specific Objectives and Investment Priorities. In addition, the anticipated budgetary breakdown between each of these Priority Axes is provided, which serves as the basis for the identification of the market segments in the demand analysis and also as consideration for the investment strategy budget. The report is built initially on the OPRG draft, sent to the European Commission (EC) in May 2014, and subsequently updated based on the draft, sent by the MA and MoF to the PwC team in the end of September. The reader needs to consider that the negotiation process between the MA and the EC is still ongoing at the time of finalisation of this report and further changes to the OPRG may be performed after the report issue date. Then an overview of the FIs that are envisaged by the MA and assessment of the compatibility between the OP objectives with the ex-ante conditionalities is conducted in order to identify their potential impact on the FI implementation. Based on the performed assessment, there are three conditionalities that are not fully fulfilled at the time of issuing this report, but there are currently no identified issues or

²European Commission, 2014. "Ex-ante assessment methodology for the use of financial instruments".

otherwise significant risks in this respect. Bulgaria has to report the fulfilment in the Annual Implementation Report not later than December 2016.

The section concludes with a summary of the important regulatory considerations that will have to be taken into account in the implementation of FIs to support the OPRG, such as state aid implications.

Market environment

The study presents the ‘macro-economic’ environment of the country but it primarily focuses on an overview of economic and social aspects that can affect the financing of projects and the use of FIs for regional development in Bulgaria. This exercise helps to establish the economic framework in Bulgaria and to identify the indicators relevant for the analysis.

In recent years Bulgaria has experienced an unstable political situation and economic crisis. However, the banking system remained strong and liquid while a fiscal consolidation process was initiated and helped the country recover from the initial negative effects of the crisis. Despite this effort, institutional and structural weaknesses, as well as external factors like the financial crisis difficult recovery of the EU are still limiting the inflow of foreign investment and the financing of projects. Due to the above as well as some specific issues (e.g. insufficient financial information on municipalities), the banks remain reluctant to finance projects, especially in urban development.

This section highlights that regional disparities are important in the country and have to be addressed. The low quality of infrastructure and public services, the sometimes wide imbalances in quality of life call upon a solid regional development strategy that can be further supported by the use of FIs. In this context, areas such as energy efficiency, urban development, culture and tourism provide opportunities for investment.

Existing Financial Instruments and lessons learned

Overall, from EU perspective, a strong momentum for the use of FIs was generated in the last programming period (increased absorption, a number of units set up in 2012).

The use of FIs has been increasingly promoted in the EU over the last 10 years. European institutions such as the European Investment Fund (EIF) and the European Investment Bank (EIB) designed specific policies such as JEREMIE and JESSICA in order to provide simplified procedures and know-how, for Member States to use their allocated European funds into FIs. Other international organisations such as the European Bank for Reconstruction and Development (EBRD) also implemented FIs to support the financing of specific policy areas.

In order to support the analysis of lessons learned from the use of FIs, an overview of the 2007-2013 OPRD has also been provided. The MA of OPRG has managed to reach an absorption rate of 67% as of 30 June 2014, which is above the national average for all Operational Programmes of 64%. The report analyses the existing financial instruments on the Bulgarian market such as: JESSICA, Housing Renovation Fund, EBRD, EIB, EERSF. The outcome of this exercise is a SWOT analysis³ of each financial instrument.

The main lessons learned from the 2007-2013 programming period include:

- Analyses of portfolio of projects demonstrated that FIs are able to bridge gaps;

³ Refer to section 5.3 ‘Lessons learned from the use of FIs’

- The regulatory framework needs reforms (PPP, EE, level of indebtedness and related constraints of municipalities);
- Banks are reluctant to finance urban development projects;
- There is high level of administrative burden;
- The quality of projects is not good enough, mostly due to insufficient management capacity within demand-side players (like small municipalities, hospitals);
- The process of selection of JESSICA fund managers is too long;
- Limited financial information is available regarding municipalities;
- There is limited diversity of FIs.

For detailed description of the activities of the above mentioned FIs, refer to section 5.2 'Financial Instruments in Bulgaria'.

Analysis of market failures, suboptimal investment situations and investments needs

The *analysis of the supply* is carried out by reviewing the supply of funding for regional development by key players on the market. Private and public supply providers are identified and quantification of their supply in the past programming period is calculated: **EBRD (EUR 449.4m); EIB (EUR 122.5m); EERSF (EUR 22.4m)**⁴. However an estimate for overall supply for the future programming period cannot be provided since supply-side stakeholders are not able or willing to provide any quantification for the upcoming years⁵. Despite the above limitation, the supply analysis identifies key influencing factors for the trend in the supply in the future programming period, such as: stable economic environment, liquid banking sector, increasing importance of FIs in programming period 2014-2020, expectations for stabilisation of political environment. These factors indicate an upward trend in the supply of funding in the next programming period, compared to the previous one. Further details of the supply of funding are presented in section 6.1 'Analysis of supply'.

The *analysis of the demand side* is performed with the limitation that: demand for tourism and cultural heritage is not available as at the date of the report, as the tourist sites that are planned to be financed by the OPRG are not defined; potential overlapping of different elements of demand could not be quantified. Despite these limitations reasonable indication of main elements of demand is quantified, as follows:

- review of an indicative project pipeline which provides for **EUR 165m** demand in the area of urban development;
- analysis of the outcome of a survey conducted with municipalities with a result of **EUR 1,901m** in the field of urban development and **EUR 446m** in energy efficiency (residential sector and dormitories);
- an indicative calculation of the investment needs for the national energy policy for the 2014-2020 programming period, based on strategic documents review, resulting in **EUR 1,530m** demand (in residential and public buildings).

From qualitative perspective ⁶ the following market segments have been identified:

- Commercial areas;
- Educational infrastructure;

⁴ Limitations on the above calculation include that some of the financial products to IFIs are targeted to segments outside the eligible activities in OPRG like support for SMEs.

⁵ As per stakeholders interviews conducted with supply side participants. Detailed list of the interviewees is attached in Annex A.

- Road infrastructure;
- Transport and mobility;
- Sports infrastructure;
- Healthcare infrastructure;
- Energy efficiency;
- Tourism and cultural heritage.

The results of the combined quantitative analysis of demand and supply shows that the demand outweighs supply substantially. As such, this is an indication⁷ for a material investment gap and suggests failures at the market level of a structural nature, which have a pervasive effect on the whole market. This illustrates the need for reforms on all market levels in order to allow the market to function properly.

The ***qualitative analysis*** takes into consideration the findings from literature review, from extensive desktop research and from interviews held with relevant stakeholders is combined with the analysis of the market supply and demand to identify several market failures, including:

- Administrative barriers;
- Information asymmetry;
- Heavy public procurement and project preparation processes;
- Limited access to long-term funding;
- Lack of capacity and relevant skills of demand side players;
- Underdeveloped project pipeline;
- Regulatory restrictions;
- Limited predictability of municipality income.

The full list of identified market failures, their description and potential solutions are described in section 6.3 and 6.4.

Added value of the Financial Instruments

The study continues with analysis of the added value that FIs could bring to the three identified priority areas:

- Urban development identified through a review of project pipeline which includes a widest range of market segments. Territorial focus of the area is on the cities supported by OPRG;
- Energy efficiency technically specific area where special skills are required in managing a FI. Territorial focus of the area is on the cities supported by OPRG;
- Tourism and cultural heritage area with specific policy approach applied by the MA in determining the targeted tourism & cultural sites to be supported by OPRG⁸. Territorial focus of the area is on the whole territory of Bulgaria.

Main value added dimensions of FIs include: co-financing, leverage (**leverage of 1:1 to 2:1** is achieved in the 2007-2013 programming period); revolving effect; reduction in the importance of grant-based support; quantification of value added (quantification in energy efficiency results in a 315,630 kWh/year and 729.3 t CO₂/year); addressing regional disparity; improvement in the access

⁷ Note that any supply and demand quantification is indicative only. A more comprehensive and accurate assessment was not possible due to some limitations, the most important of which include: limited market information for projected supply, potential overlapping of projects, lack of defined list of tourism sites to be financed.

⁸ The list of supported planned tourist sites is not finalised by the date of the report.

to long-term finance; improvement of flexibility through a decrease in administrative burden; improvement in the capacity of municipalities. Further detailed description of value added of the FIs is presented in section 7 'Assessment of the value added of the Financial Instruments'.

Proposal of structure and investment strategies of the FIs

The analysis of the FIs market relevant to regional development and the identified added value by FIs lead to the conclusion that there is potential for the establishment of FIs dedicated to regional development in Bulgaria during the 2014-2020 period.

In respect to the management and governance structure there are 3 possible options:

- Option 1: Structuring FIs without a Fund of Funds
- Option 2: Structuring FIs with a Fund of Funds
- Option 3: The MA providing FIs support directly to final recipients

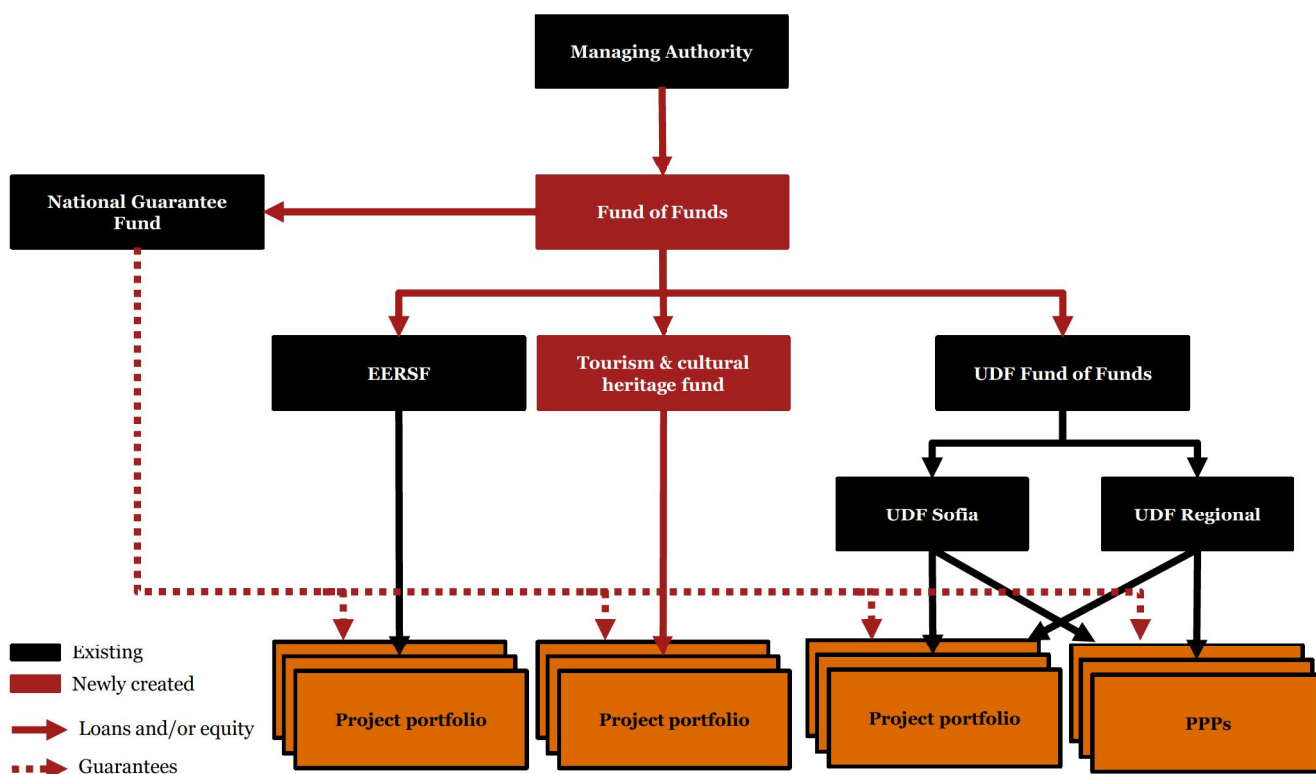
In order to reflect the different challenges of the priority areas urban development, energy efficiency and tourism and cultural heritage, the proposed structure, shown in Figure 12 below, identifies the option 2 as the proposed one.

This structuring of the FIs would include a single Fund of Funds, which would invest in the three dedicated funds covering the priority areas as follows:

- **Urban development:** While this could be done through the creation of a new fund, it is proposed that this be done by investing *into the existing JESSICA structures*;
- **Energy efficiency:** This could be done through the creation of a new financial instrument. It is however recommended that investments in this area *continue through the EERSF structure*, taking into account the lessons learned from past experience;
- **Tourism and cultural heritage:** This will involve the *creation of a new FI*.

The MA would create a Fund of Funds that would oversee investments in line with the suggested envelopes indicated in the OPRG into separate funds dedicated for each of the thematic areas. The funds would then support the provision of grants through the OPRG by providing soft loans to encourage absorption of ESI Funds. In addition, the Fund of Funds could invest into the National Guarantee Fund (a subsidiary of the Bulgarian Development Bank), which would use the investment to provide guarantees for loans to private-sector providers of financial products or guarantees on behalf of beneficiaries (e.g. as replacement for collateral of real estate).

Figure 1: Proposed structuring



Within the above structure the MA may consider under the UDF-Fund of Funds to have a separate fund for (a) specific region(s) which need(s) a more focused support (for example, the North-western region in Bulgaria).

The assessment performed identifies the following indicative estimates of funds that could be channelled through FIs **budget** in the three respective policy areas:

- Urban development: **EUR 146.5m**
- Energy efficiency: **EUR 43.7m**
- Tourism: **EUR 63.6m**

Further analyses and justification of the above estimates are presented in section 8.5 'Assessment of the proportionality of financial allocations for investment through FIs and relevantly leverage applied'. Leverage and other key characteristics of the investment strategy are presented in section 8.2 'Financing the priority areas'.

Keys steps and recommendations for the Managing Authority (MA)

The study concludes with the action plan which integrates the setting up of the Financial Instruments into the programming process of the 2014-2020 OPRG in Bulgaria.

The different stages of the action plan include several key recommendations for the MA to help the constitution and implementation of the FIs:

- Validation of the Financial Instrument
- Creation of the Fund of Funds
- Selection of the specific funds
- Operations

- Monitoring and evaluation

Conclusions and key success factors

In addition to the outcomes and conclusions presented above, the results of the present assessment study clearly point to the need for considering and acting upon a number of key success factors that will play a role in the creation and implementation of Financial Instruments dedicated to sustainable urban development, energy efficiency and the support of tourism infrastructure and cultural heritage in Bulgaria, namely:

- Build on existing experience with FIs;
- Provide technical support for setting up projects;
- Ensure maximum flexibility, transparency and lower costs⁹ for end beneficiaries;
- Raise awareness;
- Redefine the scope of the projects;
- Consideration for a change in regulatory framework to respond to market failures;
- Separating the economic and political time horizons;
- Ensure maximum flexibility, transparency and lower costs for end beneficiaries.

⁹ Not limited to financial terms, but also transactional costs like time, etc.