

EUROPEAN COMMISSION
DIRECTORATE-GENERAL
REGIONAL AND URBAN POLICY
Operational Efficiency and Central Europe
Hungary
Head of Unit

Brussels,
REGIO F.5/ES

Subject: ERDF project CCI No 2013 HU 161 PR 0025 "Infrastructure Development in the Szeged Health Pole"

- Final deadline for completion of major project application

Dear Mr Köpeczi-Bócz

On 31 October 2013, the Hungarian authorities submitted to the Commission a major project application, in which they envisage a contribution from the ERDF under the priority axis two of the Social Infrastructure Operational Programme: Health care infrastructure development.

The Commission, having regard to the opinion of the external experts, has appraised the major project in the light of the elements set out in Article 40 of Regulation (EC) No 1083/2006.

However the following information listed in Article 40 of Regulation (EC) no 1083/2006 required for the Commission to complete the appraisal of the major project is missing or is insufficient to enable the Commission to carry out its appraisal:

(a) Information on the nature of the investment and a description of it, its financial volume and location; the following elements are missing or should be complemented in the following way:

Result:

The Application Form in section B.5.3 states that the project facilitates the achievement of the following priority-level indicators:

1. Average age of high-value medical machines and instruments at the hospitals developed,
2. Standardized death rate of malignant neoplasma per 100,000 inhabitants.

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According to the opinion of the Commission, the contribution of the project to the second goal is, to a large extent, outside the project scope. Furthermore, the economic cost-benefit analysis incorporates this contribution through a projected lower mortality rate for tumorous conditions. Please justify the inclusion of this benefit in the economic analysis or exclude it from the calculation.

Budget

The total investment cost and eligible costs have been prepared in constant prices and at past exchange rate levels. Please revise the budget according to the last real costs available and the basis of the tendering price and the real exchange rates applied. Taking into account the state of implementation contingencies might be added to the total costs.

The cost breakdown in Section H.1 presents VAT as eligible costs. Footnote no. 4 on this page requests justification for these cases; however, the Application Form does not contain any information on this (is there VAT generated on output/revenues collected by the beneficiary that could compensate the VAT paid by the beneficiary on the costs?). Please provide justification for the statement.

State aid

Section G.1 of the Application Form indicates that no State aid is involved in the funding of this infrastructure. However, the information provided is not sufficient to exclude the economic character of the activity of the beneficiary. Therefore, it cannot be excluded that the project raises State aid issues.

Please provide confirmation as to whether the beneficiary will offer health services based almost entirely on the principle of solidarity, whether it will provide its services free of charge to affiliated persons on the basis of universal coverage and whether, in case it will conduct other commercial activities, it will keep separate accounts for these commercial activities.

For your reply, please refer to the Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest (OJ C 8, 11.1.2012, p. 4), as well as the Guide to the application of the European Union rules on state aid, public procurement and the internal market to services of general economic interest, and in particular to social services of general interest.

Implementation and procurement plan

The project time table is optimistic (AF D.1) as far as the procurement of different medical and IT equipment are concerned. With most of equipment imported, longer procurement periods of the furniture and equipment than the 3 (sometimes 4) months foreseen can be expected. This should be reflected in the overall project time table.

Technical issues

The application does not include detailed plan drawings of the different hospital blocks. Please include more detailed technical plans in order to be able to assess the layout, functionality and proximity of clinical services.

The application form contains unclear information about the institutional and organisational framework determining the implementation of the project (section B.4.1. a). Please include a more complete description of the project management.

(b) The results of the feasibility studies; the following elements are missing or should be complemented in the following way:

Option analysis

The Application Form presents several options which have been considered before choosing the current project. Although there are details concerning the previous/alternative options, there are no concrete data concerning their financial details (there are only statements “cost would have been far higher than the available budget”). Please provide information on the option analysis, as the comparison of costs and benefits of various options should ensure that the most advantageous option is chosen.

Demand analysis

The Commission is aware that the project should be rather seen in the context of its objectives and hence from the supply side of improving the quality of the health care services. However, at least for the operating revenue forecasts, some kind of forecast would have been warranted. Please conduct a demand analysis examining the future demand for the provided services.

Information concerning the grant decisions

The information in section D.2.3 of the Application Form is confusing. In some cases the details refer to the grant decision where the aid intensity is stipulated to be 90% (with 10% own contribution) while in the second half of the section refers to the general 85% co-financing rate of the Commission. Please clarify and better structure this section.

(c) Cost-benefit analysis, including a risk assessment and the foreseeable impact on the sector concerned; the following elements should be complemented:

General methodology

The methodology adopted for the carrying out of the cost-benefit analysis does not comply with the requirements of the CBA Guide of the Commission. Fundamental assumption of the CBA Guide is for the financial analysis to build on the project technical scope and the demand for project services and for the economic analysis to build on the financial analysis. The application fulfils neither of these assumptions. The financial analysis is entirely separated from project scope and results. The economic analysis is not based on the financial analysis.

Financial analysis

The BAU scenario assumes that without the project, investments of EUR 1.5 m will be needed every five years. Even though other components of the cash flow grow with inflation, this periodic investment does not. It is assumed that matching ad-hoc state financing would be available for them. This investment has no impact on the projected cash deficits shown. The BAU scenario shows yearly deficits of EUR 85,000 in 2010,

growing to approximately EUR 303,000 in estimated real terms by 2030. No residual value is assumed for the periodic investments.

The with-project scenario (PR) includes the project's investments. Yearly net revenues are EUR 162,000 in 2013 and grow in approximate real terms to EUR 300,000 by 2030. Residual values are computed for building investments using a linear depreciation rate of 2%/year, implying a 50 year useful life.

The only differences between the cash flows of the BAU and PR scenarios are increased Health Insurance Fund revenues and increased material costs. This suggests that the expectation is for the volume of treatment to increase slightly as a result of the project. Maintenance costs are unchanged. It is unclear how the operating cost savings expected from the reduction of the number of buildings, or the possible partial replacement cost of some of shorter-lived machines and instruments have been taken into account, if at all.

A major problem with the financial analysis is that the project performance indicators are not incrementally computed, that is, they do not result from the incremental cash flow that should have been derived by subtracting the BAU cash flow from the PR cash flow. Instead, calculations are based on comparing the investments made with the revenues of the with-project situation alone. This underestimates the net revenue attributable to the project by ignoring the foregone losses of the BAU scenario, which should be taken into account as revenues of the project. The effect of this error is underestimation of the financial performance indicators.

For these reasons, the financial analysis is not acceptable as it is and should be redone.

Economic analysis

The formulation of the calculations employed to compute the economic performance indicators is unclear, needlessly complex and to some extent distorting. Capital costs are expressed in real terms; operating costs and patient's duration of stay are subject to inflation, which results in adding incomparable values. Discounting is applied piecemeal at several places in the analysis, which is error prone and renders the resulting net flow unsuitable for the calculation of the project's IRR. The IRR reported on in the feasibility appears as a number in the relevant workbook, not as the result of calculation that could be checked.

The economic CBA of the application additionally includes a number of specific methodology problems on their own rendering the profitability misleading.

These problems have been identified in two main areas:

1. Fiscal adjustments and use of conversion factors when moving from financial CBA to economic CBA
2. The unit values applied to economic benefits – e.g. in the case of “Value of a Life Year”

Re 1): In the economic CBA, VAT is eliminated from investment and operating costs. In addition, according to the FS, ‘taxes and social contributions’ have been deducted from wages. However, the deduction is made from not only wage costs but also from all other staff related operating costs such as employer's contributions and travel to work costs. The wage cost element of investment costs has not been adjusted.

Re 2): The unit values applied for the economic benefits included in the CBA deviate from standard methodology. The 'Value of a Life Year' (VOLY) from reduced mortality is set at the full per capita GDP in the region. Usually, a formal valuation approach is applied in defining the VOLY resulting in rather lower values. Furthermore, the value of reduced mortality is calculated only to the age of 65. This implies that the VOLY effectively is nil beyond the age of 65. This also deviates from conventional methodology where certainly life beyond 65 has an economic value; the benefit calculation is to be based on the remaining life expectancy instead.

The project will entail important economic costs in the form of noise, dust, and increased transport flows during implementation. The application does not address these issues which should have been considered (see also section 3.8).

The CBA requires the economic analysis to incorporate financial flows in economic values from the financial analysis only and adding then externalities. As indicated above this is not the case for the application as the economic analysis includes several financial items (decrease in the average length of stay, avoided maintenance investments, operational cost savings), which are not included in the financial analysis.

In the light of the above, the Commission would like to ask you to redo the whole economic cost -benefit analysis.

Sensitivity and risk analysis

The sensitivity and risk analysis of the application is insufficient. The variables identified for the analysis are the rate of increase of operating revenues, the rate of price increase for medical supplies, the mortality rate for cardiovascular diseases and the mortality rate for tumorous conditions. The first variable is not even included in the CBA. The second is not a key one with costs of medical supplies accounting for a small share of total operating costs only (25%). The mortality rate for cardiovascular diseases is not a key variable as the number of avoided deaths is small.

Financing plan

Please provide an explanation for the annual programme commitment in order to understand the basis for this distribution (also to be in line with information provided in section B.4.1 and B.4.2)

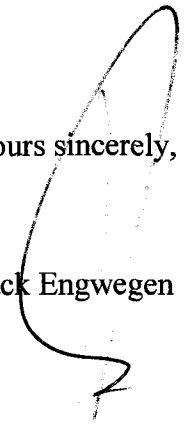
(d) The analysis of the environmental impact; the following elements are missing or should be complemented in the following way:

The project is located in the centre of an urban area, where levels of increased traffic with heavy machinery is expected during the construction. Although this additional traffic should have been addressed as a critical environmental issue, the screening decision does not provide any assessment of this. Additional information would be needed to clarify this shortcoming.

You are invited to submit the missing information or to withdraw the major project application within two months from the date of this letter. However, due to the seriousness of the shortcomings and the short time available to conduct a new financial and economic

analysis, the Commission would like to recommend to withdraw this application, and to re-submit it when all the elements of the application are fully completed.

In the absence of submission of the missing information or withdrawal of the major project application within the deadline indicated above, the Commission will adopt a refusal decision in accordance with Article 41(3), on the grounds that the major project was not submitted in accordance with Article 40.



Yours sincerely,

Jack Engwegen