European Bank for Reconstruction and Development

Update on Best International Practices in Public Private Partnership with Regards to Regional Policy Issues

Review Report

November 2005
BEST INTERNATIONAL PRACTICES IN PUBLIC PRIVATE PARTNERSHIP WITH REGARDS TO REGIONAL POLICY ISSUES

Review Report
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## Glossary

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<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tr>
<td>BOO</td>
<td>Build Own Operate</td>
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<tr>
<td>BOOT</td>
<td>Build Own Operate Transfer</td>
</tr>
<tr>
<td>BOT</td>
<td>Build Operate Transfer</td>
</tr>
<tr>
<td>DBFM</td>
<td>Design Build Finance and Maintain</td>
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<tr>
<td>DBFO</td>
<td>design Build Finance and Operate</td>
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<tr>
<td>EC/EU</td>
<td>European Community / European Union</td>
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<tr>
<td>EMU</td>
<td>European Monetary union</td>
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<tr>
<td>ERDF</td>
<td>European Regional Development Fund</td>
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<tr>
<td>EUROSTAT</td>
<td>European Union Department of Statistics and Accounting Regulation</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>HSL</td>
<td>High Speed Line</td>
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<tr>
<td>IFI</td>
<td>International Finance Institutions</td>
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<tr>
<td>ISPA</td>
<td>Instrument for Structural Policies for pre-Accession</td>
</tr>
<tr>
<td>NGO</td>
<td>Non Governmental Organisations</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>PFI</td>
<td>UK Private Finance Initiative</td>
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<tr>
<td>PPP</td>
<td>Public Private Partnership</td>
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<tr>
<td>PSC</td>
<td>Public Sector Comparator</td>
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<tr>
<td>SAPARD</td>
<td>Special Accession Programme for Agriculture and Rural Development</td>
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<td>SCUT</td>
<td>Portugal Shadow Toll Road Programme</td>
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<td>SPV</td>
<td>Special Purpose vehicle</td>
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<tr>
<td>VNG</td>
<td>Association of Netherlands Municipalities</td>
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Summary

This report summarises the review of best international practices in Public Private Partnerships with regards to Regional Policy issues.

The review was based on desk research and was carried out using all resources available to Atkins including the web, Atkins library and phone interviews with PPP centres in a selected sample of countries.

When undertaking the review it appeared that a number of PPP transactions, particularly from countries at early stages of implementing PPP, were not reported, or reported but without any critical reviews of the experiences. Views on this missing information were briefly given by the interviewees from the PPP centres.

From the review of best practice in countries where PPP is widely used, and in the Czech Republic chosen for the case study, the following comments could be made:

The Australian PPP experience is generally considered to be successful, and is well advanced particularly in the Transport sector. As one of the pioneering countries in introducing PPP, Australia established a robust PPP legislation and policy frameworks from the outset which created a favourable environment for the private sector involvement particularly from the international major investors, thus providing the required level of competition to ensure best value for money.

One of the catalysts of success of the Australian PPP transactions at the local levels is the tight budgetary discipline leading to low debt levels among local authorities which led to their high credit worthiness and to high market confidence. However, to achieve this, central and local governments adopted minimum debt level policies favouring over many years fully privately finance schemes. This explains the concentration of PPP schemes in urban areas where high demand secures high and fast returns on investments. This approach may not be applicable to other countries where infrastructure is mostly supply driven, aimed at driving the local and regional economic development.

In Hungary municipalities have already experienced the use of BOT schemes in waste water management. The results were mixtures of success and failure. In general terms municipalities of bigger size, more stable sources of revenue and with highly skilled and knowledgeable public sector procurement officers in contract negotiation and management have carried out better deals than smaller municipalities lacking such skills.

In legal terms, Hungarian municipalities may independently enter into PPP contracts without prior central government approval. In practice, there have been minor PPP projects initiated by municipalities, namely in public utility services, though these do not qualify as PPPs in the true sense (BOT). Not having the right of full sale of the utilities, municipalities often outsource the related services under a PPP contract to a service provider company, in which the municipality retains 49% of ownership.
In summary, traditional PPP projects are rare among Hungarian municipalities although there have been a number of initiatives in various areas of development aimed at getting the private sector involved in one form or another.

The Dutch experience with PPPs is very recent and was initiated with the creation of PPP centre in year 2000 to pave the way for government departments to use PPP as a method of achieving value for money services procurement. The Dutch Government has adopted a very precautious approach to municipal involvement in borrowing to ensure control over the country overall debt and deficit levels. In practice municipalities can freely borrow in the open market, issue bonds and guarantees under the condition that the currency is Euro (requirement by law) and after approvals from the province or the central government. In addition, to guarantee a loan for an investment, the European state aid rules apply.

The Central Government intervenes to control municipal and provincial future debt levels, only if the national EMU-shortage is in danger. Information about the EMU-shortage of municipalities and provinces is regularly collected by the Central Bureau of Statistics. As a consequence, The Netherlands as well as its provinces and municipalities enjoy credit rating of triple A.

Such cautious approach, while ensuring local authorities’ solvency, have though limited their PPP experience to projects with highly predictable risk profiles requiring limited guarantees and thus limited risk transfer to the private partner.

In Portugal PPPs have become useful tools for the government to develop public infrastructure. Shadow toll road concession schemes were the first to be procured in this way. This allowed a rapid programme of road construction to be achieved at a time when public sector budgets for new capital investment were heavily constrained. The objective was not only to enhance the availability of the road infrastructure, but also to compensate for regional economic imbalances and generate employment opportunities, with the smallest possible initial financial contribution from the government.

After the success of these infrastructure projects, the focus switched to the construction of football stadiums mostly for the Euro 2004 games. Currently programmes for hospitals and rail infrastructure are underway. Further opportunities will also arise as the Lisbon Metro is being expanded to link in with various overland commuter lines and the Lisbon Airport.

At the local level, PPPs have already been used by Portuguese Municipalities for the provision of water supply, waste treatment, energy (wind farms) and urban public transport services. Other services are still provided through corporations, including local transport (metro, tram, bus companies), where the state holds the majority of shares. Though, given the social orientations, most of such corporations’ services are subsidised and rarely break even, where the subsidies are co-funded by the European Community.

The decision making is entirely carried out by Municipalities who have full freedom by Law to enter into PPP agreement with a private partner, as long as no Central Government contribution is required. The only restriction is on direct borrowing or guaranteeing loans on behalf of the private partner. These are regulated by rules provided in the Budget Law which issues a yearly ceiling on maximum borrowing as a function of the municipality previous year budget and the expected revenue streams for that year.
PPP projects while supporting more efficient use of scarce public resources, their use have been in some cases abused in Portugal, leading to commitment of public sector budgets for a long period of time, thus reducing future years’ budgeting flexibility, a major concern for a small country integrating a monetary zone, like Portugal, that regards fiscal policy as the sole stabilization policy under its control.

In the Czech Republic the development of public infrastructures, is still carried out by the public sector with support from budgetary funding. The use of PPP as a procurement tool has so far been limited to concessions for the operation and maintenance of public services and facilities (waste collection, treatment and incineration, street lighting, sewage systems)

A legislative framework for PPP is being finalised, aiming defining the competences of the central and local governments and to create the required legislative base (Code of Commerce, Public Procurement, Concession Law, Bankruptcy Law).

In 2004 the Czech Government’s PPP Policy was officially approved, and a PPP legislation (Concession Act) has been submitted for approval to the Czech Parliament. At the municipal level, budgetary rules are still to be devised to allow PPP transactions to be carried out in full harmony with EU rules on public debt and budget deficit.

The Czech Republic is required to comply with the EU Maastricht Criteria. To do so it will need to monitor all PPP transactions as a source of debt and long term commitment of public funds. This is an issue facing many EU and non-EU countries with highly decentralised fiscal policy and there are no effective accounting rules to close loopholes. The main underlying reason is the uncertainties surrounding the year on year spending and the difficulty of long term budgeting. Meanwhile, PPPs continue to be used to bypass expenditure controls, and to move public investment off budget and debt off the government balance sheet. Moreover, resort to guarantees to secure private financing can expose the government to hidden and often higher costs, compared to traditional public financing.

In summary it can be seen from the notes above, and in far more detail in the main report, that there is no single approach to PPP that is currently practiced in the countries we have investigated. Our understanding of the PPP market worldwide supports this and it is therefore not a simple process to provide a ‘best practice’ guidance applicable to all countries when discussing the possibility of implementing PPP.
1. **Introduction**

**STUDY BACKGROUND**

1.1 EBRD have been tasked with reviewing the PPP sector in Europe to advise their member states on best practice. To undertake this Atkins were appointed to undertake a study to ‘Update on Best International Practices in Public Private Partnership with Regard to Regional Policy Issues’

1.2 The study objective, as specified in the Terms of Reference, is to study and produce a report covering the following topics:

- Summary of global best practice common to countries with successfully executed PPP projects/transactions, with a primary focus on fiscal policies and the share of responsibilities between central government, regional and local authorities;
- Reference to particular case studies, including from Czech Republic, accompanied with analysis of their approaches towards PPP implementation and lessons learnt; and
- Recommendations as to the consequences of application of the policies.

1.3 The aim being to report the findings of the study through a showcase in one of the EBRD countries of operation in Central/Eastern Europe.

**DEFINITION OF GROUP A AND GROUP B COUNTRIES**

1.4 To undertake an efficient review of PPP experience it was felt that this task would be best carried out over a sample of countries selected to be representative of the wide variety of PPP experiences around the world to allow drawing conclusions that are applicable to a broad context of PPP initiation as well as governmental organisations.

1.5 It was felt important that the sample of countries to be investigated should allow wide variations over the following three key parameters, expected to play major catalyst roles for the delivery of PPP transactions at the local level, to allow the study of their impacts:

- Common vs. Civil Law countries;
- State vs. Federal structure;
- Well established vs. infant structures in the process of implementing PPPs.

1.6 Consequently, a sample of countries was selected and organised in two categories. A first category **(Group A)** representing the most successful PPP experiences and includes variations among the first and second criteria above. The countries selected were:

- Australia;
1.7 To this regard, a definition of what is a successful PPP experience at the local level was required. Similarly, some generic definitions of Local Fiscal Policy and Decentralisation are also required. These are provided in Appendix A to this report.

1.8 The first four of the above countries will be investigated in detail representing the main sources of the knowledge from which best practices will be drawn. The fifth, the UK, will be used as a benchmark, given its particular legal structure, and will be used for example only.

1.9 The Hungarian case substituted the Finnish case following discussions with the Czech authorities who expressed interest in investigating the Hungarian model given the similarity of context between the two countries and the specific Hungarian regional policy, particularly in relation to fiscal issues.

1.10 The second category (Group B) included countries at the early stages of implementing PPPs with a mixture of failing and successful experiences. It was felt that the following set of countries would be representative of those at early stages of PPP implementation; where regional/local authorities are involved in the process with no clear rules of decentralisation and share of responsibilities; and where PPP legislation still to be improved:

- Croatia;
- Czech Republic;
- Romania.

1.11 As Atkins has been involved in recent years as Government Advisors for the development and implementation of PPPs in the above countries, the review of their PPP experiences will be carried out purely from Atkins Library and drawing on Atkins experts’ personal project experience in those countries.

REVIEW METHODOLOGY

Collation of Relevant Documents

1.12 The review involved a desk study reviewing best practice across countries where PPP is currently undertaken at the sub-national level. All relevant documents (reports, literature, reviews, etc.), were collected from web sources, Atkins library, contacts in the countries and a one day visit to Portugal.

1.13 For all countries from Group A, it was our intention to collate all relevant literature available in the public domain as well as from Atkins Library. When we embarked in the research the following hindrances were experienced:
Most official web sites, e.g. governments and associations included information on rules, laws and guidance, which tells more about what should be rather than about the ongoing practice.

Materials from non governmental organisations, international associations, work groups and networks often provide critical reviews of legislations as well as practices in the country. However, most of the data and reports are somehow out of date given the fast evolving legislative and PPP practices, particularly the European context. Most of the organisations issuing those documents were contacted for further updates, but in vain, as most available reviews did not result from continuous country monitoring but rather undertaken as a one off work to support planning or programme development.

More up to date materials such as conference and academic papers are available at costs from main news magazine portals, often too high for the study budget to bear with no guaranteed relevance.

1.14 For countries from group B all documentation was collated from Atkins library complemented with contributions from all our experts within the study team and other who have had past involvement in the selected countries.

Review and Reporting

1.15 Our review was geared towards understanding the specific reasons and measures behind success or failure of PPP transactions. In particular, we have focused on the following aspects:

- the government structure and levels of decentralisation;
- the PPP legislation in place;
- the country regional fiscal policy;
- the risk allocation, procurement process and funding methods;
- the procurer’s experience with PPP transactions and level of use of advisors’ expertise;
- the technical and financial viability of the approved schemes;
- the country’s credit rating;

1.16 Following the request from Czech Republic officials, as one of the main recipients of the Case Study, we have also reviewed for Group A countries the management practice in Central Governments of municipal debt levels, including providing a brief answer to the following questions:

- How, and to what extent municipal borrowing contributes to the State debt?, what are the rules for taking on debt for a PPP within a municipality? and who has overall control of that debt level?
- What fiscal tools are available to municipalities and what freedom do they have to use them with/without prior state approval?
- How does the state monitor and manage the municipal debt levels? i.e. how are municipality spend/borrowing levels defined within the states PSBR levels?
The review was then completed with an understanding of how the arrangements between Central Government and municipalities in relation to the above questions have contributed to the success and pitfalls of PPP transactions.
2. Review of Best Practices (Group A)

2.1 As stated in the introduction section of this report, the countries selected for review have been defined into two categories; Group A representing countries with established PPP markets and the most successful PPP experiences, and Group B representing countries with emerging PPP markets with a mixture of failing and successful experiences. This section reviews the Group A Countries.

2.2 This group of countries includes variations among Common vs. Civil Law and State vs. Federal structure. The countries included in this group are:

- Australia;
- Hungary;
- Netherlands;
- Portugal; and
- UK.

2.3 Four of these countries have been investigated in detail and represent the main sources of knowledge from which best practices will be drawn. The UK case was used as a benchmark, given its particular legal structure, and was used for example only.

AUSTRALIA

Background

2.4 Six colonies were created in the late 18th and 19th centuries; they federated and became the Commonwealth of Australia in 1901. The new country took advantage of its natural resources to rapidly develop its agricultural and manufacturing industries. In recent decades, Australia has transformed itself into an internationally competitive, advanced market economy.

2.5 Australia has a population of around 19.9m, GNP of $29,000 per Capita (on par with the four dominant West European economies). Its main industries include mining, industrial and transportation equipment, food processing, chemicals and steel.

Government Structure

2.6 The Australian Constitution of 1901 established a federal system of government. Under this system, powers are distributed between a national government (the Commonwealth) and the six States. There are also 2 self-governing Territories within Australia. Figure 2.1 outlines the structure of the Australian constitution.

2.7 In the early 1980’s, Australia went through a change of government that led to policies that promote new ways of doing business in the public sector. This movement intensified during the 90s with the privatisation of Telstra, the national
telecommunications carrier. This was followed by a reform that encouraged decentralisation, the transfer of power from the State to the ministries, thus fostering greater autonomy among the ministries and other public agencies.

Figure 2.1 – Structure of the Australian Constitution

2.8 Three tiers of government were established in Australia:
- Federal/Commonwealth;
- State or Territory; and
- Local.

Federal Government (FG)

2.9 The Federal Government implements laws made by the Commonwealth Parliament. The Commonwealth has most of the direct taxation powers and is thus a major source of funding for State activities; it has responsibilities for matters of national significance such as defence, trade and works of national significance such as national highway and railway networks. The Commonwealth recognises an obligation to fund urban highways if they can be shown to be part of the national grid, but does not have any current direct involvement in the delivery of urban transport.

States

2.10 Matters not provided under the Australian Constitution as a Commonwealth responsibility are the responsibility of the States. The States and Territories are responsible for provincial matters such as policing, roads and traffic etc. The State and Federal Governments have a natural reluctance to either introduce new taxes or to raise levels of debt to fund infrastructure or service development. PPPs in Australia have developed in response to this federal funding model to meet the demands of the community for new infrastructure and services. The States have

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1 Current Status of Collaborations in Selected Countries; Centre for Technology in Government, 2003, p.1.
2 The Australian national government can be referred to as the Federal, Commonwealth or Australian Government.
some indirect taxing powers (e.g. land taxes and have primary responsibility for service delivery: Health, Education, Police, Roads and Public Transport).

**Local Governments (LG)**

2.11 Local Governments assist the States and the Northern Territory and can take the form of a city or town council or a shire. They are responsible for town planning, local roads etc. Local Government in major cities is fragmented and most metropolitan areas have a multiplicity of local councils (except Brisbane which has just one local Government for the whole of the metropolitan area\(^3\)). Where local Government has an influence is in the built environment – councils are key stakeholders in transport network design. Local Government is also responsible for providing low-level infrastructure such as bus shelters.

2.12 Local Government can only regulate, not legislate (controlled by laws of various State Governments). What this structure means for urban transport is that capacity for planning, infrastructure provision and service delivery lies overwhelmingly within the State and Local Government is but a minor player.

2.13 With the notable exception of AusLink\(^4\) paper, little consideration has been given by the Federal Government as to how the priorities of State and Local Government can be facilitated\(^5\).

**Regional Fiscal Policy**\(^6\)

2.14 Australia, for the most part, has a strong record on fiscal policy. Policy has usually been applied in a countercyclical fashion, the Commonwealth's debt has not neared levels where sustainability would be seriously threatened and taxes overall have been held well below levels in most other developed nations. Both State and Federal Governments have adopted a policy of reducing and, in some cases, eliminating their debt as a central plan of fiscal policy.

2.15 A study undertaken by the Chifley Research Centre examining fiscal policy rules in Australia\(^7\) stated that fiscal policy is currently confronted with major concerns. Both State and Federal Governments have tended to focus on eliminating debt rather than optimising net worth, resulting on some poor decisions; reduced rigour on spending decisions during periods when revenues were buoyant combined with an aversion to deficits in all circumstances, has led to policy becoming pro-cyclical in recent times; and demographic and other structural changes will increase pressure on key areas of public spending and requires a long-term and comprehensive strategy to manage the pressures.

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\(^3\) In Brisbane (Queensland), the Local Government manages all of the urban services.

\(^4\) The Federal Government released its new land transport plan AusLink in 2004. This major government initiative includes a National Land Transport Plan which outlines the Government’s approach to improving and integrating the National Network and the investments it will make a single funding regime, under a new AusLink programme, for the National Network separately earmarked funding for local and regional transport improvements new legislative, intergovernmental and institutional mechanisms.

\(^5\) Evatt Foundation publication- Unhealthy Partnership- Paying for PPPs; Paul Fitzgerald on PPPs at the launch of The States 2004.


\(^7\) Fiscal Policy Rules in Australia, Dr Ric Simes, Sept 2003, p.3.
2.16 Australia's fiscal objective is to achieve balance, on average, over the course of the economic cycle. The credibility of Australia's fiscal policy has been enhanced through the Charter of Budget Honesty legislation in 1998.

2.17 Governments at the Commonwealth, State and Local level currently eschew the use of debt and taxes to finance infrastructure.

2.18 The Organisation for Economic Cooperation and Development's (OECD) Economic Outlook provided a positive assessment of the Australian economy. Australia's real GDP projected to grow by 3.7% in 2004, is likely to exceed that of Canada (2.8%), UK (2.7%), Japan (1.8%), France (1.7%), Italy (1.6%) and Germany (1.4%).

2.19 Australian governments (at the Commonwealth and State levels) are among the leading governments around the globe in terms of debt reduction. Over the past two decades, the share of public sector investment within GDP has declined significantly. A contributing factor behind the slide in public investment in Australia has been asset sales and the shift in the provision of certain (economic) functions to the private sector.

**Credit Rating**

2.20 According to Moody's report on Australia's credit rating released August 2003, credit strengths for the country are: 1) strong growth performance over the past few years, demonstrating the economy's ability to withstand international cyclical fluctuations; 2) open trade policies and a market-oriented regulatory regime, providing a favourable environment for growth and investment; 3) the healthy budgetary and public debt situation maintained over the medium term, while a vigilant stance towards monetary policy ensuring price stability; and 4) stable political institutions underpinning the pragmatic policy stance of successive governments, and allowing for the relatively peaceful resolution of potentially divisive issues.

2.21 Moody's recently said that the outlook of Australia's credit ratings are stable and its ratings are well anchored by the Government's low debt levels, which are trending lower, and Moody's analysis suggests that there is an extremely low probability of the Government imposing measures that would interfere with external debt repayments of entities domiciled in Australia.

2.22 Credit Rating of Individual States:

- PPPs in the States of Victoria and New South Wales are well established. Victoria has adopted a very prudent fiscal approach in recent years which has maintained investor confidence in the State and has underpinned Victoria's growth. This prudent fiscal policy approach has also delivered a high credit rating for Victoria.

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8 The Charter of Budget Honesty Act 1998 puts in place a legislative framework for the conduct and reporting of Government Fiscal Policy.
10 ibid., p4.
♦ New South Wales (NSW) has a well articulated fiscal strategy that is underpinned by legislation. The contribution of private sector funding to infrastructure provision has been about 7% of the State’s capital budget over the last 10 years\textsuperscript{13}.

**Public Private Partnership**

2.23 Australia has extensive experience with private delivery of public infrastructure, but the PPP label is still relatively new. In the last decade or so, prior to the very recent establishment of PPP policies in a number of Australian jurisdictions, Australia has had a range of privately financed infrastructure projects spread across many sectors, including transport, health, education, justice, defence, energy and utilities. The success story for PPPs has been in the provision of roads.

2.24 In 2002, overall private sector investment totalled $55 billion across the energy, water and transport sectors. Road funding accounted for 9.3% of this. Major privately-funded road infrastructure projects have included the Sydney Harbour Tunnel; the M2, M4 and M5 motorways through Sydney; the Sydney Airport Rail Link; and the Melbourne City Link\textsuperscript{14}.

2.25 The Bureau of Transport Economics estimates the total transport task in Australia will double over the next two decades. The network of roads, bridges and other transport infrastructure must expand to meet that demand. The cost is large and cannot be met solely from government sources\textsuperscript{15}.

**Figure 2.2 – Australian Context of PPP**

\footnotesize

- DCM - Design, construct and maintain
- BOO - Build, own and operate
- BOOT - Build, own, operate and transfer

\textsuperscript{13} PPP in Practice: Initiating and Supporting Major Economic Infrastructure, Western Australian Technology & Industry Advisory Council, I.9.


\textsuperscript{15} ibid.
2.26 Figure 2.2 above illustrates the Australian PPP family. Most private road investments have occurred under BOOT (Build, Own, Operate and Transfer) arrangements and have been very large by Australian standards.

**PPP Law and Legislation**

2.27 Although each jurisdiction has developed their own policy guidance on PPP, there is an overarching policy framework in place in the form of the *Commonwealth Procurement Guidelines*\(^{16}\). These guidelines apply to all Commonwealth Agencies involved in private financing, particularly in relation to the assessment of value for money.

2.28 The guidance and policies are in place to help ensure the effective and responsible allocation of Commonwealth resources and fiscal management. The procurement policy framework is a subset of the *Financial Management Framework* related to the procurement of property or services.

2.29 The *Financial Management and Accountability Act 1997* sets out the financial management, accountability and audit obligations on agencies forming part of the general Government Sector, in particular; for managing public resources efficiently, effectively and ethically; and for maintaining proper accounts and records of the receipts and expenditure of Commonwealth money.

2.30 Policy and guidance material to advice on the use of private financing arrangements is contained in the Finance publication *Commonwealth Policy Principles for the Use of Private Financing*\(^{17}\).

2.31 Key features of the Commonwealth Policy Principles for the use of Private Financing:

- Appropriate approval is required before engaging the market in a tender process. Table 2.1 outlines the relevant level of approval required in relationship to the asset replacement value thresholds. Private financing proposals over $20 million in asset replacement value must be referred to the Finance Minister for approval, and the Government must be consulted for proposals exceeding $50 million\(^{18}\).

<table>
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<tr>
<th>Asset Replacement Value</th>
<th>Approved by:</th>
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<td>&lt; $20m</td>
<td>Agency Chief Executive</td>
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<tr>
<td>$20m-$50m</td>
<td>Minister for Finance</td>
</tr>
<tr>
<td>&gt;$50m</td>
<td>Cabinet</td>
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\(^{16}\) Revised Commonwealth Procurement Guidelines were issued on January 2005 by the Australian Government. The guidelines were issued under Regulation 7 of the Financial Management and Accountability Regulations 1997.

\(^{17}\) *PPP Guideline: Commonwealth Policy Principles for the use of Private Financing*, Department of Finance Administration, May 2005.

\(^{18}\) Commonwealth Procurement Guidelines, Section 9.11.

2.32 A PPP unit has been established in the Federal Department of Finance and Administration. Agencies are encouraged to contact the Unit during the early stages of project development. The assistance and support of the Private Financing Unit is available to all Australian Government Agencies. Its role is to:

♦ oversee the development of the government’s policy framework;
♦ assist agencies with the development of proposals; and
♦ advise government on the value for money of particular proposals.

2.33 The Unit aims to add value by:

♦ reducing transaction costs incurred;
♦ shortening the time taken to develop proposals; and
♦ ensuring that relevant issues are addressed in a timely manner.

2.34 New legislation ‘AusLink’ was released in 2004 by the Australian Government designed to improve planning, decision-making and funding for national land transport infrastructure. The Australian Government recognises the importance of PPP provision of land transport infrastructure and sees the private sector having an expanded role in this area.20

2.35 Under AusLink, starting in 2005-06, the Government will introduce two funding streams directed to local and regional priorities; $800 million over four years will be available to local councils and will be competitively allocated. It will contribute to priority regional transport projects which local councils would otherwise find difficult to fund21.

2.36 The Australian Government will continue to provide funding to State and Territory Governments for the maintenance of transport infrastructure assets. However, the basis on which the Australian Government provides funding will change. Instead of having funding responsibility for all maintenance on the National Highway, it will now contribute to maintenance on the AusLink Network. This means that it will share maintenance costs with States and Territories – generally the owners of the assets.22

2.37 Each State and Territory will be able to apply the Australian Government maintenance funding contribution to the National Network as they judge most appropriate.

PPP Funding Methods & Government Involvement

2.38 Legal responsibility for roads in the Territories is borne by the Australian Government while in the States it is shared between the State road authorities, Local governments, and in some cases other authorities established by the State Governments. The roads between major towns (Inter-urban roads) are the

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21 ibid., p xiii.
22 ibid., p.65.
responsibility of the State. Figure 2.3 overleaf outlines the current responsibilities for transport infrastructure planning and funding.

2.39 The State road authorities provide financial assistance to Local government authorities towards the cost of construction and maintenance of unclassified roads\(^\text{23}\). The States control the borrowing of Local government.

2.40 The scope for PPPs has been largely between business and State Governments. All PPPs are guaranteed by the State government. While local government has long participated in outsourcing arrangements, it has yet to embrace PPPs substantially. An example of a current PPP from local funding is in Brisbane, Queensland; Brisbane City Council is in the process of procuring a North-South Bypass Tunnel as a PPP, following the principles in the State Government’s Value for Money Framework\(^\text{24}\).

2.41 Australia’s major investment banks have called for clear guidelines at a local government level to underpin all PPPs\(^\text{25}\). They have commented that State Governments need to open up more opportunities for Local Government to participate. A framework is required for Local Government to engage all stakeholders and develop PPPs\(^\text{26}\).

2.42 Australian infrastructure has always been funded by private investors, predominantly through government borrowing. The emergence of Special Purpose Vehicles (SPVs) in PPPs has changed infrastructure investment, but the need for government borrowing is still substantial.

2.43 Funding for the States/Local government is done by the Grants Commission. Individual States can borrow on their own behalf, without Loan Council approval. Since the Financial Agreement Act 1994, the Loan Council has played a much lesser role\(^\text{27}\).

2.44 The contribution of private sector funding to infrastructure provision has been about 7% of the State’s capital budget over the last ten years\(^\text{28}\).

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\(^\text{24}\) Major Infrastructure Projects Office Brisbane City Council, Invitations for Expressions of Interest, March 2005.

\(^\text{25}\) Putting the Community back into PPPs, 2003, Macquarie website.

\(^\text{26}\) Comment made by Macquarie Bank’s Chief Executive Community Partnerships, Peter Wright, 2003.

\(^\text{27}\) Reviewing Australia’s Infrastructure, Lindsay Tanner MP, 2005.

2.45 Agencies are to plan their forthcoming annual procurement and must publish on AusTender, by 1 July each year, an Annual Procurement Plan (APP) to draw businesses early attention to potential procurement opportunities\(^{29}\).

### Local PPP Policy Frameworks

2.46 All Australian states have policy documents governing the identification, establishment and operation of PPPs. These documents draw heavily on the groundbreaking and detailed set of manuals first released by the State Government of Victoria in June 2001\(^{30}\).

2.47 Although each state has a slightly different process relating to developing PPPs, they all share many common features, often contemplating the same main tasks in the same order. Overviews of each of the States PPP policies\(^{31}\) are provided below:

- **Victoria** was the first state in Australia to release a PPP policy, leading the way with Partnerships Victoria, the benchmark against which the other state PPP policies are measured. In terms of projects, the Victorian County Court Project was opened in May 2002. The contracts for Wodonga Wastewater Treatment plant, Spencer Street Station redevelopment, and Berwick Community Hospital have been let. Victoria continues to lead the way with respect to the development of PPPs.

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\(^{29}\) Commonwealth Procurement Guidelines, Section 7.16.


\(^{31}\) State PPP policies taken from the Australian Council for Infrastructure Development, May 2003.
New South Wales (NSW) released its Working with Government policy in late 2001, along with a potential project list. NSW has aimed to be as consistent as possible with Partnerships Victoria, although there are some differences in processes. In December 2002 the Government released a State Infrastructure Strategic Plan and information on Emerging PPP Opportunities.

Queensland released its Public Private Partnerships policy in late 2001 and released detailed PPP guidance documents in 2002. The Queensland Government has committed to consider all projects requiring more than $30 million of government funding as a PPP. The Queensland Government has short listed a number of projects including the $800 million Gateway Bridge duplication in Brisbane and the $200 million Petrie to Kippa-Ring Railway north of Brisbane. The Government recently announced the Southbank Tafe redevelopment also as a PPP.

Western Australia (WA) released its PPP policy, Partnerships for Growth, in December 2002. WA has previous experience in PPP-type project delivery, particularly in health, with the Peel Hospital and Joondalup Health Campus being delivered through a partnership with the private sector. AusCID considers that a few projects in WA are possible as PPPs, including a desalination plant to meet Perth's current water problems.

South Australia (SA)'s policy, Partnerships SA, was released in mid-2002. A PPP unit in the SA Treasury was established in November 2000. Few projects were announced in SA 2001 budget, including the upgrading of the Glenelg transport corridor and the procurement of new trams, a new regional hospital in the Barossa and a new women’s prison. Further project information is expected in 2003.

Tasmania has a private investment in infrastructure policy, released in July 2000, and is currently not looking to update its PPP methodology. The number of projects delivered using private finance has been limited, with the exception of some hospitals, including North West (Burnie) General Hospital and Mersey Community Hospital.

Northern Territory - The Northern Territory Government realised a PPP policy framework that is largely based upon the Partnerships Victoria policy.

PPP Project Case Studies

Three project cases are discussed in Appendix B-1 to this report, highlighting success and failure examples of PPPs in Australia:

- Melbourne City Link;
- Western Sydney Orbital (Westlink M7); and
- Melbourne’s Public Transport Franchising.

The examples highlight experience within the Transport sector, undertaken within the two States of Victoria and New South Wales where the use of PPPs for infrastructure is particularly well established.

32 The policy framework, guidance materials and appendices are available from as http://www.otd.nt.gov.au/.
Conclusion – Australian Local Government PPP Experience

2.50 From the review of the Australian PPP Experience at the State and Local Government (city/town councils or shire), the following conclusions could be derived:

♦ All PPP schemes undertaken by Local Governments have received support from the Federal government in the form of technical assistance. Local Governments are free to define the scope of PPP schemes, free to define their budget allocations and free to borrow beyond the budgetary allocations from the federal government to fund their annual programmes. Local governments have some own sources of revenue from indirect taxation (e.g. land taxes), which they are free to allocate according to their needs. When borrowing is involved the state approval is required.

♦ The general policy of the Australian Government towards reducing the level of debt, has resulted in advantaging the fully privately financed schemes, vs. schemes funded through PPP or full public funding, despite the free access to borrowing given to the state authorities.

♦ PPP schemes undertaken by state or local authorities have combined the experience at the Federal level with State knowledge of the local needs and local priorities. Such approach follows the principle of optimality of share of responsibilities “tasks are allocated to those that are better prepared to deliver them”.

♦ Australia is a vast territory with highly concentrated population around the main urban centres. Rural population is scare and almost inexistent in some states. This facilitates the task of provision of local public services, mostly urban, including the planning, programming and implementation. In particular, being in highly dense urban centres, PFI projects secure high demand and raise big private sector appetite for them.

♦ On the PPP finance side, the federal structure of the government does not seem to be having much effect on the implementation of PPP transactions at the state and local levels. The relationship between the federal government and the states and their share of responsibilities is fairly similar to that of non-federal states. The local taxation represents a marginal part of the local governments’ revenues, and the states still rely mostly on transfers from federal government. In addition, the state PPP legislations and policies are derived from single national frameworks issued by the federal government.

♦ Australian state gained good experience (more than ten years) in the use of PPP as a mechanism for delivering public services and infrastructure. Successful experiences, though, have been mostly in urban transport infrastructure, where the high demand means little local government subsidy required.

♦ In most cases, PPP transactions were open to the international bidders, who brought with them international finance. This has led to good due diligence being carried out and major risks mitigated up front, which is one of the reasons for success. On the other hand the high interest from international investors reflects high credit rating of Australia and its local authorities as well as the adequateness of the legal and PPP frameworks in place and the capacity of the delivering authorities, which in turn secured good value for money.
Failing experiences were mostly attributed to unrealistic bids, weak business cases, and inappropriate transfer of commercial risks.

The reduction of public sector share of investments within GDP over the last two decades, and the sale of assets to private sector, has reduced the burden of high infrastructure investments on the national budgets and thus reduced the need for borrowing. Such investments in infrastructure while providing long term economic benefits do little on the short term. However, freeing the budgets from such investment burden provides opportunity for investment in service improvements that are able to generate immediate boost to the economy. Such investment approach has led to the reduction of Australia's debts while boosting its economy, which in one stone got the two birds of improved credit worthiness and private investors' market confidence.

HUNGARY

Background

2.51 Hungary has made the transition from a centrally planned to a market economy, with a per capita income one-half that of the Big Four European nations. Hungary continues to demonstrate strong economic growth and acceded to the European Union in May 2004.

2.52 The private sector accounts for over 80% of GDP. Foreign ownership and investment in Hungarian firms are widespread, with cumulative foreign direct investment totalling more than $23 billion since 1989.

2.53 Hungarian sovereign debt was upgraded in 2000 and together with the Czech Republic holds the highest rating among the Central European transition economies; however, ratings agencies have expressed concerns over Hungary's unsustainable budget and current account deficits. Inflation has declined from 14% in 1998 to 7% in 2004. Unemployment has persisted around the 6% level, but Hungary's labour force participation rate of 57% is one of the lowest in the OECD. Germany is by far Hungary's largest economic partner. Policy challenges include cutting the public sector deficit to 3% of GDP by 2008, from about 5% in 2004, and orchestrating an orderly interest rate reduction without sparking capital outflows.

Government Structure

2.54 Public administration in Hungary is divided between state public administration and public administration performed by local government. Hungary has nineteen counties and over 3,100 municipalities. Each municipality is equal before the law. There are two elected layers of governance: parliament and over 3,100 municipal assemblies.

2.55 There are also seven regions created after nearly six years of intense debate that included options to turn Hungary into one region together with general disagreement over the defining of inter-regional boundaries. Boundaries were not based upon demographic, economic or geographic fault lines but rather by political compromise; the nineteen counties were retained and added together to form regions. Beyond planning and coordination, regional officials have few functions. Hungary's regions were the next debate, naturally, centred on which “poorer” counties to include in the
Central Region dominated by Budapest which exceeded 75% of the EU reference GDP per capita figure by the late 1990s. Regions stretch laterally over diverse economic and geographic zones in an arbitrary manner.

**Hungary’s Regional Development Dilemma**

2.56 Those organizations with the greatest democratic legitimacy and citizen involvement have the least authority and certainly no own sources of funds with which to conduct regional development. Conversely, the National and Regional Development Councils and the County Development Councils control funds for which municipalities and micro-regional associations, private businesses and NGOs have to compete.

2.57 Ministries, national agencies and other authorities dominate the Regional Development Councils and the National Regional Development Council and may decide over the allocation of funds and supervise their use, while micro-regions, led by municipalities, are in a subordinate grant-seeking position even though their plans may reflect true cross-sectoral and grass-roots interests.

2.58 The Regional Development Councils were only formed under pressure from various EU funding sources that require plans to be made on a regional basis. Instead of creating regional governments or authorities, Hungary’s seven “statistical-planning” regions form the target areas for EU funding, and legislation requires that the national budget allocate funds to each region annually. Representatives of the County Development Councils, the county assembly presidents, are the only elected officials on the Regional Development Council. The rest are delegated and subject to ministerial veto if conditions deem it necessary.

2.59 The County Development Council is the first level of organization dominated by elected officials of a self-governing body. Their role is to coordinate the various plans of municipalities and micro-regions, as well as of NGOs and private businesses. The County Development Council prepares financial plans and takes part in the allocation decisions regarding the various available national equalization funds. The Council gives grants as well as supervising the implementation and monitoring the use of funds. The Council itself may seek funds for its own operations and for the giving of additional grants.

**Regional Fiscal Policy**

*Background*

2.60 Hungary’s Local Government Law, in effect since 1990, allocates great responsibilities to local governments regardless of size with respect to public services. These responsibilities are matched with the authorisation to conduct for profit businesses, to own and manage commercial property, to own and manage portfolios of securities, and to borrow for capital investment projects, freely, without any need for approval from or registration with a higher level of government. Hence Hungarian local governments were free to borrow for capital investment purposes from domestic and foreign banks, and to issue bonds, at whatever terms and in currencies the two parties found acceptable.
2.61 Given the freedom to operate businesses and to conduct for profit operations, the assumption was that profits from these operations could be used to finance debt to build infrastructure, health and other fields. With the advent of the 1990 Local Government Law, Hungary’s 3,100 plus local governments became independent entities subject only to the supervision of Parliament, with no intermediate layer of government or administration (counties, districts etc) to approve, intervene or monitor their activities. Given virtually unlimited freedom to manage assets and to conduct business, local government operational budgets and mandated activities could be threatened if the proper prudence and experience were absent. Any proposal to monitor or control local government activity by the central government was hence viewed with suspicion. For these reasons, as well as fiscal stress at the national level, several local governments borrowed too much for non-mandatory purposes that by the end of 1994 the central government had to consider methods to reign in irresponsible borrowing and activities at the local level.

2.62 The situation in early 1995, besides budgeting for the 25 basic, and several hundred subsidiary tasks that local governments must perform by law, municipalities began to borrow funds for profit-seeking activities, endangering mandatory tasks and solvency in many cases. Borrowing in some cases exceeded the total budgets of smaller municipalities, and the economic viability of non-mandatory infrastructure was also questionable. Given the unfettered freedom of local governments to manage their assets and budgets (within the constraints of shared taxes, transfer payments and local tax capacity) the central government faced the possibility of having hundreds of cases of contingent liabilities and the risk of having to directly carry out mandatory local tasks if local governments failed.

2.63 By 1995, Hungary’s trade, budget and current accounts deficit placed such pressure on the government, that it enacted series of fiscal restrictions known as the “Bokros package.” Combining a one-off devaluation with a host of real cutbacks in spending and other restrictions, the situation of indebted local governments became more serious. By the end of 1995, several local governments lobbied for, and received one-time grants from the central government’s general reserves to resolve insolvency caused by mismanagement and excessive debt. The availability and disbursement of funds to five municipalities in distress due to irresponsible and excessive borrowing for non-mandatory purposes threatened to establish a bad precedent, and immeasurable contingent liabilities for the central government. The eventual repayment of these temporary bridge grants to the Central Government was to be addressed in a future debt adjustment law where the central government would assume the role of a creditor. Given that the International Monetary Fund and other international organisations wished to make the entire state budget as transparent and unequivocal as possible, negating contingent or implicit state liabilities became a policy goal.

2.64 Hungary’s corporate bankruptcy law, in force since the late 1980s, was not entirely applicable to borrowers who could not be liquidated without the state taking over their duties. Furthermore, each citizen has a constitutional right to representation at the local level, so local government cannot be liquidated like a commercial code enterprise. Without the political will or ability to tightly control local government borrowing and business practices by constitutional and legislative instrument, the Hungarian government decided to propose a municipal debt adjustment law that
would be invoked if prudence and other pre-emptive measures failed. Since the
Municipal Debt Adjustment entered into force only 18 municipalities have filed for
debt adjustment. The law was able to pre-empt additional filings as both creditors
and debtors were encouraged to seek redress outside of the court system, and to
take other steps to ensure solvency and operational efficiency. In essence the law is
successful since within the overall legal framework and capital market, municipalities
stopped borrowing in excess of their capacity to service debt.

2.65 The initiation of the debt adjustment act in 1995 and its coming into force in 1996
must be viewed in the context of declining real resource transfers to the local
government sector, the privatisation of the economy, and the stated goal of
successive governments to rationalise local government services without changes in
the constitutional framework. Instead of revamping task allocation due to political
obstacles, Hungary’s approach has been to regulate where possible and to allow
market actors to assume risk.

2.66 As a consequence of the above, the freedom given today to municipalities by the
Hungarian laws can not be abused anymore. One reason being that municipal
revenues such as central grants and income from privatisation proved to be enough
(over the last ten years period) and the other reason is that, because of no state
guarantee on municipal debt, there is a strong market control on borrowing, i.e.
because the state does not repay municipal debt, so municipalities can only raise
loans if they meet the credit worthiness criteria set by the lenders, such as:

♦ Income sources of the municipalities, as the most important requirement for local
credit worthiness, require the existence of a stable income, the amount of which
depends on the municipality, and not on the will of the central government or
economic cycles.

♦ The due diligence of local managers should result in their ability to (i) respond to
changes in local market conditions, (ii) recognise problems, (iii) implement
alternative solutions to solving problems, (iv) evaluate and compare solutions, and
(v) make long-term forecasts. Furthermore, if a bank finances a municipal project, it
must thoroughly analyse the feasibility of the project, its liquidation value and the
political stability of local management.

♦ Local politicians must often make unpopular decisions (introduction of new taxes,
increase of the old taxes), which they must be able to explain. The explanation of
why changes are necessary and inevitable could be based on theories of public
policy – e.g., where local taxes are higher, the municipality is able to spend more on
public services thus increasing the net benefit to the taxpayer.

♦ Credit worthiness of citizens, which irrespective of how brilliant the local
government policy, if the citizens or local companies are not able to pay the taxes
and user fees, the municipality will not be creditworthy.

♦ Trust in the municipality, as Hungarian municipalities do not meet the market
criteria, they are in a very difficult situation due to the lack of traditional financial
sources, but also based on economic rationality, they will have to use loans for their
investments.

2.67 The central government has therefore two main tasks related to the credit worthiness
of municipalities. First, it has to keep its own credit worthiness as high as possible in
order to maintain the credit worthiness of the municipalities and secondly, it has to enhance and rationalise the institutional and legal framework for municipal credit market participation.

Summary

2.68 Municipalities are effectively the only relevant tier of Local Government as far as the decentralised delivery of public services is concerned.

2.69 By Law a number of subsidiary tasks were allocated to municipalities as part of the decentralisation process in return for annual budget allocations. As the allocations are never sufficient to perform all tasks under their remits, municipalities are entitled to freely decide on raising loans or issuing bonds. However, loan debts or bond issued can not be secured with the coverage of government budgetary or grant contributions or by the principal municipal assets. Municipalities may incur an annual debt (including loans and interests, bond issues, guarantees and sureties given and leasing) not exceeding its adjusted independent current revenues. This does not include short-term (less than one year) loan debts and the current year's portion of debts repayable in several years. "Adjusted independent current revenues" mean 70% of the projected annual independent revenues less short-term liabilities (principal and interest payments, leasing fees) payable in the current year. "Independent current revenues" consist of local taxes and stamp-fees collected by the municipalities, interest earnings, environmental protection penalties and other special revenues. The representatives' council makes the decision on raising the loan and the State Audit Office (ÁSZ) subsequently verifies the lawfulness of the borrowing. However, the real due diligence is that of the Lenders who have the real control on borrowing.

Public Private Partnership

2.70 The Hungarian Government has been committed to promoting Private-Public Partnership (PPP) at the Local Level as a mean to procurement, particularly given the shortage of local financial resources.

2.71 A PPP Department was created within the Ministry of Economy and Transport and an interdepartmental committee was set up in 2003 between:

- Ministry of Economy and Transport
- Ministry of Finance
- Ministry of Justice
- Prime Minister’s Office
- Central Statistical Office

2.72 The committee has identified a number of potential areas where PPP could be used, including:
Road infrastructure development program

- Long-term goal: 2500 km length of expressway network by 2015 following the Act CXXVIII on the development of the Hungarian expressway network of December 2003.
- Example: M6 motorway, part of the V/c Helsinki corridor, with approximately 252 km section between Budapest and the Croatian border to be built in 2 phases: first phase between Budapest and Dunaújváros (54 km) by 2006; second phase between Dunaújváros and the Croatian border (198 km) by 2007.

Student hostels

- Development of university infrastructure, following the Government decision on creating 10 000 accommodations in student hostels.
- The pilot project of the University of Debrecen (under construction) was procured using a classical DBFO structure
- 11 further similar PPP schemes for other universities

Penitentiary system

- Development of the penitentiary infrastructure - two new PPP prisons
- DBFO construction during a period of 15-20 years, 700 prisoner places / prison, including an Operation element excluding those tasks are performed by the state which cannot be carried out by the private sector (custodial services, on site medical facilities and registering of prisoners)

Hungarian Municipalities Experience with Public Private Partnership

2.73 To deliver the services under their remits, municipalities may independently enter into PPP contracts without prior central government approval. In practice, there have been minor PPP projects initiated by municipalities, primarily public utility service projects, though these do not qualify as PPPs in the true sense.

2.74 The Public Utilities Act specifies that municipality do not have the right of full sale of the utility (project). Consequently, municipalities often outsource the service under a PPP contract to a service provider company, in which the municipality retains 49% of ownership. In summary, traditional PPP projects are rare among municipalities although there have been a number of initiatives in various areas of development aimed at getting the private sector involved in one form or another.

Road infrastructure development program

2.75 Three project cases are discussed in Appendix B-2 to this report, highlighting success and failure examples of PPPs in Hungary:

- Project Case A - ASA and Rethmann Waste Management;
- Project Case B – M1-M15 Motorway;
- Project Case C – M5 Tolled Motorway.
The examples highlight a municipal experience in Waste management and two Road Transport schemes undertaken by the central government.

**Conclusion – Hungarian PPP Experience**

From the Hungarian experience with PPPs, particularly in the road sector the following conclusions could be drawn:

- Direct negotiations and competitive tendering can both result in a positive outcome, but a professionally conducted competitive tendering process has major advantages, including possible long term cost savings;

- Pricing and risk sharing can be resolved in different ways, but it is risky to base contracts on loosely founded expectations regarding income growth.

- The M5 experience highlights the importance of an appropriate allocation of risks between the public and private sectors and the critical requirement for avoiding the transfer of unmitigated traffic risk to private sector investors and their lenders. This is especially important in transport corridors without previous experience of tolling.

- The early operating experience of the M5 illustrates the difficulties, which even the most experienced traffic forecasters have, in arriving at dependable forecasts of toll acceptance by drivers in a traffic corridor with no prior experience of tolling.

- Given the inherent uncertainty of traffic forecasts in such situations, the Government commitment to support, through making arrangements, such as the revenue deficiency facility, were critical in ensuring the financial existence and viability of some Projects and in avoiding the risk premia, which lenders and investors would otherwise require.

- Experienced technical, traffic, financial and legal advisers were important to both the Government and private sectors in order to achieve a satisfactory allocation of risk and an appropriate revenue support mechanism.

- The financial viability of capital-intensive projects is dependent on achieving loan maturities of acceptable length. The loan maturity available to borrowers in Hungary has substantially increased in Hungary as a result of Hungary’s improved economic position and EU accession status. IFIs played critically important roles in enabling the necessary loan maturities to be achieved.

- Notwithstanding the high economic and political priority of some Projects, the viability of the PPP were often undermined by underlying economics, which in practice does not bear out the optimistic traffic forecasts at the time of decision to build schemes.

- The M1-M15 Project has established itself as a benchmark of the dangers to which project participants are exposed when traffic risk on a Greenfield project is transferred to private sector participants without mitigation or contingent support.

- There is a wide variety of different commercial structures (availability charges, shadow tolls, etc.) that need to be explored as part of projects financial feasibility studies (business case), which need to be explored.

- A defaulting private sector concession can lead to re-nationalisation.
NETHERLANDS

Background

2.78 The Kingdom of the Netherlands was formed in 1815. A modern, industrialized nation, the Netherlands is also a large exporter of agricultural products. The Netherlands participated in the introduction of the Economic and Monetary Union (EMU) in 1999.

2.79 The Netherlands has a population of around 16.3 million, GDP/capita of $28k. It has a prosperous and open economy, which depends heavily on foreign trade. The economy is noted for stable industrial relations, moderate unemployment and inflation, a sizable current account surplus, and an important role as a European transportation hub. Industrial activity is predominantly in food processing, chemicals, petroleum refining, and electrical machinery. A highly mechanized agricultural sector employs no more than 4% of the labour force but provides large surpluses for the food-processing industry and for exports. The country continues to be one of the leading European nations for attracting foreign direct investment. Economic growth slowed considerably in 2001-03, as part of the global economic slowdown, but for the four years before that, annual growth averaged nearly 4%, well above the EU average. The government is wrestling with a deteriorating budget position, and is moving toward the EU 3% of GDP budget deficit limit.

2.80 The Netherlands' nominal GDP amounted to Euro 454,276 million in 2003, the sixth largest among the EU members. Its per capita GDP was 11% higher than the EU average. The gross public debt/GDP ratio slightly rose to an estimated 55.7% at the end of 2004 from 54.3% at the end of 2003, due to fiscal deficit.

Government Structure

2.81 The Dutch Constitution defines the Netherlands as a decentralised unitary State, with three tiers of government: Central Government, including the Houses of Parliament (Senate and Second Chamber), and Local governments including Provinces and Municipalities. All Local governments are autonomous and the law makes no distinction between small or large municipalities. Of course, the nature of issues facing large cities is not the same as those of rural municipalities, but basically all have the same tasks and responsibilities.

2.82 There are twelve provinces in the country and 467 (in 2005) municipalities. In addition some regional districts, the Netherlands Antilles and Aruba.

2.83 The European Union is becoming more important – more than 50% of legislation in The Netherlands comes either directly from Brussels or is influenced from Brussels. The legislation affects all tiers of government directly. The twelve provinces of the country have joined hands in the Inter-provincial council (IPO).

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33 http://www.jcr.co.jp/E0503/E12056.htm  
34 Association of Netherlands Municipalities (VNG), http://www.vng.nl
2.84 The Association of Netherlands Municipalities (VNG) was established in 1912 by 28 Dutch cities. After World War II, the size of VNG increased considerably, and its number of staff reached 500 in the late 1990s. Dutch municipalities today rely on VNG to represent their interests at the national government and to render services in all fields of municipal activities. From the very beginning, VNG has set up (and later privatised) companies, ranging from mutual insurance companies against the hazards of fire and storms (in 1918) and against fraud (in 1937), to an accountancy firm (in 1914). In 1914, VNG also took the initiative to establish a Municipal Credit Bank (which later became the Bank for Dutch municipalities).

Decentralisation

2.85 The Netherlands is a country with considerable experience in decentralisation. Municipal government is relatively autonomous and deals with a large package of tasks and responsibilities.

2.86 Provinces and municipalities have two sources of income: central government funding and income they raise themselves. Most central government funding comes in the form of special-purpose grants, with central government prescribing how they should be spent. In addition, municipalities receive block grants from the Provinces or Municipalities Fund, which they may spend as they see fit. Municipalities raise less income themselves than they receive from central government. Their own sources of income include property tax, court fees, and local charges. They may also raise income through charges such as dog licenses and tourist taxes.\(^{35}\)

2.87 Municipalities can freely borrow in the open market under the condition that the currency is Euro (requirement by law). They can issue bonds but in the Netherlands they normally don’t. The credit quality of the state of The Netherlands but also of provinces and municipalities is a so called “implicit triple A”. They also can guarantee loans but only under the condition that the currency is Euro. To guarantee a loan for an investment, the European state aid rules apply. To do this municipalities do not need prior approval from the province or the central government.

2.88 The Central Government intervenes to control municipalities and provinces’ future debt levels, only if the national EMU-shortage is in danger. Information about the EMU-shortage of municipalities and provinces is regularly collected by the Central Bureau of Statistics.

PPP Background

2.89 Possibilities for Public Private Partnerships were investigated in the Netherlands as early as 1999, where reflections and discussions were held across sectors of the economy and a sound policy framework was developed. A PPP Knowledge Centre, which is part of the Ministry of Finance, was established to gather together and make accessible the knowledge and experience of both the private sector and government agencies, to design clear and effective rules for collaboration between government agencies and the private sector, to suggest appropriate projects for public-private

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partnership, and to produce regular reports on the results of public-private partnership.

2.90 The Dutch model often referred to as Integrated contracts DBFM (Design Build Finance and Maintain). An integrated contract to a private-sector consortium for the performance of a public service such as the provision of infrastructure or the construction of government buildings, schools etc. In a contract of this kind, the various successive steps of the project (design, construction, maintenance and sometimes facility management and/or the operation of e.g. a government building) are integrated. The term of the contract is based on the life cycle of the project (e.g. 15-120 years).

2.91 The government formulates the functional requirements to be met by the project, without prescribing how they are to be achieved. This leaves room for the private sector to come up with the best and/or most efficient solution for the overall term of the contract. This means that as early as the design phase it is possible to take account of such aspects as maintenance and operating costs.

2.92 The private sector has much more input in the design of the project itself than with conventional procurements, where the government prescribes many of the details in the form of design specifications. To be able to procure a PPP contract, in other words, the government must have a clear idea of what ‘output’ (translated into a schedule of functional requirements) it is seeking to achieve.

PPP Legal Framework

2.93 Any action by a government by which establishes conditions for economic activities is governed by the general principles of the EC Treaty. At the same time, all government activity in the Netherlands is subject to the Algemene Begaselen van Behoorlijk Bestuur (General Principles of Proper Administration)\(^{36}\). The EC Treaty is concerned principally with the European Union’s rules and principles on non-discrimination, equal treatment, transparency, mutual recognition and proportionality. The way in which a joint venture is constituted must be compatible with the law of the European Community.

PPP Policy Framework

2.94 The Netherlands’ PPP Knowledge Centre has established a sound policy framework for PPP. The most important elements are:

- a list of basic conditions that PPP must meet in order to succeed. Essential points are that the government must know what it wants and must remain at arm’s length. There must also be sufficient political support;
- guidelines for the government’s use of financial instruments in PPP projects (equity, loans, subsidies with benefit sharing, etc);
- checklists for PPP contract types, such as DBFM (design, build, finance and maintenance), and other forms of partnership;

UPDATE ON BEST INTERNATIONAL PRACTICES IN PUBLIC PRIVATE PARTNERSHIP WITH REGARDS TO REGIONAL POLICY ISSUES

Review Report

- **instruments to screen the PPP potential of projects upfront and for comparing PPP with traditional implementation agreements to see if it offers added value;**
- **guidelines for efficient structuring of PPP-processes, with flexibility for modification as the occasion demands;**
- **recommendations on the use of market consultations, so that this instrument can be used more accurately, generate more information and cut unnecessary costs;**
- **a guide to making effective and proper use of European directives on public procurement in the PPP field.**

2.95 The fundamental policy objective is to enter into partnership with private parties so as to be able to deliver public services more cheaply, quickly and or efficiently. Just to set the record straight: private funding can play an important role here, but it is not the primary aim of PPP, it’s just a mean to improve incentive structures. The way the Dutch government seeks to exploit PPP is essentially the same as in other countries: government must be output oriented, the scope of projects must be optimised and above all, a balanced risk distribution must be achieved between public and private parties. A number of models exist for this purpose. Use is often made of international standard contract types such as BOT, DBFM and so on, e.g. in the field of infrastructure. In other areas – particularly in urban development – use is made of PPP models that enable public and private parties to develop plans in a concerted effort. After a plan has been developed, a working method is devised, and potential partners are identified. Market players must realise that often a number of public and private bodies are involved in these arrangements, and that consensus between the parties involved is essential to success.

**PPP in Local Government**

2.96 Municipalities in the Netherlands have the right to enter into concession/PPP agreements with the private sector. Though, the resolution to do so requires permission of the province.

2.97 Municipalities have used PPPs in past ten to twenty years to procure urban transport services (e.g. buses), water treatment, housing developments, and schools as detailed in the following section. Examples of this include the so called Vinex-locations where in the past years several Municipalities all over the Netherlands have developed residential housing with private partners. Also some industrial parks have or are being developed with private partners. These types of development are local industrial parks as well as regional industrial parks and port developments.

2.98 The types of agreement with the private sector are different. Some agreements have the character of full risk participation together with the private sector. Other agreements have more the character of a concession with turnkey contracting.
PPP Activities in The Netherlands

2.99 Priority projects have been defined as those which may be expected to lead to results in the short term (e.g. decisions on joint planning, contracting strategy or the award of a concession).

2.100 The PPP Knowledge Centre will provided assistance in prioritized projects in arranging the process and in financial and legal structuring. The experience gained from providing support to projects will be put to the use in the development of the instruments required for public/private cooperation. Over the years the emphasis has been focused on developing models for joint-venture projects, the development of standard modules and a checklist for PPP contracts, changes to the European procurement directives in the light of the development of PPPs in Europe, and the continuing development of models for the financial structuring of PPP transactions.

PPP in Railways

2.101 The first success in the field of rail projects has already been achieved in the form of two contracts for the Dutch High-Speed Line (HSL-Zuid) between Amsterdam and the Belgian border: the contract for the Infrastructure Provider, which has won a number of international awards, and the train operator's contract. At the time of writing a study is in progress, using the Public Private Comparator, to see whether the Hanse Line (between Lelystad and Zwolle) can be built under a PPP. Public-private partnership is also being considered for the Zuiderzee Line, but political decision-making on this project has yet to be completed. Given the success of PPPs in light rail projects in other countries, a study will also be carried out to determine whether light rail projects in the Netherlands can also be implemented with greater private-sector involvement.

2.102 In the area of rail management and maintenance, Railinfrabeheer (RIB) is currently developing new forms of contract based on greater responsibility for the private sector. Such contracts are likely to be implemented within the relatively near future. There are also a number of stations to be built as part of New Key Projects, including the Amsterdam Zuidas (South Axis) project, in which PPP contracts look like offering opportunities for creating social added value – an argument that the Ministry of Transport will be putting to the other interested parties in the project in its drive to encourage more public-private collaboration.

PPP in Roads

2.103 The first PPPs in road-building in the Netherlands are now beginning to bear fruit. The roads involved are the A59 motorway, the N31 trunk road and the Sijtwende project at Leidschendam-Voorburg. At the end of November 2002 the province of North Brabant announced that it had selected a bidder for the PPP for the construction and maintenance of the A59. At the same time the province also announced that the total cost of the project would probably be well below the benchmark price as established with a Public Service Comparator developed by the province, the methodology of which had been approved by the PPP Knowledge Centre. At the time of writing the A59 project is the subject of an in-depth evaluation. The results of this are expected before the end of the year and will be made public.
2.104 In parallel with the use of PPPs in construction projects the government has also created the climate for a broader use of PPPs in the nation’s road system. One example is the Access and Mobility Act (Wet bereikbaarheid en mobiliteit), which opens the way to the operation of tolls on new public highways.

2.105 In the roads sector the emphasis as a whole is on continuing the controlled expansion of public-private collaboration. Projects being considered for the PPP approach include the following: the Second Coentunnel in Amsterdam, including the Westrandweg and Verlengde Westrandweg, the A4 motorway between Dinteloord and Bergen op Zoom, the A2 motorway project at Maastricht and the A4 between Delft and Schiedam. PPP options are being worked out for each of these projects, taking account in each instance of experience gained in other construction projects carried out in public-private collaboration, such as the A59 motorway project. A pilot project is also planned with toll levying. In addition, the possibilities opened up by the PPP approach are also being surveyed more closely by the A4 Mobility Market Commission (Commissie Mobiliteitsmarkt A4). (See Appendix C for a PPP case in Wijker Randstad Tunnel project).

**PPP in Utilities**

2.106 On 2 October 2002 the DBFM contract was signed for the AHR wastewater purification project for the Hague region, a clear signal that the PPP approach can deliver considerable savings. Compared with the estimates produced by the Delfland water board, the private-sector bid was more than EUR 70m or 13% cheaper. At the same time firm commitments have been entered into regarding the investment that the consortium will make and – more importantly – about the quality of the consortium’s service provision to customers throughout the term of the contract.

2.107 There is no reason why these savings and improvements in quality cannot also be achieved in other major wastewater purification projects currently in the planning or early implementation stages. Agreements are currently being drafted with the umbrella organisation of Dutch water authorities (the Unie van Waterschappen) and the Directorate-General for Public Works and Water Management (Rijkswaterstaat) on ways of making contracting authorities in this field more aware of the potential benefits of taking the PPP route in delivering their public services. Rijkswaterstaat is presently investigating whether sludge processing can be carried out under a PPP.

**PPP in Education and Culture**

2.108 The education sector faces two major challenges. In the first place teachers have to be able to spend enough time on their core task, i.e. providing good education. Second, substantial sums need to be invested in facilities, either because of maintenance arrears or because of existing buildings no longer meet the requirements of a modern education system.

2.109 A study carried out by the ministry of Education, Culture & Science and the PPP Knowledge Centre has shown that public-private collaboration in schools construction can lead to an improvement in the quality of the buildings themselves. It also emerged from the same study that transferring responsibility for the management of buildings and facilities to the private sector can help both school
administrators and teaching staff use their time more effectively because they are better able to concentrate on their core task. Indirectly, then, a PPP can have the effect of boosting the quality of the education system as a whole.

2.110 The government is keen to help local authorities and school administrators in setting up qualitatively good PPP arrangements and thus to bring about a continuous stream of projects. To this end, three work flows have been established. In the first place, the local authorities and school administrations responsible for the schools construction pilot projects are being actively supported in the procurement of two high-quality PPP contracts which will demonstrably result in added value. Second, a ‘PPP Toolbox for schools construction’ is to be developed in parallel with the pilot programme and based on the knowledge and experience gained from it.

2.111 Using the standards and tools in the Toolbox, local authorities and school boards needing to invest in high-quality accommodation will be enabled to travel the PPP path at considerably lower transaction costs and in a shorter time. The Framework of Considerations for implementation options in schools construction is already available. The framework helps local authorities and school boards faced with a problem of accommodation to carry out a preliminary evaluation of the relative merits of the options open to them in the implementation of a construction project. Third, in the first half of 2003 a road show was held at various places throughout the country where local authorities and school administrators could learn about public-private collaboration in schools construction, the experience that had been gained so far in the pilot schemes, the opportunities offered by the PPP approach, and how they themselves could put that experience to work.

2.112 The PPP Knowledge Centre has drawn up a document summarising the frequently asked questions that emerged during the road shows. In the autumn of 2003 the road show is to have a sequel in the form of a ‘deepening-out round’, during which local authorities and school boards that have already decided to consider the PPP approach or are actively thinking about considering it will be given an opportunity through workshops to learn more about the steps that have to be taken. It is hoped that this process will lead to a broad stream of follow-up projects.

2.113 In addition, in the autumn of 2003 the Knowledge Centre and the ministry of Education, Culture & Science will be examining how far it is possible to use public-private collaboration as a means of achieving public goals in the policy areas of culture and the media. This may lead to the start of a number of concrete pilot projects.

PPP in Government buildings

2.114 Current developments are giving the Government Buildings Agency (Rijksgebouwendienst) cause to become actively involved with public-private collaboration. The developments in question are the agreements enshrined in the Strategic Accord, the reports of the Netherlands Court of Audit (Algemene Rekenkamer) on public-private collaboration, and the developments surrounding the parliamentary investigation of the construction industry.
2.115 It was agreed that in January 2003 two projects of reasonable size would be selected to be pilot projects as a means of gaining experience with the PPP approach. Both these projects are now expected to be awarded at the beginning of 2005. The Government Buildings Agency is also involved in the possible PPP for the renovation of the ministry of Finance, a decision on which is to be taken in June next year. The Government Buildings Agency hopes within two to three years to be able to gain sufficient knowledge and experience with public-private collaboration to allow it to be offered to government clients as a fully fledged implementation option. To achieve this, a start will be made in the short term with a PPP implementation programme to disseminate knowledge within the Agency. Depending on the results of the first pilot projects it is likely that others will follow.

Other PPP activities

2.116 At the end of 2002 the PPP Knowledge Centre completed a study of the possibilities for using public-private collaboration in the care sector. The conclusions were positive and the findings were set out in a report entitled ‘Publiek-private samenwerking in de Zorg, het full-service concept: een zorg minder’. In summary, the conclusions of the study were that the ‘full service’ concept can result in improved quality of accommodation and facilities services in the care sector and that public-private collaboration can contribute to improving the efficiency with which these services are produced, making them cheaper, better, or both. Incidentally it is a basic premise of the full service concept that clinical care should at all times remain, as it is now, the responsibility of the hospital or institution concerned. In conjunction with the ministry of Health, Welfare & Sport, work is now proceeding on a follow-up programme on the basis of which experience and knowledge will be accumulated for a first pilot project.

2.117 The programme for 2003 included a working visit to the chief stakeholders in a project in the UK, a market consultation exercise and the making of a PSC (Public-Sector Comparator) for a project still to be realised. The PSC will be designed to give an insight into the potential added value that public-private collaboration will deliver relative to conventional implementation and the extent to which public-private collaboration may be limited by existing legislation and regulation.

2.118 In a number of other countries positive experience has been gained with public-private collaboration in the prison and defence sector. As a result, in conjunction with the ministry of Justice a study was carried out in July 2001 to investigate the possibility of using PPPs in the Dutch prison service. The report and the results of the PSC carried out during the study showed that public-private collaboration would make cost savings possible without compromising quality. At the time of writing the finishing touches are being put to a follow-up study which more closely examines some aspects of public-private collaboration in prisons.

2.119 The potential benefits of public-private collaboration in the defence sector lie in economies of scale and the advantages of optimising costs on a life cycle basis. At the same time, under certain strictly controlled conditions it would be possible to cut costs by allowing a private-sector partner to make better use of the capacity present in defence materiel by using it for commercial purposes. The possible benefits of
public-private collaboration in the defence sector are being further investigated in collaboration with the ministry of Defence.

**PPP Knowledge transfer and standardisation**

2.120 It is crucially important for the knowledge and experience gained in the first PPP projects to be recorded, standardised and disseminated as far as possible. The evaluation of the past three years of public-private collaboration in the Netherlands shows that standardisation of processes and contracts is a very important factor in shortening the process of procurement and lowering transaction costs. This makes the PPP approach that much more attractive to both the public and the private sector, which is why it will be necessary in 2003, in addition to the project follow-up programmes, to turn our attention to standardisation. However, this in no way detracts from the fact that ultimately every project is tailored to suit the circumstances and that it is important to do justice to the specific features of the individual project. In this context the PPP Knowledge Centre hopes in 2003 to achieve the following results in the area of knowledge development and dissemination and the standardisation of processes and contracts:

2.121 Developing and making available models for concession contracts, payment mechanisms and checklists (by sector) with the chief legal and financial points of attention based on the experience gained with the first generation of projects.

2.122 Creating and making available a file of case histories.

2.123 Organising PPP courses for project leaders and policy officers in central government and other government authorities, plus a postgraduate course in public-private collaboration in conjunction with the Erasmus University of Rotterdam.

2.124 PPP Knowledge Centre is engaged on the development of a toolbox. This means that the documents that are important to the procurement of a DBFM contract for schools construction will be standardised by removing project-specific elements and confidential information. This process covers selection of guidelines and internal protocol, consultation guidelines and internal protocol, bidding guidelines and internal protocol, and the DBFM contract. It also contains a description of the various phases of the process (selection, consultation and bidding, negotiation and contract close), together with an examination of questions such as:

- what is the purpose of the product of the contract?
- who are the parties in the contract?
- how much time and money will it cost to produce the product of the contract?
- what can be done by way of preparation for the product of the contract?
- what are the pitfalls?
- how will bottlenecks be resolved?

2.125 A DBFM contract manual was issued, setting out how such a contract can be used by a local authority in collaboration with the school concerned.
**Summary of the Dutch Experience in PPPs**

2.126 Besides setting up policy frameworks, central government has also selected PPP pilot projects to supplement already existing PPP projects set up by local authorities. To this end it has chosen more than 30 promising, attractive, large-scale projects whose funding has moreover largely been secured and which have been approved by parliament.

2.127 The projects in question tend to be in the fact-finding or planning stage and tendering is largely expected to take place within the next two years. They cover a number of sectors: road and rail infrastructure, public transport, urban development, green infrastructure (development of rural areas), agriculture, cattle-farming and knowledge infrastructure. Sectors such as schools and prisons, where PPP seems to promise substantial efficiency gains, are also under consideration. It is hoped that this broad choice of areas will boost support for PPP in the Netherlands. Significant gains have already been made in a number of selected projects, partly through the application of the specially designed policy frameworks.

2.128 The tendering process for PPP contracts for building and operating the High Speed Rail Line (HSL), to mention the most high-profile example, is in full swing. A DBFM contract will be tendered for the construction of the HSL’s infrastructure (excluding the concrete supports for the rails, which will be tendered separately). The contract length is 30 years, and the payment of the infrastructure provider will depend on infrastructure delivery. This autumn, moreover, a start will be made with tendering DBFM contracts for two sections of motorway, the N31 in the North and the A59 in the South, hopefully paving the way for similar road projects. These first projects are crucial to the further development of PPP in the Netherlands. Not only will they show how policy on aspects such as tendering rules and the incorporation of PPP into democratic decision-making translates into practice, but they will also determine PPP’s image in the Netherlands. If these projects can be shown to be a success, support will grow.

2.129 If PPP works well in the N31 and A59 schemes, it will be in a strong position in the so-called BOR (Bereikbaarheids Offensief Randstad) plan to improve the transport system in the western Netherlands, the country’s economic heart. Billions of euros are being invested in this scheme, which seeks to reduce congestion in the region. The question at present is which types of PPP contract should be used in this gigantic project.

**The Way Forward**

2.130 In order to analyse the progress in PPPs, the Knowledge Centre commissioned in 2002 an evaluation of 51 projects. The projects were divided into two sectors: design, build, finance and maintain or operate projects and area development projects. The analysis in the first sector included 28 projects in rail and road infrastructure, utilities and housing for which DBFM/O contracts are applied or this option was being seriously considered. In the area development sector (rural and urban area development, business parks and inner city restructuring and combination projects) 23 projects were evaluated. The general conclusion from the analysis was that the projects selected for PPP were often relatively complex, started off with inadequate
budget and received insufficient political priority. The volume of the deal flow has therefore been largely dependent of several large projects. To give a few examples:

2.131 The HSL-South Infraprovder DBFM contract and the HSL-South Transport concession were completed at the end of 2001. The HSL-South IP contract, with a contract value of €1.2bn, arranges an availability of 99 per cent for the HSL-South infrastructure over a 25-year period. In 2002 the HSL-IP contract has been awarded two prizes from Euromoney’s Project Finance magazine.

2.132 The first road DBFM contract in The Netherlands was signed in February 2003. The contract with a value of €218M will have duration of 18 years and includes the upgrade of an existing secondary road to highway (A59) and future maintenance.

2.133 Another road project (N31) is in the stage of selecting bidders and in the summer of 2003 negotiations with the preferred bidder are planned to start. Preparations are already underway at the Ministry of Transport, Public Works and Water Management for the next phase of road projects.

2.134 In September 2002 a project development agreement with a contract value of €429m has been signed with the Delfluent consortium headed by Vivendi water and the Delfland Waterboard. Financial close of the DBFO contract for the construction and management of a wastewater treatment plant and the refurbishment of another one for the area of The Hague is expected at the end of 2003.

2.135 In July 2002 a public agreement was signed between two ministries, two municipalities and two school boards paving the way for PPP projects for secondary schools. The European procurement procedure of a DBFM contract for one of the schools called ‘Montaigne Lyceum’ has just been started.

2.136 A lot of progress has been made in the Netherlands through a number of, often large projects, in developing PPP knowledge and experience within the private as well as the public sector.

Lessons for the future

2.137 From the start of the Dutch PPP programme in 1999, value for money had been the primary driver. The Knowledge Centre only engaged in projects that should deliver either more quality for the same budget, or the same quality for a smaller budget.

2.138 The value for money criterion has not always proven to be a sufficiently strong driver of the PPP programme for two reasons. Firstly, too much time and money is spent in the early stages of potential projects on discussions if the prospects for realising value for money are good enough. Secondly, the benefits of PPP increase with the experience of public sector managers and private sector service providers. The value-for-money-criterion stimulated a focus on individual projects, while the development of a broad and deep market for PPP requires the creation of pipelines of projects. For example, realising two or three small road projects will not directly stimulate the private sector to develop a strong road management capability, nor will it stimulate the public sector to improve on its expertise to tender PPP road projects. The very innovative Dutch High Speed Rail Infrastructure PPP deals have been very
successful in creating value for money but because of the fact that they were one-offs they have not been successful in creating a new market for PPP in the rail sector.

2.139 The primary objective of future PPP-programmes should be to increase the quality of existing public services. This would help changing the focus from individual projects to pipelines of projects and would stimulate the development of a broad and deep market for PPPs. Value for money is still relevant, but more on a programme level than on the individual project level. Learning costs in early projects will be compensated by more value for money in later projects. Efforts on the part of the Dutch government and the Knowledge Centre to gradually introduce PPP appear to be bearing fruit. There is a broad support for it, a sound policy framework has been developed and it is likely to be used in a lot of potential upcoming projects in the area of infrastructure, utilities, government buildings, schools, and healthcare. In the next years it is expected that PPP will be added to the toolbox of Dutch governmental institutions as a generally accepted instrument to deliver high quality services to the public.

PORTUGAL

Background

2.140 Portugal has a population of 10.5m, GDP/person of $18k (about 70% of the European average), and a land area of just 92k sq km. The country is quite mountainous and has a splendid Atlantic coastline where most population is concentrated and where economic (particularly tourism) activities take place. One of the major transport hubs is the great harbour in Lisbon at the mouth of the Iberian Peninsula’s major river the Tagus.

2.141 Portugal has become a diversified and increasingly service-based economy since joining the European Community in 1986. Over the last decade, successive governments have privatized many state-controlled firms and liberalized key areas of the economy, including the financial and telecommunications sectors. Economic growth has been above the EU average for much of the past decade, but fell back in 2001-03.

2.142 GDP per capita stands at 70% of that of the leading EU economies. Portugal has been increasingly overshadowed by lower-cost producers in Central Europe and Asia as a target for foreign direct investment. The coalition government faces tough choices in its attempts to boost Portugal’s economic competitiveness and to keep the budget deficit within the 3% EU ceiling.

Government Structure

2.143 In Portugal decentralisation and share of responsibilities is organised in two tiers, the Central Government and the Municipalities. Although, the creation of regions has been decided, it is still at the very early stage and the already created regions are yet to acquire the required human and financial resources to assume any responsibility for public service delivery. The proposed regions will be formed with representatives from all member municipalities that share similar policy objectives and where the
geographical proximity requires cooperation for cheaper (economy of scale) and more efficient delivery of services to the residents (share of resources and skills). Thus, currently at the Local level, only Municipalities are assigned responsibilities for the provision of urban and sub-urban public services.

2.144 The decentralisation resulted in a split of responsibilities between and central and local governments over the delivery of some services and a joint partnership on others. For instance in the education and health sectors the provision of regional services, including the infrastructure (hospitals, secondary schools) and the operation of services, are provided by the Central Government, whereas the Local services are funded by the Municipalities. In the Water, Power and Transport sectors services are often provided through national companies (corporations or holdings), jointly funded by the State and the Municipality.

Regional Fiscal Policy

2.145 Municipalities come under the umbrella of the Ministry of the Environment who is responsible for co-funding their investment requirements. Municipalities have their own sources of revenues from residential and commercial taxes collected locally. For the Central Government contribution, Municipalities are required to prepare a yearly investment plan, where they have full freedom on defining its scope and priorities according to their own local policies, and where the Central Government has the only remit of ensuring compliance with the national budget constraints. The intention in the future is to progressively implement a five year investment plan as required by the EU from which important component of the municipal investments are co-funded.

Public Private Partnerships

2.146 Following the launch of the National Road Programme in 1996, the Portuguese Government initiated a programme of new motorways on a project finance basis, with an aggregate investment cost of around EUR 5 billion. The first phase of the programme included two real toll and six shadow toll (SCUT6) road concessions (an additional SCUT was included later). Some of these highways provide main transit corridors between Portugal and Spain, which constitute a vital part of the national motorway network. A rapid programme of road construction was required at a time when public sector budgets for new capital investment were heavily constrained. The objective was not only to enhance the availability of the road infrastructure, but also to compensate for regional economic imbalances and generate employment.

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37 ASECAP, the European tollsters association statistical bulletin for 2004 reports Portugal has 1140km (708mi) of tollroads with 843 toll lanes at some 112 toll stations or toll plazas. After Italy it is the biggest user of electronic tolling with 1.6m vehicles with transponders. 460, or more than half its toll lanes are equipped for ETC. The nationwide system is known under the brand name Via Verde (green way) and was started in 1991 using the first generation backscatter tags from Micro Design (name changed to Q-Free) of Norway. By 1995 all toll plazas had ETC, a first in Europe. Brisa recently signed a contract with Kapsch for dualmode readers to handle the huge existing population of MD5803 tags and also newer CEN-278 or European standard transponders which are becoming more commonly used, especially in France. Both operate at the same 5.8GHz frequency which complicates schemes to make the transponders work together. Brisa is Portugal's dominant tollster with a majority of the toll motorways in the country and several SCUTs. A publicly listed company it has been building tollroads in Portugal since 1975 and now operates eleven totalling 1005km (624mi) with another 80km (50mi) under construction. In 2003 Brisa took $600m (E500m) in toll revenue. It is the fifth largest company by market capitalization on Portuguese stock exchanges. Its chairman Vasco Maria Guimarães Jose de Mello - Iberian names are splendid eh? - is one of the country's most prominent businessmen. Brisa has major shareholdings in tollroads in Latin America, Spain, and Italy.
opportunities, with the smallest possible initial financial contribution from the government.

2.147 Over the last decade, PFIs and PPPs have become useful tools in Portugal for the government to develop public infrastructure.

2.148 After the success of these infrastructure projects, the focus in 2003 switched to the construction of football stadiums for the Euro 2004 championship, hosted by Portugal. The football associations embraced the PFI/PPP concept, albeit with some fine tuning in relation to other PFI/PPP projects. The stadiums were successfully built and ready for Euro 2004.

2.149 The country is now set for further major PPP programmes in the health sector followed by a new rail infrastructure programme. The hospital programme calls for the launch of tenders for 10 new hospitals by the end of 2006, and the Portuguese railway is gradually restructuring its operating system leading to further commercialisation and possible part privatisation.

2.150 As the Portuguese Government is committed to developing its high speed rail link with Spain, in November 2003 the two Governments agreed on building 5 new high speed lines and possibly a new bridge over the River Tagus.

2.151 Further opportunities will also arise as the Lisbon Metro is being expanded to link in with various overland commuter lines and the Lisbon Airport.

2.152 The shadow toll (SCUT) was considered by international agreement as a great success which explains the high appetite for it manifested by international investors. This view however is beginning to change since the government recent attempt to introduce tolls on the shadow tolled highways. Toll revenues will be used to cover the yearly bill that the government will have to pay the shadow toll companies starting 2006. The bill estimated at $600m (E500m) per year in 2006 will escalate to $800m by 2008.

2.153 Portugal's 2750km (1700mi) of motorways are about two-thirds tolled, one third non-tolled including concessioned but not yet opened motorways. Most of the untolled roads have been financed with 'shadow tolls' - government payments to the private enterprise financiers and constructors of the road based on traffic. Like so many "innovatory finance" shadow tolls don't establish any new revenue stream, and therefore tend to be a short-term expedient - as Portugal is discovering. Shadow tolls are ways of having the private sector provide the initial financing which is attractive to politicians wanting to cut the ribbon on a new road. But the government still has to come up with the money to pay off the shadow toll concessionaire year by year, so it gets into a situation little different from a government which simply borrows and builds the road itself, and then has to service the debt and do maintenance.

2.154 The SCUT-IP5 concession for 167km (104mi) of motorway going north to the Spanish financed in 2001 was largest shadow toll concession in the world. The financing was for $1.5b (E1.2b).
2.155 The worry is that the SCUTS do not have great toll potential. According to Standard & Poor's (London), even without tolls the SCUTs have been forecast to have light traffic. Projected traffic for 2006 for the SCUTs: Algarve 16k, Beira Interior 13k, Costa da Prata 39k, IP5 9k, Grande Porto 33k, Norte Litoral 23k, Interior Norte 7k. S&P thinks that the crunch had to come, and that the SCUTs being floated were unsustainable financially. S&P was starting to look at the effect of the SCUT burden on the overall credit rating of the government of Portugal. By 2007 SCUT payments would have increased ten fold to 0.4% of Portuguese GDP. Portugal was headed inexorably in the direction of New Jersey whose debt service is now using up the whole of its transportation trust fund.

PPP Law

2.156 A number of changes have been introduced in the area of corporate finance legislation and securitisations. Two had an enormous impact on the market; one creating a platform for financing the stadiums related to the Euro 2004 championship and the other allowing the Portuguese state to conclude the first securitisation of non-performing tax claims ever carried out in Europe. As well as these two events, many others will undoubtedly follow the development of legislation relating to private finance initiatives, based on public and private partnership and securitisations.

2.157 It was during 2003 that the government decided to implement a decree law (86/2003 of April 26) known as the PPP law, which applies to existing and future PPP projects. PPPs are defined in the law as a contract or union of contracts, according to which a private entity agrees with a public entity to develop a long-term activity and cater to a public need, and where the financing and operation of such activities are partially or totally the responsibility of the private entity.

2.158 PPPs can be financed either in a project finance regime or not. Project finance concerns the financing of long-term infrastructures, industrial projects and public services based on a non-recourse or limited recourse financial structure, where project debt and equity used to finance the project are paid back from the cash flow generated by the project.

2.159 The private sector companies use project finance as a means of funding large projects off balance sheet. The private companies create a special purpose vehicle (SPV), which consists of the consortium shareholders and is created as an independent legal entity that enters into contractual agreements with a number of other parties necessary in a project deal.

2.160 The public entity - the state and other public entities, the funds and autonomous services, and other public companies or entities incorporated to satisfy public interests - awards the SPV an agreement (public works concession agreement or public service concession agreement) granting it an exclusive ownership of a specific facility or asset for a certain number of years. At the end of the agreement the asset is handed back to the public sector. The agreement usually entitles the SPV to build, finance and operate for a fixed period of time, although there are variants.

2.161 The new law has created other types of agreements, such as: (i) the services agreement (contrato de prestação de serviços) where the public entity continues to
operate the public service and the private entity cooperates in certain services; or (ii) the management agreement (*contrato de gestão*) according to which the private entity manages a public establishment rendering services to third parties and is paid a fixed or variable amount periodically by the public entity (these types of agreements are used in the health sector); or (iii) the cooperation agreement, which relates to establishments or infra-structures owned by charities or other private solidarity entities.

2.162 The new law tries to avoid situations where risks, such as those in relation to the environment or expropriation of land, have not been measured by the public entities, or where the state assumes certain payment obligations without having created the required budgetary allowances (for example, highway SCUT concessions or virtual tolls, where the payments are made by the public entity and not by the user of the highway). The law clearly requires the public entity to measure the risks and avoid future compensations to the private entities or payments unforeseen when the agreement was negotiated. The public entity must negotiate a PPP with a reasonable assurance of the stability of the agreement.

2.163 It is clear that the public entities will only be able to attract private entities to these projects if the agreements are complied with and, moreover, if unilateral modifications by the state that change the financial balance of the agreement are exceptional and not the rule and the private entity is totally compensated for these modifications.

**PPP at the Local Government Level**

2.164 In Portugal, given the social orientations, most of the corporations’ services are subsidised and rarely break even. This applies to the Local (metro, tram, bus companies, etc.), as well as the national corporations (National Train Company “CP”, Rail Network Manager “REFER”, etc.), though the subsidy is partly provided by the European Community funds.

2.165 PPPs have already been used by Portuguese Municipalities for the provision of water supply, waste treatment, energy (wind farms) and urban public transport services. The decision making is entirely carried out by the Municipality who has full freedom by Law to enter into PPP agreement with a private partner, as long as no Central Government contribution is required. The municipalities, however, given their lack of experience and capabilities to prepare, negotiate and commission PPP contracts, often seek support from Central Government support through entities like Parpublica. The only restriction on municipalities is on direct borrowing or guaranteeing loans on behalf of the private partner. These are regulated by rules provided in the Budget Law which issues a yearly ceiling on maximum borrowing as a function of the municipality previous year budget and the expected revenue streams for that year.

**Conclusions – PPP Experience in Portugal**

2.166 The Portuguese PPP experience demonstrated the effectiveness of PPP for the rapid development of infrastructure and the improvement of service to end-users. But effectiveness is not enough; the real goal is economic efficiency. The recent changes in the design of contracts and in the appraisal rules were aimed at obtaining real
efficiency in the provision of infrastructure and services, real value for money. In Portugal and Europe, the different PPP models and procedures should be carefully analysed and evaluated, in order to learn from experience.

2.167 The PPP experience in Portugal indicates that projects more clearly defined in term of outputs (i.e., the specific requirements of the service to be provided or the licensing requirements for the infrastructures needed) tend to present better results from the public sector viewpoint: shorter tender processes, better price conditions (figures lower than expected or presenting lower increases relative to other projects) and higher success in the completion of deadlines.

2.168 The environmental licensing of projects is increasingly crucial for the success of PPP projects, so there are great efforts being directed into making the required environmental impact studies and obtaining initial licenses prior to going to tender, in order for the bidders to know all the required limitations and mitigation measures that they should include in their proposals.

2.169 Being used to the traditional tender of infrastructure projects and to the provision of service by the public sector, government departments tend to incorporate in the tender documents many input specifications and to prescribe several processes, designs or technologies.

2.170 There is therefore a constant need to purge documents of the unnecessary specifications, allowing the private bidders (and managers) some space for innovation and for efficient management; there is also a need for output and performance specifications to replace those discarded input and process specifications.

2.171 In some PPP schemes — such as hospitals, rail and tram — the adequate sharing of risks induced a split of responsibilities and payments between two concessionaires: one that provides an infrastructure for a long term (typically 30 years) and one that provides a service (for a much shorter period) using that infrastructure. That is the model for hospital PPPs, because the contractual arrangements for the clinical services can only be agreed for a period shorter than the one needed for whole-life-costing of infrastructure. That is also the model for rail and tram PPPs, where infrastructure and rolling stock is subject to availability risk, and transport service is subject to traffic risk (for shorter periods, because government and local authorities cannot commit themselves for long periods on some factors that affect traffic risk, such as maximum ticket rates, new transport systems, or urban parking rules).

2.172 The main lesson resulting from the Portuguese experience is probably the need for careful accounting of aggregate long-term government commitments. Falling short of a genuine long-term budgeting (a 30-year window would be convenient), which no country has ever implemented, a specific appropriation process for PPPs — like the one Portugal adopted — has two direct effects:

♦ It allows for a better evaluation of the affordability of every new project. In the cases where payments by end-users are not enough for achieving the long-term financial equilibrium of the project, the characteristics of the PPP scheme should be defined taking into account the potential availability of public funding for the
whole life of the project, or even some degree of public subsidy during the initial years.

♦ It reduces the concerns about eventual transfer of costs from current to future generations. The particular time schedule of investments and payments in PPP contracts — with payments typically starting only after the completion of infrastructure, several years after signature of contracts — implies that these contracts, if improperly dealt with, are a powerful instrument for keeping public expenses out of the books, for under-evaluating them and for biasing decisions in favour of PPP schemes that accelerate investment and delay payments by the public sector to the private partners. This creates the possibility of undertaking inefficient projects, or efficient projects that are too much of a burden for future generations to pay, future generations that were not included in the decision process.

2.173 The budget laws now require the production of an estimate of the long-term impact of the PPP on public accounts and that the adequate appropriations have to be made prior to launching a PPP programme.

2.174 Reference should be made to the fact that some PPPs financially commit the public sector for a long period, increasing the rigidity of the public expenses, a major concern for a small country integrating a monetary zone, like Portugal, that regards fiscal policy as the sole stabilization policy under its control. This should be traded off with two positive impacts: the fact that PPPs imply — and, in a certain way, foster — better long-term budgetary planning; and the potential PPPs present for achieving a more efficient use of scarce public resources.

2.175 In Portugal, the central government public investment budget (PIDDAC) amounts to more than 6 billion euros, with one third of that applied to transport projects (mainly railway, highway and ports). In the last years, the annual highway PIDDAC was 750 million euros (including maintenance of existing roads and bridges and building of new ones), around 0.5% of GDP; the PPP concessionaires invested a greater amount. But, two years from now, and for the next 20 years, the projected amount of yearly shadow toll payments will reach 700 million euros, inducing an upward pressure in the transport budget. That is why the current Portuguese government decided to introduce real tolls in some shadow toll concessions, a matter that will be subject to revision in the next few months. In the health sector, the 10 PPP hospitals (with 30-year contracts for the buildings and 10-year contracts for the provision of services, including clinical services) will create another yearly payment of around 0.5% of GDP, but are expected to replace expenditure on old hospitals and to induce efficiency in the sector and so could act as a deterrent to expenditure growth in public hospitals.

2.176 PPPs may create some rigidity in the management of public expenditures, for many years, but they may be used to induce efficiency in the provision of public services and infrastructure (reducing long-run financial needs) and to force increased monitoring of budget requirements (inducing some short-run savings).
Background

2.177 The UK was one of the first countries to introduce the concept of public-private partnerships. Some of the most successful partnerships have been in the transport sector. Much attention has focused on the success of the private finance initiative (PFI) in the road sector that has already brought more than £1 billion of new capital into the sector. The UK Government’s Ten-Year Plan, published in July 2000, envisaged an even greater role for private sector finance. During the ten-year period, total transport investment was expected to reach £121 billion, of which about £56 billion is expected to come from the private sector. Total expenditure on roads is estimated to be nearly £32 billion, of which £5 billion is expected to come from the private sector.

2.178 The UK has also been a leading innovator in other partnership programmes. The UK’s public-private partnership programme (PPP) includes extensive outsourcing of the planning and management of roads. This has been used extensively at the local government level and is being increasingly applied on the national road network. Under these arrangements, private sector entities act as agents for government and deliver a wide range public services previously provided directly by government.

2.179 The above innovations have brought significant benefits to the transport sector. They have delivered projects more quickly, costs have been better controlled (cost savings of up to 30% have been achieved), project quality has been better (there are contractual penalties for poor performance), safety incentives have reduced road accidents, they are more effectively marketed to the public, and they tend to show a higher level of customer satisfaction.

Experience of Public Private Partnerships

Overview

2.180 In the United Kingdom, research commissioned by the Treasury Taskforce and the National Audit Office provides positive evidence of the overall potential for Public Private Partnerships to deliver value for money. The key findings of this research can be summarised as follows:

- The review identified average savings of 17% against the Public Sector Comparator on an unnamed sample of 29 completed projects. Three projects accounted for almost 80% of the total combined saving, and the average saving across the remaining 26 projects was a more modest 7.5%.

- 81% of local authorities rate the value for money achieved by PFI deals to be satisfactory or better and 72% of local authorities have a good relationship with their service provider. Only 4% of authorities consider that PFI has delivered poor value for money, and only one percent of authorities have a poor relationship with their service provider.
**PPP in Infrastructure**

**Water**

2.181 The global water industry is currently in a period of unprecedented change, driven by a growing demand for water and a need for substantial investment in new technology and improved water infrastructure. The scale of these investments, combined with the need to introduce new technologies and skills, provide a significant incentive for the UK to make use of private sector skills and finance to satisfy the requirements of the European Union.

2.182 Examples of projects that have been taken forward and the savings that have been achieved in Scotland using a Public Private Partnership approach are summarised in the following table.

**Table 2.3 – Wastewater Treatment Projects in Scotland**

<table>
<thead>
<tr>
<th>Wastewater Treatment Project</th>
<th>PSC Cost</th>
<th>PFI Cost</th>
<th>Estimated Saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almond Valley Seafield &amp; Esk</td>
<td>£313m</td>
<td>£180m</td>
<td>42%</td>
</tr>
<tr>
<td>Levenmouth</td>
<td>£106m</td>
<td>£82m</td>
<td>23%</td>
</tr>
<tr>
<td>Dalmuir</td>
<td>£75m</td>
<td>£59m</td>
<td>22%</td>
</tr>
<tr>
<td>Meadowhead, Stevenson &amp; Inverclyde</td>
<td>£135m</td>
<td>£96m</td>
<td>29%</td>
</tr>
<tr>
<td>Highland</td>
<td>£66m</td>
<td>£66m</td>
<td>1%</td>
</tr>
<tr>
<td>Tay</td>
<td>£153m</td>
<td>£144m</td>
<td>6%</td>
</tr>
<tr>
<td>Aberdeen</td>
<td>£154m</td>
<td>£125m</td>
<td>19%</td>
</tr>
</tbody>
</table>

**Roads**

2.183 DBFO contracts are the most common forms of Public Private Partnership that have been used in UK. Research conducted by the National Audit Office identifies overall savings of 12% on the first four DBFO roads projects in England and a saving of 8% on the A74 (M)/M74 scheme in Scotland. Research conducted by the Construction Industry Council suggests an overall cost saving of between 10% and 20% on the first nine DBFO roads projects in Great Britain.

**Public Transport**

2.184 The organisation of local and regional public transport in Europe and across the world is in a process of transition. A common feature of change is the growing use of competition to deliver productive efficiencies and improved levels of service. The forms of competition used are varied, but can be broadly classified into concession based systems (i.e. competition for the market) and open competition or deregulated systems (i.e. competition in the market).

2.185 Great Britain and Portugal, has introduced open entry or deregulated systems.
2.186 The introduction of competition and the award of exclusive contracts have resulted in increased regulatory costs. However, the introduction of competition has also resulted in significant operating cost savings and increased service levels.

2.187 Research conducted for the European Commission suggests that the introduction of competition can generate cost savings of 10% to 20% when only minimal restructuring of the industry is required. Savings of 35% or more can be achieved if significant restructuring is required and over manning exists. However, concessions based systems are most effective in improving services and reducing costs simultaneously.

**Accommodation**

**Health**

2.188 An increasing number of countries are starting to use Public Private Partnership approaches for the provision of health sector accommodation and related services. The most common form of Public Private Partnership that has been used to date is the DBFO model, which has been used for the provision of hospitals and specialist healthcare units in Great Britain.

2.189 The UK experience represents the most significant and relevant evidence on the potential of Public Private Partnerships to deliver value for money in the provision of health sector accommodation. However, independent research conducted by the Construction Industry Council and the National Audit Office suggests that the cost savings achieved against the Public Sector Comparator on such projects are often less than 5%. Indeed the research highlights that the cost of some PFI contracts has actually exceeded the Public Sector Comparator.

2.190 The findings of the Construction Industry Council and the National Audit Office are supported by research conducted by the House of Commons Health Committee in 1998 and 1999 and presented in the recent report by the IPPR. The research concludes that the value for money benefits associated with PFI hospitals have been variable, with savings against the Public Sector Comparator commonly less than 5%.

<table>
<thead>
<tr>
<th>NHS Trust</th>
<th>PSC Cost</th>
<th>PFI Cost</th>
<th>Saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Manchester</td>
<td>£2.1bn</td>
<td>£2.1bn</td>
<td>Negligible</td>
</tr>
<tr>
<td>Norfolk &amp; Norwich</td>
<td>£1.7bn</td>
<td>£1.6bn</td>
<td>2.40%</td>
</tr>
<tr>
<td>Greenwich Healthcare</td>
<td>£1.4bn</td>
<td>£1.4bn</td>
<td>1.20%</td>
</tr>
<tr>
<td>Calderdale Healthcare</td>
<td>£1.4bn</td>
<td>£1.3bn</td>
<td>1.50%</td>
</tr>
<tr>
<td>Bromley Hospitals</td>
<td>£1.2bn</td>
<td>£1.2bn</td>
<td>1.10%</td>
</tr>
<tr>
<td>Worcester Royal</td>
<td>£1.1bn</td>
<td>£1.1bn</td>
<td>0.30%</td>
</tr>
<tr>
<td>Barnet &amp; Chase Farm</td>
<td>£198m</td>
<td>£193m</td>
<td>2.50%</td>
</tr>
<tr>
<td>Carlisle Hospitals</td>
<td>£174m</td>
<td>£173m</td>
<td>3.40%</td>
</tr>
<tr>
<td>South Buckinghamshire</td>
<td>£169m</td>
<td>£162m</td>
<td>4.20%</td>
</tr>
<tr>
<td>North Durham</td>
<td>£181m</td>
<td>£177m</td>
<td>2.10%</td>
</tr>
</tbody>
</table>
2.191 The research conducted by the IPPR suggests that part of the reason for the small savings on PFI hospitals may be restricted by the nature of the DBFO model being used, where the bulk of staff and services are retained within the public sector. The services typically transferred to the private sector include building maintenance, cleaning and occasionally IT or equipment provision.

**Education**

2.192 The education sector in Great Britain is currently undergoing a period of significant change with the increasing application of the Private Finance Initiative to fund the construction and operation of new accommodation. A large number of projects are being procured under the Private Finance Initiative in all parts of the education sector and the experience of these projects to date provides an indication of the potential to achieve value for money through Private Finance Initiative. Examples of the projects procured through the Private Finance Initiative are set out in the table that follows.

<table>
<thead>
<tr>
<th>Project Title</th>
<th>Project Summary</th>
<th>Value £m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Further and Higher Education</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Falkirk College</td>
<td>New buildings</td>
<td>60</td>
</tr>
<tr>
<td>New College, Nottingham</td>
<td>Refurbishment</td>
<td>17</td>
</tr>
<tr>
<td>City of Bristol College</td>
<td>New buildings</td>
<td>12</td>
</tr>
<tr>
<td>Liverpool Community College</td>
<td>New buildings</td>
<td>18</td>
</tr>
<tr>
<td>Manchester College of Arts</td>
<td>New buildings</td>
<td>16</td>
</tr>
<tr>
<td>Weymouth College</td>
<td>New buildings</td>
<td>13</td>
</tr>
<tr>
<td>King’s College London</td>
<td>New buildings</td>
<td>142</td>
</tr>
<tr>
<td>University College London</td>
<td>New buildings</td>
<td>28</td>
</tr>
<tr>
<td>University of York</td>
<td>Refurbishment</td>
<td>24</td>
</tr>
<tr>
<td>University of Wales</td>
<td>New buildings</td>
<td>4</td>
</tr>
<tr>
<td>University of Brighton</td>
<td>Residential units</td>
<td>14</td>
</tr>
<tr>
<td><strong>Schools</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colfox School, Bridgeport</td>
<td>New buildings</td>
<td>12</td>
</tr>
<tr>
<td>Falkirk Schools</td>
<td>New buildings</td>
<td>73</td>
</tr>
<tr>
<td>Glasgow Schools</td>
<td>New buildings</td>
<td>70</td>
</tr>
<tr>
<td>Cardinal Heenan High School</td>
<td>New buildings</td>
<td>13</td>
</tr>
<tr>
<td>Barnhill School</td>
<td>New buildings</td>
<td>20</td>
</tr>
<tr>
<td>Kingston upon Hull</td>
<td>New buildings</td>
<td>2.8</td>
</tr>
<tr>
<td>Pimlico School</td>
<td>New buildings</td>
<td>24</td>
</tr>
<tr>
<td>London Borough of Enfield</td>
<td>New buildings</td>
<td>25</td>
</tr>
<tr>
<td>Parrs Wood Schools</td>
<td>Refurbishment</td>
<td>24</td>
</tr>
<tr>
<td>Miltoncross School</td>
<td>New buildings</td>
<td>47</td>
</tr>
<tr>
<td>Birmingham City Council</td>
<td>New buildings</td>
<td>65</td>
</tr>
<tr>
<td>Staffordshire County Council</td>
<td>School services</td>
<td>13</td>
</tr>
</tbody>
</table>

2.193 Independent research conducted by the Construction Industry Council suggests that, on the whole, the value for money benefits associated with the early education PFI projects were variable, with savings against the Public Sector Comparator commonly
less than 5%. However, since 1998, the majority of school PFI projects have been bundled together by local authorities to provide economies of scale, a more streamlined procurement process and to deliver better value for money. The value for money achieved on Private Finance Initiative projects in Great Britain has improved as a result of the bundling process, and evidence from the bundled projects signed to date suggests that savings of more than 5% are now being achieved.

Other Accommodation

2.194 The savings achieved on other accommodation projects such as prisons, courts and office accommodation have generally been much higher (at approximately 10%) than in health and education. The IPPR report highlights that on these types of projects a much greater range of services are transferred to the private sector, meaning that there is much less of a separation between ancillary and core services and a clearer distinction between the responsibilities of the public and private sectors.

2.195 For example, in prison PFI projects, the private sector has been able to fully integrate the design and construction of the prison with its day-to-day operation. This has resulted in significant advances in prison design, and has facilitated significant productivity gains by the transferred workforce.

Technology

2.196 Public Private Partnership arrangements have also been used in Great Britain for the provision of technology based assets such as equipment, vehicles and IT systems. Procurement of equipment and vehicles using Public Private Partnership arrangements has been a success, with high profile projects such as the Ministry of Defence White Fleet achieving significant improvements in value for money. However, experience of Public Private Partnerships for IT systems has been more mixed with a number of very high profile failures.

2.197 The mixed success of Public Private Partnerships for IT systems has highlighted a number of particular issues that set IT projects apart from other PPP contracts. These issues have a strong influence on the ability of Public Private Partnerships to achieve value for money in the terms of both the procurement and the delivery of IT projects:

♦ IT projects are usually unique and solutions are not easily replicated from one project to another. It has therefore been impossible to deliver the levels of standardisation and economies of scale that have been achieved on infrastructure and accommodation projects;

♦ There are significant difficulties associated with the scoping of IT projects, particularly where they involve re-engineering an authority’s business processes;

♦ IT projects contain much higher development and obsolescence risks than projects in the infrastructure and accommodation sectors. For example, a part-developed IT system will have a much lower value than a part completed school or hospital. As a result, financial institutions are less likely to take project risks until successful commissioning / roll-out of the IT systems is achieved;
Contractors often finance projects from internal resources on a full recourse basis. This means that projects lack the rigorous risk assessment and due diligence processes that are usually undertaken by financial institutions;

Because IT projects invariably integrate with core business processes, the authority's service requirements are much more likely to change during the period covered by the contract; and

The procurement process for IT projects is particularly expensive and time-consuming and significant value for money benefits could be achieved through further standardisation and streamlining of procurement processes.

**Key Success Factors**

2.198 Experience in UK suggests that the ultimate success of a Public Private Partnership project is influenced by a range of factors including the experience of a contracting authority and its advisers, the ability of the private sector to deliver better value for money and the willingness of the private sector to accept an appropriate degree of risk transfer without the need for public sector guarantees.

2.199 In some instances, however, Public Private Partnership projects are not properly structured and as a result they fail to deliver optimum value for money and risk transfer. For example, a number of the early projects procured in the United Kingdom focused too much on the achievement of an off balance sheet accounting treatment rather than upon the delivery of a value for money solution. Equally, a number of early projects in other parts of the world were driven only by the desire to use private sector finance and not by the desire to secure a cost-effective allocation of risk.

2.200 The most common issues or problems that have been encountered during the procurement and development of Public Private Partnership projects in Great Britain are summarised below. Where these issues have emerged, they have often resulted in poorly structured contracts, lengthy and costly procurements, high bidding costs and reduced value for money:

- Inappropriate levels of risk transfer (either too little or too much);
- Inappropriate legal codes;
- Poorly defined procurement methodologies and a lack of standardisation;
- Poor co-ordination between government departments and agencies;
- Insufficient consultation with key stakeholders at an early stage;
- Reluctance to make appropriate use of professional advisers;
- Lack of public sector commitment to Public Private Partnerships;
- Continued focus on input specifications rather than output specifications; and
- Over-optimism with regard to third party revenues.
3. **Review of Best Practices (Group B)**

3.1 Group B countries represent those at the early stages of PPP implementation; regional/local authorities are involved in the process with no clear rules of decentralisation and share responsibilities; and PPP legislation still to be improved. These countries include:

- Croatia;
- Czech Republic; and
- Romania.

**CROATIA**

**Background**

3.2 As a Group B country, Croatia’s experience will be reviewed from Atkins’ own project involvements. Atkins was involved mostly in the Transport sector from which our knowledge of the Private Sector Participation in the country was gained.

**Geography**

- 56,000 square kilometres;
- 4.4 million population;
- 28,000km public roads;
- 7,500km state roads; and
- 800km motorways.

**Economy**

- GDP 2003 – US$ 24.8 billion;
- Projected GDP growth: 3.8% (2004), 3.5% (2005); and
- Long Term debt rating: BBB-.

**Politics**

- Croatia declared its independence from Yugoslavia in 1991;
- President, Prime Minister, Cabinet of Ministers;
- 20 counties, 122 towns, 424 municipalities; and
- Target date for joining the European Union is 2007.

**Government Structure**

3.6 After the multi-party elections in 1990, the Constitution of the Republic of Croatia was adopted on December 22, 1990 and independence was proclaimed on June 25,
1991. It was then that the public administration of Croatia was for the first time
determined by the regulations of the Croatian Parliament.

3.7 The Government of Croatia serves a 4-year term of office between elections. The
previous and current political situations in country are as follows:

♦ 1991-2000 HDZ Party;
♦ 2000-2004 Coalition Party; and
♦ 2004- HDZ Coalition party.

3.8 Croatia signed a Stabilisation and Association Agreement (SAA) with the European
Union in October 2001. As a signatory Croatia will gradually take on board the core
obligations of membership, start aligning its legal and economic framework with that
of the EU, strengthen co-operation with its neighbours and co-operate with the EU on
a number of issues.

3.9 Since it acquired the candidate status (June 2004), Croatia is now committed to
reconciling the 31 sections of the ‘Acquis Communautaires’.

Local and Regional Self-Government

3.10 The circumstances of the war of independence entailed the need to set up and
strengthen all the components of a proper system of government for an independent
state. Consequently a Local Self-Government and Administration Law were issued in
1991, defining the system of local self-government. In 1993, the first local elections
according to the new organization were held.

3.11 Local and regional self-government are governed by laws concerning local and
regional self-government, the election of members of representative bodies of local
and regional self-government, of the county areas, cities and municipalities in the
Republic of Croatia, the city of Zagreb, and the financing of units of local and regional
self-government laws.

3.12 Local self-government is determined by four laws:

♦ that concerning local self-government and administration;
♦ the areas of the counties, cities and municipalities in the Republic of Croatia;
♦ the financing of units of local self-government and administration; and
♦ the determination of operations from the self-governing sphere of interest of units
of local self-government and administration.

3.13 The system of local self-government in a broader sense covers in 2004: 425
municipalities (four more than at the beginning of 2000), 122 cities, 20 counties (to
the extent that they are regional self-government units), and the city of Zagreb (which
is both city and county).

3.14 During 2001, new regulations were introduced in Croatia, bringing certain changes
into the system of central government and local self-government. Through these
regulations, some operations of central government were decentralised and devolved
to the jurisdiction of local and regional self-government. The jurisdiction of local self-
government is defined in a manner very close to the so-called general clause, and at the regional level, the affairs handled by the central government and the local self-government are separated. As a result of these changes in the law, local and regional units obtained new tasks in the area of basic and secondary education, health care, welfare and culture.

3.15 Local self-government operations cover areas of zoning and the planning of settlements, communal economic activities, protection of the environment, pre-school education, culture, sports and welfare. The task of the county is to coordinate the interests and views of the municipalities and cities in their area, and the even development of these units.

3.16 Cities and municipalities within the sphere of competence of their self-government carry out operations of local importance that directly realize the needs of the citizens, and that have not been assigned by constitution or law to the state bodies. This kind of determination of their sphere of influence corresponds to the principle of subsidiarity. The following operations are determined as obligatory:

♦ housing and the arrangement of settlements;
♦ zoning and town planning;
♦ utilities or the communal economy;
♦ concern for children;
♦ welfare;
♦ primary health care;
♦ pre- and elementary schooling;
♦ culture, physical education and sports;
♦ consumer protection;
♦ protection and improvement of the natural environment;
♦ fire fighting and civilian protection.

3.17 In their self-governamental sphere of influence, the counties carry out operations of regional importance, particularly in the domains of:

♦ education;
♦ health care;
♦ zoning and town planning;
♦ economic development;
♦ transports and transportation infrastructure;
♦ planning and development of the network of educational,
♦ health care, social and cultural establishments.

3.18 If they provide the financial resources for them, units of local self-government can also carry out operations that are in the jurisdiction of the county.
Fiscal policy

3.19 Decentralised responsibilities in Croatia have increased substantially since reforms in 2001. Local governments at either county or municipal level have added primary and secondary education, social welfare and health care to their existing responsibilities for communal services and utilities. Between 1999 and 2003 local government expenditure increased from 11.1% to 15.2% of general government expenditure and from 6.1 to 7.5% of GDP. These increases have been limited by the fact that local governments have not assumed responsibility for the remuneration of school and health care staff.

3.20 Local government units taking over the newly devolved functions have received added percentage shares of Personal Income Tax (PIT) and are also eligible for equalisation fund payments which meet any gap between the income tax shares and the standard normative costs of the extra responsibilities. Autonomous functions are funded by basic shares (by origin) of personal and corporate income taxes, and a variety of taxes on real estate, consumption, gifts, inheritance and vehicles together with fees and charges.

3.21 Linkage to income tax should ensure reasonably buoyant funding for these functions in relation to the growth of the national economy. Equalisation funds should ensure that mandated standards of delegated tasks can be financed. Overall local government balances have improved considerably since 2001 suggesting that the new funding basis for local government responsibilities has been adequate.

3.22 An equalisation fund evens out capacity to meet minimum spending targets in respect of education, health care and social welfare. For other types of expenditure there are two types of equalisation, firstly additional shares of personal and corporate profit taxes for Areas of Special National Concern and mountainous areas and, secondly, a current expenditure grant distributed according to mixed criteria relating to per capita revenues and spending needs. Grants reduce revenue disparities only to a very limited extent and their allocation only partially correlates with objective factors such as regional GDP or tax revenue. A number of reasons have been suggested in the country report including some generosity in the classification of Areas of Special National Concern and mountainous areas which receive extra tax shares, and the absence of any numerical formula for applying the statutory criteria governing the distribution of current grants.

3.23 Local government units have general freedom in allocating funds for current expenditure, despite the existence of spending norms for decentralised services. Grants for capital expenditure are earmarked by sectoral ministries for specific investments.

3.24 The bulk of local tax revenue consists of shares of national revenues specified by Parliament. However, authorities have, and increasingly exercise power to impose surcharges of up to 10% on personal income tax. They are free to determine rates of charges for local utility services and some minor taxes on local property and consumption.
3.25 Rates of revenue sharing are prescribed by law and therefore transparent. However, the Government has considerable discretion in designating Areas of Special National Concern which attract extra revenue shares and in allocating both the current and capital investment grants.

3.26 The Key challenges facing Croatian fiscal system include the development of more precise criteria for the distribution of equalisation funds.

**Decision making process**

3.27 A review was carried out in 2002/2003 by the Institute of Public Finance of Zagreb on the Local Government budgeting and decision making revealed that so far, the government has not dealt in any serious way with the planning of public investment, nor has any overall approach to the financing of capital projects at the local unit level been set up. Consequently, the competent institutions, above all the Ministry of Finance, find it difficult to control the degree to which the local government capital investments are financed and carried out. Besides, capital projects are not included in public investment programs.

3.28 The institute suggested that a complete and detailed record of capital projects financed at the local level should be kept at the central government level, in order to control the transfer of capital grants to local units. It is necessary that the procedure of capital investment planning should include feasibility studies giving consideration to the potential sources of financing. As this relates to projects that are of great importance to the society as a whole, the obligation to make a social justifiability study of each such investment should be imposed.

3.29 Local administration on the other hand should be equipped and trained to use modern methods of capital project planning. This, of course, goes for the administration at the national level as well. All local units should be obliged to measure the costs and benefits of capital projects, and to plan capital projects over a longer period of time. The situation one year later, there have been no significant changes. A novelty is that local units must work out in detail the capital part of their budget for 2003, in order to plan capital programs and borrowing for a number of years. The capital part of the budget encompasses all expenditure for the procurement of non-financial assets, with the exception of current non-financial assets. During the planning of capital programs, projects under way and reconstruction projects are given priority. This is a recommendation of the MF to local units contained in the guidelines for the preparation and drawing up of the budgets of local units in the period from 2003 to 2005.

**PPP Experience in Croatia**

3.30 Of the three concessions awarded by the Republic of Croatia (RoC) to date only the Bina Istra and the Zagreb-Macelj projects involve the private sector in the concessionaire and can be described as PPP projects. The concession company for the third scheme, the Zagreb-Rijeka project, is 100% owned by the Government. To date we have only been able to gather limited background information for the latter scheme.
3.31 The two PPP concession contracts to date have been negotiated as single-bidder negotiations between the Ministry and the private sector bidding company, during difficult political and economic times, as the country has emerged from the recent conflicts in the former Yugoslavia regions. As such, it is unlikely that they offer best value, though this is not easy to confirm, due to the lack of best value reviews undertaken to date, and the lack of available time and data/records to carry out a more detailed benchmarking exercise at this stage. Any evaluation of Value for Money comparison between the different concessions and the HAC operation will need to be subject to further research outside the scope of the project.

3.32 The need for all PPP concessions to undertake a best value review is well established by the calculation of a Public Sector Comparator (PSC). This is a method of looking at the whole life cost of the PPP and comparing it with the same costs if the project was procured under a standard Public Procurement. This must show, in Net Present Value (NPV) terms, a lower cost for the PPP otherwise it would be financially beneficial for the Public Sector to carry out the project under normal Public Procurement.

3.33 The risk profile of the two PPP projects are roughly similar, with the Government taking responsibility for land acquisition and service diversions, the Government (or HAC, the Government-owned motorway company) owning 49% of the Concession Company, and the State supporting the project in the event that projected traffic volumes fall below certain pre-agreed levels.

3.34 For both schemes, the project finance packages have relied heavily on the support provided by the Croatian Government, which effectively guaranteed debt service to project lenders, regardless of how the schemes perform. Also, the Croatian Government has supported the concession by paying a so-called “Financial Contribution” at the start of each year. This is intended to be added to the forthcoming year’s toll revenues, as forecast by the concessionaire.

3.35 Although we have not analysed these concessions in any great detail, it would appear that the risk share profile generally appears to be reasonably consistent with the principle of transfer of risk to the party best able to manage it, albeit the Government has probably paid a premium for the financial risks transferred to the private sector, compared with other international PPP deals, and it is likely that the Government would have got better value for money from a more open competition. Nevertheless, innovative funding packages have been developed to enable Croatia to implement more major new infrastructure projects than many of its Central and Eastern European neighbours under difficult circumstances – in itself a notable achievement.

3.36 The issues with these concessions that must be taken into account in any future development of the PPP market in Croatia can be summarise as follows:

- Non competitive Procurement probably resulting in lower Value For Money than available from a true competitive PPP;
- Risk allocation questionable resulting in the Government taking on more of the financial risk of the projects than would be expected in a true competitive PPP;
Government involvement in the concession companies resulting in Government borrowing which is contributing to Public Sector Debt; and

Poor ‘quality guarantee’ systems within the concessions therefore contributing to a lack of value for money and user benefits.

Government Procurement

3.37 In the context of the conclusions reached as a result of this project we have regarded all activities undertaken by HAC (Public company in charge of the motorway network) and HC (public company in charge of the national road network) as ‘Government Procurement’, despite the ‘private’ nature of these two companies and the ‘independent’ incomes from the Fuel Tax and Tolls etc.

3.38 HAC is responsible for the remainder of the motorway network not covered by the three concessions and carries out all operation (including tolling) and maintenance in-house. From what we have seen, there appears to be limited incentive for O&M and tolling works to be carried out in the most cost-effective manner, as the payment for these services is simply based upon a budget allocation within the HAC’s internal financial system. It is more than likely that significant savings could be made if work activities could be packaged and competitively tendered as long-term PPP contracts and awarded to concession companies with appropriate pain-gain payment mechanisms.

3.39 New motorway construction schemes tend to be procured traditionally by HAC with separate design, construction and monitoring contracts awarded to the private sector through competitive tendering - although HAC has also negotiated some contracts directly with the private sector, as was the case for sections of the Zagreb-Split Motorway, for which contracts were placed directly with Bechtel. Although HAC is funded through fuel tax and toll revenue income, new motorway schemes have also been funded through a number of major sovereign guarantee loans, amounting to some €1.5bn in total to date. Again, based on international experience, it is likely that significant cost savings could have been realised if these new schemes had been placed as competitively tendered PPP projects, and it is unlikely that funding will be as readily available for future new schemes, as pressure inevitably increases to reduce the country’s exposure to long term outstanding debt.

3.40 HC is responsible for the rest of the state network, funded through fuel tax, abnormal load charges, advertising and levies on international transit vehicles. Design, construction and refurbishment work is procured from the private sector through competitive tendering. Although HC has begun the process of privatising its in-house routine maintenance companies, there is little effective competition yet, since each Municipality tends to have one road maintenance company which owns all the equipment and therefore has a monopoly on any routine maintenance contracts awarded. HC will need to encourage more open-competition in the private sector, by perhaps placing the plant and equipment in the hands of separate plant hire companies and considering the award of longer-term PPP maintenance concessions, if it is to benefit from better value for money contracts.
3.41 The issues with the state owned ‘private’ companies that must be taken into account in any future development of the PPP market in Croatia can be summarised as follows:

- Any change in the current funding process, especially the direct payment of Fuel Tax to HAC and HC and the complete retention of Tolls by HAC will have significant impact on their viability as ‘private’ companies;
- HAC having responsibility for all design and procurement of new motorway construction while also being the national O&M company must result in, at a minimum, a reluctance to promote PPP where all Design, Construction, Operation and Maintenance will go to a concession company.
- Lack of incentive to maximise value for money operations for O&M in both HAC and HC due to complete lack of competition for these services;
- Lack of complete government control on raising of sovereign guarantee loans by HAC and HC; and
- Further privatisation of the maintenance companies will help address value for money issues

Changes in Funding

3.42 At the time of the investigation it was suggested that the Government was considering changing its position regarding the Fuel Tax. Currently the tax collected is distributed 50% to HAC and 50% to HC directly from the oil companies and does not go through the national treasury. However it was suggested that this may change in the near future and that the fuel tax could be taken into the national treasury and then HAC and HC would receive the finances from this under a budgetary system.

3.43 It is obvious that the current system is seen by both HAC and HC as their key to being ‘private’ companies. However their borrowing, due to the sources of their income, has to be sovereign guaranteed by the state and is therefore a considerable burden on the states borrowing requirements and limits. It is important, therefore, to review the potential implications for the removal of Fuel Tax as a direct income and replacing this by a budgeted system from the Ministry of Finance.

Stakeholder Consultation

3.44 From a brief review of current practice, the role of stakeholder consultation in such a process is not well understood and even less practised, certainly, as far as the road sector is concerned. There continues to exist at operating levels of government a view that ‘…professionals always know best’ and so consulting with non-professionals is seen as non-productive. However, Stakeholder Consultation is a fundamental process enabling policy makers to engage with their communities to ensure that the citizen's needs are 'placed at the centre of service delivery'.

3.45 Consultations are required every time interventions by the Network administrators can potentially affect the road users. The development of new policies and plans should be carried out in a consultative approach through workshops, exhibitions and advertising, to allow pressure groups to express their concerns and suggestions for better service delivery. Their stated and revealed preferences should be taken into
account when new schemes of policies are introduced. Also, ex-post evaluations of previous interventions should be made public and opportunities for commenting should be offered to the various stakeholders.

3.46 In our brief discussions with the network administrators, there was a lack of understanding over the concepts of 'service delivery performance' and 'technical standards' as applied to works. There was an assumption that rigorous application of technical standards would automatically deliver quality services without the need to measure the perceptions of Stakeholders/ordinary users. In this respect the experience of Best Value and continuous improvement as applied in the UK to the quality and delivery of public services is highly relevant. Significant effort is likely to be necessary to develop an appropriate set of indicators for Croatia.

**CZECH REPUBLIC**

**Background**

3.47 One of the most stable and prosperous of the post-Communist states, the Czech Republic has been recovering from recession since mid-1999. Growth in 2000-03 was supported by exports to the EU, primarily to Germany, and a near doubling of foreign direct investment. Domestic demand is playing an ever more important role in underpinning growth as interest rates drop and the availability of credit cards and mortgages increases. Real GDP growth reached 4% in 2004, and is set to accelerate to 4.1% in 2005 and to 4.4% in 2006, driven primarily by growth in exports and capital investment. Inflation will moderate in 2005-06, owing to increased retail competition and a strengthening of the koruna. The current-account deficit remained wide in 2004, at 5.2% of GDP. The deficit is forecast to narrow to 4.7% of GDP in 2005 and to 4.5% in 2006, as oil prices fall and increased competitiveness keeps export growth solid.

3.48 In September 2003 parliament approved a reduction in the corporate tax rate to 24% by 2006, from its current level of 26%. The rates for personal income tax range from 15% to a top rate of 40%. Indirect taxes will play an increasingly important role within the overall tax regime. In January 2004 value-added tax (VAT) on the majority of services moved from 5% to the 22% rate used for goods (which was cut to 19% in May), and taxes on petrol, cigarettes and alcohol increased.

3.49 The general election in June 2002 enabled the formation of a coalition government by the Czech Social Democratic Party (CSSD), the Christian Democratic Union-Czechoslovak People’s Party (KDU-CSL) and the Freedom Union, with a majority of two seats. In June 2004 the government led by Vladimir Spidla collapsed. Mr Spidla’s former deputy, Stanislav Gross, moved to form a new government with the same coalition. This administration collapsed in April 2005 and Mr Gross was replaced by Jiří Paroubek in mid May, thereby preserving the ruling three-party coalition and warding off the possibility of an early election.

**Government Structure**

3.50 In 1990, the old hierarchically organised system of National Committees, which represented the state power in regions, districts and municipalities, was abolished.
and a new system of local government created by an amendment to the Constitution and through the new Municipal Act and District Office Act. In autumn 1990, during the run up for municipal election, Regional National Committees were abolished without replacement, District National Committees were replaced by District Offices representing the state administration, and municipalities became the basic units of local self-government.

3.51 The new system of local government is based on the separation of the local self-government from the state administration. The basic organs of municipal self-government are a directly elected Municipal Assembly, from which Municipal Council and Mayor are internally elected. The new Constitution, approved in 1991, also declared the existence of regional self-government with directly elected regional assemblies.

3.52 At the district level, there is a District Congress (Assembly), consisting of representatives of municipalities (often mayors) delegated according to the municipalities’ population size. While large towns have many votes, there is a single representative for several small villages, a strongly biased urban-rural distribution of voting power. District Assembly has a very limited power and its role relates to the distribution of central government equalisation grant from the district to municipalities and the approval of District Office budget.

**Figure 3.1 – Regions and Districts of the Czech Republic**

3.53 Municipalities remain the only significant tier of government at the local level and have the highest level of responsibilities after the central government. Each municipality represents a legal entity, with responsibilities divided between own and delegated ones. The own responsibilities include among other tasks in education, welfare services, housing, health care, culture, public safety, street cleaning, water,
electricity and gas supplies, sewerage system. Among delegated responsibilities can be found the birth, death and marriage registers and building permissions as well as various tasks on environmental protection, sanitation, and statistics.

3.54 The basic reform of local government system took place in 1993 together with the overall tax reform. Since that date local finance system underwent several minor changes until a radical change that took place in 2001 together with the introduction of regional governments.

Regional Fiscal Policy

3.55 Municipalities have a right to manage municipal property, adopt municipal budget, establish legal entities, adopt a municipal development program, approve local physical plan and issue municipal ordinances. The basic local development planning documents declared in the Municipal Act of 1990 are the municipal development program, that specifies long-term priorities of socio-economic development, the medium-term physical plan and the municipal budget, that specifies financial and in particular investment allocation in the short-time perspective. While the budget is necessary for municipal governance and physical plan is commonly used instrument, municipal development programs are rarely developed. There are only a small number of cities and larger towns, which are currently preparing municipal development programs often called strategic plans.

3.56 The Municipal Act of 1990 allowed for disintegration of municipalities amalgamated during the Communism, led to an emergence of a large number of very small municipalities (about 60% of municipalities have less than 500 inhabitants and further 20% between 500 and 1,000). The self-government of such small municipalities is very week in financial and professional matters and has limited bargaining-power in relation to the state government as well as private sector developers. In many cases, small municipalities create associations and establish companies to organise certain tasks, such as collection and treatment of municipal waste or water, sewage and other networks construction and management.

3.57 The main trend in municipal finance has been the decrease of dependence on central government grants and the increasing role of revenues from the share on personal income tax from individual entrepreneurs and employees, property tax and other own incomes that include local fees and revenues from the sale and lease of municipal property. Municipalities are also entitled to borrow money and issue communal bonds (this approach has been used, for example, by the City of Prague to gain finance for investments in transport infrastructure). There are large differences of own incomes per capita between municipalities (this is partly diminished by the central government equalisation grant). The system of local government finance has changed several times during the 1990s, resulting in instability and causing difficulties for financial and investment planning at the municipal level. An important characteristic of municipal finance from the point of view of local development is a high share of investments (35-40%) on municipal expenditures.
Sources of Municipal Finance

3.58 The autonomy of local government is assured by the Constitution and the Act on Municipalities. The budget of each segment of public finance is presented on an annual basis. With the exception of local budgets and district office budgets, all others are approved by Parliament.

3.59 The most important source of local budgets is tax revenue. There are no local taxes, only local fees at present. Municipalities participate on personal income tax and corporate income tax. They also receive the total yield of real property tax collected within their territory. As for the tax on buildings, the base is given in the form of physical parameters and the level and type of usage.

3.60 The income tax sharing was up to 2000 and included 20% of the total yield of corporate income tax distributed on the basis of population of each municipality.

3.61 The personal income tax has three parts in the Czech Republic:

i) wage tax which was distributed among municipalities according the district collection,

ii) employers tax for municipalities where employers’ office are registered, received 10% of the collected amount, and

iii) 20% distributed according the number of citizens in each municipality. The rest was assigned to the central government.

3.62 The unincorporated income tax yield was allocated to the municipality, in which the particular entrepreneur had his permanent home address.

3.63 This system has led to growing disparities among municipalities of different sizes and location. It also involved additional costs, which then lowered the tax revenue for municipal sector.

3.64 The change applicable since 2001, however, did not solve the problem of a rather small municipal discretion over their revenue. A certain room for own decision of local government is provided only by local fees, where local government administers this revenue source. However, the law sets the list of local fees and their upper limits.

3.65 The system of central government grant consists of mainly operating subsidies, which are decided each year when preparing the central budget. They do not take into account the revenue level of any municipality as they are calculated as a certain amount per pupil in pre-school facilities and primary schools, per bed in social care facilities, as a contribution to the tasks of state administration provided by local government and so on. Capital grants are as well decided when preparing the central budget on ad hoc basis.

3.66 All grants transferred to local government are specific grants in the sense that their provision does not allow local government to allocate them freely and have to be
used as specified by the central government. Non spent grant amounts go back to central government and can not be rolled over for the next year. To receive grants municipalities have to make an annual statement for these in their budgets.

**Czech PPP Experience**

3.67 Concessions were used in Czech Republic as early as by the princes of the Přemyslid House (13th Century). Originally, served for the distribution of special and exclusive rights, e.g., the brewing right, were later on used by the Austro-Hungarian Empire to procure infrastructure e.g. rail lines development.

3.68 Currently, and following the political change in 1989 and the subsequent privatisation of state assets and companies (1991-1995), the use of concessions has so far been limited to the operation of public services and facilities. The development of public infrastructures, however, continued to be carried out by the public sector with support from budgetary funding.

3.69 The use of PPP as a procurement tool in Czech Republic has been used in the operation and maintenance of services such as:
- Distribution companies: water-stations, sewerage
- Regional companies providing public service:
  - waste dumps
  - incinerating plants
  - refuse collecting
  - waste treatment plants
  - public transport
  - street lighting etc.

3.70 A legislative framework for PPP is being finalised. Its main aims are:
- to define the competences of government / regions / municipalities
- to create the required legislative base (Code of Commerce, Public Procurement, Concession Law, Bankruptcy Law)

3.71 In January 2004 the Czech Government’s PPP Policy was officially approved, and in currently PPP legislation (Concession Act) is being reviewed by the Czech Parliament.

3.72 At the municipal level, municipal budgetary rules are still to be devised to allow PPP transactions to be carried out in full harmony with EU rules on public debt and budget deficit.

3.73 Potential areas for PPP use in the future, once such framework is in place include:
- Hospitals
- Highways: e.g. Katowice - Brno, Brno - Vienna, Prague City Bypass;
Railways: Speedway to Prague airport, electrification of Brno – Nuremberg line, Upgrade of Katowice - Breclav;
Airports – management and operation of Prague & Brno airports;
Subway Line D in Prague

Czech Experience in Motorway Concessions

3.74 Following the cancellation by the government of the D5 Motorway concession tender (on the Nurnberg-Plzen-Prague corridor) in 1993 (scaring the social impacts of the introduction of relatively high toll rates), on-going motorway construction is financed from the State budget and sovereign borrowing. In 1998 however, only one third of the total road expenditure (approximately ECU 440 million) were financed from the budget: the remaining amount was borrowed from international financial institutions, mainly the European Investment Bank (EIB). Although the bypass around Plzen on the D5 is already completed, Prague is not yet linked to the Western-European motorway network.

3.75 In form of a windshield sticker or vignette a yearly lump sum motorway fee (a special road user tax, not proportional the level of use of the infrastructure) was introduced in 1995. The price of the vignette was doubled in 1998. Due mainly to lack of efficient control and the high evasion rate, the generated revenues (about EUR 30 million per year, which are not dedicated to finance motorway linked expenditures), did not cover even the operation and maintenance costs of the existing motorways’ network (570 km).

3.76 The idea of user charge was then abolished until present day. Ideas to reintroduce it in the upcoming Prague City Ring road as a real toll road scheme are being explored.

Financing PPP Transactions in Czech Republic

3.77 The Czech Republic is required to comply with the EU Maastricht Criteria limiting the public debt to 60% of the GDP and the annual public budget deficit to 3% (See Appendix C for full list of Maastricht Criteria). To maintain compliance with those criteria, the Czech government is required to monitor all PPP transactions as a source of debt and long term commitment of public funds.

3.78 This is an issue facing many EU and non-EU countries with highly decentralised fiscal policy and there are no effective accounting rules to close loopholes. The main underlying reason is the uncertainties surrounding the year on year spending and the difficulty of long term budgeting. Meanwhile, PPPs continue to be used to bypass expenditure controls, and to move public investment off budget and debt off the government balance sheet. Moreover, resort to guarantees to secure private financing can expose the government to hidden and often higher costs than traditional public financing.

3.79 An internationally accepted accounting and reporting standard could promote transparency about the fiscal consequences of PPPs, and in the process make increased efficiency rather than a desire to meet fiscal targets the main motivation. In any event, as PPPs become more commonplace, market analysts and rating
agencies are developing the expertise to assess the fiscal risks they involve, and in particular the consistency of future commitments under PPPs and contingent liabilities with debt sustainability. Thus any misuse of PPPs is unlikely to escape market scrutiny for long.

3.80 The latest amendment to EUROSTAT accounting methodology, made it specific that PPP transactions, including those carried out by local authorities, should be reflected in the general public debt. The following is Eurostat’s recommended accounting treatment of the following PPP operations:

- **Operating contracts.** Where a PPP asset is owned by the private operator, payments under operating contracts for services provided to the government are recorded in the government operating statement as an expense.

- **Concessions and operating leases.** Concession fees and other payments by private operators of concessions to the government (e.g., profit shares) are recorded in the operating statement as revenue\(^{38}\). When the government leases an asset it owns to a private operator, lease payments to the government by a private operator are also recorded as revenue\(^{38}\).

- **Financial leases.** The acquisition of an asset under a financial lease would be recorded in the operating statement at cost, together with incurrence of a lease liability to the private sector. The asset and liability would also be recorded on the government balance sheet. Subsequent depreciation of the asset, and interest and amortization payments on the lease would then be recorded in the operating statement. As the lease liability is reduced, the PPP net asset value will build up on the balance sheet (provided that the liability is reduced at a faster rate than that at which the asset is depreciated). When the lease concludes, the asset will be recorded on the government balance sheet at its residual value.

- **Transfer of PPP assets to government.** If there is provision for a PPP asset to be transferred at zero cost to the government, the asset transfer is recorded in the operating statement as the acquisition of a non-financial asset at its residual value, balanced by a capital transfer from the private owner. Any purchase price involved would be an expense, and the capital transfer is reduced by the corresponding amount\(^{40}\). The asset would also be recorded on the balance sheet at its residual value at the time the transfer takes place, and subsequent depreciation of the asset would be recorded in the operating statement.

3.81 The issue of burden imposed on future budgets with mandatory disbursements as well as the reduced flexibility in future budgeting has not been dealt with the latest EUROSTAT amendments nor there are any mechanisms at present allowing for the monitoring or regulation of the acceptable levels of commitment of future budgets due to long-term agreements, such as in PPPs, leaving the Czech Government

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\(^{38}\) The treatment of concessions has been questioned, however. Since a concession involves the transfer of the government’s monopoly power to the private sector, the view has been expressed that concessions should be considered non-financial assets. This treatment can be seen as an attempt to extend the discussion of the treatment of mobile phone licenses to concessions. However, in the case of mobile phone licenses, it was agreed that an underlying asset, the spectrum, existed, whereas in the case of concessions, no such asset exists.

\(^{39}\) When the government leases an asset from a private owner, lease payments by the government are recorded as an expense; however, as indicated in Section III, this is not usually regarded as a PPP.

\(^{40}\) If the government pays more than residual value for an asset, the asset is still acquired by the government at its true residual value, and there is also a capital transfer from the government to the private operator.
unable of monitoring municipal debt levels and rendering difficult the compliance with EU Maastricht criteria.

**Case of PPP projects involving limited risk transfer to the private sector**

3.82 The practice of EUROSTAT and in a number of countries is to classify PPP assets as government assets. This is done with a view to recognise that the government plays a role in the economy and conducts fiscal policy through PPPs. For accounting purposes, EUROSTAT treats PPP investments that expose governments to significant risk as public investment, while the state of Victoria in Australia and the United Kingdom assume that the government is acquiring the PPP asset through a financial lease\(^{41}\). These two approaches are formally the same. It is likely that accounting for limited risk transfer will be paid considerable attention by the accounting profession as it seeks to develop a general accounting and reporting standard for PPPs. In this connection, the focus is likely to be on refining the approach to accounting when assessments of risk transfer suggest that the government bears the balance of risk and, as a consequence, PPP assets are treated as government assets.

3.83 It is questionable, however, whether classifying PPP assets as either government or private assets is an appropriate way of reflecting the extent of risk transfer. PPPs involve a range of risks, and government exposure to PPP risk will vary widely across projects. Ideally, an attempt should be made to gauge the risk to which the government is exposed under each PPP contract, and to assess the fiscal consequences of such risk. This, however, is extremely difficult to do, even in the relatively straightforward case of explicit guarantees. But classifying PPP assets as either government or private assets instead is insensitive to the extent of risk sharing, and could discourage PPPs where the private sector is prepared to bear significant (but not most) risk and cover a sizable share of project costs. This being the case, the accounting profession, rather than refining the current approach to accounting for limited risk transfer, should seek to develop a workable approach to assessing and quantifying PPP risks borne by the government, and to disclosing these risks. Countries will then have to develop their own capacity to assess risk transfer under PPPs.

3.84 Under Eurostat rules, PPP projects implemented by a single municipality or a region will inevitably affect the overall public sector spending capacity and flexibility for future allocations in Czech Republic. In particular, some future municipal projects might be impaired due to excessive borrowing incurred by uncontrolled past PPP transactions carried out by other municipalities. It is therefore not unconceivable that certain control should be imposed on the manner of "drawing on" the public debt limits by the individual municipalities.

3.85 This is an area that will be explored during the case study from Czech Republic. Discussions with the Ministry of Finance as well as associations of municipalities will be required to explore feasible means of better control on municipal finances under the current rules of decentralisation.

\(^{41}\) In the case of the United Kingdom, this practice has resulted in 57 percent of PFI assets being classified as government assets (HM Treasury, 2003).
3.86 Various mechanisms of Municipal Debt control are in effect in OECD and Council of Europe (COE) member states allowing local borrowing for capital investment purposes but requiring liquidity loans to be paid back within the year. Only few countries use stock-based municipal borrowing limits, even when the total stock of municipal debt is counted against the Maastricht criteria. A review of the mechanisms is presented in Appendix C-2 to this report.

**PPP Legal Framework – Czech Law Issue**

3.87 Atkins have been commissioned by the City of Prague to investigate the feasibility of introducing other forms of financing, possibly through a Public Private Partnership (PPP) for the section of the City By Pass between Myslbekova and Pelc-Tyrolka. This process would involve the development of a concession based operation where the necessary capital finance required to construct new sections of the route would be sought through the private sector.

3.88 Among other areas, the current Legal Framework was reviewed to check its suitability for such transaction and to recommend amendments where necessary. The following is a summary of our findings. Further details are available in Appendix F.

*Entering into a PPP agreement*

3.89 There is an uncertainty regarding the entering by the City into a PPP agreement in respect of a local road, given that the Act on Roads contains restrictions regarding transfer of full responsibility for operation and maintenance by the owner of a road to a third party and that it expressly allows only the state to enter into a PPP agreement and only in respect of a motorway. We recommend that this legal situation be resolved by a change in legislation.

*Accounting and tax*

3.90 Under Czech applicable accounting regulations, it is not possible to achieve an off-balance sheet treatment of the project assets whereby the City would remain the owner of the road (as required by the Act on Roads) and the private partner would record the project assets on its balance sheet throughout the duration of the project implementation agreement.

3.91 Even if an off-balance sheet treatment was possible, it is not clear what consequences the hand-over of the project assets at the end of the implementation agreement would have for the City’s accounts and what additional tax obligations could arise under the Czech tax laws upon hand-over.

3.92 We agree, we recommend that appropriate changes in legislation are made in the relevant accounting and tax legislation.
Public Procurement

3.93 Based on our analysis, we have identified no fundamental obstacles in the current legislation on public procurement in the Czech Republic that would hinder the selection of a private partner for the contemplated project.

3.94 This is a provisional conclusion pending the issue of the New Public Procurement Act currently being drafted (and due to become effective on 1 January 2006).

Romania

Background

3.95 Romania is a lower middle income country with a gross national income per person of US$2,310 in 2003. With a population of some 21.7 million, it is the second largest country in Central and Eastern Europe and is larger than 19 of the 25 current members of the European Union (EU).

3.96 The country is comprehensively reforming and restructuring its economy with a view to joining the EU in 2007. As part of this, the Government has initiated a process to build institutions and design and implement public policies to fundamentally transform Romania's economy and society.

3.97 Despite economic growth in the past three years, important challenges remain. Further structural reforms are crucial to build a competitive market economy capable of withstanding the pressures of EU integration. Moreover, poverty persists with 25 percent of the population living below the poverty line. Some 60 percent of Romania's poor live in rural areas despite the country's substantial potential in agriculture, forestry, and fisheries.

Developments since the transition

3.98 Romania's transition, starting in 1990, was in many respects more difficult than in the other countries of Central and Eastern Europe. This was partly because by the late 1980s, the country's economy was on the verge of collapse after 40 years of rigid central planning that emphasized self reliance, an excessive focus on heavy industry and large, uneconomic infrastructure projects.

3.99 In an attempt to minimize the social costs of transition, and often to placate vested interests, the Romanian government initially hesitated to impose tight fiscal constraints and privatize large loss-making enterprises. In the late 1990s, attempts to impose macroeconomic stability without full structural support led to negative economic growth, and poverty increased sharply, doubling from 20 percent in 1996 to 41 percent in 1999.

Recent economic performance

3.100 Since 2000, the Government has implemented macroeconomic policies which are supportive of growth. A disciplined fiscal policy, which complemented a tight monetary policy and was augmented by strong advances in structural reform, led to
improved financial discipline in the enterprise sector and has placed public finances and the financial system on much firmer footing.

3.101 This resulted in robust GDP growth for three consecutive years. In addition, inflation and interest rates declined steadily, the fiscal deficit was brought under control, foreign exchange reserves increased to historic highs, and the external balance was held to comfortable levels.

3.102 Export growth remained vigorous, fuelled by private investment and the initial competitive depreciation of the currency. The competitiveness of the enterprise sector was boosted by productivity gains. Romania is now a visible and attractive destination for international investors as a result of better sovereign ratings and improved access to international capital markets.

3.103 Romania faces today a number of challenges to attain its twin goals of poverty alleviation and EU accession, including:

♦ Accelerating structural reforms. Key challenges include completing the privatization agenda, improving the business climate by eliminating administrative barriers, and implementing a transparent and predictable tax system.

♦ Reforming the legislative process and the judiciary. In the past, reforms were impeded by frequent changes in legislation and the lack of capacity to implement the new laws. It is therefore essential to streamline existing legislation and develop an effective system to pass new laws. In addition, the professionalism and integrity of judge’s needs to be enhanced and the independence of the judiciary strengthened. The judicial process also needs to be made quicker and more efficient.

♦ Reforming the energy sector. Although energy sector reforms have been impressive, payment arrears still exist and power sector subsidies continue. These continuing subsidies are one of the major factors contributing to the country's fiscal imbalances.

Regional Policy in Romania

3.104 Before 1968 three, at least administrative, levels were active lower than the central government: local administration, i.e. cities and communes, semi-regional administration, i.e. judete (counties), regional administration and other levels under or above judete, i.e plasi/ocoale, tinuturi, regions, raioane. In 1968 the regional units were abolished and the judete cites, and communes (rural) were (re)introduced. This reform was aiming at further centralisation of the system, process which would permit the Party to continue the industrialisation process and the other communist reforms. Currently the Romanian territorial-administrative structure does not differ from the one in place in 1970, despite the obvious necessity to adapt this structure to the new political and economic realities and also despite the direct pressure of the integration process. The changes operated in the 2003 Constitution are practically insignificant for the construction of the territorial-administrative system in Romania.

3.105 Reforming the public administration in Romania in order to cope with the challenges posed by the "Aquis" implementation has represented along the negotiation process
one of most difficult to fulfil Copenhagen condition. This problematic issue goes deep into the communist administrative practice in place for almost 50 years. After a timid begin in 1991, the year 1998 marked the initiation of a wide administrative reform at the pressure of the European Union. Far reaching legislation was adopted: Law 189/1999 on Local Public Finances complemented by the Ordinance no. 36 for local taxes, Law 188/1999 on Civil Servant Status, the Law 215/2001 on Public Local Administration.

3.106 Presently, according to the legislation in force, the local administration is responsible of public services as: social assistance, (including child protection policy) and social services (housing and community services), cultural institutions (theatres, museums, and cinemas), primary education, consultation in agriculture. A process of fiscal decentralisation was also initiated, the local administration has the possibility to collect taxes and borrow money from the capital market as complements to the local budget achieved through re-distribution from central level (the equalisation system).

3.107 The problems encountered in the process of decentralisation are numerous. Firstly the adopted laws are not further implemented. Secondly a general cry out for an amelioration of this legislative framework manifests in Romania in the specialised environments. A better co-relation between public services and fiscal decentralisation has to be achieved, this creating the proper conditions for local governance levels to take action and improve the quality of services they are offering.

Regionalisation in Romania

3.108 Not only had the quality of the administrative system but also its territorial organisation in 42 counties come after 1989 under criticism. They are considering too small and inadequately equipped to face the challenges posed by development policies in the new economic context. During the communist regime regional issues were not scoring high on the Party/government’s agenda and regional disparities, already significant at the very beginning of the 90’s, have been growing during the transition. The process of decentralisation of public services towards councils and municipalities with different financial weight rather enhances instead of attenuates these regional disparities. (World Bank 2002:4, Ionita&Fartusnic 2002:1).

3.109 The 8 macro-regions created in 1997 through the Green Card of Regional Development are neither distinct territorial units nor deconcentrated institutions of the central administration. They are the result of grouping of counties with no common interests or profiles, administrated by weak institutions with few attributions and low authority (Ghinea&Moraru 2002:5).

3.110 As regulated by the previous Law on Regional Development (no. 151/1998) at the national level the National Council for Regional Development, formed of Directors of RDAs and Ministries and presided by the Prime Minister, was responsible with the co-ordination of the Regional Policy. Nevertheless, despite the clarity of the legislative act, it was impossible to localise this NC or monitor its activity. The new law on regional policy 315/2004 formalised an informal practice already existent, and places the NCRD under the jurisdiction of the Structural Funds co-ordinator, presently the Ministry of Public Finance, which can delegate this task further which
dominates the decision making process. This detail otherwise confirms the insignificant role the NCRD per se pays currently in this structure.

3.111 A change of legislation (beginning with the Constitution and of the Law on Local Public Administration and Fiscal Decentralisation) is considered necessary for the reinforcement of the regional authorities’ powers. The institutional set up has to be reformed, the Agencies and Councils for Regional Development have to receive more competencies, clearly delimited (divide or/and shared) from the ones of the central level, and together with them a strong position in the whole administrative system. As in the case of the decentralisation process, the regional institutions should become corresponding fiscal resources, eventually also fiscal powers, in order to enable them to fulfil their role of development planners. The latest changes into legislation clarify only the financial situation of the RDAs, i.e. their activity will be financed by the authorities who ask them to carry out tasks, but it does not enhance their power position into the governance level.

**Romania PPP Experience**

3.112 In Romania the National Company of Motorways and National Roads (NCMNR) and its predecessor NAR has benefited from EU-ISPA grants and several sovereign loans from IFIs (WB, EIB and EBRD) to develop and rehabilitate the road network. Both of the NCMNR’s multi-year National Motorway Development Program and national Road Rehabilitation Program are expected to be funded primarily through loans and grants. In 2002/3 the communal road network has begun to receive support from EU SAPARD program as well as the World Bank Rural Development project.

3.113 Prior to 2002, a Road Fund that receives 45% of Fuel Tax was used as the main source of road financing. The income was shared between the national roads (65%) and county roads (35%) and covered the administrative costs, routine maintenance. Loan service payment and limited rehabilitation costs of national roads. The Fund was abolished in 2002, following an advice from IMF and WB, and the road funding became dependent entirely on budgetary allocations. Under the new mechanism, it became difficult to increase the expenditures, to meet the requirements for maintenance and operation in order to ensure sustainability within the sector.

3.114 A legislation allowing private sector involvement in the provision of public roads and toll collection was introduced in 1997. This was followed by the creation in 1998 of a Motorway Directorate within the National Road Administration, in charge of the preparation and implementation of planned Motorway schemes.

3.115 Rehabilitation and upgrade of the only dual carriageway between Bucharest and Pitesti (96 km) were co-financed by an EBRD sovereign loan. Attempts were made to introduce real toll collection and to contract out the operation and maintenance through a concession to an SPV didn’t succeed. In 1997 an international tender was launched for financing, building and operating the Pitesti – Bucharest – Constanza motorway, was cancelled in 1999 following several serious budgetary constraints and the bidder’s request for substantial public contributions in order to make the first phase (Pitesti-Bucharest-Lehliu) bankable.
3.116 Following this, it became obvious that the conditions in Romania were not mature enough for a PPP type procurement of Motorways. Instead the construction of the Bucharest – Fundulea and Fundulea – Lehliu sections were co-financed by EIB sovereign loan. The construction works progressed slowly and the two sections began to operate only in June 2004.

3.117 Our recent experience involvement in the DN1 Route between Bucharest and Brasov shows that generally speaking the PPP contracts negotiated to date were not conform to what internationally recognized as a PPP. The main shortcomings are:

- PPP regulations in Romania provide for exemptions on public procurement rules, in situations where there are insufficient bidders to create a competition. This often led to superfluous negotiations, not to the best advantage of the Government.
- The specifications of the projects often provided limited opportunity for technical innovation, which reduced the scope for cost reduction and for the realisation of greater benefits. At the same time it was left to market to decide the critical factors of concession length, O&M performance standards and handover criteria.
- Construction costs are based on feasibility studies and therefore do not provide any form PP type saving and the signed contracts to date did not provide Value for Money.
4. **Summary of the Impacts of PPPs on Central Government Accounts**

4.1 As requested by the study main recipients, the following table summarises the key aspects diagnosed by the review as most relevant to the success or failure of sub-national governments’ PPP transactions and the subsequent impacts on Central Government Accounts.
### Group A Countries

<table>
<thead>
<tr>
<th>Country</th>
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</table>
| Australia | Successful and well advanced particularly in the Transport sector. Robust PPP legislation and policy frameworks were established from the outset, created a favourable environment for international private sector involvement. Central and local governments adopted minimum debt level policies. Advantaging fully privately financed schemes, vs. schemes funded through PPP or full public funding. | Three tiers of government were established in Australia:  
**Federal Government**: has most of the direct taxation powers and is thus a major source of funding for State activities, and has responsibilities for national matters e.g. defence, trade and works (national transport networks).  
**States**: are responsible for provincial matters such as policing, roads and traffic etc. The State and Federal Governments have a natural reluctance to either introduce new taxes or to raise levels of debt to fund infrastructure or service development.  
**Local Governments**: assist can take the form of a city or town council or a shire. They are responsible for town planning, local roads etc. and providing low level infrastructure such as bus shelters. LG has an influence is in the built environment. | Local Governments are free to define the scope of PPP schemes, free to define their budget allocations and free to borrow beyond the budgetary allocations from the federal government to fund their annual programmes. Local governments have some own sources of revenue from indirect taxation (e.g. land taxes), which they are free to allocate according to their needs. When borrowing is involved the state approval is required.  
The general policy of the Australian Government towards reducing the level of debt. | Tight budgetary discipline leading to low debt levels among local authorities. High credit worthiness and market confidence at both the local, state and federal levels. |
Hungary

There have been minor PPP projects initiated by municipalities, primarily public utility service projects, though these do not qualify as PPPs in the true sense.

Municipalities often outsource the service under a PPP contract to a service provider company, in which the municipality retains 49% of ownership.

Traditional PPP projects are rare among municipalities although there have been a number of initiatives in various areas of development aimed at getting the private sector involved in one form or another.

Hungary has nineteen counties and over 3,100 municipalities, each has an assembly. There are also seven regions with responsibility limited to planning and coordination, regional officials have few functions.

Local Government Law, in effect since 1990, allocates great responsibilities to local governments regardless of size with respect to public services.

These responsibilities are matched with the authorisation to conduct for profit businesses, to own and manage commercial property, to own and manage portfolios of securities, and to borrow for capital investment projects, freely, without any need for approval from or registration with a higher level of government.

In particular, municipalities may independently enter into PPP contracts without prior central government approval.

With no state guarantee on municipal debt, there is a strong market control on borrowing, i.e. as the state does not repay municipal debt, municipalities can only raise loans if they meet the credit worthiness criteria set by the lenders.
### Netherlands

The Dutch experience with PPPs is very recent and was initiated with the creation of PPP centre in year 2000 to pave the way for government departments to use PPP as a method of achieving value for money services procurement. The Dutch Government has adopted a very precautionary approach to municipal involvement in borrowing to ensure control over the country overall debt and deficit levels. In practice municipalities can freely borrow in the open market, issue bonds and guarantees under the condition that the currency is Euro (requirement by law) and after approvals from the province or the central government. In addition, to guarantee a loan for an investment, the European state aid rules apply.

The Netherlands has three tiers of government: Central Government, including the Houses of Parliament (Senate and Second Chamber), and Local governments including Provinces and Municipalities. All Local governments are autonomous and the law makes no distinction between small or large municipalities.

There are twelve provinces in the country and 467 municipalities.

The European Union is becoming more important – more than 50% of legislation in The Netherlands comes either directly from Brussels or is influenced from Brussels, affecting all tiers of government directly.

Municipal government is relatively autonomous and deals with a large package of tasks and responsibilities.

Provinces and municipalities have two sources of income: central government funding and income they raise themselves.

Municipalities can freely borrow in the open market under the condition that the currency is Euro (requirement by law), as well as issuing bonds. The credit rating of the state as well as provinces and municipalities is currently “implicit triple A”.

They also can guarantee Euro currency loans, without prior approval from the province or the central government.

The Central Government intervenes to control municipalities and provinces’ future debt levels, only when the national EMU-shortage is in danger.

Such cautious approach of the Dutch state ensured local authorities’ solvency. It has though limited their PPP experience to projects with highly predictable risk profiles requiring limited guarantees and thus limited risk transfer to the private partner. This is also reflected in the limited and relatively recent experience with PPPs.

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<td>Portugal</td>
<td>In Portugal, given the social orientations, most of the corporations’ services are subsidised and rarely break even. This applies to the Local (metro, tram, bus companies, etc.), as well as the national corporations (National Train Company “CP”, Rail Network Manager “REFER”, etc.), though the subsidy is partly provided by the European Community funds. PPPs have already been used by Portuguese Municipalities for the provision of water supply, waste treatment, energy (wind farms) and urban public transport services. Portuguese Government is organised in two tiers, the Central Government and the Municipalities. Although, the creation of regions has been decided, it is still at the very early stage and currently only Municipalities are assigned responsibilities for the provision of urban and sub-urban public services. The decentralisation resulted in a split of responsibilities between and central and local governments over the delivery of some services and a joint partnership on others. For instance in the education and health sectors the provision of regional services, including the infrastructure (hospitals, secondary schools) and the operation of services, are the responsibility of the Central Government, whereas the Local services are funded by the Municipalities. In the Water, Power and Transport sectors services are often provided through national companies (corporations or holdings), jointly funded by the State and the Municipality.</td>
<td>Municipalities come under the umbrella of the Ministry of the Environment who is responsible for co-funding their investment requirements. Municipalities have their own sources of revenues from residential and commercial taxes collected locally. For the Central Government contribution, Municipalities are required to prepare a yearly investment plan, where they have full freedom on defining its scope and priorities according to their own local policies, and where the Central Government has the only remit of ensuring compliance with the national budget constraints. The only restriction on Municipalities is on direct borrowing or guaranteeing loans on behalf of the private partner. These are regulated by rules provided in the Budget Law which issues a yearly ceiling on maximum borrowing as a function of the municipality previous year budget and the expected revenue streams for that year.</td>
<td>The decision over PPP transactions at the Local level is entirely made by the Municipality who has full freedom by Law to enter into agreement with a private partner, as long as no Central Government contribution is required. Municipalities, however, given their lack of experience and capabilities to prepare, negotiate and commission PPP contracts, often seek support from Central Government through entities like Parpublica. The intention in the future is to progressively implement a five year investment plan as required by the EU from which important component of the municipal investments are co-funded.</td>
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<td>UK</td>
<td>The UK was one of the first countries to introduce the concept of public-private partnerships. Some of the most successful partnerships have been in the transport sector. Much attention has focused on the success of the private finance initiative (PFI) in the road sector that has already brought more than £1 billion of new capital into the sector. The UK has also been a leading innovator in other partnership programmes. The UK’s public-private partnership programme including extensive outsourcing of the planning and management of roads. This has been used extensively at the local government level and is being increasingly applied on the national road network. Under these arrangements, private sector entities act as agents for government and deliver a wide range public services previously provided directly by government.</td>
<td>The UK Government is organised into two tears of Government, the Central Government and Local authorities. The latter ranges from regions to counties to districts and boroughs, with counties being the most relevant authority in planning and delivering of public services. The regions are responsible for the overall regional services and for defining development policies, whereas the counties and sub-levels are responsible for the more detailed planning and budgeting. Municipal Debt control mechanisms in effect in UK allow local borrowing for capital investment purposes but require liquidity loans to be paid back within the year. Also, credit approval ceilings are given each year by the central government, who defines a maximum borrowing amount, and where all sources of repayment are directly or indirectly controlled by the central government. Even the level of local capital spending is “suggested” by the appropriate ministry. Guarantees to third parties are allowed and not counted against debt limits. However, no municipal asset may be used to guarantee debt, only cash flows could be used for the purpose. PPP transactions in UK allowed off-balance financing of most capital expenditures for public services and achieved unravelled value for money savings. They also supported the country fast modernisation and conversion of the economy in the late 80th by enabling faster upgrade of infrastructure and services delivery. Projects were delivered more quickly, costs have been better controlled (cost savings of up to 30% have been achieved), project quality has been better, e.g. safety incentives have reduced road accidents, they are more effectively marketed to the public, and they tend to show a higher level of customer satisfaction. However, in some instances, PPP projects were not properly structured and as a result failed to deliver optimum value for money and risk transfer. For example, a number of the early projects procured focused too much on the achievement of an off balance sheet accounting treatment rather than upon the delivery of a value for money solution and securing a cost-effective allocation of risk.</td>
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**Group B Countries**

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<tbody>
<tr>
<td>Croatia</td>
<td>Croatia has very recent experience with PPPs, mainly in the road sector. Road concessions started with the ARZ concession and currently three concessions awarded. Of the three, only the Bina Istra and the Zagreb-Macelj projects involve the private sector in the concessionaire and can be described as PPP projects. The concession company for the third scheme, the Zagreb-Rijeka project, is 100% owned by the Government. In the two PPP concessions, the Government took responsibility for land acquisition and service diversions. HAC (the Government-owned motorway company), owning 49% of the Concession Companies, and the State supporting the project in the event that projected traffic volumes fall below certain pre-agreed levels. For both schemes, the project finance packages have relied heavily on the support provided by the Croatian Government, which effectively guaranteed debt service to project lenders, regardless of how the schemes perform. Also, the Croatian Government has supported the concession by paying a so-called “Financial Contribution” at the start of each year.</td>
<td>The Croatian Government is organised into Central Government and Local self-governments. The local self-government covers 425 municipalities, 122 cities, 20 counties and the city of Zagreb (which is both city and county). Local self-government operations cover areas of zoning and the planning of settlements, communal economic activities, protection of the environment, preschool education, culture, sports and welfare. The task of the county is to coordinate the interests and views of the municipalities and cities in their area, and the even development of these units. Cities and municipalities within the sphere of competence of their self-government carry out operations of local importance that directly realize the needs of the citizens, and that have not been assigned by constitution or law to the state bodies.</td>
<td>Local government units have general freedom in allocating funds for current expenditure, despite the existence of spending norms for decentralised services. Grants for capital expenditure are earmarked by sectoral ministries for specific investments. However, the Croatian government has not dealt so far in any serious way with the planning of public investment, nor has any overall approach to the financing of capital projects at the local level been set up. Consequently, the competent institutions, above all the Ministry of Finance, find it difficult to control the degree to which the local government capital investments are financed and carried out. Besides, capital projects are not included in public investment programs.</td>
<td>Currently an earmarked tax on fuel is collected and distributed 50%/50% to motorway and national road companies, directly from the oil companies and does not go through the national treasury. The current system is seen by both companies as their key to being ‘private’ companies. However their borrowing enabled by this source of income, has to be sovereign guaranteed by the state and is therefore a considerable burden on the states borrowing requirements and limits. At the time of investigation, the Croatian Government was considering ceasing the fuel tax (under pressures from IMF), and replacing the companies’ income with budgetary allocations from the Ministry of Finance.</td>
</tr>
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</table>
### Experience with PPPs

The development of public infrastructures in the Czech Republic is still carried out by the public sector with support from budgetary funding. The use of PPP as a procurement tool has so far been limited to concessions for the operation and maintenance of public services and facilities (waste collection, treatment and incineration, street lighting, sewage systems).

A legislative framework for PPP is being finalised, aiming at defining the competences of the Central and Local governments and to create the required legislative base (Code of Commerce, Public Procurement, Concession Law, Bankruptcy Law).

In 2004 the Czech Government’s PPP Policy was officially approved, and a PPP legislation (Concession Act) has been submitted for approval to the Czech Parliament. At the municipal level, budgetary rules are still to be devised to allow PPP transactions to be carried out in full harmony with EU rules on public debt and budget deficit.

### Structure of the Government

The Czech Government is organised into Central Government, the region and Municipalities. Municipalities remain the only significant tier of government at the local level and have the highest level of responsibilities after the central government. Each municipality represents a legal entity, with responsibilities divided between own and delegated ones. The own responsibilities include among other tasks in education, welfare services, housing, health care, culture, public safety, street cleaning, water, electricity and gas supplies, sewerage system. Among delegated responsibilities can be found the birth, death and marriage registers and building permissions as well as various tasks on environmental protection, sanitation, and statistics.

The Municipal Act of 1990 allowed disintegration of municipalities leading to the emergence of a large number of very small municipalities (about 60% of municipalities have less than 500 inhabitants and further 20% between 500 and 1,000).

### Fiscal policy & decentralisation

Municipal Act of 1990 specifies long term priorities of socio-economic development, the medium term physical plans and the municipal budget. The latter specifies financial and in particular investment allocation in the short-time perspective. While the budget is necessary for municipal governance, municipal development programs rarely saw the light, except for a small number of cities and larger towns that are currently preparing municipal development programs (often called strategic plans).

The self-governments of such small municipalities is very week in financial and professional matters and has limited bargaining-power in relation to the state government as well as private sector developers. In many cases, small municipalities create associations and establish companies to organise certain tasks, such as collection and treatment of municipal waste or water, sewage and other networks construction and management.

### Impacts on Central Government Accounts

The fiscal stress at the national level and the consequent short budgetary allocations have made several Local Governments at risk of either borrowing beyond their capacity for reimbursement, or under performing the services under their remits. The need for subsidising most of the local services that are now at world prices, with low users’ purchase power, has contributed to the failure of some PPP initiatives in those countries.

The Government has been exploring ways of controlling Local Governments borrowing with little success and any proposal to monitor or control Local Government activity is viewed with suspicion.
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<td>A legislation allowing private sector involvement in the provision of public roads and toll collection was introduced in 1997. The conditions were not mature enough for a PPP type procurement of Motorways. Instead investments were often co-financed by IFIs sovereign loans. With the abolition of the road fund in 2002 and the reintroduction of the budgetary allocations, it became difficult to increase the expenditures, to meet the requirements for maintenance and operation in order to ensure sustainability within the sector. At the municipal level some PPP concessions were undertaken in the utilities (e.g. municipal water), dominated by the international concessionaires offering better services but with little/no competition leading to higher prices for consumers and little value for money savings.</td>
<td>The Romanian government is organised into Central Government, 8 macro-regions and 42 counties. The counties are considered to be too small and inadequately equipped to face the challenges posed by development policies in the new economic context. A process of decentralisation of public services towards councils and municipalities with different financial weights contribute to balancing the previous regional disparities. The macro-regions created in 1997 through the Green Card of Regional Development are neither distinct territorial units nor deconcentrated institutions of the central administration. They are the result of grouping of counties with no common interests or profiles, administrated by weak institutions with few attributions and low authority. Local Government is responsible of public services as: social assistance, (including child protection policy) and social services (housing and community services), cultural institutions (theatres, museums, and cinemas), primary education, consultation in agriculture.</td>
<td>A process of fiscal decentralisation was initiated, where the local administration has the possibility to collect taxes and borrow money from the capital market as complements to the local budget achieved through re-distribution from central level (the equalisation system). When contracting external loans, the local communities must have the approval of a Commission mandated to authorize and approve the loans (formed of representatives of the local public administration, the Government and the National Bank of Romania). This procedure is followed if a certain amount (periodically updated) is exceeded. The Ministry of Finances can guarantee an external loan contracted by a local government unit. In this case the Ministry will supervises the contracting procedure as well as the reimbursement of the loan.</td>
<td>With the very little involvement of local governments on PPP projects, involving local government borrowing, or issuing guarantees or bonds, there are currently limited impacts reported on their impacts on central government accounts.</td>
</tr>
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</table>
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Appendix A – Concepts and Definitions
INTRODUCTION

The investigation of successful PPP experiences in order to link successes to the enabling environments requires clear definition of what is considered to be a successful PPP experience, and how this relates to the regional fiscal policy in place.

SUCCESSFUL PPPs

PPP policies, programmes or projects are designed and implemented under a variety of contexts and it would be difficult to find a level ground for the assessment of their success. A PPP project for instance could be considered very successful under one context and moderately successful under another depending on the recipients’ expectations.

Indicators such as the cost of a PPP transaction or the timely delivery are not objective as the acceptability of delays and cost overruns varies between countries and between regions of the same country. It is therefore important to define success in a way that is less subject to bias. One way of doing this is through comparison of expected and outturn project objectives. Objectives in this context relate to surplus benefits that a PPP procurement method is expected to bring over a traditional method. The main objectives sought from a PPP approach include the following:

- Maximise the Value for Money (VfM) of providing a service over a long timescale;
- Maximise efficiency and innovation to achieve VfM;
- Enable the Public Sector to procure services consistent with economic policy; and
- Pay for services which achieve the required quality.

The above objectives translate into the following:

- **Value for Money & maximising efficiency** is one of the key benefits in the introduction of PPP. It has been shown in countries around the world where PPP has been introduced that the ability of the private sector, through Innovation and Best Practice provides Value for Money. There is always the argument that the private sector cannot borrow money as cheaply as the public sector. This is generally true. The private sector’s cost of capital is part of its price for taking risk. One reason why the public sector can borrow more cheaply is because it is retaining risk that would be transferred under a PPP procurement route. However, international precedent shows that, even allowing for the higher cost of capital, the private sector introduces efficiencies and manages and mitigates risk in such a way that the whole life cost of a concession, with all financing costs is still cheaper, by on average 15%-20% than the Public Sector.

- **Providing Services** that would not otherwise be available relates to the amount of capital the Government either can or is willing to provide itself. The private sector is willing, and the investment market is also willing, to invest in major
infrastructure projects that are shown to be viable. The private sector can deliver these in a way the public sector cannot as it has the resources to do so. The public sector has always had to rely on the private sector to provide the expertise. With a concession based operation this is still the case but the introduction of private finance makes the range of this expertise much wider on an international front.

♦ **Reduction of Public Sector Borrowing Requirement (PSBR)** is a key issue with the implementation of PPP. It must be understood that in a PPP operation the Government will contribute significantly, if not wholly, to the costs of the services to be provided. However, instead of any capital having to be borrowed by the state, therefore constituting a portion of the PSBR, the capital is borrowed by the investor and it is paid for, by the state, over the life of the concession, from budgetary sources.

Based on those objectives, the following indicators could be devised as a measure of success. It should be noted that this hasn’t totally resolved the issue of relativity of the perception of success. However, for the purpose of comparison between approaches across countries, regions and sectors, the proposed indicators could be sufficient.

1. Discounted Net Present Value of the investment;
2. Duration of the development and implementation periods;
3. Levels of risk transfer (non monetary risks that are not included in indicator 1 above);
4. The improvement to service quality compared with the public sector procurement, both quantitative (savings and reliability) and qualitative (users perception);
5. Impacts on local and national public accounts (including contingent liability and long term commitment of public funds);
6. Private investors’ satisfaction and impacts on the locality/nation attractiveness to inward investments.

**REGIONAL FISCAL POLICY**

A regional fiscal policy entails the most comprehensive and possibly traceable degree of decentralisation since it is directly linked to budgetary practices. Fiscal decentralisation refers to the resource reallocation to local Governments. Arrangements for resource allocation are often negotiated between the central and local authorities based on several factors including interregional equity, availability of resources at all levels of government and local fiscal management capacity.

Fiscal Decentralisation should not be confused with deconcentration, which is only a manifestation of the decentralisation. Deconcentration is a process geared to increasing the effectiveness and flexibility of the provision of public services, previously centralised through regional and local offices. Other than this geographical similarity, deconcentration has little to do with decentralisation.
Decentralisation could be defined as an alternative method to central provision of public services at a more cost effective way. It involves the transfer of responsibility for planning, management and resource raising and allocation from the central government and its agencies to the lower levels of government. It is closely linked to the concept of subsidiarity, which proposes that functions (or tasks) should be devolved to the lowest level of social order that is capable of completing them. As the UNDP states: "Decentralising governance is the restructuring of authority so that there is a system of co-responsibility between institutions of governance at the central, regional and local levels according to the principle of subsidiarity, thus increasing the overall quality and effectiveness of the system of governance, while increasing the authority and capabilities of sub-national levels.

There are three broad types of Decentralisation: political, administrative and fiscal and four major forms of decentralisation: devolution, delegation, deconcentration and divestment.

**Political Decentralisation** normally refers to situations where political power and authority has been transferred to sub-national levels of government. The most obvious manifestations of this type of decentralisation are elected and empowered sub-national forms of government ranging from village councils to state level bodies. Devolution is considered a form of political decentralisation.

**Devolution** refers to the full transfer of responsibility, decision-making, resources and revenue generation to a local level public authority that is autonomous and fully independent of the devolving authority. Units that are devolved are usually recognised as independent legal entities and are ideally elected (although not necessarily).

**Political Decentralisation** requires a constitutional, legal and regulatory framework to ensure accountability and transparency. It also necessitates the restructuring of institutions and developing linkages with civil society and the private sector. Simultaneously, political Decentralisation necessitates universal participation and new approaches to community institutions and social capital.

**Administrative Decentralisation** aims at transferring decision-making authority, resources and responsibilities for the delivery of select number of public services from the central government to other levels of government, agencies, and field offices of central government line agencies. Administrative Decentralisation is often simultaneous with civil service reform. There are two major forms of Administrative Decentralisation:

**Deconcentration** refers to the transfer of authority and responsibility from one level of the central government to another while maintaining the same hierarchical level of accountability from the local units to the central government ministry or agency, which has been decentralised. Deconcentration can be seen as the first step in a newly Decentralising Government to improve service delivery.

**Delegation** redistributes authority and responsibility to local units of government or agencies that are not always necessarily branches or local offices of the delegating authority. While some transfer of accountability to the sub-national level units to which power is being delegated takes place, the bulk of accountability is still vertical and to the delegating central unit.
**Fiscal Decentralisation** is the most comprehensive and possibly traceable degree of Decentralisation since it is directly linked to budgetary practices. Fiscal Decentralisation refers to the resource reallocation to sub-national levels of government. Arrangements for resource allocation are often negotiated between the central and local authorities based on several factors including interregional equity, availability of resources at all levels of government and local fiscal management capacity.

**Divestment** is when planning and administrative responsibility or other public functions are transferred from government to voluntary, private or non-governmental institutions with clear benefits to and involvement of the public. This often involves contracting out partial service provision or administrative functions, deregulation or full privatisation.

The design of Fiscal Decentralisation emphasises a number of trade-offs between efficiency (cost effectiveness) and other objectives often held as central arguments against Fiscal decentralisation, such as balanced distribution of resources to ensure horizontal fiscal equality across regions and the macro-economic stability.

One of the most popular measures of Fiscal Decentralisation is the share of revenues of Sub-national Governments. This is a simplification as Decentralisation depends on other parameters. For instance, a greater share of revenues doesn't necessarily mean higher Decentralisation is in place, as it can be the case that a second country with lower share of revenues at the local level may be more decentralised overall because its sub-national governments have more significant autonomous sources of revenue or discretion over tax rates, or greater freedom in how to make expenditure decisions on public services at the sub-national level. It is also the case when high revenues are shared at the sub-national level where the local officials are not democratically elected and are only accountable to central government authorities.

**PPPs and Regional Fiscal Policy**

Regional fiscal policy in the PPP context is relevant as taxation remains the main source of revenue for Local Governments, from which PPP transactions could be funded. Tax revenues often play an important role in increasing the borrowing capacity and the credit worthiness of the borrower. The ability to raise taxes at the local level could support a true decentralisation of authority and decision making provided that some conditions have been met. Among the benefits of a decentralised regional fiscal policy:

- Less dependency on central government revenues;
- Bringing decision making closer to people which yields programmes and services that better address local needs;
- Freedom to directly raise revenues (local taxes, borrowing);
- Greater responsibility for spending programs;
- Greater responsibility for macroeconomic stability;
Greater local community ownership of the whole fiscal system;

Strengthen the role of local authorities and improve service provision through improved capacity for fast interventions to solve problems; which in turn assists in better revenue and tax collection;

Greater congruence of spending programs with local needs and demands; and

The ability to provide fiscal incentives, especially tax exemptions and budgetary subsidies to encourage commercial investments in poor regions.

However, fiscal decentralisation does not always lead to the best and experience has shown that there are number of risks underlying its implementation such as:

Central authorities over (suffocating) or under (loose) control of decentralised localities, e.g. lump sum transfers into local institutional framework unable to provide efficiency and effectiveness or/and unwilling to adhere to transparency and accountability principles;

Decentralisation tied to deficit funding (local or national);

Decentralisation that depends totally on central transfers due to underdeveloped local tax revenue base;

Local fiscal policy that distorts macroeconomic equilibrium (locally and centrally);

Institutional and transactional costs of multiplying tax jurisdictions outstripping the benefits;

Weak central oversight/audit and accountability for the transferred funds; and

Central government may be reluctant to vest discretion to local governments which may well be controlled by opposition parties.

The question to be answered here is by which process regional fiscal policies can affect the development and implementation of a PPP policy, programme or project. Public Private Partnership (PPP) as a concept is a logical extension of the decentralisation process and local socio-economic development. PPP is an appreciation of the fact that both the public and private sectors are partners in development. PPP is a vital component of the decentralisation process. This is where civil society and the private sector, for greater participation in local government and management, are being encouraged to enter into meaningful partnership arrangements for the production and provision of rural, urban and municipal services.

The main bottlenecks in this process are that the existing legal framework does not always allow the Local Government to enter into effective partnership with the private sector, e.g. restriction (ceiling) on the contract values that the local authority can directly contract to the private sector; the risk that decisions to enter into PPPs may not be effectively discussed with the beneficiaries; Local Governments often lack
information to make informed decisions on the issue and they do not operate as business entities, therefore the private sector is very suspicious of their competence; the interest of the Public and the Private sector may not coincide; Proper internal procedures and monitory systems on the part of Local Government are often absent, which allows the private sector to cheat them; Political considerations determine whom the local authorities should enter into partnership with; Local Government lacks the required infrastructure, which could serve as bait for the private sector to enter into PPPs with it.

The success of a decentralised PPP initiative would require:

♦ A legal framework to allow Local Governments to enter into fruitful partnerships;
♦ Entrepreneurial skills and Capacity of the Local Government to manage PPPs;
♦ Participation of all stakeholders in decision making and implementation;

The argument in support of Fiscal Decentralisation as leading to better efficiency is not boundless and it is generally recognised that optimal transfer varies depending on the context and the type of service. In fact the gain in efficiency essentially originates from increased individual welfare that originates from the amount of funds spent at the sub-national level\(^{42}\). This can be true for some services since local and regional governments are better at discerning the preferences and needs of their constituencies and can more easily adapt their expenditure policies to fulfil them (consumer surplus). However, there are some public goods, those with national benefits that can be more efficiently provided at the national level. It is also true that spending funds through sub-national governments can lead to greater producer efficiency (producer surplus) that is the same service or infrastructure can be delivered at a lower cost, or a particular budget can yield larger quantities or better quality of services or infrastructure when funds are spent at the sub-national level. However, there is little empirical evidence among literature supporting this other than in developing and transitional economies, where the institutional environment necessitates greater degree of Decentralisation because of the high transaction and administrative costs implied by centralised systems.

Also the benefits of having discretion over tax rates, granting tax privileges and offering some forms of assistance to businesses willing to locate in a particular jurisdiction, particularly obvious in North America and Western European Countries, could be attenuated by the phenomena of tax mobility. Mobility, however, leads to competition between local authorities, which in turn lead government officials to deliver services at minimum feasible cost, thus enhancing producer efficiency at the sub-national level.

Decentralisation has been more common and deeper phenomenon in industrialised countries. One explanation of this is that only at relatively high levels of per capita income that Decentralisation is demanded or becomes “attractive” to taxpayers in the

\(^{42}\) For instance in many developing countries, central governments have been criticized for allocating too many capital investments at the cost of more productive current expenditures. E.g central governments may have greater tendency to spend funds on national defence, when priorities of taxpayers maybe better reflected by greater expenditures on education and health.
sense that its benefits outstrip the disadvantages that it may engender such as income disparities, macroeconomic distortions and instability.

Most countries, within Group A in particular, have legislated clear regulations and limitations on municipal borrowing. This includes in some cases the regulations and procedures on managing local bankruptcy situations. It is therefore important for the study to analyse the various debt instruments and the local policies towards them, and should aim to answer the following questions:

♦ what are the local objectives?
♦ what is the trend in municipal borrowing, what has been achieved?
♦ what is the national government transfer policies?
♦ what is the system of domestic commercial bank system and practice of preferential loans, rates?
♦ what is the role of external sources of funding and the strategy of foreign investors in local government lending?
♦ what municipal debt financing mechanisms?
♦ what is the regulation on municipal borrowing, including the procedures on managing local bankruptcy situations?
Appendix B – PPP Project Experience
APPENDIX B – 1 AUSTRALIA

Project Case A – Melbourne City Link

5.1 The Melbourne City Link project became operational in December 2000; it involved a 34 year concession to build, own and operate a privately owned toll road connecting three of Melbourne’s public freeways at a cost of $1.8 billion.

5.2 The 22km road directly links the CBD, international airport, rail network and Australia’s largest seaport. It is an automated, fully electronic tollroad - one of the first in the world - and has no toll plazas, toll booths or coin chutes, which helps to maintain free-flowing traffic on the expressway. City Link users are required to register with the Link operator, CityLink Melbourne, either by opening a toll account or buying a day pass. Those who open an account will receive a small wireless device known as an e-TAG to install on the vehicle's windscreen.

5.3 The road was built entirely with private funding. The financial attractiveness of the project was enhanced by the availability of Commonwealth tax concessions on infrastructure bonds – now modified and reduced due to concerns about negative impact on government revenues\(^{43}\).

5.4 The Victorian Government\(^ {44}\) and the private developer Transurban City Link, now known as CityLink Melbourne Ltd, (CML) are the parties to a Concession Deed pursuant to the Melbourne City Link Act 1995. Under this Deed, Transurban is required to design, build, finance, operate, levy tolls and maintain City Link for a period of 34 years. The Melbourne City Link Authority oversaw and facilitated the project on the basis of a private build-own-operate-transfer (BOOT) scheme. This work is continued by VicRoads.

5.5 The Melbourne City Link Authority (MCLA) was a State Government agency established in 1994 to facilitate and oversee the Melbourne City Link project on behalf of the Government of Victoria. Its designated functions included land acquisition, advice on legislation, monitoring of design and construction, risk management, public affairs and community consultation. During its eight years of operation, the principal responsibility of the Authority was to negotiate the Government's contractual arrangements with the private developer and facilitate

\(^{43}\) PPP in Practice: Initiating and Supporting Major Economic Infrastructure, Western Australian Technology & Industry Advisory Council, 2004, Section I.8.

\(^{44}\) Local Government Victoria works with 79 local councils and is responsible for administering the Local Government Act 1989 and liaises with peak local government bodies and other agencies both State and Commonwealth which have policy, funding or legislative links. Department of Infrastructure website, www.doi.vic.gov.au.
delivery of the project. The Authority acquired land for City Link and the Exhibition Street Extension, monitored the State’s risks, negotiated with other government agencies, participated in extensive community consultation in relation to design aspects, and contributed to the resolution of a host of construction, operations and public affairs issues.

5.6 On 17 June 2004, VicRoads became responsible to the Minister for Transport for the management of the City Link contract, public safety on City Link, the protection of State interests and assets and the integration of traffic on the road network. Figure 3.5 illustrates the city Link Project Structure.

5.7 Design and construction of City Link was undertaken by TOJV, a joint venture between Transfield and the Obayashi Corporation of Japan, under contract to Transurban. The Melbourne City Link Authority and Transurban nominated an Independent Reviewer to act as a check on the quality of construction design and implementation.

5.8 The project has been rated as highly successful and has proved popular.

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45 ‘VicRoads’ is a statutory authority responsible for maintaining and improving the condition and performance of Victoria's 22,240 km of arterial roads and 4924 bridges and major culverts. VicRoads also develops road safety programs, registers vehicles and licenses drivers. VicRoads work with other government agencies, local government and the private sector to provide cost-effective products and services to the community.

46 Melbourne City Link Project Overview, VicRoads website.
Project Case B – Western Sydney Orbital (Westlink M7)

5.9 The Westlink M7 project involves the financing, design, construction, operation and maintenance of a 40 km long, four-lane motorway linking the Hume Highway / M5 at Prestons with M4, and the M2 at Baulkham Hills, as part of the Sydney Orbital freeway and motorway circuit. The route will consist of two travel lanes in each direction and wide central median which will allow for the possible construction of extra lanes or public transport facilities in the future.

5.10 The project was awarded to a private sector group, the WestLink Motorway consortium (sponsored by Macquarie Infrastructure Group, Transurban, Abigroup and Leighton Contractors) in October 2002. Construction has commenced and the motorway must be completed by August 2006.

5.11 In Sydney, New South Wales – a State Government agency ‘Roads and Traffic Authority’ (RTA) manages 17,623 km of State Roads including 3105 km of National Highways. This includes facilities such as traffic lights, roundabouts, signs and linemarking. It also manages nearly 3000 km of Regional Roads and Local Roads in the unincorporated area of NSW where there are no Local Councils. It provides financial assistance to local councils to manage 18,497 km of Regional Roads and, to a limited extent, Local Roads, through funding and other support.

5.12 RTA works in conjunction with State and Local government agencies, the responsibility and funding of the roads are outlined below:

♦ National Roads - National Highways - a designated subset of State Roads. Managed by the RTA. Fully funded by the Federal Government;
♦ State Roads - Managed by the RTA. Fully funded by the State Government, except for National Highways;
♦ Regional Roads - Generally managed by local councils though the RTA manages 510km Regional Roads in far western NSW where there is no council. RTA provides financial assistance to councils to help them manage their Regional Roads; and
♦ Local Roads - Generally managed by local councils, though the RTA manages 2,461km of Local Roads in far western NSW where there is no council. Generally funded by councils with financial assistance from the State and Federal governments.

5.13 The Minister for Roads (on behalf of New South Wales) had declared specified parts of the M7 motorway as a tollway and had directed the Roads and Traffic Authority (RTA) to act as the roads authority for this tollway.
5.14 The estimated design and construction cost for the motorway itself is $1.54 billion, and the total cost of the project, including the costs of connecting roadworks and financing costs, is $2.23 billion.

5.15 The project will replace the Cumberland Highway as part of the National Highway network, and about $360 million of funding support has been provided by the Commonwealth Government.\footnote{Westlink M7 motorway: Summary of contracts, prepared by the Roads and Traffic Authority, Aug 2003, p.2.}

**Project Case C – Melbourne's Public Transport Franchising**

5.16 Melbourne, a city of around 3.5 million people, was the first and remains the only, Australian city to franchise both its passenger train and tram networks. Both the tram and train fleets were acknowledged as being in need of significant upgrade at the time of franchising. Franchising also included the regional public transport system (V/Line passenger) then operated by the State.\footnote{PPP in the Commonwealth of Australia – Which Public and how Private? John Stott, State Transit Authority of New South Wales, October 2004, p.6.}

5.17 The last two decades has seen a number of major changes in the way public transport services are delivered. Public monopolies long dominated service provision but this service delivery task is increasingly being passed to the private sector.

5.18 Whilst complete de-regulation is unusual, the most common change is for the public sector service provision to be replaced by private provision by a single operator, who receives a franchise or concession to deliver services in a specified area (or route) for a specified period. Competitive tendering processes are commonly used to select the successful operator.

5.19 The Victoria State Government made a decision to offer franchises the operation of the tram and train networks. The franchising occurred in 1999. The money came from the State Government – the State Treasury managed the franchising process.

5.20 Tenders were expected to take full control of the system and to progressively upgrade rolling stock and infrastructure. The Government indicated that it expected annual patronage growth of 3.6% p.a. over a 15 year period; this compound 70% increase was adopted in the funding model and relied upon by the tenders.\footnote{PPP in the Commonwealth of Australia – Which Public and how Private? John Stott, State Transit Authority of New South Wales, October 2004, p.6.}

5.21 The winning franchisees projected the elimination of operating subsidies within 10 years and, within 15 years; all payments were proposed to be either performance or investment based.
5.22 This process was intended to transfer risk to private sector partners. Unfortunately the tenders proved to be financially unsustainable and the government still had to inject cash into the system.

5.23 The most publicised outcome of the franchise process has been the financial failure of the National Express Group (NEX), the largest operator among the franchisees. NEX ceased operations in late 2002, only three years into the franchise process. Outstanding creditors were owed at least $70 million and NEX forfeited its performance bond of $135 million which the State Government used to help meet the increased costs of future replacement services.\(^{49}\)

5.24 The Victorian State Budget for 2003/04 continued the process of upping the financial commitment to the franchised services.\(^{50}\) The objective of reducing the call on the public purse has not been met and was, in reality, never likely to be met.

5.25 It is thought that the main reason for the failure of this project was because the Tenders were too optimistic in their bids.\(^{51}\) It is likely that the tenders took the view that given the government’s strong wish to outsource, they would ultimately be able to transfer the risk back to the government, which turned out to be the case.

5.26 Another factor is that they had an ineffective integrated fare collection system in which evasion was rife, but this alone would not have caused the collapse – the major attributing factor is that the bids were demonstrably unsustainable.

5.27 The interesting thing about PPPs in Australia is that the roads projects have been so successful that the financial markets have not shown much enthusiasm for public transport infrastructure PPPs unless Governments hold most of the risk. For Governments the reluctance of the markets has eroded much of the attraction for public transport PPPs.\(^{52}\)

**Project Cases - Approval Process**

5.28 Both States’ policies (Partnerships Victoria and Working with Government) establish processes to be followed by government agencies in the development of a PPP.

5.29 In both States, Cabinet Committee approvals are required at least three times during the project’s development. A project must be approved in-principle by the relevant Cabinet Committee and funding for any likely government contribution confirmed, prior to any approach to the market.\(^{53}\)

5.30 A further approval would also be required after substantial pre-tender work has been undertaken, and prior to expressions of interest being sought. These two approvals are necessary to offer confidence that the project is:

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\(^{49}\) Melbourne’s Public Transport Franchising: Lessons for PPPs, John Stanley and David A. Hensher, October 2003, p.7.

\(^{50}\) ibid., p.8.


\(^{52}\) ibid., p.12.

Consistent with the government’s policies, and is of sufficient priority to receive funding; and

 Likely to have the necessary features of a PPP, including sufficient market appetite, to result in a value-for-money outcome.

5.31 In New South Wales, the Cabinet Committee’s approval to proceed to the first stage of a tender process will normally delegate the subsequent approval of a short-list and a Request for Detailed Proposals to the responsible Minister and Treasurer.

5.32 In Victoria, it is usual for a separate Cabinet Committee approval to be obtained prior to issuing a Project Brief. This would usually be the final Cabinet Committee approval sought during the project development process, with the selection of a preferred proponent and negotiations delegated to the responsible Minister, in consultation with the Treasurer.

5.33 To support the project development process, and to facilitate the Cabinet Committee’s consideration of projects, both States have established specialist Private Projects and Partnerships units within their Treasuries.
APPENDIX B – 2 HUNGARY

Project Case A - ASA and Rethmann Waste Management

Background

5.34 The market penetration of strategic investors in the Hungarian MSWM market took place in the first half of the 1990’s. The second half was characterised by large public grants for landfill construction.

5.35 By mid decade about a dozen foreign waste management companies had established footholds in one or more Hungarian municipalities. A.S.A., an Austrian controlled waste management company (later acquired by Vivendi) and the prominent German waste management company Rethmann were the earliest and biggest entrants to the market.

5.36 Debrecen is Hungary’s second largest city, with a population of about 250,000 in north-eastern Hungary. In 1991, ASA and the city of Debrecen formed a joint venture (AKSD) for waste management. The foreign partner committed itself to the replacement of the vehicle fleet and to the construction of a landfill compliant to E.U. standards. The municipality contributed facilities in kind.

5.37 After taking over the collection and transport service, AKSD decided to sell out the fleet of some 40 vehicles inherited from the municipality, and replaced them with a fleet of nine new high capacity compactor vehicles imported from Germany. The landfill was entirely financed by the foreign partner and was commissioned in 1994. It was the first landfill in Hungary designed to meet E.U. standards.

5.38 Szolnok is a middle-sized town of about 80,000 inhabitants in the Central Plains Region of Hungary. In the early 90s the Municipality embarked on an aggressive strategy of privatizing its public services, which included the construction and operation of a municipal waste water treatment plant through a private consortium. As in the case of ASA in Debrecen, Rethmann committed itself to the replacement of the vehicle fleet and associated containers, and to the construction of the landfill. The former was accomplished shortly after the formation of the joint venture. However, no fixed date was set for the construction of a new landfill.

5.39 The motivation of the municipal governments to invite private investors to take over the MSWM functions was fundamentally the same. They both operated the service with an overly large number of obsolete and deteriorating equipment, with excessive maintenance costs and a bloated staff. Both municipalities lacked the financial resources for the modernization of equipment. Further, their old landfills were nearing the exhaustion of their capacity and they were aware of the need to introduce higher E.U. conform standards of landfill construction, for which they equally lacked the funds. At the same time, foreign strategic investors were present and interested.
UPDATE ON BEST INTERNATIONAL PRACTICES IN PUBLIC PRIVATE PARTNERSHIP
WITH REGARDS TO REGIONAL POLICY ISSUES

Review Report

PPP Structure

5.40 As of 1991, the City of Debrecen and ASA embarked on a joint venture with the foreign partner holding a 51% controlling share, and the Municipality holding a 49% share.

5.41 As of 1996, most municipal services in Szolnok, including waste management, were privately operated. The town attracted a total investment of about Euro 20M through public and private enterprises. Rethmann was awarded the contract for MSWM in Szolnok in 1995, and hence becoming majority shareholder (51%) of the joint venture. The Municipality of Szolnok retained a 45% share and remaining 4% were shared between the County and a regional association of municipalities.

Competitive Tendering in Szolnok vs. Direct Contracting in Debrecen

5.42 Debrecen founded its joint venture with ASA through direct negotiation. Szolnok’s approach to privatisation is an outstanding example of an award after competitive bidding, which is described below.

5.43 Step 1: Awareness Building. The vehicle fleet was obsolete, maintenance costs were rising, staff was bloated, and the service constituted a perpetual drain on the city’s budget. The existing landfill space had a capacity of a few years left; and a new landfill would need to comply with new regulations.

5.44 Step 2: Strategy Formulation. The City Council mandated a series of strategic papers:

♦ A preliminary concept for the transformation of the Public Utility Company of Szolnok
♦ Valuation of the Company’s assets
♦ Development of alternative business plans, under a number of scenarios
♦ A transformation plan of the Company, featuring alternative privatisation concepts.

5.45 The business plans confirmed that neither internal resources, nor increases in fees could provide sufficient funds to meet urgent investment requirements. The Municipal Council reached the decision to establish a separate municipal corporation for MSWM, SZOLKOM Rt., and to subsequently offer shares in the corporation to an investor who would undertake the required investments. This strategy had the advantage that after the asset valuation and the separation of accounts, the financial situation of MSWM in Szolnok became transparent to interested investors under their due diligence.

5.46 Step 3: Tender Documentation. With outside legal advice, documentation was prepared to solicit offers from investors. This documentation was quite specific about the Municipality’s expectations but allowed sufficient flexibility in submitting offers. Important items the bidder was to specify included:

♦ The intended ownership stake of the bidder, which could not be less than 51% or more than 74% of the company. It was decided during the strategy phase that it was necessary to offer a majority stake to attract a serious foreign investor, but
at the same time retain the requisite minority share to safeguard the Municipality's interest on vital matters (26% under Hungarian law).

- The vehicles and equipment it intended to provide to meet service standards specified in the documentation.
- The phasing of investment for a new landfill to cater to the needs of Szolnok and surroundings for at least 50 years.
- A plan for introducing selective collection and recycling of reusable wastes, and the selective treatment of hazardous household waste, and to specify the respective investments it proposed for the purpose.
- Proposals for tariffs and a method for collection, of indexation for inflation and other changes
- A 5-year business plan for the joint venture

5.47 Step 4: Tendering and Bid Evaluation. A number of offers were evaluated by ad hoc Committee, which made its recommendation to the Municipal Council. The Municipal Council had the exclusive right for the final decision on the tenders, including the right to reject all the tenders. In the event the tender was awarded to Rethmann.

5.48 Szolnok thus adopted a transparent and professional tendering process, one of the first municipalities to do so for an MSWM contract award in Hungary. Main advantages of such a process are transparency and competition. Also, as the contract is an open covenant of the Municipal Council, it implicitly reflects a consensual approach for problem resolution. The partnership between Szolnok and Rethman, now in its 9th year, can be regarded as a positive case of consensual decision making between the partners.

5.49 Most early MSWM service contracts and joint ventures (including in Debrecen) were concluded in direct negotiations, with the Mayor in the chair. One advantage of direct contracting is the short time needed to conclude the contract. The Szolnok procedure took three years, most of which spent in building consensus. However, in the absence of a consensus-building phase, a direct contract is prone to be assailed by political and business opponents. In fact, Debrecen paid a higher price later.

**Tariffs Fees and their Collection**

5.50 The fact that the two joint ventures have remained financially viable concerns to date, with high standards of service, and in the case of Debrecen, with a high standard landfill disposal, demonstrates that private investment can be mobilized to modernize the service, thus contributing to meeting the needs of higher service levels and environmental sustainability, and, in the process, contribute significantly to meeting the costs of compliance to EU Directives.

5.51 While the basic rationale and strategy of ASA and Rethmann in Hungary are similar, there are also important differences in the structure and operation of the two PPPs, as noted in the table below:
### 5.52
In Szolnok, the company earns its entire revenues from tariffs and fees, which are directly collected. The joint venture contract explicitly mandated the company to collect the fees from households. This was at the time an exceptional arrangement in Hungary. In most other PPPs, the municipality determines the fees, and the households pay to the municipality, while the municipality pays the service company on some other basis, e.g. a formula related to the number of inhabitants served. Further, in most municipalities, the service remains subsidized. Thus Rethman’s case demonstrates that it is possible to operate MSWM in a financially viable and self-financing manner based on direct client relationship with the customers.

### 5.53
ASA’s experience in Debrecen has been altogether different encountering the difficulties of risk sharing in an uncertain environment. AKSD’s initial contract with Debrecen is the case of a risk sharing structure based on expectations that turned out to be wrong. The contract was based on the principle of guaranteeing that yearly annual revenues, fixed in advance, would cover investment and a return on capital over the five-year period (1991-1996). Over this period, AKSD was to receive escalating lump sum fees for the core service of collection, transport, and disposal of household waste. The notion behind this structure related to the population’s limited capacity to pay at the start, coupled with expectations of a rapid increase in both the municipality’s revenues and the population’s capacity to pay. According to the agreed formula, the lump-sum fee in the last year was to be five-fold the fee in the first year. The expectations of rising incomes and revenues did not materialize. In the event, after considerable acrimony, AKSD reduced its fee for the last years of the original contract, and starting in 1997, the parties agreed to adjust the lump-sum fee annually, for inflation and other factors, according to a complex formula. While the formula for fee determination proved to be inappropriate, the case still demonstrates positive conflict resolution. What eased the conflict was that the Municipality had a stake in the financial survival and viability of AKSD, having a 49% stake in the venture. It was also fully informed of the Company’s financial difficulties, as the Finance Director of the company, according to the original contract, was a nominee of the Municipality.

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54 In addition to revenues from households, the company has direct contracts with industry, and specific subcontracts with the municipality for special services (e.g. snow removal, maintenance of sidewalks and bus stops, maintenance and operation of pay-parking lots, and another dozen activities.)
Lessons Learned

♦ Joint venture deals in MSWM can be financially viable and sustainable, without central government support, and can effectively contribute in MSWM regionalization;

♦ Direct negotiations and competitive tendering can both result in a positive outcome, but a professionally conducted competitive tendering process has major advantages, including possible long term cost savings;

♦ Pricing and risk sharing can be resolved in different ways, but it is risky to base contracts on loosely founded expectations regarding income growth.
Project Case B – M1-M15 Motorway

Background

5.54 As the level of State debt did not permit public financing, a PPP approach was considered necessary for the realisation of non-recourse financing of 57 km of new motorway. Additionally it was judged that a PPP allowed more rapid implementation, including earlier financial close, of the Project than would have been permitted in conventional public sector procurement and financing. The debt would also have a longer maturity than would have been possible at the time by the Government of Hungary acting on its own as a sovereign borrower, or as a guarantor of a Special Purpose Company.

5.55 The project consisted of the design, financing, building, operation and transfer (35 years after effectiveness of the Concession Agreement) of 43 km of motorway from Gyor to the Austrian border (M1) and 14 km of motorway linking the M1 to Bratislava (M15). This would have a semi-open toll collecting system with one main toll plaza and five tolling stations on three interchanges. The parallel, un-tolled country road was to remain unimproved. The traffic volume un-tolled was forecasted to amount to 25,000 AADT (annual average daily traffic), comprising 70% international traffic and 60% commercial traffic. The full traffic risk (volume and revenue) was transferred, without mitigation, to the private sector.

5.56 In contrast to other motorway schemes in Hungary, there was no support from the State other than in initial planning and site acquisition, whose costs were to be reimbursed in the form of profit sharing. The Concessionaire was free to set initial tariffs (tolls) at their revenue maximising level and thereafter to adjust them in accordance with agreed indexation provisions (HUF CPI inflation and adjustments for HUF/foreign currency exchange rate variations). The economic rationale for the Project was largely based on time savings to be realised by users (estimated at 20 minutes per full journey). There were no significant construction (ground or geological) risks as the terrain is flat without the requirement for significant structures to be constructed.

5.57 The case highlights the difficulties of transferring unmitigated traffic volume and revenue risk to private sector concessionaires, even for two high priority sections of motorway forming part of the Trans-European motorway network. It also shows the risks to which PPPs are exposed in the absence of full political support to private sector investment and toll setting.

PPP Features

5.58 The principal parties involved were the Bureau for Concession Motorways, established by the Ministry of Transport in the Motorway Directorate in 1991, and ELMKA, Rt., a private sector company, comprising the international contractors and toll-road operator. The private party provided 19% of total financing required in the form of equity and shareholder funds. In addition, the Lenders were involved for Euro 329 million arranged by Banque Nationale de Paris (BNP), co-arranged with the European Bank for Reconstruction and Development (EBRD), and syndicated to 11 commercial banks. The Loan maturity was 14 years. At the time this was the longest maturity secured by a Hungarian public or private borrower. Hungarian Forint
financing amounted to HUF 12,000 million, arranged and provided by the EBRD and Hungarian commercial banks and insurance companies, together providing 81% of total financing.

The PPP Process

5.59 The design and construction permit was secured by the Bureau for Concession Motorways in advance of the tender being initiated. Similarly the site had been acquired and paid for by the State. A two-part tender was launched in 1992 (in compliance with the Act on Concessions (No.XVI), approved by Parliament in 1991. Four consortia were pre-qualified in August 1992. The best and final offers were received from two preferred bidders in January 1993. The Concession Contract was executed with a single preferred bidder in April 1993, effective in January 1994. The principal tender criteria was the level of tariff required by the Concessionaire, subject to meeting technical commercial and financial criteria specified in the tender documentation. A two-year construction period was required and the M1 opened to traffic in January 1996.

Actual Experience

5.60 Traffic volumes in the first full year of commercial operation amounted to 6,350 AADT, 46% of original estimates and ELMKA’s total revenues were some 50% below forecasted levels. This reflected a significant diversion by many commercial vehicles to the un-tolled alternative route.

5.61 Additionally the overall passenger car volumes were much reduced in part due to the development of large shopping centres within Hungary, removing the need for cross-border travel. Furthermore, delays in border crossing formalities for some users of 8 to 10 hours or longer, reduced the apparent value of the time savings potentially generated by the Project.

5.62 In 1996 litigation proceedings were launched against ELMKA, amongst others by the Automobile Club of Hungary, contesting the fairness of the toll levels. The court ruled that toll rates were not consistent with the level of service provided. In consequence senior lenders suspended loan disbursements for the M15 Project and construction was suspended. ELMKA experienced serious cash-flow shortfalls and defaulted on its loans in 1998.

5.63 Following the election of a new Government, the Concession was taken over by a special purpose public sector company in 1999 and the Republic of Hungary assumed debt service obligations, from January 2003. The loans were restructured to give an overall maturity of 20 years, reduced rate of interest and a reduction in the amount outstanding, (debt write-down) secured by a sovereign guarantee.
Other Hungarian Motorway Projects

5.64 The Bureau for Concession Motorways subsequently initiated tenders for other motorway schemes in Hungary including the M5, M3 and M7. Feasibility studies showed, in contrast to the situation for the M1-M15 that a stand-alone private sector financing solution was not possible and would require traffic volume or revenue shortfall support mechanisms. A tender procedure for the award of a private sector concession for the M3 Motorway was cancelled in 1995 and the Project was implemented by a state-owned public sector special purpose company. This was financed by means of direct Government contributions and Government guarantees. EIB loans initially made up 50% of project costs but this loan has subsequently been cancelled.

Lessons Learned

♦ Notwithstanding the high economic and political priority of the Project at the time, the viability of the PPP was undermined by underlying economics, which in practice did not bear out the optimistic traffic forecasts at the time the Concession was first negotiated and financed.

♦ Traffic forecasts are widely recognised as difficult to get right (compare forecasts for passenger forecasts for Eurostar passenger train services London to Paris and Eurotunnel revenues with the actual outturn), especially so when alternatives modes of transport or corridors are available to users.

♦ Optimism in the traffic forecasts was exacerbated by the adoption of tender criteria which emphasised the lowest possible tariff, and the insistence on a stand-alone private sector investor.

♦ The M1-M15 Project has established itself as a benchmark of the dangers to which project participants are exposed when traffic risk on a greenfield project is transferred to private sector participants without mitigation or contingent support (as opposed to the M5, see case 19).
There is a wide variety of different commercial structures (availability charges, shadow tolls, etc.) for attracting PPP involvement in motorway and highway investments.

A defaulting private sector concession can lead to a re-nationalisation.

**Project Case C – M5 Tolled Motorway**

**Background**

5.65 The 157-kilometre M5 forms part of the Pan-European Transport Corridor IV (Berlin-Prague-Bratislava-Budapest-Bucharest-Thessaloniki-Istanbul). It is the main link from Budapest to Hungary’s Southern region and an important extension of the western and central European motorway network towards Belgrade and Bucharest.

5.66 Pre-qualification documents were released to private sector bidders in April 1992. Following the selection of three pre-qualified bidders in September 1992, a tender was launched in 1993, leading to the selection of two preferred bidders in February 1994. A 35-year concession contract was signed with the successful bidder, a Special Purpose Company formed by a French-Austrian-Hungarian consortium, Alföld Koncessziós Autopálya Rt. (AKA). The main shareholders in AKA are the general contractors, Bouygues S.A. and Bau Holding AG. Financial close was delayed until December 1995 as a result of a requirement imposed by lending banks for a fresh traffic study. In turn, this led to a requirement to increase the revenue support arrangements available to the Project from the Hungarian authorities. The operating and maintenance services are provided to AKA by Maygar Intertoll Rt, a company fully owned by the South African toll road operator, Intertoll. The concession award was made in accordance with the local Concession Act XVI/1991.

5.67 The first Phase comprises the upgrading and rehabilitation of existing roads and the construction of approximately 90 kilometres of new highway. A semi-open tolling system was adopted with two main toll plazas and 8 toll barriers on interchange access roads. AKA was required to complete the construction of the second and third Phases of the Project by 2003. The second Phase comprises a 45 kilometre extension from Kiskunfelegyhaza to Szeged and the third a further 15 kilometre extension from Szeged to the State border.

**PPP Features**

5.68 The toll for passenger cars was set at HUF 5.00 per km in 1993 terms, and approximately at a fourfold multiple for heavy goods vehicles. Discounts for residents and frequent users were agreed. AKA is permitted to adjust toll rates in accordance with Hungarian retail price inflation and with any devaluation of the Hungarian currency, should such depreciation exceed the inflation differential between HUF and the respective foreign currency in which AKA’s external indebtedness is denominated.
5.69 The EBRD “A” Loan is provided directly by the EBRD, whilst the “B” Loan is provided by commercial banks, arranged by Commerzbank and ING. However, the EBRD extends its preferred creditor status (ranking ahead of other lending institutions in the event of rescheduling or revenue shortfall, by virtue of its multilateral status). At the time the “B” Loan was the largest non-sovereign international commercial bank loan raised by a Hungarian borrower. Repayment of the loans is in the form of annuities, calculated on the basis of an 18 year maturity, but with final repayment due in Year 13 as a “bullet” payment. The “bullet” payment corresponds to 55% of the initial principal amount. In order to achieve acceptance of this structure amongst commercial banks, the EBRD undertook to provide a guarantee of the final repayment.

5.70 A refinancing of all AKA’s borrowings was undertaken in 2003, with the objective of extending loan maturity, taking advantage of lower prevailing interest rates, increasing gearing, (the amount of debt in the overall financing in relation to the equity) thereby allowing the equity rate of return to investors to be enhanced. Subject only to the support arrangements and in particular the revenue deficiency facility described below, all operational, commercial and financial risks were placed on AKA. Thus, repayment of AKA’s borrowings and the payment of dividends to AKA’s investors are dependent on AKA’s cash flow and profitability.

**Experience to Date**

5.71 Construction was achieved on schedule, or for some sections, ahead of schedule and within budget. In 1997, the first year of operations, the average daily traffic volumes at 7,700, were significantly below forecast levels and AKA was obliged to draw on the stand-by facility (cash deficiency / revenue shortfall fund) agreed with the Government. Following a proactive marketing campaign by AKA and traffic calming measures, implemented by the Government on competing routes, the requirement to draw on the Stand-by Facility in 1998 and in subsequent years was significantly reduced. The availability of the revenue shortfall mechanism provided a critical safety net to AKA, without which it would have found itself in default in the same way that the M1-M15 was unable to pay its debt service obligations.
5.72 As a result of the imposition of tolls on an existing road alignment, extensively used by domestic and international heavy goods vehicles, a significant amount of traffic in the corridor, (50% or greater in the first year of commercial operation), diverted to Route No. 50, an untolled road running parallel to the M5. Traffic volumes on Route No. 50 had increased by 30% in relation to the levels prevailing before the opening of the M5. The vehicles diverting to Route 50 comprised principally local residents and cross border truck traffic, especially from the Ukraine and Turkey. The increased noise pollution and safety hazard led to protests by local residents. Subsequently, following negotiations involving the Ministry of Transport, AKA, AKA’s lenders and the relevant municipalities, it was agreed to implement traffic calming measures on Route No. 50 and to build by-passes. AKA was able to resist pressures to reduce the agreed toll rates on the M5 (in contrast to a similar situation prevailing on the M1 Motorway) but did agree to a programme of more substantial discounts for frequent and local users. Some users brought legal cases against AKA concerning toll rates in force but the Courts rejected these complaints.

**Government Contributions**

5.73 Revenue Shortfall Mechanism. The Government of Hungary is obliged for the first six and a half years’ of commercial operations (i.e. until 2006) to provide AKA with compensation in the form of a subordinated loan facility, repayable after discharge of Project indebtedness to senior lenders, in the event that AKA's actual revenues, for whatever reason, are below the levels in the Agreed Base Case.

5.74 The total amount of the shortfall facility is capped at HUF 9,000 million in 1993 terms (approximately EUR 50 million).

5.75 The Concession Agreement provided for the Government to contribute at no cost the following: the preliminary design for the Project, building permits and environmental clearance, land acquisition and such roads and motorways that are already in existence and traffic calming measures on competing roads. In return for the above in-kind and financial contributions the Government will be reimbursed through a profit sharing scheme, which is expected to account for approximately one third of the dividend stream forecast in the agreed base case.
5.76 The M5 continues as a viable PPP. The Government of Hungary provided capped, contingent, revenue shortfall support during the first nine years of commercial operations. Traffic volumes were significantly below forecast levels, but the Concession Company was able to avoid a default by drawing on the contingent Government support payments and a restructuring of its long-term borrowings.

**Lessons Learned**

♦ The M5 experience highlights the importance of an appropriate allocation of risks between the public and private sectors and the critical requirement for avoiding the transfer of unmitigated traffic risk to private sector investors and their lenders. This is especially important in transport corridors without previous experience of tolling.

♦ The early operating experience of the M5 illustrates the difficulties, which even the most experienced traffic forecasters have, in arriving at dependable forecasts of toll acceptance by drivers in a traffic corridor with no prior experience of tolling.

♦ Given the inherent uncertainty of traffic forecasts in such situations, the Government support arrangements, especially the revenue deficiency facility, were critical in ensuring the financial existence and viability of the Project and in avoiding the risk premia, which lenders and investors would otherwise have required.

♦ Experienced technical, traffic, financial and legal advisers were important to both the Government and private sectors in order to achieve a satisfactory allocation of risk and an appropriate revenue support mechanism.

♦ The financial viability of a capital-intensive road project is dependent on achieving loan maturities of acceptable length. The loan maturity available to borrowers in Hungary in 2003 has substantially increased in relation to the circumstances prevailing when the M5 financing was first initiated as a result of Hungary’s improved economic position and EU accession status. The EBRD
played a critically important role, at that time, in enabling the necessary loan maturities to be achieved.

♦ Even without the improvement in Hungary’s overall economic position, the rate of return to investors would have been significantly improved by refinancing the initial borrowings, once construction risks had disappeared and the financial results for a number of the early operating years can be made available to lenders.

**Review of the Hungarian Experience in the Road Sector**

5.77 A Road Fund established in 1989 collected roughly 10% of the retail fuel price as an earmarked tax, the main source to finance all expenditures related to the national road network. Aiming at the restoration of budgetary unity and unimpeded control of public spending by Ministries having responsibilities for monetary and fiscal policy, the road fund was abolished on 1st January 1999. Financing of public roads is once again highly dependent upon short-term priorities and yearly budgetary reallocation of public resources. Former directorates of the road administration, dealing with operation and maintenance of 30,000 km public roads were transformed into State owned, non-profit oriented public utility companies in 1996. Nearly all road and bridge construction companies were privatized in the early nineties.

5.78 A stand alone Motorway Directorate has been established in 1990 having responsibility for the management, maintenance and development of the then 270 km long motorway network. Within that organization, a Bureau for Motorways in Concession functioned as a separate entity from 1991 to 1997, preparing and managing several international tenders for motorway concessions (M1/M15, M3, M5 and M7 Toll Motorway Projects), within the framework of the Concession Act approved by the Parliament in May 1991.

5.79 The first attempt of that kind was launching an international tender for the M1/M15 Toll Motorway Project in 1992. This was a 43 km motorway section (“missing link”) on the Vienna-Budapest (M1) corridor of international traffic, with a 14 km branch towards Bratislava (M15), connecting earlier built, non-tolled motorway sections in Austria (65 km, A4) and inside Hungary (128 km of M1). Due to extremely severe budgetary constraints, only land acquisition costs were covered by the State (5% of total investment cost).

5.80 Concession for financing, building and operating the tolled sections was awarded and a concession contract signed with ELMKA private company lead by French and Austrian shareholders (Strabag, CDC, BNP, Transroute) in 1993. Financial closing was achieved in 1993 (main lenders: EBRD, BNP), based on a limited recourse project finance package of EUR 320 million (built upon 80/20% debt/equity mix). Construction of the M1 section was completed within budget and on schedule by the end of 1995.

5.81 In a litigation started by a lawyer of Hungarian Automobile Club against ELMKA in November 1996, the plaintiff complained about the toll rates (about EUR 0.15/km for cars) considered excessively high in international comparison. The first instance court’s decision (confirmed by the appeal court later) obliged ELMKA to pay back to the plaintiff about one third of the toll, but did not oblige the company to reduce its tariffs. Despite the quite considerable traffic on the tolled M1 section (6,000-6,500
vehicles/day, more than 45% of the total corridor traffic) substantial traffic and revenue shortfalls against forecast were encountered in 1996-1998. These shortfalls should be attributed mainly to the substantial slow-down of traffic growth in the whole corridor. In 2001 (when ELMKA has been disappeared already), the Highest Court of Hungary overruled all previous lower level Court rulings acknowledging that (i) ELMKA Rt did not misuse its market position as a monopoly; (ii) motorway toll is a market price which could be defined by the contracting parties, taking into consideration prevailing conditions

5.82 The motorway generated a considerable amount of revenues: around HUF 3.0-3.5 billion, (EUR 14 million) a year, from which VAT 12% was paid directly to the Hungarian Treasury. Due to the growing revenue shortfall against forecast, however, the company was unable to pay the first debt principal due in June 1998 and became insolvent. At the request of the stepping-down government the lenders accepted temporary postponement of that payment and did not consider the company insolvent, provided an agreement is reached on restructuring. Aiming to fully restructure the project (injecting additional capital and rescheduling the debt) the shareholders and the lenders started negotiations with the new government, to over-bridge the emerging problems in 1998.

5.83 During the 1998 election campaign, parties of that coalition government promised either abolition or nation-wide unification and substantial reduction of motorway tolls in Hungary. It was declared, that motorway users have to pay only the operation and maintenance costs, while capital costs could be financed through international grants, budgetary contributions and sovereign borrowing (i.e. without the participation of the private sector under the concession system).

5.84 In compliance with the appropriate provisions of the Concession Contract, the lenders reached an agreement with the government in April 1999, to transform the outstanding debt of the company into a sovereign debt under much more favourable terms and conditions than those of the original (non-sovereign guaranteed) debt. The company itself was substituted in July 1999 by a newly established, fully state owned special purpose company (NyuMA). The shareholders suffered substantial losses, being obliged to write off the whole equity of ELMKA, without compensation. When NyuMA took over the tasks of the concessionaire, the toll rates on M1/M15 motorways were reduced by nearly 50% (in the car category e.g. from HUF 1300 to HUF 700) in August 1999. As a consequence, the traffic volume on M1, especially that of cars, increased by 15-20% during the coming months, while the revenues compared to those collected during the same period a year earlier, decreased by 45%.

5.85 Following a competitive concession tender to finance, build and operate a 157 km section of M5 Toll Motorway (including an already existing 27 km motorway and a 30 km half-motorway section), another concession contract was signed with AKA private company in 1994. Financial closing of the 1st Phase project (97 km) was achieved by the end of 1995. The public-private partnership type deal was built upon a limited recourse project finance package with debt/equity mix of 80/20%. The amount of in-kind plus material governmental contribution is equivalent with more than 45% of total project cost (ECU 370 million). The main shareholders are Bouygues and Bau-Holding, the main lenders EBRD, Commerzbank and ING Bank. The first phase (Budapest – Kiskunfélegyháza) was duly completed within budget and on schedule in June 1998. As a consequence of substantial governmental contribution, toll rates are
much lower (EUR 0.07/km for cars) than on the M1 motorway. Despite some traffic shortfall against forecast, the traffic (9000 vehicle/day in average in 2002) and the revenue stream (supplemented until 2003 by a State guaranteed, EUR linked, semi-annually and in total capped, standby type operational subsidy) has been considered satisfactory until the end of 2003. The company was meeting its financial obligations and rescheduled its outstanding debt successfully (obtaining much better conditions) in Summer 2003. It was kept, however, permanently under attack by the public and the media, because of the high tolls which deterred considerable traffic of heavy good vehicles onto the (partly urbanized) parallel main road. According to the Concession Contract. AKA owned the concession rights over the 2nd Phase (45 km extension from Kiskunfélegyháza to Szeged) until the end of 2003. Aiming to start construction of that section, as well as to extend the motorway vignette system (see below) onto the M5 Motorway, after lengthy negotiations the Hungarian Government bought out 40% of AKA’s shares and the Concession Contract was renegotiated and amended in February 2004. The share price has been calculated acknowledging yearly net 14.4% ROE. As a consequence, the vignette system replaced direct toll collection on the M5 Motorway at 12 March 2004, implying a sharp increase of traffic volumes (especially that of HGVs) on the motorway, during the following months. The toll revenues of AKA were replaced by availability fees to be paid regularly from the State budget. To finance construction works started in May 2004 on the section leading to Szeged, AKA arranged further loans guaranteed by the State from its main lenders. It has to be mentioned, however, that financial closing of the whole transaction did not reached yet at the end of August 2004.

5.86 A competitive tender launched in 1993 to finance, build and operate a first phase of the 250 km long M3/M30 Toll Motorway (including an already existing 56 km motorway section) was cancelled in late 1995. The government considered too high the material contribution requested by the preferred bidder, to make the 1st Phase (96 km) bankable. A fully State owned special purpose company (EKMA) was created to organise the financing, manage the building and finally operate the toll motorway. Nearly 70% of the financing was covered by sovereign loans provided by EIB and KfW. With cost overruns of about 20% (due mainly of change orders) the 1st Phase was opened on schedule in October 1998. Obviously for political reasons, the commencement of toll collection (in a closed system) was postponed twice, and started only in January 1999, with a moderate rate (EUR 0.045/km for cars). This rate is made available by the fact that the debt serviced by the Treasury is not connected to the toll revenues at all. A further 65 km of the M3 motorway, financed entirely from the State budget has been completed in 2002, while the first 8 km of M30 was opened in November 2003. The entire section is due to be completed by September 2004.

5.87 A National Motorway Company (NMCo) has been established in 1999, with the aim to deal with development of the motorway network in Hungary (except M5 Motorway, which remains for the time being a performing private concession). On the 3rd of January 2000 a so-called vignette type access fee/toll system has been introduced on the entire M1/M15 motorway (extending toll collection onto the previously freely accessible 128km) and on the 102 km long M3 motorway. Operator EKMA was merged with NyuMA and the Motorway Directorate in 2001 and functioning since then as State Motorway Management Company (SMMC). The vignette system has been extended to the newly rehabilitated 112 km long M7 motorway in January 2003.
5.88 Each vehicle using these State managed motorways is obliged to buy a vignette accompanied by a receipt, the registration number to be clearly marked on both. The vignette should be placed on the windshield, but does not prove the eligibility of the vehicle to use the motorways if not accompanied with the appropriate receipt. There are weekly, monthly and yearly vignettes available (valid for 10 days, a calendar month and a calendar year respectively). In Summer 2003 a 4-days vignette proved to be so popular, that in 2004 will be available during the entire year. The introductory prices in 2000 for cars were HUF 1,300, 2,400 and 22,000 respectively, while the multiplier was 2 and 4 for medium size trucks and HGVs, respectively. The prices in 2003 are HUF 1900, 3200 and 29000 (see Table 1 and Table 2 at the end of the Appendix). Vignettes can be purchased from NMCo and Hungarian Automobile Club offices, or at filling stations. Registration plate numbers and validity period of the vignette bought are recorded on-line into a data bank through terminals installed at these points.

5.89 The toll gates/boots previously collecting money on M1 and M3 motorways were functioning exclusively as control points in 2000. They were entirely demolished in 2001. In 2002 cameras were established at 4 sites (2 on the M1, 2 on the M3), using licence-plate recognition based electronic control system, operated by the Ministry of Interior’s services. The random control of vignette users by „flying squads” is quite expensive, but apparently inefficient. It is estimated, that more than 20 percent of the vehicles using the State managed motorways are not holding a valid vignette. The vignette system is unfair and does not comply with EU directives, since time dependent flat rates are not proportional with distance travelled, and inefficient, because the generated revenues (e. g. HUF 1500 million in 2003) do not cover the maintenance and operation cost of the State managed motorways (HUF 21000 million in 2003).

5.90 NMCo issued an invitation to tender, related to finance, build and operate under a concession/PPP scheme a new section of M6 Motorway (Érd-Dunaújváros, 57 km), lying on the Pan-European Transport Corridor V/C, on 30.01.2004. According to the tender documentation, the concession period is 22 years and remuneration of the private partner should be based on availability fees, or alternatively on shadow tolls (i. e. direct toll collection excluded). Four potential bidders expressed their interests but only three has been short-listed in April. The winner of the tender, as it has been announced officially in August 2004, the consortium formed by Bilfinger-Berger BOT GmbH (Germany) - Porr Infrastruktur AG (Austria) - Swietelsky Hungary and other Hungarian firms. The agreed project cost is EUR 508 million (EUR 8,9 million/km). According to the preliminary financial plan the debt/equity ratio is 90/10. The potential lenders are Commerzbank, Kreditanstalt für Wiederaufbau, Magyar Külkereskedelmi Bank and others. The Hungarian Government accepted to pay yearly EUR 25 million as availability fee throughout the whole concession period, provided the concession company (to be registered) will meet its obligations. Financial closing is expected to be reached by mid-October, allowing to start the works immediately, which is considered as essential to meet the completion deadline set for June 2006.
**APPENDIX B – 3 NETHERLANDS**

**List of Potential Schemes for PPP procurement**

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### Update on Best International Practices in Public Private Partnership with Regards to Regional Policy Issues

**Review Report**

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<td>Spoorzone Breda</td>
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<td>Delft Cluster*</td>
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<th>Other projects</th>
<th>Other projects</th>
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* changes due to revised priorities

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Case of the Reconstruction of Freeway A59 by the ‘Poort van Den Bosch’ consortium

5.91 The ‘Poort van Den Bosch’ consortium has been working on the reconstruction of the provincial road N59 Rosmalen – Geffen into the Freeway A59 since the summer of 2003. The road is located in the south of the Netherlands, between the cities of ‘s-Hertogenbosch and Oss. The new freeway is scheduled to be complete January 1, 2006. With this reconstruction, the road will be safer and current congestion problems and hindrance to surrounding communities will be relegated to the past.

5.92 The reconstruction of the N59 is the first road project in the Netherlands to be executed as a Public Private Partnership between the government (Province of North-Brabant) and private companies. The ‘Poort van Den Bosch’ consortium will not only design and construct the new freeway, but has also arranged the pre-financing and will maintain the freeway for 15 years. The total cost for the new freeway is 218 million Euro's.

5.93 Plans for reconstruction of the N59 have existed since the 80’s. However, after a study in the 90’s by the operational organization of the Ministry of Traffic and Transport, Rijkswaterstaat, it was determined that no financial resources were available to execute the reconstruction until 2007.

5.94 The Province of North-Brabant insisted on resolving the situation and proposed a Public Private Partnership for a quicker realization of the A59 freeway. The Ministry of Traffic and Transport agreed with this proposal and in 1999 the tendering process began. The tender was won by the Poort van Den Bosch consortium, and in February 2003 the contract between the Province of North-Brabant and Poort van Den Bosch was signed. This Public Private Partnership enables the realization of the A59 freeway 5 years earlier and for a cost 15% less when compared to traditional tendering.

5.95 After completion of the new A59 freeway on January 1, 2006, the ‘Poort van Den Bosch’ consortium will maintain the road for 15 years. Rijkswaterstaat will maintain the road after this period. The ‘Poort van Den Bosch’ consortium will receive a quarterly payment from the government, on the basis of availability of the infrastructure. There is a penalty regime to decrease payment in the event of lane closures and under-performance.

Case of the Wijkertunnel Randstad (Tunnel) Project

Background

5.96 As of 1980’s the circulation in the Randstad, the Netherlands central region, was made very difficult by traffic congestion and car accidents. The economic costs of these transportation problems were estimated at an annual amount of approximately €180m in the early 80’s and a further increase was forecast. The growing demand for public investment for the extension and modernisation of the national transport

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55 www.poortvandenbosch.nl
infrastructure occurred in the middle of a structural crisis of the national economical and political system, as recession, high rates of unemployment, budget deficits up to 6.7% of GDP hit the country in 1983. In this situation, the proposal to mobilise private capital and know-how for major infrastructure projects was part of the national government plan developed in 1983 which included a privatisation programme and a PPP approach similar to the UK Private Finance Initiative (PFI).

5.97 A task force of the National Transportation Department (“Ministerie van Verkeer en Waterstaat) developed a draft framework for the financing, risk allocation and contractual schemes for two urgent major transportation projects in the Randstad: The “Noordtunnel” and the “Wijkertunnel”, presented in this case study. The financing contract for the Noordtunnel was signed in 1988, while the competitive tendering process for the Wijkertunnel started in 1991.

PPP Features

5.98 The main criteria for selection of the bidder were: financial liquidity, experience with major tunnel construction programmes and the most economically advantageous bid. The last criteria however could not be tested competitively because the ING BANK was the only bidder. Despite the missing assessment of value for money, negotiations between ING BANK and the Dutch National Department of Transportation took place between May 1991 and September 1992. The modified PPP toll contract covered the following aspects:

♦ a private investment of €183m (sales tax not included) for the period 1993 to 1996
♦ an operating concession of 30 years with a subsequent transfer of the tunnel to the National Department of Transportation
♦ an option for the national government to buy out the contract earlier
♦ a shadow toll system that raised several subsequent concerns particularly as the minimum revenue was set at the financial / traffic demand base case and maximum revenue was not capped but related directly to actual usage.

5.99 In addition, ING was granted an EIB loan of around 93m Euros.

5.100 The national audit court examined both of the PPP projects Noord tunnel and Wijkertunnel in the mid 1990’s. As regards to the choice of the private partner, risk allocation and the public costs of the projects, the examination underlined that:

♦ if a competitive tendering process only leads to one bid it should be repeated with modified bidding documents
♦ interest rates for the involved bank grants should not be fixed for 30 years but adjusted regularly to reflect changing capital market conditions
♦ the tariff fee should be fixed for all vehicles to guarantee long term calculable costs for the state
♦ a public sector comparator should be developed and integrated into the process of selecting both the PPP alternative (as opposed to traditional public sector alternatives) and the private partner because in both tunnel projects, the audit court calculated that the PPP solutions had been 34 to 41% more expensive than the public sector alternative.
5.101 These results of the audit court examination and general concern over the lack of value being derived assisted in reshaping the national approach to PPP implementation. A major recognition was the lack of national competence and analytical tools available for the analysis of options. The major consequences of the review can be summarised as:

- establishment of a national PPP competence centre, founded in January 1999 in the framework of the Department of Finance, with, as one of its objectives, the development of a Public Sector/Public Private Comparator, standard contracts and to organise the knowledge transfer in and between the departments participating in PPP projects.
- establishment of a scientific study group to support the development of economic supervision instruments (based on an economical cost effective analysis) in April 1993 as a forerunner to the competence centre.
- the need for a clear division of responsibilities between the State being responsible for policy formulation, project preparation and procurement and the private sector for the long term delivery of infrastructure and services.

**PPP Structure of Wijkertunnel Randstad**
Lessons Learned

5.102 The project is generally considered as having major structural deficiencies. It is interesting to note the major changes that have been implemented in The Netherlands and which now drive the development of new PPP projects.

- While the project partly transferred design and construction risk to the private party, demand risk was borne by the public party and resulted in substantial costs to the State as maximum revenues were not capped. Additionally no provision was made for including project life cycle costs in the contract.

- The inclusion of (potential) private partners during the preparation and planning of a PPP can harness the problem solving potential of the private sector and PPP models. However this should in no way negate the need for the public party to have a clear strategy, detailed understanding of its needs, objectives, technical and financial details of a PPP approach; and a competitive tendering process contributing to the creation of real value for money.

- The development of a national PPP competence centre is a clear advantage for the development and application of analytical methodology, development of national know-how, provision of assistance to local authorities and the general dissemination of experience and support.

- The project clearly demonstrates that project costs and overall value for money are affected by the effectiveness of the procurement process in identifying the most cost effective solution. Also the public party should clearly identify the financial and economic case for a PPP option beforehand by comparing it to traditional public sector methods. Only if it clearly provides better value for money should a PPP option be selected (as is now the case in most EU Member States). Similarly the individual bids of the private sector should also be subjected to comparison to clearly identify the costs and benefits of each. As stated above such analysis requires the development of skills and know how at a national level together with standardised methodology.

- A modified toll model for public-private tunnel projects can be more expensive for the taxpayer than a public solution if PPP experiences in transportation projects are missing.

- In a country such as the Netherlands, with a strong SME sector, there is a restricted number of potential private partners able to undertake major infrastructure projects. As a result the project structure needs to be tailored accordingly. General opinion in the Netherlands suggests that such a project would not be repeated given the overly generous terms accorded to the private party in an attempt to attract the required financing.
**APPENDIX B – 4 PORTUGAL**

**Case of Beiras Litoral and Alta Shadow Toll Road**

**Project Description**

5.103 The project entails the widening and upgrading of 167 kilometres of the existing two-lane (2x1) IP5 highway between Aveiro, in the Coastal West, and the Spanish border at Vilar Formoso (East), via the cities of Viseu and Guarda. The existing road goes across hilly terrain with gradients of up to 8%.

5.104 Vehicles per day range between 9,000 and 12,000, varying with location and season. Trucks account for as much as one third of total traffic flow. The accident rate on IP5 has been notably high. Despite the heavy traffic, the absence of non-tolled alternative routes, induced the government to adopt a shadow toll regime for the concession, then with expected construction costs under €250m. The concessionaire thus receives tariff payments directly from the grantor, which are calculated according to the number of vehicle kilometres of usage and determined with reference to a banding system.

**Institutional and Management Structure**

5.105 In 1998, the Portuguese Government, through the Ministries of Public Works and Finance, solicited bids from the private sector in a public tender. After a preliminary screening process, two of the bidding groups (led by Portuguese contractors) were admitted to the negotiating phase as preferred bidders, and their respective Best and Final Offers were submitted in October 2000, presenting bid values much higher than the ones presented in the initial phase of the tender: the expected net present value of payments from government to the concessionaire nearly doubled relatively to the initial bids, reflecting the fact that estimated construction costs almost trebled, attaining €693.4m; start-up costs amounted to €75.5m and financing costs to €164.9m. In February 2001, the consortium Lusoscult - Auto Estradas das Beiras Litoral e Alta S.A. was awarded the concession for a thirty year period, including 5 years for the construction with phased opening. In order to reduce costs and increase road safety, the project included the construction of large new sections of highway, instead of enlargement of existing ones. The concessionaire is incorporated as a limited liability SPV company under Portuguese law. The shareholders comprise several Portuguese contractors and financial institutions with commercial interest in the Project also as lenders.

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>SPV Equity (%)</th>
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<tbody>
<tr>
<td>Mota &amp; Companhia</td>
<td>18.6</td>
</tr>
<tr>
<td>Bento Pedroso Construções</td>
<td>14.2</td>
</tr>
<tr>
<td>Engil</td>
<td>14.2</td>
</tr>
<tr>
<td>OPCA</td>
<td>12.4</td>
</tr>
<tr>
<td>Banco Espirito Santo</td>
<td>10.6</td>
</tr>
<tr>
<td>BCP – Banco de Investimento</td>
<td>7.5</td>
</tr>
<tr>
<td>7 other Construction Companies, each with 3.30 per cent</td>
<td>23.1</td>
</tr>
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</table>
5.106 The Government is paying for existing sections of the IP5 road, which will either be widened, duplicated or replaced by new sections. In 2002, the environmental appraisal of the project resulted in the refusal of the project and the requirement of enlargement of all existing sections regardless of their gradient or sinuosity (that should be, nevertheless, corrected). As this represents a deviation of more than 200 metres away from preferred alignment, the concessionaire is entitled to compensation for any additional costs or for delays in relation to the baseline of the submitted variant. As the environmentally accepted alternative (of just enlarging the existing road) was not accepted by government, construction works were stopped, and work schedule is delayed several years, waiting for an agreement between concessionaire, government and local authorities (and for the result of its ulterior environmental evaluation). Only the eastern section of IP5, 35km between Vilar Formoso and Guarda, is completed.

<table>
<thead>
<tr>
<th>USE OF FUNDS</th>
<th>FUR MILLION</th>
<th>PERCENTAGE</th>
<th>SOURCES OF FUNDS</th>
<th>FUR MILLION</th>
<th>PERCENTAGE</th>
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<tr>
<td>Construction Costs</td>
<td>693.4</td>
<td>60.5</td>
<td>Equity</td>
<td>102.0</td>
<td>8.9</td>
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<td>Start-Up Costs</td>
<td>55.5</td>
<td>6.5</td>
<td>EIB Loan</td>
<td>470.0</td>
<td>41.0</td>
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<td>Financing Costs</td>
<td>164.9</td>
<td>14.4</td>
<td>Commercial Bank Loan</td>
<td>448.4</td>
<td>39.1</td>
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<tr>
<td>Other start-up costs (incl. fees and reserves)</td>
<td>51.5</td>
<td>4.5</td>
<td>Net VAT Cash flow</td>
<td>126.2</td>
<td>11.0</td>
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<tr>
<td>VAT, Working Capital Build-up and operating cashflow</td>
<td>161.3</td>
<td>14.1</td>
<td></td>
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<tr>
<td>TOTAL</td>
<td>1,146.8</td>
<td>100.0</td>
<td>Total</td>
<td>1,146.8</td>
<td>100.0</td>
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5.107 The commercial bank loan is repayable in annuities over 25 years, commencing on the final completion date of the project. It is structured as a non-recourse loan, with repayment entirely dependent on the SPV’s revenue performance according to the level of motorway usage and the resulting revenue stream. The loan from the European Investment Bank has a slightly longer maturity of 27 years and is guaranteed by a commercial bank syndicate, with the possibility for guarantee release during the loan life – 50% after year 8 and 50% after year 16 – provided agreed covenants, including debt servicing ratios, meet certain contractually defined tests.

5.108 The revenue risk under the shadow toll regime is mitigated due to the existing heavy traffic and the fact that around 81 per cent of the traffic flows forecast in the SPV business case at full completion in 2005 was already achieved on the existing IP5 route in 2000. This risk profile is reflected in the interest rate margins charged by the commercial banks, starting at 125 basis points during construction and progressing towards 100 basis points thereafter depending on the project performance.

**Shadow Toll Regime**

*Figure B-4.2 – Financial Structure*
5.109 The shadow toll regime reduces the uncertainty attached to traffic forecasts under a fully tolled (user pays) regime. Under the shadow toll regime there is no deterrence to use alternative non-tolled routes, and savings in operational (toll collection) costs and in land investment costs (construction and equipping of toll plazas) can also be made.

5.110 Shadow tolls present some adverse aspects to the public sector that must be evaluated against the benefits. In first place, the regime implies the transfer of costs from users to the public purse and ultimately to the taxpayer. In second place, the regime provides some guarantees to concessionaires, in order to reduce the traffic risk or to create additional sources of profit. For instance, in Portugal, they implied the granting of some local “monopoly” to concessionaires: the government agreed contractually to freeze the Road Plan as it was in 2000, in the vicinity of road concessions, for 30 years, abstaining from increasing the level of service of those roads beyond the stipulated in the Plan.

5.111 That is very difficult to satisfy in the long-term. The conditions related to future enlargements are also important. Some of these matters may be significant when payment is made according to shadow toll, but non significant if payment is made according to availability.

5.112 The shadow tolling for IP5 is based on four categories of potential traffic volumes. The first category is intended to cover the concessionaire’s fixed operating & maintenance costs plus interest and principal payments on senior debt. The second category covers variable operating & maintenance costs plus interest and principal payments on subordinated debt. Revenues derived from the third category are used to pay dividends. During the first six years of the project (including the construction period plus the first operational year) the government pays only fixed amounts based on the availability of the motorway. Thereafter, shadow toll payments are made three times a year: May and September payments are set at one third of the respective year’s estimated traffic and the January payment is adjusted to reflect actual traffic volumes achieved in the preceding twelve months.

5.113 The dramatic increase in projected costs of Beiras Litoral e Alta concession to the public purse occurred also in other road concessions, creating a significant burden to public accounts. The expected amount of shadow tolls in 2007 is higher than the current highways agency budget for construction and maintenance of national roads in all country. That, and the fact that traffic prospects are very good in this concession, prompted the government to announce in May 2004 that this highway (as well as several other SCUT roads) will have real tolls when completed.
Lessons Learned

♦ The absence of environmental approval (at least for the road alignment) is a negative factor that impacts significantly in the process of implementing a PPP. In this case, as in others in Portugal, it created large delays (several years) and the possibility of large cost overruns that will be supported by government. This changes the initial risk allocation, eventually destroying the well balanced distribution of risks designed during tender.

♦ Without a clear statement of the project objectives (standards of quality and service required), there is opportunity for presentation of sub-standard bids in the initial stage of tender, forcing an upgrade of proposals in the second stage (negotiation), with corresponding increase in proposed level of shadow tolls. This reduces the degree of effective bidding competition, even in formally competitive tenders, as bidders are allowed to present unrealistic proposals with unreasonable prices (because they know that the projects will be forced to upgrade, creating the chance for increasing prices). The definition of objectives is also useful in avoiding the introduction of changes in the projects during construction, by public authorities, something common in PPP in Portugal and source of ulterior compensations to concessionaires.

♦ With no careful initial appraisal of the project and inherent development of a public sector comparator, project sponsors cannot reasonably expect the outcome of tender to present prices (for the public sector or for the users) that justify the option for a PPP. Additionally, there is no guarantee that the result is sustainable from the viewpoint of public accounts. When the traffic allows, the
The lessons obtained in Portugal, in this and in other PPP projects, mainly in the road and train sectors, were the drivers of recent changes in legislation • requiring an adequate appraisal of PPP proposals and the evaluation of their long-term impact on public accounts, as well as some rules for efficient design of risk sharing in PPP • and lead to the creation, in 2003, of a PPP Unit, in Parpublica SA, with significant responsibilities in PPP evaluation and appraisal and in both research and dissemination of information. Those institutional changes are crucial in the new PPP programmes, in transport and in the health sector, more focused on the provision of services to the end-user.
APPENDIX B – 5 UNITED KINGDOM

Case of the Scottish Water Solutions Project

Background

5.114 The Scottish Water Authority, SWA, was formed in April 2002 from the merger of three former water authorities. SWA provides water and wastewater services to 2.2 million household customers and 130,000 business customers across an area, one third the size of Britain. With a £1 billion turnover, SWA ranks No 16 in Scotland's top 20 businesses and is the 4th largest water and wastewater service provider in the UK.

5.115 The introduction of the 2002 Water Act (Scotland) followed a detailed review of how the water industry was positioned to respond to the need for the biggest capital investment programme in recent history. The industry had become significantly less efficient than the private sector in England and Wales. Infrastructure was worn out, customer service was poor and investment was urgently required to meet new European directives aimed at improving water quality and better protecting the environment. The Scottish Executive decided that as a result of economies of scale, a single authority would be better placed than three separate authorities to:

♦ Deliver the necessary capital investment programme
♦ Become a more competitive force in the UK water industry
♦ Harmonise charges across Scotland
♦ Provide better quality drinking water, a cleaner environment, and improved customer services, at least cost to customers

5.116 SWA is a public sector model in the UK water industry. It remains answerable to the Scottish Parliament but is structured and managed like a private company. SWA has been set the challenge by its economic regulator, the Water Industry Commissioner for Scotland (WICS), of reducing its operating costs by 40% between 2002 and 2006 and of delivering savings of £500 million on its capital investment programme between 2002 and 2006.

5.117 New expertise was brought in to join experienced industry personnel in leading the reform of the water industry in Scotland. This expertise was purposely drawn from different sectors including banking, utilities and the private sector.

5.118 The first task was to carry out probably the most complex merger that has ever taken place in Scotland as the former regional authorities – East of Scotland Water, West of Scotland Water and North of Scotland Water were merged. As an example, 300 inherited IT systems were reduced to 80.

5.119 SWA has responsibility for delivering a capital investment programme covering the period from 2002 to 2006 and amounts to some £1.8 billion. It decided that the best way of making this investment was to create a subsidiary company, Scottish Water Solutions (SWS) to deliver the investment required in the most cost-efficient way.
PPP Features

5.120 Scottish Water Solutions, SWS, is a unique joint venture set up to deliver SWA’s £1.8 billion capital programme. SWS was formed by SWA and two consortia in one of the largest partnering agreements of its kind and a first for the UK’s water industry. Whilst alliances are becoming more common in the water industry they are generally not on such a large scale. SWS is also set apart as there are eight partners with equity in the business – making it a PPP partnership within a company structure.

5.121 SWA owns 51% of SWS with the rest split equally between the two consortia: Stirling Water, comprising Thames Water, KBR, Alfred McAlpine and MJ Gleeson and UUGM which is formed by United Utilities, Galliford Try and Morgan Est. Today, SWS brings together some of the most experienced figures in the UK water industry with global experience of asset management, engineering, programme management, construction skills and delivering major capital investment programmes.

5.122 Interest from other parts of the UK and overseas is growing as SWS accelerates work on over 1,200 projects to improve water quality and wastewater treatment processes across Scotland.

5.123 SWA is reported as delivering real benefits to the Scottish public only two years after it was created to transform the water industry. SWA is now significantly more efficient, with opex running at around 20% less than it cost two years ago. The quality of drinking water is improved and the delivery of the £1.8 billion investment programme to modernise the infrastructure is now gathering pace, moving towards the implementation of at least £40 million worth of investment every month.

5.124 Achievements include:

♦ Making the industry more efficient by reducing opex by around 20 per cent in only two years.
♦ Delivery of around 50 transformation projects across the business which have changed ways of working and will deliver savings of around £80 million between 2002 and 2006.
♦ Completing one of the most complex corporate mergers ever undertaken in Scotland – bringing together East of Scotland Water, West of Scotland Water and North of Scotland Water.
♦ Successfully merging the terms and conditions of all employees from the three former authorities.
♦ Launching Scottish Water Solutions, an innovative partnership to deliver efficient investment for Scottish Water and its customers
♦ Since being formed in April 2002, Scottish Water has invested around £670 million on improvements to water and wastewater.
♦ Projects delivered include major water treatment works, improvements to wastewater systems, schemes that prevent flooding to homes and work to replace old and leaking pipes.
♦ Work has now started on the prestigious £100 million Katrine Water Project which will protect Glasgow’s water supply for the next generation.
Planning to invest £317 million between 2002 and 2006 to improve the quality of drinking water.

Planning to invest £483 million between 2002 and 2006 to clean up Scotland by improving the environment with cleaner beaches, rivers and coastlines.

Leading the way in customer service with ‘Promise to Resolution’ - a new way of working which delivered an ongoing annual saving of £18 million.

Lessons Learned

- Separate international specialist service providers can be brought together to deliver added value solutions for capital expenditure projects and using experts from alternative sectors can aid innovation.
- SWS JV includes a significant number of SWA managers and staff which has helped in developing an effective partnership and internal expertise.
- Robust sector regulation (Economic, Service, Environment, Quality, H&S) aids contractual negotiation and application.
Case of the Scottish PPP Water Projects

Background

5.125 Given the levels of infrastructure investment required, prior to the formation of the single Scottish Water Authority in 2002 (see case 2), the three former water authorities used Public Private Partnerships (PPP) and Private Finance Initiatives (PFI) to finance their large scale investment projects. It was also possible to tie several smaller projects together under one finance package. The water authorities entered into contracts with a total value in excess of some £600m. The financial framework within which the Water Authorities operated was determined by meeting the following key financial objectives:

♦ Meeting the statutory rate of return set by Scottish Ministers
♦ Setting charges at a rate which were sufficient to meet the expenditure requirements of Authorities
♦ Containing borrowing within the limits set by Scottish Ministers (External Finance Limits)

5.126 Their sources of income included:

♦ Revenue from consumer charges
♦ Scottish Executive authorised borrowing (External Finance Limits)
♦ Funding from EU Structural Funds
♦ Public - private partnerships

5.127 After an extensive consultation process, competitive tenders were invited. These were compared to traditional public sector options and, taking into consideration risk transfer, the PPP option offered the best value. With the development of PPP / PFI projects in Scotland, across many sectors, a Private Finance Unit was established with the aim of providing guidance and support to both the public and private sectors on PPP in Scotland. It is a ‘first stop’ source of advice and data on PPP in relation to programmes managed directly by the Scottish Executive, its agencies and other public bodies, and on the use of PPP in local authorities. In addition to providing advice and guidance, the PFU produces regular updates on progress / issues in relation to PPP/PFI projects in Scotland.

PPP Features

5.128 Given the size and range of the investment programme a number of typical projects are presented.

5.129 **Almond Valley, Seafield and Esk - Stirling Water, Scotland.** Following Stirling Water taking over five wastewater treatment plants (WWTP) from East of Scotland
Water, in West Lothian and Edinburgh, some £100M was invested in upgrading the works. Stirling Water is a consortium, which includes three private companies:

- Thames Water (49%)
- M J Gleeson (41%)
- Montgomery Watson (10%)

5.130 Stirling Water is responsible for designing, building; operating and maintaining improved treatment facilities. The consortium arranged the financing of the scheme and won the Project Finance Award for ‘European Water Deal of 1999’.

5.131 A key aim was to ensure compliance with new European Union Directives on the quality of wastewater facilities, and initial works have already enabled the ending of the disposal of sewage sludge in the North Sea. Treated sludge from the works is now being recycled for use in agriculture and, as a result of the investment, radical improvements have been made to the quality of discharged wastewater.

5.132 The completed works have been successfully handed over to the operator, Thames Water International, who will operate the works for a 30-year concession period.

5.133 The Almond Valley and Seafield project was the biggest Private Finance Initiative (PFI) contract awarded in the UK water and wastewater industry at the time. The project serves a population of 585,000 (rising to 685,000), an operating duration of 30 years and a value of £105 million.

5.134 The project includes:

- Primary and secondary treatment of sludge
- Digestion and thermal drying of sludge
- Improved odour control
- Effluent disinfection using UV light

5.135 All in accordance with EU Urban Wastewater Directive, North Sea Directive, and Scottish Environmental Protection Agency (SEPA) consents.

5.136 **Levenmouth.** A joint venture between Northumbrian Water and Scottish Power was successful in winning the £45 million Private Finance Initiative (PFI) to construct and operate a wastewater treatment plant (population equivalent 500,000) on behalf of East of Scotland Water (now Scottish Water) for a period of 40 years.

5.137 Caledonian Environmental Services, CES, a 50/50 joint venture, was named as preferred bidder for the Levenmouth purification scheme, to provide wastewater and sludge treatment facilities for 500,000 along the coast of Fife.

5.138 The aim of the 40-year contract is to improve the quality of the Firth of Forth and bathing water quality between Kelty and Leven, in line with the requirements of the EU Urban Wastewater Treatment Directive, UWWTD.

5.139 Subsequently, Northumbrian Water, issued £65 million-worth of credit wrapped insurance bonds of a 38-year duration to fund its Levenmouth joint venture project in Scotland.
5.140 At the time of the award, East of Scotland Water said they wanted a scheme which was ‘flexible’ and provided ‘genuine value for money’.

5.141 Caledonian Environmental Services (CES) and East of Scotland Water (ESW) signed the Levenmouth Service Contract in October 2000. Prior to this date, CES carried out construction works under a direct Enabling Works Contract with ESW, the scope of this work was ultimately subsumed into the Service Contract.

Lessons Learned

♦ Access to ‘central’ PPP expert guidance and an advisory unit can minimise potential for problems by providing the opportunity to learn from the experiences of others.

♦ Risk can be transferred with PPP, but it is important to understand the risk and to allocate it to the most appropriate party. The risk / reward balance needs to be understood and recognised in the contract.

♦ PPP can help ensure that a Water Authority will comply with its environmental obligations and improve service to customers while at the same time balancing its financial obligations.

♦ When compared with the public sector, with a process of competitive tendering, the PPP route can help deliver good value solutions for customers, taking into consideration risk transfer.
Case of Kirklees Metropolitan Solid Waste Project

Background

5.142 The Kirklees Metropolitan Council faced a deteriorating solid waste management situation, a rapidly diminishing landfill capacity and the prospect of strengthened environmental legislation and cost of land filling. In 1995 it launched a comprehensive review, including consultation with the private sector, to identify the preferred long-term waste management strategy. This included all options from ‘do nothing’ to exclusive reliance on land filling to a fully integrated solution based on a holistic management approach. The latter was adopted as the preferred option together with a ‘business model’ based on a joint venture arrangement with the private sector.

5.143 In 1998 Kirklees signed a 25-year joint venture agreement with United Waste Services Limited to deliver the integrated waste solution. The contract involves new capital investment of approximately £41 million, incorporates re-use, recycling and recovery principles and decreases dependency on land filling. The capital infrastructure will include a new waste to energy plant, a multi-materials recycling centre, a transfer loading station, 2 composting plants and 2 household waste recycling centres. £33 million of the total was provided by a Government credit scheme.

PPP Features

5.144 Kirklees decided that a joint venture model would be the most effective solution after substantial consultation which included the private sector. This resulted in the creation of a special purpose vehicle called Kirklees Waste Service Limited in which Kirklees has a 19% minority voting interest.

5.145 Kirklees transferred assets into the company in return for voting rights and equity shares which were in turn transferred to the service provider in return for reduced gate fees. The provider is responsible for delivering a waste management solution guaranteed to divert a minimum of 60% of waste from land filling through a combination of re-use, recycling and energy recovery schemes.

5.146 A unitary fee is charged over the contract life which is adjusted based on volumes received and achievement of landfill diversion targets. The current system was selected through a comprehensive strategic planning exercise. This included predicting the point at which alternative treatment methods would become cheaper than the landfill tax which was expected to rise and the cost of increasing landfill capacity which is in any case in short supply. A key consideration for selecting the PPP method was a comparison of life cycle costs of the alternative procurement methods.

5.147 The planning / research included consultation with the private sector (before publishing a tender in the OJEC), this included asking:
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♦ Whether Kirklees approach was in line with that of the potential service provider
♦ Whether there were alternative options
♦ What could Kirklees afford

5.148 Selection of the joint venture model, as opposed to a classical contractual model or BOT / DBFO, was determined by the fact that Kirklees had positive experience of using the JV model and that this was the preferred approach of the private sector. These reasons were considered more relevant than any consideration of favourable risk transfer through other models.

5.149 Procurement should have followed the EU conform negotiated procedure (according to the Public Procurement Directives), however this was difficult to reconcile with the tendering requirements of the 1990 Environmental Protection Act. As a result a restricted procedure was followed in which Kirklees issued a complete set of tendering documentation including project and shareholders agreements and output specifications. This also implied that post tender negotiations were not possible but an extended process of clarifications was provided for.

5.150 The JV provides Kirklees with a 19% voting only shareholding and a representation on the board. It maintains certain other intervention rights but these are limited. The payment mechanism has been designed to provide incentives for increased waste diversion. The period up to 2002, during which the facilities were being completed, provided a gradually increasing fee rate, fixed and variable tonnage charge and low recycling rates. From 2002 there is a guaranteed minimum tonnage, a fixed gate fee per ton, a guaranteed diversion (of 60%) and a deduction in fees based on the percent of recycling not met. The unitary payment made by Kirklees covers all costs related to service provision.

5.151 The provisions for risk sharing / transfer are such that Kirklees assumes only the risk of increases in landfill taxes and the major financial impact of new legislation (subject to a review of impact on cost of services). Additionally the risk of residual value and major changes in waste volumes are shared subject to review agreements.

PPP Structure of Kirklees SWM System
Lessons Learned

♦ Public authorities need to take a very realistic approach to what can be achieved. This includes recognising the needs and constraints of the private party. Additionally the requirements of external financiers need to be integrated at an early stage so as to reduce time delay and cost at later stages. These points highlight the need for a partnership based on mutual understanding and a certain amount of trust or each other's objectives.

♦ The public party benefits greatly from having a small and consistent core project team with the necessary skills, budget and ability to take decisions.

♦ The cost and required time of procurement should not be underestimated. This includes selecting the correct procurement procedure for the project and which meets relevant procurement regulations. Should derogations be necessary, these should be sought at an early stage to provide clarity to the procurement process.

♦ This project was complicated by parallel efforts to disband existing arrangements. Given the complicated nature of PPP projects, they should, ideally, be planned and implemented on a standalone basis in an already determined supporting framework.

♦ The joint venture model with a minority publicly-owned company proved to be the best delivery model for this situation. While this model also helps in the development of an effective partnership, they are not the only method and special purpose vehicles wholly or majority owned by the public or private sector are alternatives depending on the circumstances.

♦ A critical element of any PPP project is the degree of risk transfer. The public body must be realistic about what level of risk transfer represents the best value for money but also provides the optimal operating structure for the project and the parties.

Case of the Channel Tunnel Rail Link (CTRL)

Background

5.152 The Channel Tunnel Rail Link (CTRL) is a 110km twin-track high-speed railway that will link the Channel Tunnel with a new international railway station at St Pancras in London. When it is completed in 2006 it will provide continuous high-speed rail connections between London, Paris and Brussels with trains travelling at speeds of up to 300kph.

5.153 It was originally envisaged that the PPP would design, build, finance and operate the CTRL for ninety years. During the development of the project it was necessary to renegotiate the concession and the original PPP is now designing, building and
financing the project and then selling it to Network rail, the UK national rail infrastructure company.

History of the Project

5.154 When the Channel Tunnel was under construction in the late 1980s the French and Belgian Governments were already planning and constructing high speed rail links to enable trains to travel at speeds of 300kph between Paris, Brussels and the tunnel. In contrast, British Rail maintained that the Eurostar passenger services could be routed on existing tracks through to a new international terminal at London's Waterloo Station. This strategy not only added significantly to the journey times but also increased congestion on the existing tracks in Kent and South-East London.

5.155 In August 1987 the UK Government's Department of Transport published the Kent Impact Study which demonstrated that if no new railway infrastructure was provided in Kent, the growth of rail services in SE England would be constrained. This led British Rail to study options for a new rail link from London to the Channel Tunnel and in 1998 they published five possible routes. At the time this led to considerable difficulties in the housing market as people were reluctant to buy houses that would be affected by construction on the five routes. Under pressure from the public and Government, British Rail chose a single route in March 1989.

5.156 In the late 1980s the UK Government was promoting the involvement of the private sector in the development of public infrastructure. This policy was partly driven by the need to finance the provision of infrastructure but also by a strongly held belief that the private sector would be more disciplined than the public sector in designing and constructing infrastructure and more commercial in operating it. In December 1988 British Rail had invited six private sector consortia of engineering and transport companies to submit proposals for designing and building the rail link.

5.157 Recognising the opportunities in the Government's approach and the shortcomings of British Rail’s proposals, the privately-owned consulting engineers Ove Arup & Partners decided to develop an alternative route for the rail link and in March 1990 published their proposals. The Arup route had several technical advantages over British Rail's proposal. It followed existing transport corridors, avoided many built-up areas and entered London from the East passing through a potential new transport hub at Stratford. At the time this was seen as an opportunity to connect the rail link with the London Cross Rail and Jubilee Line Extension projects that were then being planned for London.

5.158 Over the next two years there was intense activity as the Eurorail Consortium, which had won the competition to build the British Rail route, and Arup developed their alternative proposals and lobbied Government. In October 1991 the Government announced that they preferred the Arup Route and Arup was invited to join the British Rail team to develop it. Finally in March 1993 the Government announced that:

- The Channel Tunnel Rail Link would be developed as a joint venture between the public and private sectors.
- Government would provide substantial financial support to the project.
Following public consultation, the Government would introduce legislation to provide the consortium with the planning permissions and other powers that it needed to construct the project.

This approach would enable the CTRL to be opened by the end of the century.

5.159 As the project was now very different from British Rail's original proposals, a new competition had to be held to choose the private sector partner. Arup formed the London and Continental Railways (LCR) consortium with six other companies with interests in construction, transport, property development and banking and in August 1994 began to compete with three other consortia for the project. Eighteen months later LCR was chosen by the Government to design, construct, finance and operate the CTRL. As part of the agreement LCR took over control of the Government’s share in Eurostar on the understanding that it would use revenues from the existing passenger services through the Channel Tunnel to help finance the construction of the CTRL.

5.160 In 1996 LCR began work on the design and detailed planning of the project that would lead to confirmation of the financing and to the start of construction. At the same time LCR established a subsidiary company to design and build the project. Rail Link Engineering was owned by the engineering and construction companies in the consortium and provided them with a considerable amount of work in recognition of the investment that they had made in developing the project.

5.161 By 1998 it became clear that it would not be possible for LCR to finance the construction of the CTRL under the existing agreement with Government. The principal reason for this was that the Eurostar passenger services were carrying fewer passengers that had been predicted and LCR’s share of the revenues were not forecast to meet the financing requirements of the project. By this time British Rail had been privatised and Railtrack plc had been formed to own and operate the national railway infrastructure. Furthermore, a new Government had been elected only a year before and it had a long history of opposing the previous Government’s policies on PPPs.

5.162 Throughout the summer of 1998 there were intensive negotiations between the Government, LCR, Railtrack and the financial institutions as the Government tried to save the project. The negotiations were constrained by the legislative framework of the project. The legislation that provided planning permission for the project named LCR as the promoter. Railtrack was now a privately-owned company and was the only organisation apart from LCR that could operate the railway. Finally, any increase in state aid to the project would have to be approved by the European Commission.

5.163 In October 1998 agreement was reached on a complex refinancing of the project. Under the agreement LCR would finance and build the CTRL and then sell it to Railtrack who would take over responsibility for the operation of the infrastructure. LCR would retain the right to develop the land associated with the project and the Government would provide certain guarantees to enable LCR to finance the design and construction work.

5.164 The final twist in the history of the project came in November 2001 when Railtrack plc was unable to finance its operations and was taken into administration by the Government. A year later it was reformed as Network Rail Ltd, a company limited by guarantee.
5.165 The first section of the CTRL was completed in 2003 on time and within budget reducing the journey time between London and Paris to 2hrs 35mins. When the project is completed in 2006 the journey time will be reduced to 2hrs 20mins. The total cost of the project will be more than £5bn and it will be completed seven years later than originally envisaged.

PPP Features

5.166 Project Structure. One of the most interesting features of the CTRL project is the changes that have taken place amongst the key participants over the twenty years since the project was originally conceived:

♦ Promoter – the promoter of the project is the UK Government through the Department for Transport. When the project was conceived there was a Conservative Government with a policy of privatising national infrastructure and developing infrastructure projects through PPPs. In 1997, before construction began, the New Labour Government came to power and took over responsibility for the project. In opposition they had been strongly opposed to privatisation and to PPPs. In Government they supported the privatised railway and the CTRL project. Over the life of the project there has been a total of seven Ministers of Transport responsible for the project.

♦ Infrastructure Operator – when the project was conceived the national railway infrastructure was owned and operated by British Rail. Under the concession that was granted to LCR, they would operate the infrastructure for ninety years and it would then revert to BR. In 1995 BR was privatised and Railtrack plc was formed to own and operate the national railway infrastructure. Under the restructuring of the project in 1998 Railtrack became the operator of the CTRL. In 2002, Railtrack was replaced by Network Rail.

♦ PPP Consortium – the idea for the route of the CTRL was developed and promoted by Ove Arup & Partners at their own expense. When the route had been accepted by Government Arup formed the LCR consortium to bid for the project. LCR are still responsible for the design and construction of the project and for property development associated with it.

5.167 The PPP Process. The CTRL is a good example of what can be achieved through a pragmatic approach to developing infrastructure projects through PPPs. From the start of the project there has been a commitment from Government to use a PPP process to design, build and finance the CTRL. The process has been changed and adapted along the way as new ideas have been put forward and as problems have had to be overcome.

Actual Experience

5.168 The first section of the CTRL was completed on time and within budget in 1993 and the overall project is on target to be completed in 2006. There is no doubt that the private sector has demonstrated its ability to deliver a complex engineering project efficiently.

5.169 The numbers of passengers using the high speed train services between London and Paris and London and Brussels are about half the number that was predicted when the project was in the planning stages. CTRL has failed to replace the airlines as the
mode of choice for passengers on these key inter-city routes but has significantly contributed to increased market competition on these routes.

5.170 The principal reason for this seems to be that the airlines have competed effectively with the railway and each other over these key routes by reducing fares and improving services. In contrast Eurostar has been much less commercial than the airlines in developing and marketing its high-speed rail product. This may however be a feature of rail transport as opposed to air which can be more responsive to market demand.

5.171 When Arup promoted their alternative route for the CTRL in the early 1990s, they placed great emphasis on the opportunities for high-speed domestic services from Kent and for high-speed freight.

5.172 They also stressed that the alignment of the Arup route would enable high-speed train services to be extended to the north of London. The actual experience has been that very little progress has been made with these proposals. One of the reasons for this is that the original team did not have experience of operating a railway and tended to underestimate the operational problems of integrating high-speed services into the national rail network.

Other UK Rail Projects

5.173 When the present Government came to power in 1997 they quickly accepted the privatised structure of the railway and actively promoted PPPs as the means of financing and building major railway projects. At the time the CTRL was held up as an example of how things should be done.

5.174 In practice nothing has come of these proposals. This is partly the result of other well publicised problems on the UK rail network. However, the principal reason is that most of the other projects that have been promoted are upgrades of existing routes and it is extremely difficult to separate these projects from the ongoing operation of the railway so that a PPP can take responsibility for them.

Lessons Learned

♦ Major railway projects take many years to plan, design, approve and build. And over the years it is inevitable that circumstances will change and unforeseen problems arise. The success of the CTRL is the result of consistent Government support for the project and of a pragmatic approach to modifying the PPP to suit the changing circumstances.

♦ While it is advocated that such infrastructure projects be developed in the context of a coherent sector strategy there is also an inherent risk in linking projects too closely. As in this case CTRL suffered from the equally poor performance of the Channel tunnel. While the two pieces of infrastructure are obviously closely linked, provisions may have been necessary to assess the projects in isolation and the degree of dependence each has for the other. Such analysis may have allowed more robust financial provisions / safeguards to be developed.
PPPs can deliver excellent infrastructure on time and within budget. There is consistent evidence from the UK that PPPs are much more likely to deliver the infrastructure on time and within budget than the public sector.

The CTRL has not yet delivered the range of railway services that it committed to and it seems unlikely that it will. This is partly due to a lack of realism about the problems of integrating a high-speed railway into the rest of the network. It might also result from the fact that the PPP was led by engineering and construction companies with a strong focus on building the infrastructure rather than on developing and marketing the services.

Even in the core Eurostar services passenger numbers are around half those predicted at the planning stage. Overestimations of revenues are very common on railway projects (Ref. “Megaprojects and Risk - an Anatomy of Ambition” by Flyvbjerg, Bruzelius and Rothengatter Cambridge University press 2003) If the Government had known this at the start of the project, it is questionable whether they would have supported it.

It is very difficult to transfer the risks in major railway projects to the private sector. When such projects get into difficulties, Governments have few options other than supporting the existing team.
APPENDIX B – 6 CROATIA

PPP experience in the road sector in Croatia

Background

5.175 At the time of Independence, it was considered that the inadequate motorway network (then 300-400km) would be a constraint on the country’s economical development. During the early 1990s, feasibility studies were undertaken by the Government into the development of the motorway network and 4 projects were identified to go ahead as concessions. The availability of potential bidders and funders for these early schemes was no doubt affected by the state of unrest, and the Government has procured most of these schemes as single bidder negotiations.

5.176 Under the legislative framework in Croatia, Build Operate Transfer (BOT) style road projects are permitted under the Law on Concessions and the Law on Public Roads. There is no overall PPP policy and such projects need Government approval, through the Ministry of Sea, Tourism, Transport and Development. We understand that the expropriation process, under the Croatian Law on Public Roads and the Building Law, tends to be reasonably favourable for the concession grantor.

5.177 Under the Croatian Law on Concessions and the Law on Public Roads, a public procurement procedure must be carried out before any concession to design, operate and maintain a public road can be granted. However, the Law on Concessions allows for the direct award of a concession if the concession company is wholly owned by the Republic of Croatia. The fully-state owned concession company increases the basic capital of the company and the private sector acquires an interest in the concession company. This process avoids the requirement for a public procurement.

5.178 A process of developing a competitive concession programme for the construction of the motorway network in Croatia was started in 1991. The Government launched a request for expressions of interest for these concessions to which there were approximately 20 responses. However, due to the onset of the war in the region, these concessions were never taken any further. In order to ensure that a programme of construction could be undertaken therefore direct negotiations were held with three companies. While this process has indeed delivered concessions in Croatia, they have not been procured under competitive tendering and therefore are questionable as to their true Value for Money.

5.179 The Bina-Istra scheme, a Y-shaped motorway along the Istrian peninsula, was the first scheme planned to go ahead in 1992. The scheme was originally planned to be publicly procured, but there was limited interest from prospective bidders, and it was decided that the deal would be negotiated directly with French contractor Bouygues. Financial Completion of the first phase was achieved in 1995 and the first phase of the project was completed and put into operation in 1999. With Phase 1A of the Bina-Istra project successfully completed by Bouygues in 1999, negotiations were
concluded in 2003 with the same consortium for the implementation of Phase 1B. Work is currently under construction.

5.180 In the meantime, the Croatian Government negotiated a second concession agreement directly with the Italian Company, Astaldi, for the Zagreb-Goričan motorway to Hungary, as Concession partners with HAC. A development agreement was signed between the two parties in December 1997 for a 32-year DBFO concession. However, funding, legislative and procurement problems were encountered and the deal was terminated in 2000. Instead, the project was taken over by HAC, a public company in charge of the motorway network, who completed construction in 2003 and now operate the motorway as part of its toll motorway network. The project was funded from HAC’s budget supplemented by sovereign loans.

5.181 A third concession was planned for the Zagreb-Rijeka Motorway, to include the already completed section of the Zagreb-Karlovac motorway, and the toll income it was already generating. In 1998 the Government created the Autoceste Rijeka-Zagreb (ARZ), a company 100% owned by the Government. With construction for the new section already underway by the State, the concession was put out to tender in 2000. However, only one company submitted a tender offer, and due to lack of preparation of the tendering process, the privatisation of the motorway failed and was therefore kept under the management of ARZ.

5.182 The most recent concession is the Zagreb-Macelj contract, which was awarded in July 2003 to Autocesta Zagreb-Macelj (AZM), a joint venture between Walter Concession Holding GmbH and the RoC. Again, we the deal was negotiated directly with the consortium.

5.183 It would appear that the process of concession development was well intentioned in Croatia however the Government was not as well prepared as it should have been. This is a common problem with the change from a more standard public procurement for a construction contract to the more complex concession based operations. It is also understood that there has been no cost benefit analysis undertaken on the projects that have been constructed under concession thus making it almost impossible to negotiate a best value package.

Summary

5.184 In summary, all three of the concession contracts outlined above have been the result of single bidder negotiations, and only 2 can really be described as PPP projects, given the Zagreb-Rijeka Concession Company is wholly owned by the Government. As a consequence we believe that RoC is paying premiums due to the lack of competition. It could be argued that this would theoretically reduce the length of the procurement process. However, this is not always true as it was demonstrated in the lengthy negotiations for the AZM scheme (8 years).

5.185 The allocation of technical and contractual risks is pretty consistent with European practice elsewhere. Also, following published studies of forecast versus outturn traffic levels, notably by S&P, there has been a general trend to move away from the allocation of traffic demand risk to the private sector in favour of availability and performance payments – over which the concessionaire has greater control.
Finally, from the PPP concession experiences in Croatia to date, it became clear that there is a need for more in-depth groundwork in order to produce high-quality tender packages with sensible risk allocation and to maintain tight deadline requirements for delivery.
APPENDIX B – 7 CZECH REPUBLIC

Case of Karvina Sewerage

Background

5.187 SMVak was originally a state owned enterprise responsible for the North Moravia Region in the Czech Republic, which includes Karvina. In May 1991, SMVak was privatised together with similar enterprises in the other regions. The privatisation process consisted in SMVak being converted into a stock company, whose shares were distributed free of charge among the cities and municipalities of the region according to number of inhabitants.

5.188 Approximately 92% of the shares were transferred in this way and the remaining 8% went to individuals and privatisation funds. The value of the share was based on the book value of the company assets.

5.189 In early 1999, nearly all municipalities sold their shares to private companies and investors. The sale of shares by municipalities to private investors during 1999 took place through normal channels over the stock exchange, where SMVak is quoted. Following this sale of shares most of the company stock is held by British and French water companies.

5.190 The transfer of ownership of the assets belonging to the former state enterprise therefore apparently followed normal procedures. No specific measures were undertaken to ensure transparency and competition other than those used for other public stock firms. Today SMVak is the second biggest company of its kind in the Czech Republic.

PPP Features

5.191 The PPP agreement existing since October 2000 on drinking water supply and sewage discharge is a service contract, with Karvina Municipality in the traditional role as customer, and with no risk sharing or efficiency incentives. The infrastructure and the operations are in the hands of SMVak.

5.192 A board has been established to facilitate the co-ordination and the decision making process among the cities and municipalities served by SMVak. These all have seats in the leading bodies of SMVak: municipalities are represented with 5 out of the 9 members in the managing board and 6 out of the 9 member of the supervisory board. The representation is based on the decision of the main shareholders of SMVak.

5.193 In addition, a forum, including the Northern Moravia Water Association was established, to discuss further investment and price strategy. Increases in water charges are discussed and mutually agreed after the Municipalities have proposed the underlying calculations.
5.194 A pre-contract agreement regulates the operation of a water main of Karvina (Karvina-Louky). The water main (650 m of pipe) is financed and owned by Karvina Municipality and the pre-contract does not foresee any payment of lease on the part of SMVaK. The contract contains very general provisions regarding cost distribution, technical documentation to be submitted by SMVaK and the right for SMVaK to bill consumers.

EU - ISPA Component

5.195 This is a case in which an EU ISPA grant was considered after the privatisation took place. The PPP considers a lease/operation contract, which combines elements of lease and concession. The grant was requested to extend the sewerage network system by the Karvina Municipality. The ISPA financed assets are to be owned by the Municipality, and to be leased to SMVaK, which will also operate them. SMVaK will pay an annual rent for the assets, calculated as the difference between revenues from customer charges and cost related to the water connection. In case of revenue exceeding costs, the result is considered profit.

5.196 The municipality cannot sell the assets without consulting SMVaK, and can use the revenue only to invest in the infrastructure. SMVaK takes the risk of the assets being in compliance with prevailing regulation and technical standards, as well of maintenance. Karvina Municipality is responsible for costs beyond the scope of normal repairs and maintenance. SMVaK sets charges/tariffs and procedure for billing costumers.

5.197 This contract is supposed to enter into force once the sewage extension have been constructed and delivered. The contract does not envisage any performance monitoring of the operating activities of SMVaK. It is quite normal in PPP relationships and is seen as an important guarantee for the public partner that the public services work properly. This includes not only supervision of output but also of preparatory activities of the operator, such as repairs etc. However, there is no indication that the contract will contain any specification of quality targets, performance criteria (such provisions are not found in the above SMVaK standard contract either). Consequently, there are no rules envisaged laying down procedures for monitoring of performance. Additionally the Municipality does not have in-house technical staff for such tasks.
Lessons Learned

♦ The lease/operation contract requires well-designed monitoring and performance measurement systems, payment mechanisms and sanctions to encourage and even reward improved operational efficiency. The public partner is, in the normal situation, outsourcing the operational activities but retains the statutory responsibility. The public partner must therefore on a permanent basis have the necessary information and means to ensure that satisfactory operation is maintained and that remedial steps can be taken in case of deficiencies.

♦ The key difference between public private partnerships and conventional public procurement is the transfer of appropriate risk to the private partner. It is therefore important that this risk aspect is reflected in the contractual mechanisms.

♦ The chance of extra undue benefits as result of an ISPA grant is reduced through an appropriate treatment of risk transfer and operating efficiency gains in the contract.

5.198 In conclusion, from the perspective of prevailing PPP practice, it can be assumed that a fully-fledged lease/operation contract will not provide sufficient checks and balances between the parties. It is particularly unfavourable towards the Municipality, who will have virtually no influence over the performance of SMVaK.
APPENDIX B – 8 ROMANIA

Case of Apa Nova Project

Background

5.199 The privatisation process for the Bucharest water system took place in 1996, following World Bank recommendations, and resulted in a concession agreement between Vedia and Bucharest Municipality for the management of the water system. In 2000, Apa Nova, then controlled by the French utility company Vivendi, now restructured under Veolia Environnement, won a tender for the management of the Bucharest water concession including the development of the Crivina Plant. Apa Nova is an enterprise created on an already existing link between Vedia and Bucharest Municipality. The general conditions of the PPP agreement between Apa Nova and Bucharest for the Crivina Plant, are the same as for the 1996 water system PPP agreement with Vedia. In practice, Vedia has been incorporated into Apa Nova.

5.200 The rational for the PPP is as follows:

♦ Private sector participation. The Project supports private participation in the utilities sector in Romania, which has been awarded through international competitive tendering. By giving control of management and investments to a private company and by linking its remuneration to efficiency gains and operational performance, the Municipality expects to maximise the benefits of the private sector involvement, in the form of significant improvements to Apa Nova’s capital and operating efficiency and higher standard of service.

♦ Transfer of relevant skills. Through the introduction of international management practices and operational expertise important skills will be transferred to Apa Nova’s staff. The lack of adequate skills in Romania is one of the main rationales for inviting a foreign operator. The Sponsors will develop local skills in areas such as operations management, energy efficiency, capital budgeting and financial management.

5.201 This case illustrates the ability to introduce new capital improvements linked to efficiency gains and operational performance provided by taking advantage of international management practices and expertise through a PPP agreement. The terms and conditions of the agreement are considered to be at a level representing international best practices.

5.202 The management tender was launched by the Municipality to attract financial resources and know – how to improve the water and water treatment system for the city. The project consisted of two main items: (i) the improvement of the water distribution network in Bucharest, and (ii) the completion of the Crivina potable water treatment plant located in the outskirts of Bucharest. The completion of Crivina would increase the capacity for potable water treatment to 259,000 m3/day.
PPP Features

5.203 As one of the first PPPs in the local water sector, the private contractor was selected through international competitive tendering. The terms and conditions of the agreement are considered consistent with international best practice. In particular, the concessionaire is paid under a price cap type tariff mechanism. This provides incentives for cost reductions, which are shared with consumers in the form of lower prices and/or higher levels of service quality.

5.204 Following an international competitive tender process organised by the Municipality of Bucharest, with the support from the International Finance Corporation, Vivendi Universal was selected as the preferred bidder. The agreement foresees that Apa Nova Bucuresti, owned 85% by Vivendi Universal, operates the Municipality's water and sewerage assets for a period of 25 years. The Concession Contract with the Municipality was signed on 29 March 2000, and became effective on 17 November 2000. Subsequent to the agreement execution, Vivendi Universal transferred its shares in Apa Nova to Compagnie Generale des Eaux S.C.A. following the signing of the Loan Agreement (although Vivendi was initially awarded the contract).

5.205 The agreement helped create a source of capital to support an upgrade and extension of the Bucharest water system. The partnership agreement required the private partner to provide financial resources to upgrade the system. Bucharest will contribute the existing infrastructure and own new infrastructure while the private operator obtains the right to manage and maintain the water system.

5.206 The water tariff was fixed at the moment of contract signature, with the agreement that it would be regularly adjusted. The decision to change the tariff will be made by the City Council on the basis of an application presented by the private operator. Apa Nova is, according to the agreement, responsible for the collection of tariffs and, when appropriate, pays dividends to all shareholders, including Bucharest.

5.207 The co-ordination between the two parties – Apa Nova and Bucharest, and the decision-making powers, are regulated by a board, on which the City of Bucharest and Vivendi are represented. In addition a Director General is responsible for the day-by-day management of the operations.

5.208 Part of the project included the upgrading of the Crivina plant. The project had already started 10 years earlier but the municipality lacked the financial resources and expertise to complete it.

5.209 To finance the project Vivendi and the City of Bucharest applied for an EBRD loan which offered better terms than other commercial sources of capital. The loan terms required Vivendi to intervene if necessary and to assume the responsibility for monitoring and reporting on Apa Nova’s performance to the EBRD. Bucharest has the right, as shareholder, to also monitor Apa Nova’s operations.

5.210 Bucharest looked for a private sector participation in the operation of its water and waste water system for two main reasons: to enable the necessary investment in upgrading the infrastructure and to bring in the needed new technology, know-how, and management methods. For Vivendi Universal the investment in the Romanian water sector and in Bucharest was part of its own strategy to develop new business.

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Lessons Learned

♦ The project represents a classic PPP model employed in the European water sector. It foresees a degree of stability and risk/profit sharing. The “tried and tested” nature of the model may have been beneficial to Bucharest given the uncertain PPP environment still reigning in Romania at the time.

♦ The PPP contract is bringing advantage to both parties. Bucharest is receiving reliable financing for upgrading and improving the quality of its water system. Additionally, it is able to access the required expertise and technology and may also look forward to sharing a profitable dividend. The size of the dividend or the ability of the operator to generate profits is directly related to performance and increasing efficiencies due to the price cap mechanism. This provides a degree of consumer protection. The private operator is expecting economic profits, which they are trying to obtain by improving operational efficiency and by ensuring that revenues from the water tariff are effectively collected.

♦ There is some risk concerning revenue flows as tariff collection is the responsibility of the operator and the contract foresees no tariff changes in the short to medium term. This implies a degree of risk for the operator as operational efficiencies will not have an impact in the short term.

Case of Constanta Water and Wastewater Project

Background

5.211 The County of Constanta has identified the need to undertake a major investment programme exceeding Eur 200 million over 20 years. Key targets of this program are increased water and waste water coverage, reduced unaccounted water losses (currently 66% of gross water input), increased metering, reduced operating costs, compliance with EU environmental standards, and rehabilitation or replacement of pipelines and pumping stations and four sewage treatment plants.
5.212 The current operating entity is RAJAC, Regia Autonoma Judeteana Apa Constanta, an intermunicipal company wholly owned by Constanta County Council. RAJAC undertakes water catchment management, water treatment, the supply and distribution of water and the collection and treatment of waste water for the City of Constanta and six neighbouring municipalities with a population of 747,000, increasing to over 1 million during the tourist season in June-September.

**PPP Features**

5.213 RAJAC is at present conducting a two stage tender for the private partner of the NEW CO Concessionaire for water and sewerage project with the active participation of the European Commission and the EBRD. Five international water utilities have been pre-qualified. The local law required only a single stage tender but a two stage tender that involved a technical review based on a pass/fail basis and a financial review based on the lowest tariff for the same level of services was developed to increase transparency in the selection process through the use of objective, output-based criteria.

5.214 The PPP project will be established by setting up a Special Purpose Company, New Co., to be financed with equity from the selected international utility investor and with recourse to long term debt, likely to include the EBRD.

5.215 The project plan has been developed with the following sources of financing:

- A EUR 72.4 million ISPA grant to the Government of Romania with RAJAC as financial beneficiary representing 75% of the cost of an investment programme for the rehabilitation of sewerage waste-water treatment systems and technical assistance intended to bring RAJAC into full compliance with EU waste water effluent standards.
- A USD 75 million loan from the EBRD’s Municipal Utilities Development Programme, Phase II to the Government of Romania secured by a sovereign guarantee, and on lent under a subsidiary agreement between the Ministry of Finance, the County Council of Constanta and RAJAC.
- A EUR 20 million loan from the EBRD’s Municipal Environmental Loan Facility for the refurbishment and modernisation of sewerage system.
- A foreseen private component for investment between 20 to 50 M€.
- Advisers to RAJAC and the County Council were appointed in 2002 by the EBRD using EU PHARE technical assistance funds amounting to approximately EUR 600,000. In consultation with the European Commission and EBRD the consultants evaluated options for commercial structures and risk sharing between the public and private sectors, organised meetings to promote investor awareness, set bid criteria and formulated the bidding process consistent with the requirements of the Commission and the IFIs.

5.216 This case highlights the issues arising when an IFI funded investment project on behalf of a public sector borrower is subsequently integrated with a PPP. It also provides an approach to specifying bid criteria for PPPs that reconciles the achievement of investment targets and operational performance standards with significant constraints relating on one hand to the transparency required for Public Procurement and on the other to affordability (tariff levels) and to the financial rates of return required to attract private sector investors.
5.217 RAJAC and its consultants (appointed separately with own resources) considered a number of different arrangements for engaging the private sector, including the outright privatisation of RAJAC. A new company was the preferred option because this allowed existing assets and liabilities to be transferred smoothly. The contribution of existing assets (net asset value EUR 7.6 million) will provide the County Council with an estimated 28.8% share in New Co. This shareholding is regarded as important for achieving wider public acceptance for a PPP solution while providing the County Council with an opportunity to share in the long-term profits of New Co. Operating and maintenance responsibilities (including billing and revenue collection) in respect of all existing water and sewerage services will be transferred to New Co., which will also have responsibilities for all extension and rehabilitation investments.

5.218 The European Commission has stated that it has no objections of principle to the proposed restructuring of RAJAC, and the introduction of PPP, including the transfer of RAJAC assets to New Co., provided the concession contract and the manner in which it is awarded complies with the principles of non-discrimination, equality of treatment, transparency, mutual recognition and proportionality.

5.219 The evolving nature of the regulatory environment for utilities (private and public) requires that the agreement be enforceable and provide for sufficient performance monitoring rights to ensure compliance with terms and conditions of the agreement. The agreement provides for a dual role for the County as a shareholder in New.Co whilst at the same time being responsible for enforcing regulations pending the establishment of a national regulatory capacity. This aspect will have to be closely monitored.

5.220 Significant evaluation occurred regarding the appropriate duration of the agreement. Duration must consider the balancing of many factors including expected investment programme, tariff structure and forecasts, and investor rates of return. Too short a period would leave the investor with an inadequate rate of return on equity invested or excessive tariff increases, whereas a too-long period may weaken compliance with the need for competition to play its appropriate role in time.

5.221 The County has negotiated a concession fee to be paid at closing of deal and a smaller annual concession fees. The upfront concession fee will be financed by the capital funding sources as part of eligible project costs upon agreement of the financial institutions and the Commission. Annual fees will be paid through annual cash flow from tariffs.

5.222 Employed Bidders are required to comply with milestone targets specified for each five year period of the twenty year agreement for the following:
- Percent of households provided with water and waste water connections
- Proportion of connections metered
- Compliance with drinking water and effluent discharge quality
- Reduction of unaccounted water losses
- Achieving mandatory investment expenditures.

5.223 The principal criteria of award, subject to the commitment to the achievement of the above performance criteria, will be the level of tariff, or more precisely the average annual rate of growth in tariffs required by the bidder. The lower the average rate of
increase required, the higher the bid will be ranked. In order to address affordability issues a two-part tariff structure has been utilised, as follows:

♦ Tariff A relates to metered units (corresponding to an average household) for the first 300 litres per day of consumption. Increases in Tariff A are capped at 4% per annum in real terms.
♦ Tariff B relates to consumption in excess of 300 litres. The focus on an output based specification is consistent with the PPP Guidelines and will potentially increase the value for money aspect of the project and reduce the tariff levels for customers.

**Lessons Learned**

♦ Affordability constraints require that an imaginative approach is taken to tariff-setting and reliable economic and customer information to allow options for tariff structures to be evaluated, using financial modelling.
♦ PPP agreement lengths must balance financial returns to investors, customer tariffs, investment programmes, and risk allocation factors.
♦ Legislation and election cycles should be considered early in project planning.
♦ Local authorities may have to be prepared to support legislation enabling PPP solutions.
♦ Selection and award criteria must be clearly formulated and emphasize desired outputs.
♦ Commission funded investments in the public sector are capable of being converted into PPP programmes provided the Commission is included at an early stage and its funding criteria are adequately addressed.
♦ Where there is no complete regulatory framework and the concession is regulated by contract, there is an inherent risk that political imperatives, for instance price pressures, conflict with the principles of good regulation founded on proper process.
♦ The dual role of the public partner (County) as shareholder in New Co and as public authority signing the contract with the concessionaire must be carefully monitored.

**Case of Prescom in Targoviste Solid Waste Management Project**

**Background**

5.224 Targoviste is a town of round 100,000 inhabitants situated 70 km north of Bucharest. Targoviste is the county seat of Dambovita, which has a population over half a million, about one third urban (180,000) and two thirds (380,000) rural. Targoviste is by far the largest town in Dambovita County and the combined population of the next five largest towns is less than 100,000.

5.225 There are currently two service providers in Targoviste: a private company “Prescom” and a municipal department “Salubrita”. Prescom operates the municipal service since 1994 when it was privatised. The core service is provided with five 12m3 compactor trucks. In addition Prescom has some half a dozen old trucks, which carry
the standard 4m³ bins one at a time. These are used mainly for transporting bulk waste from industrial clients. Prescom services about 80% of Targoviste’s population and five nearby communes, thus its clientele is near to 100,000 people. In Targoviste they charge households on the basis of 14,000 lei (0.45 Euro) per month per person. In the communes the charge is less than 25,000 lei per household. About 80% of the clients pay their bills on time. Billings are collected and administered by a small staff, and the accounting is computerized. Collections are entirely in the hands of Prescom, without any intervention or support from the Municipality. Prescom is profitable with annual revenue of about 20 billion lei (about 650,000 Euro), of which three fourths come from household billings and one fourth from industry. The gross profit margin is about 20%. Prescom has recently purchased two new 12m³ vehicles, which are to be put in service shortly.

5.226 The trucks were bought against a 20% down payment and a four-year lease through a private bank. Salubrita is a department of the municipal government and has only recently (in 2001) entered the waste management business, when it obtained two 18m³ MAN vehicles, together with 100 “Eurobins” and another 100, 240 litre plastic bins with EU PHARE support. The original intention of the PHARE grant was meant to provide Targoviste Municipality with equipment for servicing its own municipal facilities: schools, hospitals, and public buildings. Initially, Salubrita wanted to sell most of the bins for which it had no use, however a PHARE condition that the equipment could not be sold before a certain period, prevented the sale. Thus Salubrita started to build up a household clientele, mainly in the large blockhouses, many of which are municipal property. At present Salubrita services about one fifth of Targoviste’s population. It charges a fee of 12,000 lei per person, thus somewhat lower than Prescom. In addition it receives fees from the Municipality for its services. Salubrita is self-financing and has a positive cashflow. As a municipal department it is obliged to reinvest its profits. The management of Salubrita plans to invest profits into more equipment so as to increase its market share in Targoviste. Asked about the business strategy, the management said that it opts for privatisation via a management buyout of Salubrita.

5.227 The case highlights the problems arising in an uneven playing field in MSWM, particularly when the private enterprises face different market entry conditions than public ones.

PPP Features

5.228 There is no PPP structure in place yet. The two service providers, one private the other public, compete for market share in Targoviste. However their operations are not comparable. While Prescom is carrying out the service at its own risk and invests its own money, Salubrita’s operation owes a good deal to an initial PHARE grant.

5.229 Under Romanian Law, Municipalities may directly engage in carrying out waste management services and many municipalities have a department for MSWM and related services. However, if the service is contracted out, it must be tendered, which is also in compliance with EU Directives. Until 2002 there was no such requirement, and companies were free to engage in municipal waste services with the direct authorization of the Municipality without tendering. In addition, there is now a legal requirement in place for service providers to be licensed by a national agency. Prescom neither has a license to operate, nor has there been a tender for service provision. Thus Prescom operates informally, without legal sanction and authority,
though it does have some formal contracts with communes it serves outside Targoviste. Prescom faces the uncertainty implicit to operating without being in full compliance with the law. On the other hand Salubrita operates as a municipal department with the Municipality’s implicit authorization.

5.230 Prescom is apprehensive about a planned EU ISPA Project. It fears that the transport equipment will be granted to the municipality (or the county) and, will in effect displace its operation. From Prescom’s point of view such an apprehension is not unreasonable, given the precedent of the PHARE grant of vehicles and equipment being used by Salubrita to enter the local waste management market.

5.231 This apprehension has prompted a legal challenge which is still unresolved. In March 2002, Prescom formally petitioned the Municipality of Targoviste to issue a call for a competitive tender for the transport and collection service, as such a tender is now legally required.

5.232 Municipal authorities conducted an internal investigation and decided, on April 30, 2002, to go ahead with a competitive tender. However, this act was countered by an intervention of the Prefecture, i.e. the representative of the Central Government, which declared the municipal decision void. This was based on the grounds that the Ministry for European Integration would withdraw its application for ISPA support for the project “Rehabilitation of the Collection, Transport and Disposal of Solid Household Waste in the County of Dambovita” if the financing of this project could be done under private operator control.

5.233 The proposed ISPA project now appears as a serious threat to the survival of Prescom, which fears that if a new outside contractor is awarded the concession for the entire county (as now proposed), they will be out of business. However it should also be noted that Prescom is in a strong position to win any future tender for services. Indeed, if it is found that the collection and transport of waste is carried out in a reasonably cost effective manner, managed by local enterprises (some of which private companies who are able and willing to invest in the modernization of the equipment), the wholesale replacement of vehicles and containers via an ISPA grant may be an unnecessary.

5.234 Though Prescom has a good chance to be the winner of a single countywide concession, as members of a consortium or as subcontractors to the concessionaire, the management regards this eventuality with some scepticism, and would rather maintain their independent operations in Targoviste by expanding its service to nearby communes where profits can be made.

Lesson Learned

♦ This case demonstrates the possible mixed signals that may be created by conflicting objectives in uncertain legal environments. While the present Prescom concession is by no means perfect, it is a working example of a viable undertaking. Grant financing may not result in an optimal solution if other viable alternatives exist in the market, which should be duly considered and analysed before nascent private sector participation and development is negatively affected.

♦ The need for a coherent legal environment is clear and essential to support the development of effective PPPs. This should also be coordinated with a policy /
strategic approach to PPP development and overall financing of infrastructure and service provision.
Appendix C – The Maastricht criteria
APPENDIX C – 1 THE MAASTRICHT CRITERIA

5.235 At the Copenhagen European Council in 1993, the EU adopted a decision according to which the “associated countries in central and eastern Europe that so desire shall become members of the EU”. The decision also defined the membership criteria – the so-called Copenhagen criteria – the basic objective of which was to set out the appropriate framework for the gradual integration of the countries of CEE into the EU. One of the Copenhagen criteria provides for the implementation of the objectives of economic and monetary union in the medium term. Unlike the current members of the EU who have not joined EMU – Denmark, Sweden and the UK – the countries of CEE will not be able to opt out of membership in EMU when they have met the conditions for joining laid down in the Maastricht Treaty of 1992. These conditions are as follows.

- **Inflation.** A member state has to show a price stability performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentages points that of, at most, the three best performing member states in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.

- **Interest rate.** Over a period of one year before the examination, a member state has to have an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing member states in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions;

- **Exchange rate.** A member state has to respect the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the member state shall not have devalued its currency on its own initiative for the same period.

- The **general government deficit** may not exceed 3% of GDP, or should be falling substantially or only be temporarily above though still close to this level.

- **Gross general government debt** may not exceed 60% of GDP at market prices, or must at least show a sufficiently diminishing (rate) and approaching the reference value at a satisfactory (rate).

5.236 Since these conditions are more precisely defined than the other Copenhagen criteria, they have been closely followed by analysts, investors and policy makers, even thought they will need to be met only once new member states will have spent at least two years in ERM II.

5.237 Although at first glance these conditions seem to have been laid down very precisely, there is a certain amount of flexibility in them. This pertains in particular to the size of
The public debt, or the tendency of the debt to decline. Austria, Belgium, Greece, Italy and the Netherlands entered EMU with a public debt in excess of 60% of GDP, and by the end of 2003 only the Netherlands had reduced gross indebtedness below that level. Italy also had problems meeting the budget deficit criterion. From 1991 to 1996 the average budget deficit amounted to 9% of GDP. As a criterion for EMU entry the European Commission accepted the promise (later fulfilled) that the deficit for 1997 and 1998 would be lower than 3%. Finally, Italy and Finland had both participated in ERM for less than two years at the time of assessment of their readiness for EMU.
APPENDIX C – 2 EUROPEAN MODELS FOR MUNICIPAL DEBT CONTROL

Municipal Debt control mechanisms in effect in most OECD and Council of Europe (COE) member states allow local borrowing for capital investment purposes but require liquidity loans to be paid back within the year. Only few countries use stock-based municipal borrowing limits, even when the total stock of municipal debt is counted against the Maastricht criteria. Examples of these restrictions include:

1. Restrictions on volume of borrowing and debt service ratios:

UK: Credit approval ceilings are given each year by the government, the government defines a maximum borrowing amount. All sources of repayment are directly or indirectly controlled by the central government. Even the level of local capital spending is “suggested” by the appropriate ministry.

Denmark: No municipal borrowing is allowed at all with a few exceptions. Municipalities must finance all of their expenses, including capital expenses, through current revenues. Budgets must be balanced. Automatic permission is granted for fee-based borrowing for public utilities and other priority investments in social welfare facilities, energy conservation etc. In certain economic situations, the Interior Ministry gives permission for discretionary borrowing to stimulate local economies, sets borrowing limits for real estate and fee-supported infrastructure borrowing on an annual basis.

Germany: Each Bundesland has its own volume of borrowing limits and explicit approval is needed from the Land. Most commonly used are the projected operational surpluses that are to exceed projected capital expenses, including a mandatory “transfer” from the current account to the capital account.

Poland and Czech Republic: 15% of current revenues may be used to fund debt service.

Croatia: 20% of own resources may be used for debt service and the MOF needs to approve each loan.

Ireland: Each municipal borrowing must be approved by the Minister who determines whether they need the loan and whether they can pay it back.

Austria: Each Land has a different set of criteria for debt needing higher-level approval, and differing absolute or relative limits.

Sources of information used:
“The risks arising from Local Authorities Financial Obligations,” Draft Report by the Steering Committee on Local and Regional Democracy, no. 76, Council of Europe Publishing, August, 2002;
“Recovery of Local and Regional Authorities in Financial Difficulties,” Local and regional authorities in Europe, no. 77, Council of Europe Publishing, August, 2002;
Spain: The current account surplus may be used to finance the capital account with the Finance Ministry’s approval. Total municipal debt may not exceed 110% of annual revenues.

Norway: Borrowing is allowed for investment only. The current budget may have amortization expenses equal to the annual cost of interest and capital payments.

France: Operational surpluses and savings from prior years must exceed the annual burden of capital repayment. No other restrictions apply.

Italy: Municipalities must have balanced capital and current accounts. Interest payments may not exceed 25% of current revenues. Loans must have terms of at least 10 years. The State Treasury sets the maximum legal interest rate.

2. Restrictions on municipal guarantees:
Guarantees to third parties are allowed and not counted against debt limits in UK, Sweden, Czech Republic, and Finland.

Municipal guarantees are restricted to public purpose organizations, non-profit organizations, communal enterprises, or enterprises and institutions with municipal majority ownership in Belgium, Norway, Denmark, and Croatia.

 Guarantees to third parties are counted as municipal debt and included in the limits on debt volumes Croatia, Denmark, France, and Austria.

3. Restrictions on collateral:
UK: no municipal asset may be used to guarantee debt, only cash flow.

Property may be used to guarantee municipal loans in Ireland, Norway, Finland, and Denmark. By “Bundesland” permission only in Germany, assets may only be purchased for public purposes, and sold only if they do not serve a public purpose.

Public sector assets may not be used as collateral in Belgium, France, Italy, Spain, and Portugal.

No restrictions on the use of municipal assets as collateral in Czech Republic, Poland, and Croatia.

4. “Bankruptcy” or debt adjustment elsewhere
Of 27 COE member states, only 5 have some type of procedure similar to bankruptcy adjustment. Only two, Hungary and Latvia, have actual legislation on file. In 22 COE members it is legally impossible to have a bankruptcy on the local level. There are functional equivalents to bankruptcy procedures in Switzerland, some German states and UK, i.e. administrators or trustees may be appointed to oversee reorganization and repayment plan (do not provide “protection” from all creditors).
UPDATE ON BEST INTERNATIONAL PRACTICES IN PUBLIC PRIVATE PARTNERSHIP WITH REGARDS TO REGIONAL POLICY ISSUES

Review Report

In other countries such as Poland and Czech Republic, local governments are able to run budget surpluses to fund capital investment and borrowing, so far. The Czech and Polish Governments have ignored the possibility of debt adjustment, and conflicts with banks and bondholders have been handled based on loan agreements, contracts and civil law. The Government of Estonia is considering a debt adjustment procedure of some type based upon the Hungarian model.

The Regional Fiscal Policy Dilemma

One of the main difficulties in setting an appropriate regional fiscal policy in line with the regional development policy objectives, emanate from the difficulty to define an optimal level of control that the central government should have on local governments expenditures.

A very cautious regional fiscal policy, characterised with strict and tight budgetary rules, has the benefit of introducing discipline and diligence and therefore reducing the risks of future contingent liabilities, budgetary shortfalls or underperformance of service delivery. On the other hand the over control undermines the abilities of the local authorities to better forecast development opportunities and accordingly plan the required investments to support them. It also limits the access to available financial tools to balance emerging needs and most importantly to undertake investments with long term returns. By doing so it limits the scope of local managers to that of administrators of funds (budgets) with no or little decision making power. Little risks…little rewards.

A more relaxed regional fiscal policy, entrusting the Local managers in taking investment decisions and incurring liabilities as required while the Central Government plays the role of coordinator, insuring that major debts are not undertaken at the same time by the various municipalities, which may lead to the country’s non compliance with Maastricht criteria, probably done on the basis of a fair system, where those municipalities that can demonstrate more robust investment business cases, stand better chance to be granted the right to borrow above a predefined ceiling. Such approach has to consider both the socio-economic viability of the investment as well as its future impacts on municipal accounts, both appraised over the same period of time. Such policy allows a highly decentralised decision making that better meets the local needs while ensuring overall solvency at the country level. Such approach is nevertheless difficult and costly to administer as it requires the Central Government review of all proposed municipal investments, to be able to prioritise them according to the criteria above. This however, could be eased through involving the different levels of government in filtering and prioritising the proposed investments, (e.g. at the regional, or agglomerations of municipalities levels). A second difficulty relates to the difficulty of long term budgetary forecasting. In particular, the difficulty of forecasting the municipalities’ long term revenue streams as well as forecasting the returns of the investment itself over the same period. This is necessary if the long term impacts of investments on municipal accounts are to be used as a prioritisation criterion.

57 E.g. individual ceilings as a proportion of the municipalities’ annual budgetary revenues.
58 Defined as the time required for both financial and economic returns on investment to be achieved.
BEST INTERNATIONAL PRACTICES IN PUBLIC PRIVATE PARTNERSHIP WITH
REGARDS TO REGIONAL POLICY ISSUES

Review Report
Appendix D – Decentralisation in Czech Republic
APPENDIX D – DECENTRALISATION IN CZECH REPUBLIC

5.238 Defence is fully assigned to central government. Local government involvement represents only civil defence duties. Public order and safety is shared between two levels of government, though the majority is assigned to central government. Municipalities may introduce local police with limited power only (checking parking places). Fire brigades are mainly organised and financed by central government, though the four biggest cities also have them. Voluntary fire brigades can be found in some municipalities. They operate under the local government budget but central government supports them with grants (for special fire vehicle renovation, and so on).

5.239 Education is a shared function between two levels of government. Local government is responsible for providing children from the age of 6 to 15 with compulsory education, not including teachers' wages and a fixed volume of school textbooks. It is also responsible for pre-school education under the same terms as for the nine-year compulsory education. Teachers are not employees of local government.

5.240 Some big cities also run secondary schools, and some municipalities run special types of school – for mentally retarded children, which are generally the responsibility of central government. Some local governments provide vocational education facilities, such as music and painting schools, which are partly financed through fees. When a child up to 15 years of age from one municipality attends a school in another municipality, the municipality in which this child resides pays a proportion of the school running costs. The central government supports compulsory and pre-school education through a per-pupil grant, calculated as a percentage of the average operating costs of these schools. A small grant is also assigned to capital costs in the case of school building renovation, etc.

5.241 Health services and hospitals are financed through the health insurance system. The majority of hospitals are run by central government. Some cities also operate hospitals (mainly small ones). In these cases, they mainly support their activities through capital grants. Homes for abandoned children up to the age of 3 are also run by local government and supported by central government.

5.242 The substantial part of social services and welfare is financed by central government. All pensions, as well as unemployment and sickness benefits, and family and child allowances, make up the most important part. The situation is different when looking at social services like homes for elderly, mentally and physically handicapped adults and children, homes for abandoned children (between the ages of 3 and 18), and social asylums. These are mostly run by local government and there are some central government grants involved. They are calculated as a per bed amount derived, as a percentage, from the average operating costs. Local government organises social assistance to people in need. It is regulated by law (the benefits level and eligibility criteria) but local government has some discretion in the administration of social assistance. Social assistance includes home-care for the elderly and disabled, and the provision of cash benefit supplements.
5.243 Local government is responsible for housing. Municipalities were transferred almost all housing facilities which were built by the state prior to 1990. They may privatise this housing stock under the terms which they set themselves. Municipalities have been doing so to a different extent - the decision on which part of the housing stock to keep, was up to them and the situation differs across the country. Flats in municipal houses were sold predominantly to the occupiers of the time. Prices of these transfers differed substantially. There is rent regulation in place. Central government sets the maximum increase in rent, each year. The regulation does not concern the newly built flats financed without central government assistance. A municipality may get a central government grant for new housing construction. Besides housing, local government is also responsible for the cleaning of public areas, park maintenance, public lightening, public cemetery maintenance, refuse collection and disposal operations and management, the water supply, the sewage system and sewage treatment plants, gas and electricity supplies, and the maintenance of local roads. Mainly private companies provide solid waste collection and management of landfills, although this is not a rule. Water supply and sewerage systems were privatised. During the privatisation, municipalities got shares in these companies. Whether a municipality provides these services directly or through a public or private company, is up to their discretion. The sewage has to meet minimum standards. The sewage system and refuse collection and disposal is usually financed by the rates. Water, electricity and gas supplies are provided either by municipality companies or by public/private companies (generally, all of these companies are profitable; the surplus of the enterprises owned by the municipality could be used as municipal non-tax revenue). The state passed 34 per cent of shares in companies supplying gas and electricity in the country to municipalities. The rest is owned either by the state (National Property Fund) or by private bodies (domestic as well as foreign). Prices of water, gas and electricity supplies are still regulated by central government. The regulation reflects the actual costs, therefore prices differ across the country.

5.244 Within local government responsibilities in the area of cultural and recreational activities, municipalities run libraries, museums, zoos, galleries, theatres and exhibitions. There is a set of central government non-mandatory grants supporting these local activities. Quite a lot of local governments manage sports centres, playing fields, swimming baths and other recreational and tourist facilities.

5.245 As far as agriculture, forestry, fishing and hunting are concerned, the main part of financial aid to farmers is paid by the central government. The municipalities finance projects of local importance and regions will do it on the regional level.

5.246 With regard to mining, manufacturing and construction, the mining reduction programme covers the central government as well as subsidies for the construction of a nuclear power station. The local government gives special grants. The majority of transport and communication is the responsibility of central government. Central government is obliged to finance railways (a State Company), highways etc. The inner city transport in 16 cities is the exception. Municipalities contribute to local bus transport companies, which are private bodies. The local government has the responsibility for local routes.

5.247 ‘Other economic affairs’ is made up of: export aid (which is ensured by central government), tourism (mainly financed by municipalities), and special economic
programmes, or the expenditures of special institutions (geology, meteorology, antimonopoly), which are usually included in the central government budget.

5.248 ‘Other functions’ aggregates all remaining functions: environmental policy, partly financed by local government; and research, labour security, bank revitalisation programmes, etc. which are financed by central government. Apart from the above-mentioned own tasks of local government, there is also a set of functions which are carried out by local government as delegated or transferred functions. They include environmental protection overseas, construction permits, and birth, death and marriage registers. Statistics, water standards, sanitation etc., from the point of view of legal requirements, also belong to this group of local government functions.
Appendix E – PPP Related Legal Issues in Czech Republic
5.249 In general, a PPP regime can contemplate the owner of the respective project asset as being a governmental authority as well as a private entity, e.g., a legal entity established specifically for PPP project implementation (a special purpose vehicle).

5.250 In relation to roads, the applicable legal regulations contain mandatory provisions regulating the ownership of roads. Thus, the Act on Roads (Section 9 (1)) provides that a local road is in the ownership of the municipality on the territory of which the local road is located. Therefore, the City must own the project road (being a local road). This ownership regime cannot be changed by contract.

5.251 In our view, a different legal regulation on the basis of which the title to the road could be transferred to the private partner might in practice give rise to a number of problems and be in certain cases contrary to the public interest (problematic or at least risky especially with regard to issues related to the disposal by the owner of this road, e.g., further transfer of the title, consequences of possible bankruptcy of the road owner in respect of the road or enforcement of debt affecting its property, and other similar matters). We also believe that any legal regulation providing that the private partner would be the owner of the road could have only limited positive effects (the road itself is not an asset which might represent, e.g., sufficient security for institutions providing funding within the PPP, unless for example an authorization to collect a toll would be linked to having the ownership title). Therefore, we do not make a recommendation to change this legal regime.

5.252 We believe that the applicable legal regulation of the ownership title to roads is not an obstacle to the implementation of the project using a PPP strategy.

5.253 Having said that, the mandatory ownership regime has a significant negative consequence for the accounting and tax treatment of the PPP project – see the section of this report on Accounting and Tax Treatment for more details. We recommend that this problem in applicable legislation be resolved by amending the relevant accounting and tax legislation.

**Legislation Applicable to Entering into a PPP Implementation Agreement in Respect of a Road**

5.254 Under the Act on Roads, the owner of a road is in principle responsible for the operation and maintenance of the road (see e.g., Section 9 and Section 26 and 27). There are two exceptions to this principle:
(i) the Ministry of Transport can transfer, on the basis of a contract, certain responsibilities relating to operation and maintenance of I. class roads onto specified regional organisations (Section 9 (2) of the Act on Roads); and

(ii) the Ministry of Transport can enter, on behalf of the state, into a PPP agreement in respect of a motorway, including the transfer of operation and maintenance responsibilities, with a legal entity selected in accordance with the Act on Public Procurement (Section 9 (3) of the Act on Roads).

5.255 In addition to the above restriction on transfer of full responsibility for operation and maintenance by the owner of a road to a third party, the Act on Roads also contains provisions regarding a PPP agreement (Section 18a et seq.). These provisions expressly allow only for the transfer of certain rights and obligations of the state as a motorway owner to a legal entity for the purpose of construction, funding and operation of a motorway on the basis of a "concession agreement". Therefore, these provisions cannot be applied to local roads.

5.256 The above provisions of the Act on Roads raise serious doubts whether the City can enter into a PPP agreement in respect of a local road, which would provide, among others, for the transfer of full responsibility for operation and maintenance to a private partner. One view is that given the City's self-administration status, it should be free to regulate matters relating to its property as it deems appropriate, subject to other rules applicable to the management of the City's property (in particular, rules contained in the Act on the Capital of Prague). On the other hand, the Act on the Capital of Prague provides that the City administers its property in accordance with this Act or other applicable laws – and such other applicable law is the Act on Roads. Provided that the interpretation that only the state can enter into a PPP implementation agreement and only in respect of a motorway is correct, a similar contract entered into by the City in respect of a local road could be invalid.

5.257 Maximum certainty regarding the validity of a PPP implementation agreement is crucial to the project. In particular, banks could be reluctant to finance the project if the validity of the agreement was dubious.

5.258 We have also reviewed the draft legislation in preparation under the auspices of the Ministry for Regional Development. This legislation specifically designed for PPP projects is not concerned with the issues relating to the Act on Roads described above and, therefore, any adoption of this legislation does not alter the above analysis.

5.259 Given the above, we recommend that this legal situation be resolved by a change in legislation. One of the possibilities of changing the legislation, which we would consider appropriate in case that no other enabling legislation relating to PPP project is adopted, is an amendment to the provisions of the Act on Roads relating to the PPP concession agreement (Section 18a – 18f). A draft of a proposed change is attached in Appendix 7.1 to this report. However, another option is to adopt an amendment to the Act on Roads by which the provisions of Section 18a – 18f of the Act on Roads are deleted (and the provisions of Section 9 are amended so that they enable transfer of responsibility for road maintenance).

5.260 Any new legal regulation allowing a PPP strategy for the project should be based on the principles that it should not be too restrictive in terms of the contents of the
contract with a private partner and that the PPP implementation agreement should be to the largest extent possible governed by private law of contract.

**Liability for Road Traffic**

5.261 Regarding the relationship of the concessionaire to end users, the issue of liability for traffic accidents on the road should be considered.

5.262 Generally, under applicable legal regulations the owner of the road (Section 26 – Section 28 of the Act on Roads) is liable for damage caused to the end users of the roads. The allocation of liability does not change, unless the respective legislation is amended, even if the road owner entered into a PPP agreement with a private partner, subject to the applicable law permitting such agreement.

5.263 Current legal regulation of liability for damage suffered by third parties in our view does not impede the implementation of a PPP project. The liability regime for damage can be regulated in the agreement with the private partner.

**Restrictions Resulting from the Rules Governing the Management of the City’s Property**

5.264 The Act on the Capital of Prague contains special provisions which must be considered in respect of the implementation of PPP projects. Some of these provisions are considered below.

5.265 Section 35 (6) of the Act on the Capital of Prague does not permit the City to guarantee obligations of natural persons or legal entities, save for certain exceptions specified therein. We do not suppose that the City would be required to provide any guarantees under the contemplated PPP structure for the project and, therefore, we do not propose any changes to this provision now.

5.266 The City must publish its intention to sell or lease its real estate assets so that potential buyers may comment on such intention and present bids (Section 36(1) of the Act on the Capital of Prague). We do not suppose that the City would be required to transfer or lease any of its real estate assets under the contemplated PPP structure for the project and, therefore, we do not propose any changes to this provision now.

**Charging for Road Use**

5.267 Current forms of road use taxes and fees include (i) the road tax, (ii) a vignette fee for road use (however only in respect of motorways and high-speed roads, but not local roads). Both the road tax and fees charged for use of roads form revenue for public budgets.

5.268 The applicable legislation does not allow collecting charges for the use of local roads, the amount of which would for example depend on the distance travelled and
possibly on other terms of the use. As a result, it is neither possible that a private partner within the PPP project collects a fee from the users of the road paid directly to the private partner as the operator of the road. The possibility to collect tolls might be implemented only by amendment of the respective law (e.g., the Act on Roads). If such amendments to the law are drafted, they ought to be well prepared to enable the private operator to efficiently collect the toll and enforce the payments.

5.269 We do not suppose that the City will charge fees or tolls to users of the project road under the contemplated PPP structure for the project and, therefore, we do not propose any changes to allow such charging now.

Summary

5.270 The most important regulatory issue is the uncertainty regarding the entering by the City into a PPP agreement in respect of a local road, given that the Act on Roads contains restrictions regarding transfer of full responsibility for operation and maintenance by the owner of a road to a third party and that it expressly allows only the state to enter into a PPP agreement and only in respect of a motorway. We recommend that this legal situation be resolved by a change in legislation see above.

Accounting and Tax Treatment of a Public Private Partnership
Introduction and Problem Definition

5.271 One of the significant benefits of a public private partnership for the public authority involved should be that the assets involved in a public private partnership are not recorded on the balance sheet of the public authority. With this accounting treatment, it is the private partner who has the assets on its balance sheet. This off-balance sheet treatment potentially has a significant positive impact on the public authority’s debt in that the public authority can achieve that the initial capital expenditure relating to the assets will not increase the public authority’s overall debt. Therefore, a public private partnership structured in this manner will not have any impact on any limitations that the public authority may have regarding the volume of its debt (such as internal or statutory limitations, covenants in bank or bond financing).

5.272 The off-balance sheet treatment of assets involved in the project can be achieved both (i) for the City provided that it is allowed by the Czech accounting legislation and implementing regulations and (ii) for the national accounts of the Czech Republic if the project is structured in such a manner that the off-balance sheet treatment is also recognised by the EUROSTAT for the purposes of the „Maastricht debt“ concept (see EUROSTAT decision on the Treatment of public-private partnerships no. 18/2004 published on 11 February 2004).

5.273 It is important to note for the purposes of considering the accounting treatment under Czech legislation that the Czech Act on Roads (Act no. 13/1997 Coll.) requires that the City owns the road constructed under the project (Section 9 (1) of the Act on Roads).

Czech Accounting Regulation
5.274 Under Czech accounting legislation, the principle requirement is that assets are accounted for by the owner of the assets (i.e., assets are recorded always on the owner's balance sheet). There are a few exceptions to this principle, which are however of limited application (especially, a lessee may account for so-called „technical improvement” carried out on a leased asset, subject to complying with certain conditions). However, these exceptions cannot be applied to the road to be constructed under the project.

5.275 As a result, Czech accounting regulations applicable as of the date of this report do not permit that the private partner in the project account for the assets involved in the project and the City simultaneously remain the owner of the road. Thus, the applicable law does not enable to achieve the off-balance sheet treatment of the project assets for the City, as described above.

5.276 In addition, Czech accounting regulations do not provide for other matters related to any such off-balance sheet treatment, in particular for the hand-over of the project assets back to the City at the end of the project implementation agreement. Thus, it is not clear how and on what basis the City would keep accounting for the project assets after the implementation agreement expires. In relation to the accounting treatment of the hand-over, it is not clear under Czech tax laws what tax consequences the hand-over may have. There is a risk that the hand-over could trigger tax obligations which could seriously jeopardise the project’s financial model.

**EUROSTAT Treatment of Public Private Partnerships**

5.277 The EUROSTAT’s decision on the Treatment of public-private partnerships relates to the accounting treatment in national accounts of contracts undertaken by government authorities in the framework of partnerships with non-governmental units. The decision specifies what impact such contracts have on government deficit/surplus and public debt.

5.278 From the point of view of national accounts, i.e. most importantly the overall debt of the public sector as defined for the purposes of the Maastricht criteria, the accounting treatment of the assets involved in a public private partnership will depend on how much risk the private partner bears under the project implementation agreement. These assets will be classified as non-governmental assets and, therefore, recorded off-balance sheet if both of the following conditions are met:

- the private partner bears the construction risk, and
- the private partner bears at least one of either availability or demand risk.

5.279 If the private partner does not bear enough risk and the project assets are classified as governmental assets, then the initial capital expenditure relating to the assets will be recorded as government fixed capital formation. The government debt will increase in the form of an imputed loan from the private partner, which is part of the „Maastricht debt“ concept.

5.280 For the City, it is important to achieve a situation when under the Czech accounting regulations the assets can be treated as off-balance sheet. In other words, an off-balance sheet treatment under the EUROSTAT’s decision does not automatically ensure that the City will also achieve off-balance sheet treatment under Czech
accounting regulations. EUROS TAT's decision should therefore be fully respected only in case that there is a wider interest in having an off-balance sheet treatment also on the national level (for example, if the Czech government required the City to respect the EUROS TAT's decision).

Summary and Recommendation

5.281 In conclusion, under Czech applicable accounting regulations, it is not possible to achieve an off-balance sheet treatment of the project assets for the City whereby the City would remain the owner of the road (as required by the Act on Roads) and the private partner would record the project assets on its balance sheet throughout the duration of the project implementation agreement.

5.282 Even if an off-balance sheet treatment was possible, it is not clear what consequences the hand-over of the project assets at the end of the implementation agreement would have for the City's accounts and what additional tax obligations could arise under the Czech tax laws upon hand-over.

5.283 Prior to the signing of the project implementation agreement, we recommend that appropriate changes in legislation are made in the relevant laws which should in principle provide for the following:

(i) the accounting legislation will allow that assets involved in a public private partnership can be accounted for by the private partner even if the private partner does not own the assets (such as the road);

(ii) the legislation will allow the costs on the project assets be tax deductible by the private partner throughout the duration of the project implementation agreement;

(iii) the accounting legislation will provide for the situation of hand-back of the assets to the City at the end of the implementation agreement and specify how the City would start accounting for the assets following hand-back; and

(iv) the tax legislation will provide that the hand-back will not be associated with any additional tax obligations arising due to the hand-back of the project assets.

5.284 The legislation which should be subject to changes includes in particular the following:

(i) Act on Income Tax (Act no. 586/1992 Coll.);
(ii) Act on Value Added Tax (Act no. 588/1992 Coll.);
(iii) Act on Inheritance, Gift and Real Estate Transfer Tax (Act no. 357/1992 Coll.);
(iv) Act on Accounting (Act no. 563/1991 Coll.); and
(v) Implementing regulations to the above mentioned Acts.
Selection of the Private Partner

Legal Issues

Introduction

5.285 This part of our legal analysis provides a summary of issues which were identified based on an analysis of Czech public procurement legislation and which should be considered for the proposes of implementing a PPP strategy with respect to the possible concept, preparation and implementation of a tender organised by the City as the relevant public authority with the aim of selecting a private sector partner.

5.286 The Czech Public Procurement Act governs how public authorities in the Czech Republic (including the City) must announce and organise tenders. This Act harmonises Czech law governing the public procurement process with EU law and, in particular, the “Public Procurement Directives”. A new act, due to become effective on 1 January 2006, is currently drafted by the Ministry of Regional Development (the “New Public Procurement Act”). The new legislation should, among other things, implement new legal procedures provided for by the “New European Public Procurement Directives” (including the introduction of the “competitive dialogue” procedure) and remove some discrepancies in the interpretation of the current Act. The New Public Procurement Act should follow the same principles as the current Act; nevertheless, some of our conclusions mentioned herein may be affected by the new legislation.

5.287 Depending on the project type, the Act and the European public procurement directives in principle distinguish two procedural regimes for selecting a contractual partner:

- the regime of a “public procurement”, and
- the regime of a “concession”.

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59 This analysis has been prepared taking into account Czech laws and regulations on public procurement valid as of the date of this report.

60 Act No. 40/2004 Coll., on Public Procurement, as amended.

61 European public procurement directives include, in particular, Directive 92/50/EEC, 93/36/EEC, 93/37/EEC and 93/38/EEC each of which have been effective as of 31 March 2004, and were replaced by Directives of the European Parliament and European Council 2004/18/EC and 2004/17/EC. Each EU member state must harmonise its law with these directives by 31 January 2006.


63 In addition to the new act on public procurement, a new act on concessions should be enacted and become effective on 1 January 2006.
5.288 Under the Public Procurement Act (and similarly, under the secondary law of the EU), the “public procurement” regime requires procurement against remuneration paid by the public authority for supplies, services or construction works.

5.289 The concept of “concession” (for construction works or services) includes the same types of contracts as those concluded under public procurement, but with one difference: the payment of remuneration for works carried out, or for services rendered, is based solely or at a large extent on the private partner’s right to collect fees for the use of a specific facility or service.

5.290 Considering the expected payment mechanism for the project at hand (i.e., the majority of the project company’s cash-flow will be generated by means of payments made by the public authority – i.e., the City), it is most likely that the selection of a private partner will be governed by the legislation regulating “public procurement”.

Types of Procedures

5.291 The contracting authority must, in principle, select its private partner within an open or restricted procedure if:

♦ the project is prepared to the degree that the legal, technical, financial and organisational aspects of the matter have been determined;

♦ without further negotiations with a potential bidder, the most suitable distribution of risks and other terms of the contractual relationship with the winning bidder may be stipulated; and

♦ the contracting authority is able to provide the bidders with sufficient information in its tender documents which would allow the bidders to determine the aggregate price of the contract.

5.292 In addition to the open or restricted procedures, and if specific conditions are met, the Public Procurement Act and the public procurement directives provide for the use of a negotiated procedure. These procedures may be conducted in extraordinary cases only when “the nature of the work or the risks attaching thereto do not permit prior overall pricing”. However, according to the opinion of the European Commission, these procedures may be used only in specific cases where the nature of the work or
the scope thereof is uncertain a priori. The negotiated procedure may not be used when the uncertainty stems from other circumstances such as the difficulty to price the works due to the complex legal and financial structure of the relevant project.\(^70\)

On the other hand, the negotiated procedure is regularly used in relation to PPP projects abroad (e.g., in the UK).

5.293 With the adoption of Directive 2004/18/EC, it is also possible to apply a new procedure called "competitive dialogue" for contracts with a high degree of complexity. In light of the current wording of the Public Procurement Act, however, this procedure may not be chosen without an amendment to the valid Czech legislation.\(^71\)

5.294 In light of the above, and following our preliminary discussions with representatives from the Czech Office for the Protection of Competition (the “Competition Authority”), which acts as a supervisory authority over public procurement, we may provide the following general conclusions:

♦ in light of the high degree of complexity or even the impossibility to set up an efficient distribution of risks related to the implementation of the project without negotiations with the bidders which hinders the ability to determine the aggregate bid price by the bidders, an application of the negotiated procedure may be considered justified;

♦ before choosing this type of procedure the contracting authority should collect all relevant facts and arguments supporting the application of this type of procedure; and

♦ considering the absence of detailed procedural provisions for the negotiated procedure, the institutes provided for in other types of tender procedures (e.g., the restricted procedure) may be used by the contracting authority for the individual procedural steps in order to ensure that the selection of a private partner is as transparent as possible.

Private Partner Selection Process: Negotiated Procedure

5.295 Provided that a negotiated procedure is used, based on experience in the preparation of PPP projects abroad (in the UK, for example) and applying Czech public procurement legislation, the basic stages of an efficient private partner selection process for the City may be summarised as follows:

♦ announcement of the tender, whereby the contracting authority informs an unlimited number of potential bidders (independent bidders or consortiums) of its intention to award a public contract (to select a private partner for the project’s implementation).

5.296 This announcement must

\(^{70}\) This statement of the European Commission is cited in the Green Paper on PPP and the Community law on public contracts and concessions of 30 April 2004. The following example is given: a negotiated procedure with publication can be applied if the works are to be done in a geologically unstable area or in an area with archaeological monuments and due to these reasons the precise City of Prague of works is not known upon the announcement of the tender.

\(^{71}\) The new legislation due to become effective on 1 January 2006 should allow for this type of procedure.
be an invitation to submit an application for the participation in the tender; and

to prove the bidders’ qualification within “pre-qualification proceedings”.

5.297 At this stage, the contracting authority does not have to detail the specification of the project (in particular, the distribution of risks) so as to allow the bidders to submit specific price bids;

- the selection of a pre-defined number of qualified bidders (3 – 5 bidders depending on the project) having sufficiently demonstrated in particular their economic, financial and technical capabilities, sufficient expertise from similar projects, and the ability to meet the required project funding demands or other requirements of the contracting authority;

- an invitation for the qualified bidders to submit their introductory bids;

- an invitation to the qualified bidders to initiate negotiations, aimed in particular to set up the distribution of risks among the engaged entities, to clarify and detail the nature and technical parameters of the project, specific legal relationships among the entities, the contractual documents to be concluded with the winning bidder, etc.;

- based on the results of the “negotiations with bidders” stage, the contracting authority identifies the final form of the project (including an ideal distribution of risks acceptable to the majority of bidders on one side and to the contracting authority on the other side) that is the most advantageous for the contracting authority and that will allow the bidders to submit specific technical and pricing bids;

- an invitation for the qualified bidders to modify their bids with respect to the conclusion of the negotiations (final specification of the project);

- evaluation of the presented and modified bids and the selection of the winning bidder; and

- conclusion of a contract with the winning bidder.

5.298 Based on our (a) analysis of the current legislation on public procurement, (b) preliminary discussions on the matter with the Competition Authority representatives and (c) comparison of private partner selection processes for similar PPP projects implemented abroad (mainly in the U.K.), we have identified the following fundamental areas of issues to which special attention should be paid when preparing a private partner selection process:

- **The need to establish the project company in advance.** The valid legislation on public procurement in the Czech Republic, contrary to the provisions in the new European public procurement directives\(^\text{72}\), does not allow the contracting authority to conclude the contract with a special-purpose vehicle established post factum by the winning bidder for this purpose, but only directly with the bidder. Therefore, the bidders (or groups of bidders) must participate in the tender from the very beginning through a specific company that is to become the project company and the party to the contract\(^\text{73}\), and

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\(^72\) This procedure is expressly admitted for all types of tenders by the relevant EU Directive 2004/18/EC that contains comprehensive provisions on the field of public procurement – see Article 4(2) of the Directive.

\(^73\) This condition also limits last-minute changes to bidding consortiums.
Proving qualifications. A special-purpose legal entity (SPVs) is commonly used as the tendering entity. SPVs usually have no business history. Consequently, the SPVs must be able to demonstrate their qualifications under the procedural rules set out in the Act in a way that will sufficiently verify the financial, economic and technical capabilities of the underlying private partners supporting the SPV.

5.299 Contrary to the new European public procurement directives and the decision practice of the European Court of Justice, Czech legal rules and regulations do not expressly allow the financial, economic and technical capabilities to be demonstrated by the bidder and also by other entities within the same group with the bidder, which are not co-bidders in the tender. Within its supervisory decision-making powers, however, the Competition Authority in its 2004 decision accepted arguments that the Czech legislation should also be interpreted in light of the decision practice of the European Court of Justice in this case. Consequently, the technical capabilities of the bidder should be allowed by referring to the expertise of other consortium members, and especially where the bidder can use the relevant know-how, technical, personnel or economic or financial facilities of all the consortium’s members including the relevant parent companies.

5.300 In light of the above, special attention must be paid to setting up the qualification criteria or criteria for reducing the number of bidders to a pre-defined number (see below) so that the criteria take into account the fact that qualifications will be documented by other members of the consortiums that will not formally be direct participants in the tender.

Restricting the number of bidders. To meet the requirement of the Public Procurement Act, if, after proving their qualifications, the contracting authority chooses a pre-defined number of bidders to be invited to further negotiations, the contracting authority must set forth criteria that will apply in the further narrowing of the number of qualified bidders. As the Public Procurement Act does not provide for a detailed specification of these criteria (but does provide for the qualification criteria), the criteria might also apply to other entities within the same group; and

Course of procedure. With no detailed procedural rules for negotiations with the bidders provided for in the law, the contracting authority will have to set up a transparent and non-discriminatory procedure in the tender terms.

5.301 Such a procedure should, in particular, allow equal:

74 Considering the nature thereof, “private partner” would include, in addition to the project company, the sponsors and suppliers, among others.

75 E.g., Article 47(2) and (3) and Article 48(3) and (4) of Directive 2004/18/EC.


78 Section 40(1) of the Public Procurement Act.

79 This possibility has also been admitted in our preliminary discussions with the representatives of the Competition Authority.
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♦ access to all information;
♦ opportunities to hold negotiations with the contracting authority; and
♦ opportunities to file suggestions or objections regarding the proposed parameters of the project.

5.302 Having spoken with Competition Authority representatives, it seems they believe a procedure where no further bidders are ruled out of the tender in the negotiation process (i.e., after the selection of a pre-defined number of bidders following the pre-qualification stage) but where all the pre-selected bidders (including those not accepting the detailed form of the project) have the opportunity to file their final bid and to have their bid evaluated is a more transparent procedure.

5.303 The need to set up a detailed bill of quantities in advance. As the intended project will include, among other things, construction works, the Act expressly requires that the tender documents include a bill of quantities containing a detailed list of works and supplies.\(^{80}\) The contracting authority should keep this obligation in mind when preparing the project as the construction unit project designs must include draft bills of quantities before the tender for the selection of a private partner is announced.

New Issues set forth in Draft of the new Public Procurement Act

5.304 As indicated above, the New Public Procurement Act is being drafted by the Ministry of Regional Development to harmonise Czech public procurement law with the "New European Public Procurement Directives"\(^4\) to become affective on 1 January 2006.

5.305 Should the tender for the selection of the private partner be announced after the New Public Procurement Act becomes effective, the new legal requirements should also be considered.

5.306 Provided that the currently available draft version of the New Public Procurement Act is enacted in its existing form, it is clear that at least the following new legal principles should be taken into account:

♦ Possibility to use the “competitive dialogue” procedure. The New Public Procurement Act should introduce a new type of procedure, called a “competitive dialogue.”\(^{81}\) Provided that the project is considered to be a “particularly complex” public contract, the City may use this type of procedure. The New Public Procurement Act sets forth a detailed course of action for the procedure, including the possibility to reduce the number of tenderers within particular stages of the dialog procedure;

♦ Detailed rules on the course of the action for the “negotiated procedure”. If the City decides to use the “negotiated procedure”, new detailed procedural rules on the course of action for this procedure must be followed.\(^{82}\) Among the most important changes are (i) the possibility to reduce the number of tenders within

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\(^{80}\) Section 50(1) of the Act.

\(^{81}\) Section 27 of the draft version of the New Public Procurement Act set forth that this type of the procedure should be used when a public contract is considered to be “particularly complex”, especially when the contracting authority (the City) is not objectively able to specify the legal and/or financial requirements for (make-up of) the project.

\(^{82}\) Sections 73 – 75 of the draft version of the New Public Procurement Act.
particular stages of the negotiated procedure, and (ii) detailed rules on
negotiation with the qualified tenderers and the invitation to modify bids; and

♦ **Proving qualification by a “subcontractor”**. The New Public Procurement Act,
contrary to the European Procurement Directives, still does not expressly allow
the financial, economic and technical capabilities to the demonstrated by the
bidder and also by other entities within the same consortium with the bidder and
which are not co-bidders in the tender (“economic operator”\(^83\)). On the other
hand, the new regulation will allow the demonstration of such capabilities via
“subcontractors”\(^84\).

5.307 As the final version of the New Public Procurement Act may differ from the currently
available draft version, provided that the tender is announced after the new act is
effective, then summary conclusions would need to be reviewed in the light of the
final version of the new legislation.

**Summary**

5.308 Based on our analysis as detailed above, we have identified no fundamental
obstacles in the current legislation on public procurement in the Czech Republic that
would hinder the selection of a private partner for the contemplated project.

5.309 Provided that the subject matter of the tender meets the statutory conditions and the
contracting authority can justify the same, the private partner may be selected using
the *negotiated procedure*. If this is the case, the special areas of attention as
identified above must be taken into account, in particular the need to establish the
bidders’ SPVs in advance, the specific aspects of setting up criteria for proving the
bidders’ qualification and for reducing the number of bidders, the need to draft a
detailed bill of quantities for the construction works and other particularities of the
tender process.

5.310 However, should the tender for the selection of a private partner be announced after
the New Public Procurement Act currently being drafted (and due to become
effective on 1 January 2006) becomes effective, the newly introduced legal principles
must be taken into account, in particular *competitive dialogue* as a new type of
procedure, the detailed rules on the course of *negotiated procedure*, or the possibility
to prove the qualifications via *subcontractors*, etc.

5.311 Moreover, the final version of the New Public Procurement Act may differ from the
currently available draft version. Provided that the tender is announced after the New
Public Procurement Act becomes effective, then these conclusions may need to be
reviewed in the light of the final version of the new legislation.

\(^{83}\) Article 4 of the Directive 2004/18/EC.

\(^{84}\) Section 28(5) of the draft version of the New Public Procurement Act.
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