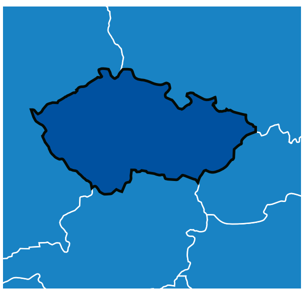
advancing with ESIF financial instruments

Stocktaking study on financial instruments by sector



Progress to date, market needs and implications for financial instruments

Environmental risk loan instrument in Czechia

Case study

European Commission

European Investment Bank
The EU bank

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Abbreviations

Abbreviation	Full name
ČMZRB	Českomoravská záruční a rozvojová banka (Czech-Moravian Guarantee and Development Bank)
CZK	Czech koruna, the national currency
EC	European Commission
ERDF	European Regional Development Fund
ESIF	European Structural and Investment Funds
GBER	General Block Exemption Regulation
GGE	Gross grant equivalent
OP(s)	Operational Programme(s)
SEF	State Environmental Fund
SME(s)	Small and Medium-sized Enterprise(s)
TA	Technical assistance

The Czech Ministry of the Environment has set up a EUR 18.5 million loan instrument managed by the State Environmental Fund (SEF) to address, reduce and manage environmental risks. The instrument is, probably, the only financial instrument in the 2014-2020 programming period addressing TO 6 – Environment and resource efficiency in the enterprise sector.

1. Description of the financial instrument

1.1 Rationale and objectives

In the 2015 ex-ante assessment for the Operational Programme (OP) Environment[1], all five priority axes were screened for their suitability for financial instruments. The result was that the highest potential was identified in energy efficiency in the public sector, outside of the scope of this case study, and for waste recycling, waste prevention in industry, as well as environmental risk prevention and management. Limited potential was identified in the areas of water management and air quality, which mainly referred to boiler replacement in housing. For nature protection and biodiversity, it was concluded that financial instruments were not suitable.

Investment in waste management, such as recycling or waste to energy, waste prevention in industry, and environmental risk management were analysed together. The total demand was estimated to range from EUR 300 million[2] to EUR 420 million with a resulting financing gap of EUR 100 million to EUR 140 million for the 2014-2020 programming period. This exceeded the available allocation of OP resources of EUR 65.2 million. About ⅔ of the financing gap related to investments into waste prevention and the remaining part representing between EUR 44 million and EUR 62 million related to financing needs for environmental risk management. The proposed allocations in the OP for waste prevention are EUR 47.2 million and for environmental risk management EUR 18 million. The main factors for market failures were identified as the following:

- Limited bankability of projects: long payback periods and low rate of return of the investments, high risk of investment, difficulties to quantify the financial benefit of the projects;
- Limited bankability of borrowers through lack of sufficient collateral and low credit scores; as well as
- Regulatory barriers: uncertainty about future fees for the disposal of industrial waste and hazardous substances.

It also became clear that the two different sectors show different characteristics regarding the barriers to investment. In 'waste prevention and management', the main barriers are the high risk of the projects and of the borrowers, whereas in 'environmental risk management and prevention', the main problems relate to the very low rate of return of the investments. In this context, the managing authority decided to set up two separate financial instruments. The waste prevention and management was launched in August 2019 and the environmental risk management and prevention instrument is operational for two years. This case study focuses on the latter instrument.

1 Ministry of the Environment, Ex-ante assessment of the possibility for use of financial instruments in the OPE, 2015, p. 52.

2 All amounts in the ex-ante assessment were calculated in Czech Koruna (CZK). For this case study a simplified exchange rate of EUR 1 = CZK 25 was used.

1.2 Scope

The financial instrument covers the following investments:

- Refurbishment of cooling systems, including ice hockey rinks;
- Reconstruction of facilities producing hazardous chemical substances;
- Reconstruction and purchase of technologies for monitoring of industrial pollution; and
- Construction and reconstruction of installations for the storage of hazardous chemical substances.

The final recipients are enterprises, independent of their size as well as public entities, such as municipalities or municipal enterprises. Projects located in the City of Prague are not eligible for the instrument as the capital city is covered by a separate OP.

1.3 Financial allocation and governance

The instrument became operational in October 2017. It has a financial allocation of EUR 18.5 million for the loan component from OP resources and about EUR 6 million for the grant component from the SEF's own resources. SEF was chosen as financial intermediary as it is the main body managing grants for environmental investments from European Structural and Investment Funds (ESIF) and national resources. The potential final recipients are familiar in working with the fund and the fund has experience with the provision of soft loans and their combination with grants from national sources. Commercial banks or the national promotional bank ČMZRB (the Czech-Moravian Guarantee and Development Bank) were not considered to be the appropriate providers due the loan-grant combination, a complexity that it was considered SEF could manage better.

The process of requesting support from the loan instrument is the same as for a grant scheme. A comprehensive project description with accompanying documentation has to be submitted for the annual call with strict deadlines.

1.4 Financial products

The instrument provides soft loans for eligible projects. The minimum level of the loan is 35% and it can reach up to 100% of the eligible expenditure. The loan is provided without appraisal fees, with an interest-free grace period of up to 14 months for the period of project implementation. The repayment period of the loan is up to 10 years, for which a 0.45% per annum interest rate is charged. The grace period can be extended up to 2 years and the repayment period will then be shortened accordingly. The loan can be combined with a grant from SEF's resources for up to 25% of the investment. The combined amount of support cannot exceed 100% of the investment cost and the gross grant equivalent (GGE) of the combined support cannot exceed the maximum amounts as defined under State aid regimes (see below). The loan offers flexible conditions, such as postponing instalments or earlier repayment without penalty.

The ex-ante assessment proposed a soft loan combined with a capital rebate of the loan that is provided conditional to the environmental impact of the investment. This proposal was not followed up as it is not possible under the current regulations.

The final recipients submit their applications for the loan and the ancillary grant via a SEF electronic form. There is also a calculator on the website to calculate the amount of total public support. The procedure of submitting an application is similar to grants from the OP Environment.

Both the loan and the grant element are paid out continuously according to the implementation of the investment.

1.5 Leverage

The financial instrument is designed in a way that it provides the maximum amount of support to the final recipients. The loans to final recipients consist only of European Regional Development Fund (ERDF) contribution without national public or private co-financing. The instrument is consequently 100% composed of ERDF funding and therefore the leverage, following the definition of the Financial Regulation[3], is 1[4]. The financial instrument additionally mobilises a national grant part of up to 25% of the investment cost and, depending on the project, own financing of the final recipient.

One objective of the instrument is to generate revolving resources that are available for investments into environmental risk prevention and management for the period after the 2014-2020 programming period.

1.6 State aid

An objective for the managing authority was to avoid notification of the State aid scheme to the European Commission (EC) and to use either the General Block Exemption Regulation (GBER)[5] or the *de minimis* regime. For the environmental sector, there are several possibilities to provide aid depending on the type of investment, the location of the project, or the size of final recipient. Generally, a project can benefit from aid under the *de minimis* rules which limit the total amount of the GGE within 3 years to EUR 200 000. Considering the size of the projects and that the final recipients may also receive State aid for other investments, this approach may be very limited. The table below gives an overview of the applicable maximum GGE for projects chosen for the financial instrument in Czechia.

3 Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018.
4 Considering that management cost and fees need to be deducted from the amounts invested, the leverage may be even below 1.
5 Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty.

Table 1: Maximum aid intensity according for projects supported by the environmental risk instrument

Article under GBER	Municipalities	Small enterprises	Medium enterprises	Large enterprises
Independent of the aid regime	85%			
Regional investment aid – Article 14		45%	35%	25%
Investment aid for investments going beyond EU standards – Article 36		75%	65%	55%
Investment aid for early adaptation to future Union standards – Article 37 * the higher rate applies, if implementation takes place at least 3 years before new standards come into force		30-35%*	25-30%*	20-25%*
Aid for sport and multifunctional recreational infrastructures – Article 55		35%	35%	35%

Source: Call description as of April 2018, 2019:
https://www.sfzp.cz/files/documents/storage/2018/04/24/1524549646_Výzva_01_2017_IFN_aktualizace_1.pdf.

Depending on the applicable Article under GBER, the amount of grant may be reduced for investments by larger enterprises under the rules of Articles 14 and 37.

2. Lessons learned

2.1 Results

As of July 2019, eight projects have been approved under the scheme. The total amount of investment of the projects financed is of EUR 7.8 million, with EUR 5.7 million provided through loans and EUR 2.1 million by grants. 30% of the total amount allocated to the financial instrument has already been committed to projects, but not yet fully paid out. Projects received loans ranging from 35% to 75% of the eligible expenditure and 25% of grant. Six of these projects are ice hockey rinks that need to refurbish their cooling systems in order to replace environmentally harmful coolants. The beneficiaries are mainly municipalities or municipal enterprises. Two industrial projects have applied successfully. One food processing company, investing into a new water treatment system, is the largest project financed by the instrument with a total cost of EUR 2.4 million, while a chemical factory, rebuilding its storage facilities for inflammable substances, is the smallest project supported with a total cost of EUR 190 000.

2.2 Barriers and challenges

There was a significant delay in the implementation of the financial instrument. The ex-ante assessment assumed that the instrument would become operational in January 2016. The decision on the design and scope of the financial instrument took longer than expected. A further difficulty came from the combination of grants and the financial instrument. Originally, it was planned to combine a loan and a grant, both from ERDF resources. This approach was abandoned as the combination in two operations was considered too complex, but an investment grant element was considered essential for the success of the financial instrument.

The financial instrument has now been operational for two years and first conclusions can be drawn. The uptake of the instrument is slower than expected as it did not exactly meet market needs. A lesson learned is that a market testing exercise directly before launching the instrument would have been useful and there should be technical assistance (TA) available for this. Nevertheless, it can be expected that the total amount of OP allocated to the instrument will be invested by the end of 2023. A second observation is that all projects have been eligible for the maximum amount of grant support. Following that, if future projects also receive 25% of support, the allocation from SEF may not be sufficient to cover all projects receiving the loan, especially if reflows are going to be reinvested.

A more general challenge encountered when implementing this financial instrument in the environmental sector is the lack of political support. The initiative of setting up the financial instrument came from the staff of the responsible line ministries, i.e. the Ministry of the Environment or the Ministry of Regional Development. At this time, the merits of financial instruments were less endorsed at the political level, which was still relying more on traditional grant support to achieve policy objectives. From the ex-ante assessment it is very clear that enterprises and municipalities prefer grants over financial instruments.

Overcoming the grant dependency is important not only at a political level but also on the level of final recipients. Especially in the environment sector, State aid in form of grants has been the norm over the last decades and enterprises may tend to postpone investments and wait for grants to be available in the next programming period.

2.3 Key enabling factors

The possibility to access preferential financing with additional investment grants is key for the success of investments with a low rate of return but high environmental externalities such as investments in environmental risk management. This is also important in the transition from generous grant schemes to financial instruments. The financial product is considered very beneficial for final recipients as it provides low interest rate and flexible conditions, such as postponing instalments or earlier repayment without penalty. Furthermore, grants for this type of investments are only available if they are taken together with loans. The 'one-stop-shop' approach of applying for the loan and grant in one application to one institution is reducing the administrative burden for final recipients and provides certainty about bank and grant financing at the same time. The loan and grant were made available through an open call until end of 2019 and it is expected to be extended beyond this date. The process of open calls is aligned with the process of investment decisions in enterprises.

The appraisal of technically very specific projects and the management of a complex State aid regime is difficult for financial intermediaries. Therefore, the implementation through SEF is important for the success of the instrument. SEF's experience with financial instruments from own funds are essential for the implementation of financial instruments in sectors where they have never been used so far. Nevertheless, despite the fact that the managing authority and the fund are familiar with revolving funds and with ESIF grant rules, they have expressed that there is need for additional capacity building on the specificities of ESIF supported financial instruments.

The preparation of investment projects in the environmental sector is quite onerous. It was mentioned that TA to better prepare projects for final recipients would be beneficial. This would result in more and better prepared projects applying.

Regarding State aid, several GBER articles are applicable for investments in the environmental sector. This brings complexity to the financial intermediary and uncertainty about the possible amount of support for the final recipient. SEF as financial intermediary is familiar with State aid from its experience in providing ESIF and national aid to final recipients. The availability of a web application to calculate the amount of aid of the combined instrument and the applicable State aid regime gives the final recipient certainty about the amount of aid the project can receive and not bring unexpected surprises about the amount of aid at a later stage of project implementation.

The financial instrument does not compete with grants for the same investments, neither from ESIF nor national resources. All allocations of this priority axis have been allocated to the combined instrument. This reduces the possibility of 'grant shopping' among final recipients and that investment decisions are postponed in order to wait for grants to become available.

The managing authority has recently launched a second financial instrument for the environmental sector. The instrument is addressing investments in waste prevention in industry and waste management in enterprises. The ex-ante assessment has shown that the financing needs of this sector are different to the environmental risk management. The rate of return is comparable with other investments in Small and Medium-Sized Enterprises, thus no investment grant is needed. The managing authority decided not to establish a separate financial instrument for this sector, but to integrate the scheme into the existing loan and guarantee instrument for SMEs, 'Expanze', under the responsibility of the Ministry of Industry and Trade and implemented by ČMZRB. For the managing authority the advantage is a faster implementation of the instrument as it is using existing and functioning processes. For final recipients the advantage is that they can access the instrument through the financial intermediaries they are already working with. Often investments into environment aspects are undertaken with other investments such as measures to increase the production capacity or changes in the production process. Having environmental aspects integrated in a general SME instrument allows to access financing for different objectives in one process, despite the fact that allocations come from different OPs and different managing authorities.

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