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COMMISSION OF THE EUROPEAN COMMUNITIES

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**REPORT FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT AND THE COUNCIL**

On the Management of EU-funds in Bulgaria

1. INTRODUCTION

Bulgaria has received important financial and technical support from the European Union in the pre-accession period and is eligible for continued high levels of financial support under the current 2007 – 2013 financial perspective (€6.852 billion from the Structural Funds alone). Pre-accession support - the PHARE programme, SAPARD (agriculture) and ISPA (infrastructure) – and temporary financial assistance provided for in the Act of Accession – the Transition Facility and the Cash-flow and Schengen Facility – were designed to help Bulgaria consolidate socio-economic reform and to prepare for the absorption of larger amounts of structural funds. These programmes are at various stages of implementation, but not all funds have been contracted and there are significant amounts remaining to be paid. The structural funds and other programme (such as the Schengen Facility) falling under the current financial perspectives are at an early stage of implementation, with only advance payments having been made.

While specific implementation modalities differ between these various programmes, there are common management and financial control standards that must be met. For example, strict procurement procedures (e.g. on tendering, evaluation and award of contract) must be followed and rigorous financial control must be exercised. European Union funding is made available only once sound financial management can be demonstrated and certified.

Bulgaria is experiencing difficulties in many of these programmes and has to demonstrate that sound financial management structures are in place and operating effectively. Administrative capacity is weak. Beyond that, there have been serious allegations of irregularities as well as suspicions of fraud and conflicts of interest in the award of contracts. Investigations by the EU anti-fraud office, OLAF, into the management of EU funds by the Bulgarian authorities have led to the temporary suspension of pre-accession funds and the freezing of payments under various other financial instruments.

Given its responsibility under the Treaty for the implementation of the budget, and in particular having regard to the need for the sound financial management of EU funds and for protecting expenditures under the EU budget, the European Commission considers it necessary to inform the European Parliament and the Council, i.e. the budgetary authority, about the situation in Bulgaria, the steps that are being taken by the Commission and the remedial actions that are being taken by or that are expected from the Bulgarian authorities. This report is not exhaustive, but examines the situation for the main funding programmes, provides an overview of measures taken to date and an indication of next steps.

The situation is serious. In recognising the dimensions of the problem, the Bulgarian government has recently taken a number of corrective steps. It has started work on procedural and legislative changes needed to effectively deal with conflict of interest, transparency and efficiency of public procurement procedures, amendments in legislation, treatment of irregularities as well as empowerment of the national authorizing officer (NAO). It has made some key high level appointments – such as the appointment of a Vice-Prime Minister responsible for the co-ordination of EU funds who is at the same time the head of the Bulgarian Anti Fraud Coordination Service. New Directors of the Audit Authority and of the Central Finance and Contracting Unit (CFCU) have been appointed. These are steps in the right direction. But, all of this must be followed up by credible, structural corrective actions and a fundamental reform.

2. STATE OF PLAY OF THE DIFFERENT FINANCIAL INSTRUMENTS

2.1. Financial instruments concerned by irregularities or deficiencies

2.1.1. PHARE/Transition Facility

The PHARE and Transition Facility programmes support Bulgaria to complete institutional reforms and to prepare for the absorption of much larger amounts of assistance under the Structural Funds. The total amount allocated from 2004 to 2007 and remaining under implementation in Bulgaria under the PHARE and Transition Facility programmes is around €650 million. The final deadline for the contracting of PHARE funds is November 2008 and for the Transition Facility is December 2009. The funds are managed by the Bulgarian authorities under the extended decentralised implementation system by four implementing agencies, which were accredited by the Commission in June 2007.

Problems

Monitoring and audits show serious weaknesses in the management and control systems and point to a number of irregularities, suspected fraud cases and conflicts of interest between the programme administration and contractors. In February, the Commission services suspended payments to two Implementing Agencies, namely the Central Finance and Contracting Unit (CFCU) and the Implementing Agency at the Ministry of Regional Development and Public Work (MRDPW) and requested they take corrective actions to improve their management and control systems. To date, the Bulgarian authorities have not taken all necessary steps to ensure sound financial management and have not adequately followed up on the detected irregularities.

Next steps

The Commission is now withdrawing the right to manage aid under the Phare programme and the Transition Facility from the two Implementing Agencies (CFCU and MRDPW). Consequently, the CFCU and the MRDPW may no longer conclude contracts under these programmes. This will affect the €250 million of funding still to be contracted. Twinning contracts included in these funds are exempt from this Decision as no irregularities have been detected in their management. These contracts are managed with the close involvement by the partner Member State.

Furthermore, the Commission maintains the suspension of payments to these two agencies. The Commission will closely monitor the situation in the light of further steps that the Bulgarian authorities take to ensure sound financial management and to follow up irregularities detected.

2.1.2. SAPARD

Bulgaria is eligible for SAPARD funding in the amount of €445 million, of which until now €235 million have been paid

Problems

There are three sets of problems concerning SAPARD.

The first relates to projects worth € 26 million which are currently subject to investigations by OLAF regarding implementation difficulties due to fraud and possibly corruption. It seems that the Bulgarian authorities have recently started recovery procedures.

The second concerns investigations into the activities of the ex- executive director of the SAPARD Agency for a measure having a total expenditure of €10 million. The executive director was dismissed in 2007 after allegations of wrongdoing in regard to the management of State Fund Agriculture. The Bulgarian authorities have originally held that the allegations were not related to the management of the SAPARD funds. However, in a subsequent investigation, the Prosecutor's Office of Bulgaria accused the ex- executive director for "wrongful approval of projects" under the measure "investments in wholesale markets". Criminal proceedings have been initiated against him.

The third problem relates to the findings of a recent audit by the Commission services, covering a total amount of €105 million still to be paid from SAPARD to beneficiaries (representing 63% of the remaining total amount to be disbursed under the programme). The audit revealed serious deficiencies regarding the control system for investment aid for three core Programme measures.

Next steps

The Commission has informed the National Authorizing Officer (hereafter NAO) of the results of the audit on the three investment measures and has asked for the implementation of an action plan. The NAO is asked to transmit this action plan together with a timetable for its implementation to the Commission by 31.07.2008.

Moreover the Commission has informed the Bulgarian authorities that future payment applications from the NAO to the Commission for any additional expenditure incurred under these three measures are suspended until Bulgaria corrects its system to the satisfaction of the Commission. The NAO should inform the Commission of necessary improvements in the system by September 2008. The Commission will consider resuming payments when information is received from the Bulgarian authorities that corrective action has been fully implemented and when this information is confirmed by an independent audit body. Payments by the NAO to final beneficiaries under the measures should only resume once the action plan is implemented.

2.1.3. ISPA - Cohesion Fund

While many Member States have experienced difficulties with the timely implementation of the Trans-European Network and environment infrastructure investments, Bulgaria is particularly slow. To date only 18% (€156 million of the available funding €879 million) has been absorbed for these projects, which were started under the ISPA pre-accession instrument but are now being finalised under the Cohesion Fund rules. In December 2007 the Commission asked the national authorities to present an Action Plan aimed at speeding up implementation of projects identified as problematic. This action plan was reviewed by both the responsible ministries and the Commission services, and specific causes of delay as well as necessary improvements were identified. These improvements must be made

rapidly in order to ensure the implementation of all projects before the final deadline for certification of expenditures (the end of 2010).

Problems

In January 2008, allegations were made in the Bulgarian press against the Executive Director of the National Road Infrastructure Fund (NRIF) concerning a conflict of interest related to the signing of contracts between the NRIF and a construction firm controlled by a family relative. In addition, two NRIF officials responsible for the implementation of EU funds were arrested and charged with taking bribes. On 24 January, the Commission sent a letter to the Ministry of Finance requesting the interruption of payments to the NRIF's three ongoing Cohesion Fund (ex-ISPA) projects and asking that the NRIF not sign any new contracts under the 2007-2013 programmes, until the matter was thoroughly investigated and any necessary corrective action taken. The Executive Director has subsequently been replaced.

Funding for the road sector (€144 million for ongoing Cohesion Fund (ex-ISPA) projects) has been interrupted and the preparation of a formal suspension is under way. The freeze on signing new contracts in the road sector (under the 2007-2013 programmes) remains in place.

Following investigations, the first audit reports submitted by the Ministry of Finance to the Commission services failed to reassure the Commission that the NRIF would be able to properly implement Cohesion Fund projects. The Commission recommended that an independent audit be carried out that would then also serve as a basis for a concrete and detailed action plan to improve the management and control systems in the NRIF. On 18 June 2008, the Commission services received an audit report prepared by an international audit company on behalf of the Bulgarian authorities, together with a detailed action plan based on the 'preliminary' findings of this audit company.

Next steps:

The recently appointed Deputy Prime Minister for EU Funds is aware of the problems and is working to strengthen the general coordination and implementation system for the Structural Funds in Bulgaria.

With a view to simplifying and reinforcing the implementation system, the Bulgarian authorities have recently decreased the number of Managing Authorities for ex-ISPA projects. This change will bring the National Road Infrastructure Fund under closer scrutiny and control of the Ministry of Transport.

One of the main conclusions of the external auditors' report is that further investigations are necessary, in particular as regards a number of possible conflict of interest cases. The Bulgarian authorities are currently in the process of organising investigations in this respect. In parallel, initial steps have been taken towards a more general overhaul of the NRIF's organisational structure. This should be seen as an essential first step in the detailed action plan referred to above.

The timely and effective implementation of the action plan will form a crucial element of the compliance assessment for the Regional Development and Transport Operational Programmes, where the NRIF is a Beneficiary. Deadlines for completion

of this assessment are between September and November 2008. Certification of expenditure for these Operational Programmes is dependent upon a positive compliance assessment opinion from the Compliance Assessment Body.

The implementation of the NRIF action plan will be reviewed by the Commission later this year. On the basis of this review, the Commission will decide whether the monitoring and control system and the administrative capacity of the Fund have been sufficiently strengthened and hence whether contracting and funding may resume.

2.2. Financial instruments in the initial start-up phase

A number of programmes are only in the initial phase of implementation. This means that only advance payments have been made at this stage, and that the Commission is in the process of examining whether the management and control systems put in place by Bulgaria to ensure the sound financial management of the funds concerned is sufficiently sound.

2.2.1. Regional and cohesion funds

The regional and cohesion funds for Bulgaria for the 2007-2013 period account for € 5667 million. Preparation and implementation of the new period for Structural Funds in Bulgaria started rather well. All programmes were submitted and approved on time and actual implementation of a number of Operational Programmes is progressing.

As foreseen in the legal base of Cohesion Policy, the Bulgarian Authorities are currently undertaking an overall compliance assessment of the entire Structural and Cohesion Funds management system. This exercise is carried out under the responsibility of the national Audit Authority, the strengthening of which remains a major concern to the Commission. In June 2008, a new director was appointed to the Audit Authority and a framework contract for using external auditors was signed. These two steps are much welcomed, but should be followed up by further actions, notably with a view to increasing significantly the in-house administrative capacity of this Authority.

2.2.2. European Social Fund

The European Social Fund co-finances two operational programmes in Bulgaria – the Human Resources Development Operational Programme and the Administrative Capacity Operational Programme. They amount to €1.185 billion. The two operational programmes were adopted in October 2007 and the first grant schemes and operations were launched in 2008. In accordance with the relevant financial regulation (Regulation 1083/2006) only the automatic advance payments (amounting to €59 million) have been made. A compliance assessment of the management and control systems of Bulgaria for the European Social Fund expenditure will be carried out by the Commission in the second half of 2008, on the basis of a submission by the Bulgarian authorities.

Next steps

The compliance assessment must provide assurance that the systems set up by Bulgaria are in accordance with the underlying relevant financial Regulation and can deliver sound financial management and efficient implementation of the Social Fund.

No reimbursement of project expenditure can be made to the Bulgarian authorities until this assessment has been agreed by the Commission. The Bulgarian authorities are expected to submit their documentation for assessment in the summer or early autumn this year.

2.2.3. *European Fisheries Fund.*

The European Commission approved the Operational Programme for the Bulgarian Fisheries sector for the period 2007-2013 in December 2007. The total eligible public expenditure of the programme amounts to €107 million, with EU assistance through the European Fisheries Fund (EFF) amounting to €80 million. The programme covers the entire territory of Bulgaria, all of which is designated as a convergence region.

So far only an advance payment has been made and the compliance assessment is expected by December 2008. The effective launch of the programme is foreseen for September 2008 with the first call for project proposals. The National Agency for Fisheries and Aquaculture (NAFA) is responsible for the implementation of the EFF Operational programme. It is currently reinforcing its administrative capacity dealing with the implementation of the Operational programme and the Common Fisheries Policy.

Next Steps

Similar to other structural fund programmes, reimbursement of project expenditure is subject to a satisfactory compliance assessment. In addition the EFF Regulations provide a number of possibilities to suspend, interrupt or make financial corrections to the Operational Programme appropriations in case of irregularities or systematic deficiencies in the management and control system. An integrated audit approach is being applied to the fisheries programme as well as the structural and agricultural programmes.

2.2.4. *Cash Flow and Schengen Facility*

Bulgaria is a beneficiary of the Cash Flow and Schengen Facility, with a total Community allocation of €239.5 million. In line with Article 32 of the Accession Act, which provides that at least 50% of the total amount must be assigned to actions at the external borders of the Union and the implementation of Schengen acquis, Bulgaria allocated €161 million (67%) for the Schengen part of the Facility.

Next steps

The Bulgarian authorities must ensure sound management and control for the Schengen part of the Facility, particularly with respect to the contracting and public procurement practices. It is not at all clear whether the Central Financing and Contracting Unit (CFCU), cited above, point 2.1.1., which is embroiled in difficulties relative to Phare funding will be able to provide the necessary assurances. Procedural safeguards must be put in place by the CFCU to guarantee that any potential or actual conflict of interests in the evaluation of tenders is avoided. In case of serious shortcomings in the management and control systems significant financial corrections and/or recoveries can be made at the time of the clearance of accounts.

2.2.5. *Funds under the General Programme "Solidarity and Management of Migration Flows"*

Bulgaria participates in the General Programme and has a combined allocation for 2007 of €1 million (for 2 of these funds) and for 2008 of €1.8 million (for 3 of the 4 Funds).

Next steps

The Bulgarian authorities designated to manage the funds under the General Programme "Solidarity and management of migration flows" must enhance their administrative capacity to prepare the programmes and operate the control systems. Absorption capacity must be improved both at the level of the awarding authorities as well as at the level of the beneficiaries.

2.3. Co-operation with OLAF

OLAF has conducted investigations into cases involving PHARE and SAPARD funding. OLAF's experience points to some fundamental weaknesses in Bulgarian administrative and judicial capacity.

There is a lack of commitment to act decisively, swiftly and in cooperation with other public authorities when fraud is identified. For example, the Bulgarian body involved with the payments under SAPARD, the State Fund Agriculture (SFA) has not been proactive in dealing with alleged irregularities, conflict of interest or fraud involving such Community funding. There have been serious deficiencies in the level of cooperation and co-ordination between the various bodies involved in dealing with these matters. In the SAPARD case, the Supreme Cassation Prosecution Office (SCPO) does not appear to have been in a position to forward evidence to the SFA in order to allow it to commence financial recovery procedures. On the other hand, when the SFA starts such recovery procedures, the matter is passed to the State Recovery Services within the Ministry of Finance. The SFA then seems to have no further role in the matter and the process stops. This means in practice that there is no focal point that assumes responsibility and ultimately no deterrent to continued bad practice.

The Bulgarian judicial authorities have a tendency to adopt an approach of breaking up a case into smaller components which precludes an effective investigation and judicial outcome. There are also instances of judicial proceedings which had been opened but, subsequently closed without justification, frustrating further investigation by OLAF.

In addition, OLAF has been faced with instances of breaches of confidentiality, improper transmission and leaks of confidential information. There is strong suspicion of the involvement of organized crime. The recently appointed Deputy Prime Minister is aware of the situation and has begun corrective action. A commitment has been made to prepare and adopt a law, facilitating the work of and assisting OLAF when it conducts on-the-spot controls under Reg. (EC) 2185/96. Finally, OLAF is working closely with the Bulgarian authorities to ensure that the lessons to be learned from the SAPARD fund cases are fully taken account of in both the judicial and control treatment of current and future cases.

3. CONCLUSION

EU funds earmarked for Bulgaria are the practical expression of the Union's solidarity with the citizens of Bulgaria. These funds are aimed at helping less favoured regions in Bulgaria, catalysing needed investment in transport, telecommunications and energy infrastructure, promoting competitiveness, fostering social cohesion and enhancing Bulgaria's overall economic performance and stability.

The efficient use of these funds requires that effective and reliable management and financial control structures are in place to foster sound implementation throughout the entire project cycle - from the feasibility assessment and project design to tendering and contracting until ex ante and ex-post control and evaluation.

Bulgaria is not able to reap the full benefits of this assistance because of critical weaknesses in administrative and judicial capacity, be it at local, regional or central level. The Bulgarian public administration suffers from a high turnover of staff, unattractive salaries which create opportunities for corruption, and outdated, centralized procedures. In particular hesitation to use enforcement powers to remedy irregularities and fraud by immediate recoveries or other protective measures and the de facto non-independence of the national audit authority and

implementing agencies give rise to serious concern. The lack of accountability and transparency in public procurement when tendering EU funds is a grave problem.

High level corruption and organised crime exacerbates these problems of general weakness in administrative and judicial capacity. As highlighted in all reports of the Commission on the Cooperation and Verification Mechanism including the one adopted alongside this Communication, continued commitment and results in the fight against corruption and organised crime is needed. It impacts directly on Bulgaria's administrative capacity and hence its ability to ensure the sound management and efficient delivery of EU funds. Bulgaria needs not only to enhance substantially its administrative capacity but also drastically curb opportunities for high level corruption and effectively fight organized crime.

Urgent action is needed because deadlines for contracting some of the funds are approaching, after which the funds will be lost to Bulgaria. Bulgaria needs to:

- Strengthen administrative capacity in the management of EU funds, by guaranteeing stability, training and technical expertise of staff. Appointments to management positions must avoid any potential conflicts of interest.
- Eliminate existing or potential networks of conflict of interest in the overall management of funds.
- Improve the supervision and transparency of public procurement procedures, at central, regional and local level in strict conformity with the applicable EU rules.
- Increase control of the legality and regularity of expenditure by conducting real and regular on the spot checks and audits on its own and across all funding programmes.
- Ensure that EU funding is protected and where necessary that recovery orders are applied without delay directly by the responsible implementing or supervisory bodies when irregularities or fraud are identified.
- Report without delay to the Commission on irregularities or fraud – whether confirmed or suspected. Clear definitions of irregularities and fraud and instructions on the procedures to be followed in reporting must be established.
- Implement measures to prevent breaches of confidentiality, and the improper transmission and leaks of confidential information in order to allow for a proper information exchange, not undermining the investigation and legal procedures.
- Take protective, corrective or disciplinary measures swiftly where necessary, and informing the Commission accordingly.
- Build on the initial steps taken in improving co-ordination between ministries, between the various stakeholders as well as between central, regional and local authorities.

Some first steps have been taken recently at national level to address these critical deficiencies in programme management and financial control. This movement is positive, in the right direction and needs to be sustained. The Commission is prepared to provide advice, assistance and support to Bulgaria to remedy these problems. It calls on Member States to also assist Bulgaria by continuing to provide independent high level expertise. As soon as Bulgaria has taken the necessary corrective measures to improve financial management and

tighten control systems, the Commission is prepared to reverse its decision to withdraw the accreditation of the two implementing agencies concerned, namely the Central Financing and Contracting Unit and the Implementing Agency at the Ministry of Regional Development and Public Work.