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Development of Financing Mechanisms in the Baltic Sea Region  
1991-2005

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## **Abstract**

The paper describes the development of financial mechanisms for environmental investments in the Baltic Sea Region during the period 1991 - 2005.

The Baltic Sea is naturally vulnerable to pollution due to its semi-closed character and long residence period of between 25 and 40 years, which results in the accumulation of pollutants. This being said however, in the late 1950's the Baltic Sea was regarded as "healthy". The large-scale industrialisation exacerbated the situation by increasing the amount of nutrient discharge and hazardous substances. By the end of the 1960's the gravity of the situation caused deep concern among several Baltic Sea countries. The need for regional cooperation on protective measures was apparent, leading to the political process that culminated in the creation and agreement of the Helsinki Convention in 1974.

### **Political processes**

Collaboration and cooperation among the Baltic Sea countries was enhanced following the liberalization in 1989. The Baltic Sea Declaration, signed in 1990, defined "The Baltic Sea Joint Comprehensive Environmental Action Programme" (JCP). In 1992, a Programme of Action for a 20-year period was approved, anticipating a phased strategic implementation throughout the region including 132 "hot spots" with an estimated total cost of about 18 billion Euros. From the beginning it was clear that one major constraint to the implementation of the programme would be financial resource mobilisation.

1991 also marked the accession process of multiple Central and Eastern European countries for membership to the European Union, concluding in the Baltic region on 1<sup>st</sup> May 2004 when all Baltic Sea countries apart from Russia became full members of the European Union. The implementation of EU legislation was a major driver for environmental investments in the application countries supported by amongst others, EU financing programmes.

A series of Ministerial meetings within the "Environment for Europe" process have addressed the development and improvement of the European environment, including methods of strengthening cooperation and financing of investments. This has resulted in the establishment of the European Action Programme (EAP) and a Project Preparation Committee (PPC) placed at the European Bank for Reconstruction and Development (EBRD).

Another important development was the European Union's Northern Dimension initiative, which led to the creation of the Nordic Dimension Environmental Partnership (NDEP). Developed in 2001, the concept builds on the successful Baltic Sea Environment Programme and responds to calls from the Russian Federation and the international community for a concerted effort to address environmental problems in northwest Russia.

A working group made up of EBRD, EIB, NIB, WB, the EU Presidency and the European Commission resulted in the creation of the NDEP Support Fund. The NDEP aims to deliver solutions to some of the most pressing environmental problems facing northwest Russia,

which, to date, consists of a €1.7 billion project in the pipeline. Through its involvement in the NDEP, the EIB received a lending mandate to finance environmental projects in Russia.

### **Financing mechanisms**

International sources of funding, including from the European Union, International Funding Institutions (IFIs), bilateral donors, export credit agencies and commercial banks, and direct investment by foreign companies have been provided over the years.

During the transition stage of the Baltic countries, where affordability has been a critical constraint to investments, the use of co-financing that blends loans from IFIs, grants from the European Union and bilateral donors has proven to be a critical tool. When combined with grants, the size of the projects can be larger, allowing greater impacts and reducing the effective cost to the cooperating government or investors. This approach also reduces the impact of adjustments to tariffs for services to project beneficiaries, thus decreasing potential adverse impacts on populations with low or fixed incomes.

The paper describes the different types of funding, a general overview of which is presented in the figure below.

<b>Domestic resources</b>	Tariffs and local environmental funds In-kind contributions Twinning arrangements Private sector participation	
<b>International resources</b>	Bilateral funding EU funding  IFI funding	Country wise Phare, LSIF, ISPA, SAPARD, Tacis, LIFE, SAVE CEB, EBRD, EIB, NIB, NEFCO, WB

In conclusion, the strong political commitment, the model of co-financing and direct involvement of IFIs has successfully facilitated investments in improved environmental management and administration, direct investments in environmental infrastructure and modern installations resulting in clear reductions of pollution loads to the air and water environment and most importantly, improved living conditions for millions of people living around the Baltic Sea.

## **Introduction**

The aim of this paper is to provide background information on the developments and creation of financing mechanisms for the environment in the Baltic Sea Region from 1991-2005. Further, these developments are related to the political developments with regard to the break up of the former Soviet Union, the increased integration into the Environment for Europe process, the EU accession preparations and the EU accession.

The paper provides a brief introduction about the Baltic Sea environment followed by a description of the political processes in the region since the 1970's and in particular since the major political changes in the early 1990's. The processes are the establishing of the Helsinki Convention and the creation of the environmental action programme, the EU accession process, the Environment for Europe process and the Northern Dimension process. The next section describes the different funding activities that have been established for the Baltic Sea region including the domestic sources and the international transfers such as bilateral donors, the EU programmes and the International Financing Institutions. Finally the paper provides a collection of data about investments related to donors and recipient countries.

## **The Baltic Sea environment**

The Baltic Sea is naturally vulnerable to pollution due to its semi-closed character and particular hydrography. The shallow, narrow Belts and the Sound permit only a slow water exchange between the Baltic Sea and the North Sea. As a result, the water in the Baltic Sea has a long residence period of between 25 to 40 years, which promotes the accumulation of pollutants.

As late as 1950 the Baltic Sea was still regarded as environmentally "healthy". Large-scale industrialization throughout the basin had not yet made its impact, automobiles were few, and intensive agriculture and forestry, based on heavy use of chemical fertilizers, was only commencing. Since then the situation has changed considerably. Pollution now threatens the entire Baltic Sea catchment area as well as the Baltic Sea itself, and ultimately the health and well-being of the 80 million people who live there.

At the end of the 1960's deep concern was expressed by especially scientists in many Baltic Sea countries of increasing pollution of the Baltic Sea. Responsible authorities in the countries recognized the concern and it was considered that national efforts only could not solve the problems. Regional cooperation was needed to agree on protection measures to be taken by all Baltic Sea countries.

## **The Political process**

### **1. Establishing the Helsinki Convention**

On the initiative by the Finnish government two international expert meetings were convened in 1973 considering the structure and subjects of an international convention. The initiative resulted in the signing of the Convention on the Protection of the Marine Environment of the Baltic Sea Area at a Diplomatic Conference in Helsinki in 1974. After the break up of the Soviet Union the new countries Russia, Estonia, Latvia and Lithuania became contracting parties to the Convention. In 1993 the Convention was amended to enable the accession of the European Economic Community. Today all Baltic Sea riparian states and the European Union are contracting parties to the "Helsinki Convention".

The liberalization, which took place in Eastern Europe countries in 1989, led to closer contact between all Baltic Sea countries and increased the commitment to environmental cooperation. In 1990 Heads of Governments and high Political Representatives signed a Baltic Sea Declaration in Ronneby, Sweden. The Declaration defined "The Baltic Sea Joint Comprehensive Environmental Action Programme" (JCP) as a tool to implement the aims of the 1974 Helsinki Convention. In 1992 a Diplomatic Conference of the Helsinki Commission approved a 20-year Programme of Action, anticipating a phased strategic implementation throughout the region including 132 "hot spots" with an estimated total cost of about 18 billion ECU. Furthermore, a HELCOM Programme Implementation Task Force (PITF) was established within the Helsinki Commission.

## **1.1 The action programme (JCP)**

The action programme addressed the objective of ensuring the ecological restoration of the Baltic Sea and the preservation of its ecological balance by identifying problems and priority actions in all the countries within the Baltic Sea catchment area. The long term Programme encompasses both preventive actions to promote sustainable use of the Baltic Sea environment, and curative actions to rectify the legacy of environmental degradation from point and non-point source pollution. In addition to these investments, the Programme supports development of appropriate environmental policies and legislation, promotes the use of economic incentives to encourage environmentally sound actions, strengthens institutional capacity and human resources, and increases the local capacity to finance environmental measures.

An ad hoc high level Task Force established within the framework of the Helsinki Commission elaborated the Programme. The members were all the Contracting Parties to the Helsinki Convention including the Commission of the European Communities as well as four multilateral financial institutions – the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Nordic Investment Bank (NIB), and the World Bank.

The Task Force used a variety of studies and sources of information to develop the Programme. These included national plans prepared by the Baltic Sea States as well as by the Czech and Slovak Federal Republic and Norway, pre-feasibility studies of environmental issues, the sources and magnitude of pollution loads, and options for pollution control and improved environmental management throughout the Baltic Sea catchment area. Special studies were also made of agricultural runoff, wetlands, and the impact of emissions into the atmosphere. The pre-feasibility studies and special studies were financed by grants totalling about 5 millions ECU from Denmark, Finland, Germany, Norway, Sweden and the Commission of the European Communities, the Nordic Project Export Fund (NoPEF), and the World Wide Fund for Nature (Sweden)

## **1.2 Financing the programme**

From the beginning it was clear that one major constraint to implement the programme would be the mobilisation of the financial resources needed. The unprecedented political and economic changes affecting the entire Baltic Sea region after 1990 had serious implications for Programme financing. The formerly centrally planned economies were going through a dramatic economic restructuring, which in the short run seriously impaired their creditworthiness as well as the capacity to produce goods and services. The short-term prospects for major economic improvements were limited. The acute demand for basic items such as energy, food and medicine in Estonia, Latvia, Lithuania and Russia impeded the use of local financing for the Programme over the short to medium-term. However, despite the difficulties, the transformation into market economies permitted them over time to assume an increasing share of Programme financing.

The Diplomatic Conference in 1992 requested the continued partnership of the four multilateral financial institutions to facilitate the funding of the programme and it was decided to organise a special conference for mobilising local, national, bilateral, international and other financial resources to implement the programme. The conference took place in Gdansk, Poland in 1993.

At the end of this process between the Baltic Sea countries another process started – the application by some Central and East European countries (CEC) for membership of the European Union.

## **2. The European Union accession process**

The enlargement process started when the CEE countries signed their Europe Agreements. Poland signed in 1991 and the three Baltic States Estonia, Latvia and Lithuania signed in 1995. Accession negotiations were carried out individually with each country on the basis of a screening of the applicant countries status vis á vis the EU requirements. The environmental screenings were concluded in 1999 and the Council decided when negotiations should be opened on specific chapters.

The formal opening of the negotiations of the Environment Chapter of the acquis took place for the first countries at the end of 2000. The EU environmental and agricultural acquis are considered difficult to implement and the EU commissions' Environment Directorate General provided support to the applicant countries via guidance documents, training and concrete assistance projects. Other bilateral donors also supported the process.

The approximation to the EU requirements consisted of transposition of the relevant EU legislation, arranging the necessary administrative and other structures for implementation and enforcement and, ratification of international conventions to which the EU was a party. In particular the establishing of the administrative capacity of implementing agencies and local administrations is a heavy burden and an area where donor support and assistance was and still is needed.

During the negotiations it was clear that post-accession periods were needed for some directives, e.g. where financially heavy investments are required or where immediate compliance would have unacceptable social implications. Such areas as urban waste water treatment, large combustion plant requirements, packaging waste and industrial pollution prevention and control requirements were permitted transition periods.

The accession process ended formally the 1<sup>st</sup> May 2004 when the Baltic Sea coastal states Estonia, Latvia, Lithuania and Poland became members of the European Union. Also, the Czech Republic, part of which discharges to the Baltic Sea, became a member. As a consequence of the membership several bilateral donors have phased out their involvement in the former accession countries and shifted the priorities towards Northwest Russia.

## **2.1 The former Soviet Union Countries**

The former Soviet Union Countries known collectively as the CIS (Commonwealth of Independent States) have formalised their relations with the EU by negotiating individual Partnership and Co-operation Agreements (PCAs). These are ten-year bilateral treaties that set up a legal framework defining political, economic and trade relationships between the EU and the partner country and commit the country to bring its legal system closer to the requirements of the European Union. For the Baltic Sea Belarus, Russia and Ukraine is of interest.

## **3. The Environment for Europe process**

Since the early 1990's, a series of Ministerial meetings have been discussing the development and improvement of the European environment after the major political changes in Central and Eastern Europe (CEE) and in Eastern Europe, Caucasus and Central Asia (EECCA). The meetings have been part of the "Environment for Europe" process.

The first Ministerial Conference was held in 1991 at Dobris Castle in the former Czechoslovakia. The conference discussed ways of strengthening cooperation to protect and improve the environment and long-term strategies toward an environmental programme for Europe.

The second Ministerial Conference in Lucerne in 1993 focused on external sources of environmental financing of actions although the participants acknowledged that the largest proportion of the financing for environmental investments in the CEE and in EECCA would come from the countries themselves. Priority setting, strengthening of local financing institutions, cost effective use of resources and using external funding as a catalyst to leverage domestic funding were underlined. The European Action programme (EAP) was established and a Secretariat placed in the OECD. Furthermore a Project Preparation Committee (PPC) was established and allocated to the EBRD.

At the third Ministerial Conference in Sofia in 1995 it was acknowledged that demand for environmental financing was still low throughout the region. It was considered that major obstacles were the high price of commercial financing, limitations on flexibility and low absorption capacity more than the lack of financing itself. Developments of flexible financing mechanisms and soft financing were needed.

The Aarhus Conference in 1998 recognised that there was a need to strengthen focus on the EECCA, as the gap between environmental financing levels in CEE and EECCA countries had become evident. Developments in

environmental financing in CEE were increasingly driven by the EU accession process and directive implementation. For the EECCA countries there were no equivalent drivers or clear goals for environmental developments. The Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force) activities were refocused toward the EECCA, with specific highlight on integrating environmental concerns into economic development, strengthening capacity for environmental financing and focusing on public private partnerships.

The fifth Ministerial Conference took place in Kiev in 2003 and status of the financing of environmental protection was considered as one important subject. Also the course for future European cooperation after the EU enlargement was set.

#### **4. The Northern Dimension**

The European Union's Northern Dimension initiative aimed to enhance co-operation between the EU and its member states and the region's seven partner countries: Estonia, Iceland, Latvia, Lithuania, Norway, Poland and the Russian Federation.

In June 2000, the European Council meeting in Feira, Portugal, endorsed the Northern Dimension Action Plan, which gave high priority to the environment and nuclear safety. It was recognised that the international financial institutions (IFIs) have a central role in fulfilling the region's investment needs through commercially viable projects.

In March 2001, the IFIs as a group expressed their willingness to work together in promoting and financing environmental investments focussing on northwest Russia and Kaliningrad. The EU's mandate, the co-operation among the IFIs and the support of donors led to the creation of the Nordic Dimension Environmental Partnership (NDEP).

The concept of the NDEP builds on the successful Baltic Sea Environment Programme. It was developed during 2001 in response to calls from the Russian Federation and the international community for a concerted effort to address environmental problems in northwest Russia where the need for environmental investments is formidable.

The Ministerial Conference on the Northern Dimension in Luxembourg in April 2001 requested a concrete proposal from a working group made up of EBRD, EIB, NIB and the World Bank, the EU Presidency and the European Commission. Two months later, the European Council welcomed this proposal in Gothenburg, Sweden and requested the European Commission, in cooperation with the EBRD, to organise a pledging conference for a fund to support NDEP activities – the NDEP Support Fund.

A Steering Group, comprising of representatives from EBRD, EIB, NIB, the World Bank, the European Commission and the Russian Federation, was established. The Group identified 12 short- and medium-term projects in water, wastewater, solid waste and energy efficiency.

In December 2001, the Rules of the NDEP Support Fund were agreed by the EBRD, which is in charge of administering the Fund. NDEP and the NDEP Support Fund became fully operational in 2002, once the pledging conference secured the necessary initial contributions. The Assembly of Contributors, grouping all donors to the Fund, held its first meeting in November 2002 to decide on the allocations for specific projects. The lead on individual

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