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I

(Information)

COURT OF AUDITORS

ANNUAL REPORT CONCERNING THE ECSC

(for the financial year 1995)

(96/C 377/01)

Article 88 of the Financial Regulation of 21 December 1977, as last amended by Council Regulation (EC, Euratom, ECSC) No 2335/95 of 18 September 1995

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CHAPTER 1

OBSERVATIONS CONCERNING THE ECSC'S SOLVENCY AND THE CHANGES IN ITS PRINCIPAL ACTIVITIES

Introduction

1.1. This chapter is chiefly concerned with the ECSC's solvency at 31 December 1995 and the changes in its principal banking and budgetary activities during the year. The ECSC's solvency is of particular interest for the following reasons:

- apart from some marginal lending from the ECSC's own funds, ECSC loans are financed by bank borrowings and bond issues. It is therefore important that the ECSC should enjoy a first-class credit rating on the financial markets. That, in turn, requires an excellent solvency level;
- since most ECSC loans are back-to-back with the corresponding borrowings (in terms of rates, currency and maturity), the only banking risk to which it is exposed is the risk of non-recovery;
- the Treaty of Paris expires in 2002 and, in consequence, any changes in the necessary own funds must be monitored carefully, in order to safeguard the ECSC's solvency right up to the expiry of the Treaty and, beyond that date, to service the borrowings corresponding to loans which, in some cases, will not mature until 2019 (see paragraph 2.3).

ECSC solvency

Solvency ratio

1.2. During the 1986 discharge procedure, the European Parliament requested the Court of Auditors to provide, for each financial year, the information necessary for

calculating and assessing the reserve, net asset and liquidity ratios by means of the appropriate formulae ⁽¹⁾.

1.3. Since 1994 the Court, like the Commission, has used the solvency ratio specified in Council Directive 89/647/EEC ⁽²⁾ as the main instrument by which to assess ECSC solvency. The denominator of this ratio comprises asset and off-balance-sheet items weighted in accordance with the Directive. On the other hand, the items which the Commission includes in the ratio numerator are the Guarantee Fund, the surplus not allocated and the non-specific value adjustment, thus excluding certain other items which might be considered to form part of the ECSC's own funds (see paragraph 1.22). The definition of own funds followed in calculating the solvency ratio is the result of an interpretation of the Directive which gives a sufficiently prudent valuation.

1.4. At 31 December 1995, the ECSC's solvency ratio was 15,99 %, compared with 14,95 % at 31 December 1994. The increase is due to a reduction in the value of the denominator in line with the decline of lending activity. Lending should continue to decline in the future, until the ECSC Treaty expires. Part of the Guarantee Fund (9 million ECU) and the whole of the non-specific value adjustment (22 million ECU) (see paragraph 1.8) have been included in the numerator and the ratio has thus been kept within the range (14 % to 16 %) recommended by the firm of experts which produced a report on the subject in July 1992, at the Commission's request. The recommended range is a prudent one and was fixed in the light of a comparison between the structure of the ECSC's balance sheet and that of comparable institutions. The special nature of the ECSC's activity was also taken into account.

⁽¹⁾ OJ No C 122, 9. 5. 1988, p.66

⁽²⁾ Council Directive of 18 December 1989 on a solvency ratio for credit institutions (89/647/EEC), OJ No L 386, 30. 12. 1989, p.14.

Spread of risk

1.5. The level of the solvency ratio is not the only indicator of a financial establishment's solvency. This is especially true of the ECSC in its current situation. Given that the Treaty of Paris will expire in 2002, the ECSC can no longer be considered on a going-concern basis. Its loan portfolio will shrink and become concentrated on a diminishing number of debtors, so that the risks will be less widely spread. A default on the part of any borrower would thus make considerable inroads into the ECSC's own funds, if the latter decline in equal proportion to the volume of lending. This type of risk, which is due to the concentration of liabilities vis-à-vis third parties, was the subject of a Council Directive on the monitoring and control of large exposures of credit institutions⁽³⁾.

1.6. In paragraph 1.5 of its Annual report concerning the ECSC for the financial year 1994⁽⁴⁾, the Court referred to the two limits provided for in the Directive and found that the ECSC had exceeded both. The limits apply to the volume of the ECSC's exposure to any one client (client or group of clients):

- the total exposure to any third party must not exceed 25 % of the ECSC's own funds;
- the total volume of 'large exposures' must not exceed 800 % of the said own funds. The exposure is deemed to be 'large' if the total exposure to any third party is 10 % or more of own funds.

In its reply, the Commission stated that it was, in fact, aware of the problem of large exposures and would take a new approach if necessary, depending on the results of a study that was being carried out by private consultants.

1.7. The study has been completed and the new approach that was finally adopted was to establish a provision for large exposures. The amount in question, 55 million ECU at 31 December 1995, was calculated as a function of the level of over-exposure, in accordance with Annex VI of Council Directive 93/6/EEC⁽⁵⁾.

⁽³⁾ Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions, OJ No L 29, 5. 2. 1993, p.1.

⁽⁴⁾ Annual report concerning the ECSC (financial year 1994), OJ No C 329, 7. 12. 1995.

⁽⁵⁾ Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, OJ No L 141, 11. 6. 1993, p.1.

Although the Directive does not really apply to the ECSC situation, this approach is an option which results in a sufficiently prudent policy concerning the exposures yielded by past transactions.

Non-specific value adjustment

1.8. The Commission reintroduced the non-specific value adjustment in 1993, with a provision of 50 million ECU. This provision was subsequently reduced to 22 million ECU at 31 December 1994 and cancelled completely in 1995. The provision was intended to cover the risk of non-recovery of debts that are not covered by first-class guarantees. These debts were analysed individually, case by case, for the risk of default and an appropriate specific value adjustment constituted where the result was positive. Where that was not the case, no value adjustment was necessary. The withdrawal of the non-specific value adjustment also makes it possible to keep the solvency ratio within the recommended range (paragraph 1.4). The improvement in the debt-risk analysis, the establishment of the provision for large exposures and the fact that the solvency ratio continues to remain within the recommended range justify the abolition of the non-specific value adjustment.

Specific value adjustments

1.9. There was a substantial increase in the balance-sheet amount for the specific value adjustment in respect of loans and advances — from 60 million ECU at 31 December 1994 to 155 million ECU at 31 December 1995⁽⁶⁾. The 160 % increase is almost entirely attributable to the situation of one debtor to whom the ECSC granted five loans (in 1992, 1993 and 1994) to a total of some 230 million ECU. As the file on this debtor stands at present, the value adjustment shown in the accounts seems adequate.

1.10. The Commission department responsible analysed the financial situations of the other high-risk debtors, that is to say, those whose debts to the ECSC are not backed by first-class guarantees. The results of that analysis did not indicate any need for further value adjustments.

⁽⁶⁾ See ECSC financial statements at 31 December 1995: specific value adjustments on loans (91 million ECU, note 5.1) + specific value adjustment for loans and payments due and not received (51 million ECU, note 8) + value adjustments for interest accrued and not received (13 million ECU, note 19)

1.11. The ECSC established large value adjustments in the 1992 year ⁽⁷⁾ in view of the position of two debtors in particular. The changes in their situations have not resulted in any further value adjustments. In the first case the ECSC finally abandoned 40 % of its claim under an agreed settlement. Since then the undertaking in question has become part of another group and undergone capital restructuring. It achieved equilibrium in 1994 and is expected to return to profits in 1995. Any value adjustment therefore appears to be unnecessary. In the second case the loan was covered in full by provisions, the interest was paid and there was a partial redemption of the loan in 1995. Nevertheless the company's situation is still precarious (bankruptcy proceedings were started in

1993) and thus justifies the retention of a value adjustment for 100 % of the outstanding loan.

Changes in the application of ECSC funds and resources

1.12. In 1995 the ECSC balanced its operating expenditure and its revenue for the year (see *Table 1*). The calls on the reserves and the available provision for financing the ECSC operating budget which were characteristic of 1992, 1993 and 1994, have returned to the earlier low level. This change was primarily due to a substantial reduction in operating expenditure.

Table 1 — Changes in application of funds and resources 1991 to 1995

(million ECU)

Headings	1991	1992	1993	1994	1995	Change
				a	b	b - a
A — Application						
Administrative expenditure	5,0	5,0	5,0	5,0	5,0	—
Net commitments ⁽¹⁾	422,1	401,4	437,2	323,1	207,2	- 115,9
Other	—	85,9	7,1	32,5	—	- 32,5
Total applications (A)	427,1	492,3	449,3	360,6	212,2	- 148,4
B — Resources of the year						
Result of non-budgetary operations	254,7	131,5	201,3	112,3	90,8	- 21,7
Levy	175,0	146,5	121,3	107,7	102,3	- 5,4
Other budget res. (fines, rebates, etc.)	—	—	—	4,8	11,6	6,8
Exceptional resources	—	—	—	91,9	—	- 91,9
Total resources of the year (B)	429,7	278,0	322,6	316,9	204,7	- 112,2
(B)-(A)	2,6	- 214,3	- 126,7	- 43,7	- 7,5	36,2
Use of the provision for financing the operating budget	- 1,4	163,2	105,9	43,3	0,3	- 43,0
Use of reserves	—	53,0	22,0	2,0	9,0	7,0
Surplus for the financial year	1,2	1,9	1,2	1,6	1,8	0,2

⁽¹⁾ Net commitments corresponding to the new legal commitments less the year's cancellations.
Source: ECSC financial statements for the year in question.

⁽⁷⁾ Report by the Court of Auditors on the accounting and financial management of the ECSC for the financial year 1992, paragraphs 1.20 — 1.22.

Changes in the application of funds

1.13. In the environment of diminishing resources that is associated with the expiry process, the level of budgetary expenditure also had to be reduced considerably. However, the extent to which the different aid categories

were affected varied (see *Table 2*). The instrument which decreased most in relative terms was the aid granted in the form of interest subsidies. The corresponding commitments dropped by 78 %, from 51,5 million ECU in 1994 to 11,4 million ECU in 1995, even though the allocation for 1995 was 33 million ECU.

Table 2 — Changes in the principal expenditure items of the ECSC operating budget (legal commitments for each year) and cancellations 1993 to 1995

Instruments	1993		1994		1995	
	million ECU	%	million ECU	%	million ECU	%
Redeployment aid						
— traditional	182,4		157,0		123,8	
— social measures steel industry	60,0		86,0		41,3	
— social measures coal industry	50,0		40,0		40,0	
Total redeployment	292,4	55	283,0	74	205,1	74
Research	124,6	23	51,9	13	61,4	22
Interest subsidies (Article 56)	114,2	22	51,5	13	11,4	4
Total commitments	531,2	100	386,4	100	277,9	100
Total cancellations	- 94,0		- 63,3		- 70,7	
Net commitments	437,2		323,1		207,2	

Source: ECSC financial statements at 31 December 1993, 1994 and 1995, note 15.

1.14. Social aid for the redeployment of workers fell by 77,9 million ECU overall (27,5 %) in 1995 and, with the exception of the social measures for the coal industry, the legal commitments entered into in 1995 were 13 % less than the commitments provided by the budget. It was possible to meet all the applications qualifying for traditional aid without any need to apply a linear reduction⁽⁸⁾. One of the factors which made this possible was the ECSC's suspension of funding for vocational training programmes and employment aid as of 1 January 1995⁽⁹⁾. The social measures for the steel industry were introduced for a period of three years, 1995 being the final year.

1.15. At 61,4 million ECU, the research aid commitments in 1995 were almost in line with the

estimates contained in the amending budget for 1995 (63 million ECU), which produced an upward revision of the initial allocation (52 million ECU)⁽¹⁰⁾. This level of 61,4 million ECU is significantly lower than the equivalent figures for 1992 and 1993. The resumption of ECSC research activity under the EC's fourth research and development framework programme has proved to be only partial⁽¹¹⁾.

Changes in resources

1.16. Although levy revenue was slightly down on 1994, it became the principal source of revenue for the year in

⁽⁸⁾ Annual report on the ECSC concerning the financial year 1994, paragraph 3.10, OJ No C 329, 7. 12. 1995.

⁽⁹⁾ OJ C No 178, 30.6.1994, p.21.

⁽¹⁰⁾ Amending ECSC operating budget for 1995, OJ No C 302, 14. 11. 1995, p.3.

⁽¹¹⁾ Draft ECSC operating budget for 1997, SEC (96) 981 final, 13.6.1996, p. 8.

1995. The decline was slowed by the appearance of new contributions following the accession of Austria, Finland and Sweden to the European Union. The levy rate has been declining steadily, by around 0,02 % per year, since 1991. The rate was thus set at 0,21 % for 1995. It is expected to continue to decline at the same rate until 1997 and will be set at 0,11 % in 1998 and at 0 % in 1999 ⁽¹²⁾.

1.17. The figure for non-budgetary transactions was also lower than in 1994. This result mainly depends on revenue generated by cash and near-cash transactions (interest and profits on bonds) and changes in provisions and value adjustments. It should perhaps be remembered that there is no margin on the ECSC's loans against borrowed funds. The four principal elements that made up this figure in 1995 deserve to be emphasised.

1.18. The value adjustment of almost 70 million ECU included for securities in the 1994 accounts was almost all withdrawn in 1995. The recovery in the markets for bonds and other fixed-interest securities was due to falling interest rates.

1.19. There were two significant changes in the value adjustments on loans. Firstly, the specific value adjustments increased by 95 million ECU (see paragraph 1.9). Secondly, the non-specific value adjustment was

withdrawn in full to an amount of 22 million ECU (see paragraph 1.8).

1.20. Finally, a provision for large exposures was established in 1995 with an amount of 55 million ECU (see paragraph 1.7).

Changes in own funds

1.21. Following the changes in the resources and application of funds described above, only 9,3 million ECU of the reserves and the provision for financing the ECSC operating budget were used in 1995, compared with 45,3 million ECU in 1994 (*Table 1*). The main call was on the Guarantee Fund (9 million ECU). The year's changes in the non-specific value adjustment and the provision for large exposures are not taken into account at this stage, as they are already included in the result for non-budgetary operations.

1.22. The reserves and the provision for financing the operating budget represent only a fraction of the ECSC's own funds, which increased by 69,6 million ECU overall (*Tables 3 and 4*). In order to understand this development it is necessary to take account of the new Member States' contributions, totalling 44,1 million ECU, 50 % of which was divided between the Guarantee Fund, the special reserve and the former pension fund in 1995. The remainder will not be called until 1996.

Table 3 — Operations against the provisions for financing the ECSC operating budget in 1995

<i>(million ECU)</i>					
Heading	Balance at 31. 12. 1994	Utilization	Allocation	Net change	Balance at 31. 12. 1995
1. Available provision for financing the ECSC operating budget	70,9	- 42,9	42,6	- 0,3	70,6
2. Provision for fines and surcharges to be paid subsequently and interest subsidies for collection ⁽¹⁾	72,5	—	1,6	1,6	74,1
Total	143,4	- 42,9	44,2	1,3	144,7

⁽¹⁾ Fines, surcharges to be paid and interest subsidies for collection are considered as ECSC resources only when they have actually been paid. Pending payment, the equivalent of these claims is transferred to provisions. The corresponding 74,1 million ECU is, therefore, not yet available as finance for the operating budget.

Source: ECSC financial statements at 31 December 1995, note 16.

⁽¹²⁾ Commission working document updating the communication to the Council on the future of the ECSC Treaty — financial activities, SEC(93) 1596 final, 20. 12. 1993.

Table 4 — Changes in ECSC own funds

Item (after allocation of surplus)	(million ECU)			
	31. 12. 1994	Allocation	Withdrawal	31. 12. 1995
Uncalled contributions from new Member States	—	22,1	—	22,1
Guarantee Fund ⁽¹⁾	429,9	14,4	- 9,0	435,3
Special reserve	165,0	5,5	—	170,5
Former pension fund	62,0	3,8	—	65,8
Surplus brought forward ⁽¹⁾	—	0,1	—	0,1
Non-specific value adjustment ⁽¹⁾	22,0	—	- 22,0	—
Provision for large exposures	—	55,0	—	55,0
Available provision for financing the operating budget	70,9	—	- 0,3	70,6
Total	749,8	100,9	- 31,3	819,4

⁽¹⁾ Own funds used by the Commission in the numerator of the solvency ratio.

Source: ECSC financial statements at 31 December 1995.

Changes in the ECSC balance sheet

1.23. The ECSC balance sheet total declined by 8,8 % between 31 December 1994 and 31 December 1995 (Table 5). The fall of 772 million ECU was mainly due to the reduced lending and borrowing activities, which were

down by 834 million ECU and 606 million ECU respectively. The volume of lending continues to be above the level of borrowing, due to the loans from own funds. Liquid assets, on the other hand, increased by 85 million ECU, chiefly as a result of the increase in the main corresponding items on the liabilities side (Table 6).

Table 5 — Changes in the ECSC summary balance sheet, before allocation of surplus, from 31 December 1994 to 31 December 1995

	31. 12. 1994		31. 12. 1995	
	million ECU	%	million ECU	%
Assets				
Loans (to banks and undertakings)	7 008	73,9	6 174	70,8
Liquid assets (bank balances and bonds)	2 081	21,9	2 166	24,9
ECSC operating budget (levies, fines and interest subsidies for collection)	81	0,9	76	0,9
Tangible and intangible assets	11	0,1	5	0,1
Other assets	14	0,1	30	0,3
Prepayments and accrued income	290	3,1	262	3,0
Total assets	9 485	100,0	8 713	100,0
Liabilities				
Amounts owed (including bond issues)	6 571	69,2	5 965	68,4
Other liabilities	470	5,0	350	4,0
Accruals and deferred income	236	2,5	208	2,4
Provision for liabilities and charges	42	0,4	41	0,5
Provision for large exposures	0	0,0	55	0,6
Operating budget (commitments and provisions)	1 504	15,9	1 400	16,1
Reserves and surplus	657	6,9	694	8,0
Value adjustment reserve	5	0,1	0	0,0
Total liabilities	9 485	100,0	8 713	100,0

Source: ECSC financial statements at 31 December 1995.

Table 6 — Changes in ECSC liquid assets and principal balancing items, 31 December 1994 to 31 December 1995

Balance-sheet item	(million ECU)	
	31. 12. 1994	31. 12. 1995
Liquid assets		
Balances with central banks	1,6	1,4
Loans and advances to credit institutions		
— repayable on demand	21,0	16,4
— with agreed maturity dates or periods of notice	434,2	457,0
— bonds	1 623,6	1 691,3
Total liquid assets	2 080,4	2 166,1
Principal balancing items		
Guarantee fund	429,9	435,3
Provision for financing the operating budget	143,4	144,8
(Multiannual) commitments for the operating budget	1 360,5	1 255,3
Specific value adjustment for loans and advances	60,0	155,0
Provision for large exposures	—	55,0
Total principal balancing items	1 993,8	2 045,4

Source: ECSC financial statements at 31 December 1995.

Closure timetable

1.24. In its Annual report on the ECSC for the financial year 1994, the Court drew attention to the problem of final accounts which are submitted late and thus make it difficult for the Court to complete its work within the deadlines imposed by Community legislation⁽¹³⁾. The Commission replied that the late submission of the accounts was due to an exceptional combination of circumstances and that it had taken the necessary steps to ensure that this would not occur in future. Regarding the Court's audit concerning the financial year 1995, the closure timetable for the Commission's accounts and the fact that the final version received by the Court on 20 June 1996 was identical to the provisional version sent on 20 April 1996 meant that the Court was able to carry out its audit work under better conditions than last year.

Conclusion

1.25. The ECSC'S solvency at 31 December 1995 was still adequate. Its own funds continue to be essential for the maintenance of its solvency and for that reason calls on them must be modest, unless they are replaced by another guarantee. On the other hand, the Commission is prudent in taking account of exposures, be they large exposures or the specific risks associated with claims that are not backed by first-class guarantees.

1.26. In 1995 the ECSC reported a significant decline in its activities. At the same time, it restored the balance between its revenue and expenditure for the year (*Table 1*), so that this year there were only minor calls on the reserves and the provision for financing the operating budget.

CHAPTER 2

OBSERVATIONS ON LENDING ACTIVITY

Introduction

2.1. The Court's most recent observations concerning the ECSC's lending operations were published in Chapter 2 of the Court's Annual report on the ECSC for the financial year 1993⁽¹⁴⁾ (hereinafter referred to as 'the 1993 report').

2.2. The three main categories of loan granted by the ECSC from borrowed funds are:

- loans to finance investment in the coal and steel sectors, as provided in the first paragraph of Article 54 of the ECSC Treaty;

⁽¹³⁾ OJ No C 329, 7. 12. 1995, paragraph 1.18.

⁽¹⁴⁾ Annual report on the ECSC (financial year 1993), OJ No C 346, 7. 12. 1994.

- loans to finance investment which encourages consumption of Community coal and steel, as provided in the second paragraph of Article 54 of the ECSC Treaty;
- so-called 'conversion' loans for investment which creates jobs in ECSC regions, as provided in Article 56 (2) (a) of the ECSC Treaty.

The Court described these three categories in its 1993 report. They have been joined by a fourth type of loan against borrowed funds, which is based on Article 95 of the ECSC Treaty. These loans are to finance investment in the coal and steel sectors in the countries of central and eastern Europe. As part of total funding of 200 million ECU, a first loan of 42,3 million ECU was disbursed in 1995 to a Polish steel works, for production modernization.

2.3. In view of the expiry of the Treaty of Paris the Commission decided, in 1994, to adjust the terms of its policy on ECSC loans and borrowings⁽¹⁵⁾ in the direction of a reduction of lending activity and the gradual freeing-up of its reserves. It stated, in particular, that the maturity of ECSC loans decided on after 1 July 1994 would not extend beyond 23 July 2002 (the expiry date of the ECSC Treaty). An exception could be made in the case of loans which do not tie up reserves, namely those that are backed by a government guarantee. The adjustment continued in 1995. Nevertheless, there are already some existing loans which tie up reserves and mature after the date on which the ECSC Treaty expires (see Table 7). Furthermore, because the interest subsidies on loans granted under Article 56 (2) (a) of the ECSC Treaty are spread over five years (see paragraphs 2.12 — 2.25), the Commission will not grant any loans of this type after July 1997, so that although payments will continue to be made until 2002, they will not continue beyond that date.

Table 7 — Changes in the balance of loans made against borrowed funds which tie up reserves
(rate for 31 December 1995)

Year	(million ECU)							
	2002	2003	2007	2008	2011	2016	2018	2019
Amount outst. at 31. 12. (gross)	708	454	445	369	279	232	114	0
Of which: amount which ties up reserves	632	378	369	369	279	232	114	0

Source: figures obtained from the Commission (DG XVIII).

2.4. Lending against ECSC borrowed funds has declined significantly over the last three years, falling from 1 473,5

million ECU in 1992 to 388,5 million ECU in 1995. (Table 8).

⁽¹⁵⁾ Adjustment of borrowing and lending policy with a view to the expiry of the ECSC Treaty, OJ No C 175, 28. 6. 1994.

Table 8 — Loans disbursed by the ECSC under Articles 54, 56 and 95 1989-1995

Year	Article 54		Art. 56	Art. 95	Total
	Art. 54.1	Art. 54.2			
1989	195,7	30,0	458,0	—	683,7
1990	243,1	155,2	585,0	—	983,3
1991	438,7	66,3	859,0	—	1 364,0
1992	215,2	831,8	426,2	—	1 473,2
1993	7,6	209,7	688,1	—	905,4
1994	108,9	347,0 ⁽¹⁾	208,8	—	664,7
1995	60,4	25,7	260,1	42,3	388,5

(¹) The 347 million ECU includes two bridging loans totalling 122,7 million ECU without which the amount of loans disbursed under Art. 54, second paragraph, in 1994 would be only 224,3 million ECU.

Fonte: Figures obtained from the Commission (DG XVIII).

Loans under the first paragraph of Article 54

2.5. The Commission has finally recovered the interest subsidies that were unduly paid in Bagnoli. The problem was first mentioned in the report entitled 'Supplementary information to the Court's annual report on the financial statements of the ECSC for the financial year 1991' and was last raised in paragraph 1.17 of the Court's report on the ECSC for the 1994 financial year.

2.6. In paragraph 2.36 of the 1993 report, the Court noted that two British mines which had received ECSC finance in the form of subsidized loans ceased production two years after the investment was made. One of the two mines mentioned in the 1993 report finally reopened in May 1994, following its transfer to a private producer. Since then the Court has established that another mine has been closed, after receiving interest subsidies of 0,3 million ECU. The number of pits that have closed after receiving ECSC aid therefore remains at two.

2.7. The Commission maintains that it cannot recover the interest subsidies paid to these mines, because the loan contracts did not provide for that eventuality. In the resolution accompanying the decision granting discharge for the management of the ECSC for 1994⁽¹⁶⁾, the European Parliament considered it highly deplorable that the Member State in question could not be forced to repay the funds that had been wasted in this way and requested the Commission to point this out to the

government concerned. Be that as it may, the Court notes that this situation will not recur in future with this type of loan, given that the granting of subsidized loans under Article 54 (1) of the ECSC treaty has ceased in the coal sector.

Loans under the second paragraph of Article 54

2.8. The volume of loans granted under the second paragraph of Article 54 of the ECSC Treaty in 1995 was markedly lower relative to the high level of the three previous years, and 1992 in particular. The previous high level of lending was attributable to a small number of very large loans, which were used to fund large-scale infrastructure projects with European interest, as provided in the relevant Commission decision⁽¹⁷⁾. For example, more than 1 000 million ECU has been lent since 1990 for projects such as the Channel tunnel, the TGV rail routes in France and the Great Belt rail and bridge link in Denmark. These are projects which would have been carried out even if there had been no ECSC intervention and, because of technical and geographical constraints, the amount of Community steel used would have been just as high. In the case of the high-speed rail routes the choice of a European producer was essential, because of the nature of the technical specifications and the need for intensive, ongoing contact between the steel manufacturers and the construction companies. In the case of the Great Belt, there was a call for tenders and the contract went to a European company. And in the

⁽¹⁶⁾ OJ No C 141, 13. 5. 1996, p. 125.

⁽¹⁷⁾ Commission notice setting out working principles governing the award of loans under Article 53, second paragraph, of the ECSC Treaty for investment aimed at promoting the consumption of Community steel, OJ No C 291, 31. 10. 1987, p.3).

case of the finance for the Channel tunnel, the ECSC became involved at a later stage, when the technical aspects of the project had already been defined. The ECSC loans thus did not lead to any increase in Community steel consumption.

2.9. The Commission granted three loans in 1992, followed by a fourth in 1994, for a total amount of 463,8 million USD (353 million ECU at the rate for 31 December 1995), for the construction of the Great Belt bridge and tunnel in Denmark. There is no interest subsidy on the loans, which are guaranteed by the Government. The amount of the loans was calculated in terms of the estimated consumption of Community steel for the project in question. The Court found, however, that although the volume of steel actually used by the end of the project will undoubtedly be slightly higher than the initial forecasts, the price estimate for the steel was considerably over-estimated, in that it has proved to be three times higher than the real price, due to the inclusion of non-qualifying elements such as treatment, transport and assembly costs. It is difficult to accept that such an error was not detected by checks carried out by the Commission departments responsible. Without this error the total possible ECSC lending would have been limited to approximately 170 million ECU, under the rule of the lower of the value of the steel used or 20 % of the project cost. Early repayment of the non-qualifying part must be called for.

2.10. The ECSC disbursed five loans (two in 1992, one in 1993 and two in 1994) to a total of 197 million UKL (233 million ECU at the rate for 31 December 1995) as finance for the Channel tunnel. These loans, which have already necessitated a substantial value adjustment (see paragraph 1.9), although they were in line with the legislation, were granted on the basis of considerations other than the specific interests of the ECSC.

2.11. In 1995 the Court also audited a project which had received a loan, with interest subsidies, under the second paragraph of Article 54. The contract was for a term of five years and provided for an interest subsidy to be paid in ten six-monthly instalments of 187 542 ECU on 28 May and 28 November. The fourth instalment was due on 28 May 1994, but was paid at the beginning of March 1994, two and a half months before the due date, for reasons which the Commission is invited to explain in its reply. Had the Commission waited for the correct date before making payment, there would have been no need for it to do so, because in the intervening period it was informed by the parent company of the latter's intention of disposing of the beneficiary company. The contract was rescinded and the interest subsidy cancelled. The subsidy payment was thus paid unduly and must be recovered.

Subsidized loans (Article 56 (2) (a))

2.12. In its 1993⁽¹⁸⁾ report, the Court drew attention to a number of inherent weaknesses in this instrument and the related management systems.

2.13. Interest subsidies are awarded as a function of the number of jobs created in a three-year period and maintained for a further two years⁽¹⁹⁾. If, at the end of the five years, the forecast number of jobs have not been created or maintained, the subsidy on the missing jobs is deemed to have been inapplicable for the whole of that period and the amounts already paid are recovered from the beneficiary. The non-performance penalty thus applies retroactively.

Audit of job creation

2.14. The responsible Commission departments use the progress reports prepared by beneficiaries and forwarded by banking intermediaries to determine whether these conditions have been complied with. As there were around 8 000 files with outstanding balances in 1995, it was impossible for the departments in question to provide an adequate level of on-the-spot checks. They were, therefore, obliged to rely to a very large extent on the progress reports. However, such reports are produced by the beneficiaries, who have no desire to lose the subsidies already received, and are forwarded by the banking intermediaries, who have no desire to upset their customer relations. The compliance risk on these reports is, therefore, high.

2.15. The Court pointed out these risks that are intrinsic to the control machinery in paragraph 2.46 of its 1993 report and the Commission, in its reply, announced its intention of alerting the banks to their responsibilities on this point. Audit visits to France and the United Kingdom by the Court at the end of 1995 and the beginning of 1996 revealed a considerable percentage of non-qualifying interest subsidies relative to the volume of funds audited. In principle, none of the files selected for audit were associated with any particular risk.

2.16. The audits in France concerned four financial intermediaries, 14 beneficiary undertakings and 1 951 170 ECU of interest subsidies granted. Following the audits by the Court it was necessary to reduce the ECSC aid by 273 605 ECU, or 14 % of the total audited. The files that contained non-qualifying interest subsidies

⁽¹⁸⁾ OJ No C 346, 7. 12. 1994, pp. 11 and 12.

⁽¹⁹⁾ Procedures for the coordination of ECSC conversion loans with Structural Fund programmes (OJ No C 59, 6. 3. 1992, p. 4).

concerned the four financial intermediaries and nine beneficiaries.

2.17. In the United Kingdom the audits concerned two financial intermediaries and 15 beneficiary undertakings, for a total of 810 080 ECU of interest subsidies granted. This time the downward adjustment was 287 610 ECU, or 35,5 % of the total audited, as non-qualifying expenditure was found in the case of 12 beneficiaries. In the course of these visits, the Court's auditors encountered many progress reports in which the number of jobs declared as having been created was not matched by the reality.

2.18. Although these results confirm the weaknesses in the systems, as the Court has pointed out already, the percentages mentioned cannot be taken to be representative of interest subsidies as a whole, because the number of files audited is too small in relative terms.

2.19. In order to avoid such problems and, more specifically, to remedy the inherent weaknesses described in paragraphs 2.11 to 2.13, beneficiary undertakings must be asked to include supporting documents with their progress reports, as corroboration for the numbers of workers employed at key dates. Depending on the Member State, these documents could be official forms initially intended for the tax or social security authorities and, as such, subject to checks by the national departments. An alternative possibility would be for the numbers to be certified by the auditors of the companies in question.

2.20. In addition, it would be better to delay payment until the necessary conditions have been met and the requisite checks carried out. In some cases the procedural instructions actually specify that the beneficiary's final report is to be submitted two months after the final Commission payment. Consequently, if there are problems, the Commission has to take steps to recover part of the amount paid, whereas the simpler alternative would be to avoid over-payment.

Audit of banking terms and conditions

2.21. In the course of one audit visit the Court found that one of the financial intermediaries concerned had not paid the ECSC loans to the final beneficiaries in full but, in certain cases, had retained 4 % of the nominal amount in order to create a guarantee Fund. In fact, though, the risk of default on the part of the beneficiary was already covered by the bank's margin, which was

equal to a maximum of 1 % a year. As a general rule, the Commission should reduce the risk of this type of irregularity by introducing a procedure which requires confirmation to be obtained from final beneficiaries.

Evaluation of the effectiveness of the instrument

2.22. The audits carried out by the Court since the publication of its 1993 report confirmed the opinion expressed in paragraph 2.54 of that report, namely, that the instrument is not efficient, particularly in terms of the initial objective of promoting the creation of jobs for jobless workers who were formerly employed in the coal and steel sectors. On-the-spot audits showed that the jobs created in the context of this instrument almost never benefit former ECSC workers.

2.23. Moreover, it is doubtful whether the amount of subsidy per job (2 000 ECU) acts as an incentive to job-creation. In practice the ECSC subsidized loan is an item that is included in a finance plan (normally on the initiative of the banking intermediary) at a stage where the decision on an investment project which involves job creation has already been taken. The subsidy is, therefore, following the jobs created, instead of the converse.

2.24. There were also found to be several cases where the beneficiaries were capable of financing the investments from their own funds, but were nevertheless awarded an ECSC subsidized loan on the grounds of the job creation forecast.

2.25. From the point of view of procedures and the possibility of this type of instrument being reproduced in another framework in future, the operation of the system of ECSC subsidized conversion loans gives rise to two comments in particular. Firstly, the amount of subsidy depends on the number of jobs created and maintained. The Commission therefore recalculates the amount in cases where the final number of jobs is below forecast, which may entail full or partial recovery of the aid paid. The retroactive nature of this penalty is felt to be unfair in cases where jobs have, in fact, been created, but have not been maintained for a sufficient length of time. These subsidies should be directly linked to specific conditions which then become inoperative once they have been satisfied. Secondly, under-achievement is sometimes due to the poor economic climate and is independent of the undertaking's own policies. In this case an undertaking which is already in a bad situation financially is also required to reimburse the Commission — an experience which it sees as compounding its difficulties. As the Court remarked in its 1993 report, this seems to be somewhat counter-productive in terms of the initial objectives. Abolition of the retrospective aspect of the

penalty for non-performance would already mitigate the effects considerably. A further possibility would be to introduce an element of flexibility into the criteria, especially as regards the choice of the key times in the overall period.

Conclusion

2.26. During recent audits the Court has seen the consequences of the increase in ECSC lending activity that was recorded in the early 1990s. They included serious financial repercussions which then necessitated substantial value adjustments (paragraph 2.10), and one excessive payment of more than twice the ceiling set by the regulations (paragraph 2.9). Furthermore the major infrastructure works to which the ECSC lent more than 1 000 million ECU under the second paragraph of Article 54 would have been carried out without ECSC assistance and would have used just as much Community steel.

2.27. In the case of the conversion loans, the intrinsic risks deriving from the system, which the Court pointed out in its 1993⁽¹⁸⁾ report, were highlighted by the examples found during recent on-the-spot audits, where expenditure proved to be ineligible, or even irregular (see paragraphs 2.16 — 2.17). This situation must be addressed as a matter of urgency. In view of the large number of files, it is not possible to perform sufficient on-the-spot checks to palliate risks of this type. Furthermore, it is inconceivable that the regulations governing this instrument can be redrafted the year before it is abolished. However, payments will continue to be made up until 2002 (see paragraph 2.3) and it is therefore imperative that the control arrangements are reinforced along the lines indicated by the Court in paragraphs 2.19 to 2.20.

CHAPTER 3

STATEMENT OF ASSURANCE CONCERNING THE ECSC

3.1. In accordance with Article 45c of the Treaty establishing the European Coal and Steel Community the Court has examined the ECSC's accounts in order to provide the European Parliament and the Council with a

statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions.

3.2. The accounts in question are the financial statements of the ECSC at 31 December 1995, which were drawn up under the auspices of the Commission and published in the *Official Journal of the European Communities* ⁽²⁰⁾.

3.3. In its report on the financial statements of the ECSC at 31 December 1995 ⁽²¹⁾, which constitutes a statement of assurance and is published with the financial statements to which it refers, the Court concluded that they give 'a true and fair view of the assets and financial situation of the European Coal and Steel Community as at 31 December 1995 and of the results of its operations for the year then ended'.

3.4. In order to assure itself of the legality and regularity of the transactions underlying the ECSC's accounts for the financial year 1995, the Court also carried out audits in accordance with generally accepted international auditing standards, relying, in particular, on analysis of the systems and the results of the tests carried out.

3.5. The inherent risks of the systems pertaining to the interest subsidies associated with loans granted under Article 56 (2) (a) of the Treaty establishing the ECSC concern the observance of eligibility criteria. The implications of these risks were found in concrete form during on-the-spot audits of this expenditure for the 1995 financial year. The audits revealed a high frequency of substantial errors ⁽²²⁾ (see paragraphs 2.12 — 2.18), although it was not possible to establish the total volume.

3.6. Notwithstanding the above observation, the Court's opinion is that it has obtained adequate assurance as to the legality and regularity of the transactions in question as a whole.

This report was adapted by the Court of Auditors in Luxembourg at the Court meeting of 7 November 1996.

For the Court of Auditors,

Bernhard FRIEDMANN

President

⁽²⁰⁾ OJ No C 251, 29. 8. 1996, p. 3.

⁽²¹⁾ OJ No C 251, 29. 8. 1996, p. 29.

⁽²²⁾ According to the terminology used by the Court of Auditors, legality/regularity errors which directly affect the amount of the underlying transactions are described as substantial.

THE COMMISSION'S REPLIES

CHAPTER 1

OBSERVATIONS CONCERNING THE ECSC'S SOLVENCY
AND THE CHANGES IN ITS PRINCIPAL ACTIVITIES

Introduction

1.1 (second indent) The Commission can confirm that since ECSC loans are back-to-back with the corresponding borrowings, the sole banking risk is that of default by borrowers. Risk management is by means of guarantees meeting the criteria customarily applied in the banking sector.

ECSC Solvency

Spread of risk

1.6 From a strictly legal point of view, the Directives on credit institutions are not applicable to the ECSC by virtue of its rules and the special nature of its activities.

1.7 The Commission shares the view expressed by the Court on the new approach adopted since 1995 to cover for large exposures and will ensure that this policy is strictly followed.

Changes in the application of ECSC funds and resources

Changes in the application of funds

1.15 In anticipation of the termination of the ECSC Treaty, the Commission has created the possibility for research activities carried out until now under the ECSC Treaty to be incorporated progressively into the framework programmes (e. g. see SEC(92) 1889 and SEC(93) 1596).

However, the orientation of the Fourth Framework Programme emphasizes generic, precompetitive research of multi-sectoral applications. The ECSC RTD programmes, during more than 40 years of activity, provided and provide financial support mainly to precompetitive sectoral research and to pilot/demonstration projects; these are not eligible under the Fourth Framework Programme, which was running during the year of reference 1995. Therefore, only part of the current ECSC RTD activities could be 'phased-in'.

In 1995, 'phasing-in' of ECSC RTD activities can be estimated to be about 16 % and 7.5 % of the average funding between 1991 and 1993 for steel and social research respectively, while no coal projects were 'phased-in' in 1995.

CHAPTER 2

OBSERVATIONS ON LENDING ACTIVITY

Loans under the first paragraph of Article 54

2.7 The Commission consulted both its Legal Service and a firm of UK lawyers with respect to the recovery of rebates paid out and they share the view that the recovery in the event of subsequent closure is not contractually possible as this unforeseen eventuality was not specifically addressed in the contracts.

Once details of the events were confirmed, rebate payments were suspended, the rebate entitlement was reviewed and the Commission withheld all outstanding amounts of rebate related to the loans concerned and covering the series of projects of the same company that were financed by the ECSC and of which all but two remained productive.

Loans under the second paragraph of Article 54

2.8 The Commission would draw attention to the following points:

- investors know that to qualify for a loan under the second paragraph of Article 54 of the ECSC Treaty, Community steel must be used. They are thus able to make the correct choice from the outset;
- ECSC participation in the financing of a project acts as an incentive to other lenders and thus makes it easier to complete the financial package;
- the ECSC, which ranks as an AAA issuer, provides funds on optimum terms, thus raising the profitability of the projects concerned.

2.9 The Commission acknowledges the overestimate noted by the Court. This error was due to an incorrect

assessment of the forecasts which the beneficiary provided in 1991 and, to a lesser extent, to a reduction in certain unit prices for ECSC products between 1991 and 1995.

It is worth mentioning that the calculation of steel consumption and its value has been based on forecasts, since the Great Belt project will not be completed before 1998. A new assessment of the use of steel will be carried out at the beginning of 1997. At that stage the Commission will be able to ascertain the correct loan volume corresponding to the actual steel use. As some of the loans reach their normal maturity in 1997, the opportunity can then be taken to extend only those ECSC loan tranches which are fully justified. In this way the total loan volume will be reduced on the basis of the aforementioned assessment.

2.10 The loans disbursed for the financing of the Channel Tunnel were agreed by both the Commission and the Council under Article 54.2 destined to promote the consumption of Community steel. The steel content of the project has been verified by the Commission and the value of the steel from Community sources exceeds the total amount of the loans disbursed. The Commission confirms that the loan decision was fully in compliance with the requirements of Article 54.2 of the ECSC Treaty.

2.11 In order to avoid any delay in receipt of payment it is customary for the Commission to prepare the payment orders for interest rebates two months in advance of the due date. With regard to the fourth payment due on an Article 54.2 loan, no reports were required to validate this payment and there were an exceptional number of public holidays in April and May when delays could normally be expected. The payment order was therefore prepared earlier than is usual practice but in fact did not suffer the anticipated delay.

The Commission has contacted a British firm of lawyers with a view to summoning the company concerned to repay to the ECSC the interest subsidies unduly received.

Subsidized loans (Article 56 (2) (a))

Audit of job creation

2.14 The Commission would agree that there is a risk that the information contained in reports does not reflect the real situation. However, the Commission's own experience is that there have been relatively few cases where this has led to a reduction or recovery of interest rebates. Therefore, the Commission feels that it is premature to draw any quantified conclusion at this stage.

2.15 to 2.17 The Commission's own control missions have specifically targeted large payments of interest

rebates and cases where the Commission had reason to believe that difficulties would be encountered. Despite this bias the number of irregularities found and the rebate corrections which resulted from these controls were considerably lower than resulted from the Court's controls of cases which apparently presented no particular risk.

2.18 In order to assess the reliability of its procedures, the Commission is now undertaking a series of controls of a representative random sample of payments using an appropriate sampling method validated by an international firm of auditors. The Court will be informed of the results of these controls.

2.19 The Commission has noted the Court's recommendations and has decided to take the following measures to improve the arrangements for managing interest subsidies:

- any new application for a sub-loan must be accompanied by an official document attesting to the number of workers actually employed at the time of the application;
- all payments of interest subsidies will be made on the basis of an official document attesting to the number of workers actually employed on the date of the last report required by the contract before payment is made;
- on-the-spot checks will be stepped up.

2.20 The date for submission of the final report cannot be advanced as it has been fixed to ensure that job creation is maintained for a full two-year period. In addition the date has been contractually agreed with the Financial Intermediaries who have in turn reflected this in their sub-loan arrangements with the individual beneficiaries.

The Commission has examined the possibility of delaying the date of the final payment until after the final report has been received, which it feels would be a preferable solution. However as this payment date has also been contractually agreed the Commission feels that it should honour its commitments.

The Commission will amend any future agreements to take account of the Court's recommendation, but does not feel that it should amend its current agreements retrospectively.

Audit of banking terms and conditions

2.21 The Commission proposes to remind all its Financial Intermediaries that the maximum margin must not be exceeded.

As far as the case mentioned by the Court is concerned, a detailed analysis is underway in order to better assess the issue.

On its own controls, the Commission checks the bank margin and has only on rare occasions found that the permitted margin of 1 % p. a. has been exceeded. The Commission may face a problem in requiring confirmation of the interest rate paid by its 8 000 sub-loan beneficiaries since the interface of the Commission is with the Financial Intermediaries and no direct contractual relations are established with individual beneficiaries.

The effectiveness of the instrument

2.22 The Commission agrees that the number of exECSC workers actually employed by sub-loan beneficiaries is generally small. However the Commission feels that the conversion loan scheme should be regarded as a wider instrument of regional policy which helps promote productive investment and alternative employment in regions which, having lost their traditional coal and steel industries, suffer high unemployment.

The first paragraph of the current procedures for the coordination of ECSC loans with Structural Fund Programmes (OJ No C 59, 6. 3. 1992) clearly states that 'The purpose of conversion loans under Article 56 of the ECSC Treaty and interest rebates is to help convert the economies of regions affected by the restructuring of ECSC industries by contributing to the financing of job-creating investments.'

2.23 The Commission would also agree that ECU 2 000 of Union interest rebates is alone unlikely to promote job creation. However the interest rebated loan forms an integral part of the financing package which may include other local, national or other Union aids. It is the cumulative effect of these diverse efforts which is intended to both promote investment and stimulate job creation.

The Guidelines and operational rules for the granting of conversion loans (OJ No C 188, 28. 7. 1990) state 'They are intended as a complement or contribution to the corresponding national assistance measures.'

2.24 The abovementioned Guidelines and operational rules for the granting of conversion loans state that these loans are designed to help 'create new and economically healthy activities or to transform existing companies.'

With this in mind the Commission does not feel it would be appropriate to carry out a financial analysis of individual beneficiaries under global loan schemes and to refuse an application and thus discriminate against a company which has adequate own resources.

The approval of an ECSC conversion loan application is therefore based on its eligibility under the relevant criteria.

2.25 The Commission would agree that the conception of any future possible job creation instrument could usefully draw on the experience of the ECSC conversion loan scheme. This would be particularly relevant as regards recovery of interest rebates already paid and the choice of key dates for job creation and maintenance.

Conclusion

2.26 The Commission takes the view that the granting of ECSC financial assistance presents certain advantages: Community steel is in fact used; a lever effect is produced for the overall financial package; and financing can be made available on the best possible terms.

As regards the excessive payment to which the Court refers, the Commission has acknowledged the overestimate in question and has adopted the measures described at 2.9 above.

2.27 The Commission feels that it would be premature to draw any quantified conclusion at this stage. It is for this reason that the representative random sample quoted in the answer to paragraph 2.18 has been extracted and is currently being examined.

In any case, as mentioned above — answers to paragraphs 2.19 and 2.20 — the Commission is adopting wherever possible the Court's recommendations with a view to reinforcing its own control function.

CHAPTER 3

STATEMENT OF ASSURANCE CONCERNING THE ECSC

3.5 The Court refers to an extremely small sample of the total of 8 000 sub-loans. The Commission is carrying out further controls on a representative random sample, the results of which will enable the necessary conclusions to be drawn. The results will be communicated to the Court — cf. the Commission's answer to paragraph 2.18.

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