



EUROPEAN COMMISSION  
DIRECTORATE-GENERAL  
REGIONAL POLICY

# **GUIDELINES FOR SUCCESSFUL PUBLIC - PRIVATE PARTNERSHIPS**

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et tient compte des résultats du Séminaire qui a réuni 100 opérateurs nationaux de 18 pays à Bruxelles le 4 juillet 2002.

PPP Coordinator : Mr Roberto Ridolfi, email : [Regio-PPP@cec.eu.int](mailto:Regio-PPP@cec.eu.int)

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Bruxelles, février 2003



Preface

Le secteur privé, de par son expérience et ses moyens financiers, est un partenaire à privilégier tant pour le financement que pour la réalisation et la gestion directe et déléguée de missions de services publics.

Dans le contexte actuel de rigueur budgétaire, l'intérêt du recours au partenariat public-privé (PPP) paraît primordial.

Dans ce cadre, les interventions des Fonds communautaires doivent, dans la mesure du possible, jouer un rôle de levier en attirant les investissements et le savoir-faire du secteur privé.

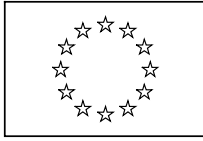
L'intégration territoriale des pays candidats à l'Union européenne est marquée par des besoins accrus en équipements publics, notamment d'infrastructures dans les domaines des transports et de l'environnement (eau et déchets solides). La réalisation de ces infrastructures est indispensable afin d'assurer un développement économique durable des pays candidats à l'adhésion. Leur financement est, et restera l'une des priorités de la politique régionale de l'Union européenne.

Déjà utilisé dans le contexte actuel d'ISPA, le PPP est appelé à jouer un rôle important dans les nouveaux Etats membres.

Conscient des difficultés à associer le secteur privé, tout en assurant une bonne application des directives européennes en matière de marchés publics et d'aides d'Etat, j'ai demandé à mes services de préparer un guide «**Guidelines for Successful Public-Private-Partnerships**» qui devrait faciliter l'analyse des risques inhérents à ces types de financement ainsi que les négociations entre les autorités publiques et le secteur privé.

J'espère que ce guide sera utile pour tous les opérateurs publics et privés des Etats membres actuels et futurs.

Michel Barnier  
Commissaire européen responsable de la politique régionale  
et de la réforme des institutions



**EUROPEAN COMMISSION**  
DIRECTORATE-GENERAL  
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Brussels, February 2003

## **Introduction**

Recent years have seen a marked increase in cooperation between the public and private sectors for the development and operation of infrastructure for a wide range of economic activities. Such Public-Private Partnerships (PPP) arrangements were driven by limitations in public funds to cover investments needs but also by efforts to increase the quality and efficiency of public services.

PPPs have a long history in some Member States of the EU while being a more recent development in others. PPPs have received a boost in various countries undergoing process of significant economic growth.

The efforts of the Accession Countries to reform and upgrade infrastructure and services could potentially benefit from the PPP approach. This is particularly true, given the enormous financing requirements to bring these infrastructures up to the standards. The Commission has identified four principal roles for the private sector in PPP schemes:

- to provide additional capital;
- to provide alternative management and implementation skills;
- to provide value added to the consumer and the public at large;
- to provide better identification of needs and optimal use of resources.

However, while PPPs can present a number of advantages, it must be remembered that these schemes are also complex to design, implement and manage. They are by no means the only or the preferred option and should only be considered if it can be demonstrated that they will achieve additional value compared with other approaches, if there is an effective implementation structure and if the objectives of all parties can be met within the partnership.

The Services of the European Commission have a particular interest in PPPs within the framework of the grants that it provides, both within the context of Cohesion and Structural Funds as well as ISPA. The use of grants in PPPs imposes constraints on projects, given the Commission's, over-riding requirement to protect the public interest.

In order to profit from the advantages of PPP all potential participants must enhance their understanding of the different approaches and the optimal methods to structure such arrangements. To this end, DG Regional Policy has undertaken a wide consultation process within the Commission, involving the EIB, EBRD, PPP units and task forces of the Member States and Candidate Countries. The Commission has attempted to integrate the views of all parties and will continue to draw upon their experience and skills in further promoting understanding and the development of PPP. This process has yielded valuable information on the strengths and weaknesses of PPP and importantly on how to integrate grant financing while also respecting the requirements of EU and national legislation.

These Guidelines are designed as a practical tool for PPP practitioners in the public sector faced with the opportunity of structuring a PPP scheme and of integrating grant financing. They do not attempt to provide a complete methodology or to define current or future policy. They should be regarded as a guide to the identification and development of key issues affecting the development of successful PPP schemes.

To this end, the Guidelines focus on four key topics:

- ensuring open market access and fair competition;
- protecting the public interest and maximising value added;
- defining the optimal level of grant financing both to realize a viable and sustainable project but also to avoid any opportunity for windfall profits from grants;
- assessing the most effective type of PPP for a given project.

The services of the European Commission recognize the evolving nature of the PPP concept but also the need for further debate and above for the expansion of knowledge and implementation capacity. The Guidelines could contribute positively to this process.

I hope that the Guidelines will assist public officials, financial institutions and the private sector in our common efforts to better implement ISPA measures as well as those to be implemented in the near future under the Cohesion and Structural Funds.

Guy Crauser  
Director General  
DG Regional Policy

## **Executive Summary**

### **Introduction**

Recent years have seen a marked increase in cooperation between the public and private sectors for the development and operation of environmental and transport infrastructure. In the European Member States this is a direct result of efforts to increase the quality and efficiency of public services, insufficient public sector financial resources to cover investment needs coupled with spending restrictions and a desire to access private sector efficiencies.

A long experience of private participation in the road and water sector now exists and there is a growing acceptance that Public – Private Partnerships (PPP) arrangements can be used as an additional and complementary [to others] instrument to meet infrastructure and service needs in a wide range of sectors ranging from environmental services to health care provision or education.

PPPs present a number of recognized advantages for the public sector to exploit. These include the ability to raise additional finance in an environment of budgetary restrictions, make the best use of private sector operational efficiencies to reduce cost and increase quality to the public and the ability to speed up infrastructure development.

The positive characteristics of PPP arrangements in developing infrastructure appear particularly attractive for the Candidate Countries (CCs) of Central Europe given the enormous financing requirements, the equally large funding shortfall, the need for efficient public services, growing market stability and privatization trends creating a favourable environment for private investment.

PPP arrangements come in many forms and are still an evolving concept which must be adapted to the individual needs and characteristics of each project and project partners. Successful PPPs require an effective legislative and control framework and for each partner to recognize the objectives and needs of the other. The European Commission has recognised the importance of PPPs and the need for an effective legal framework to ensure the application of the rules and principles of the Treaty. For this reason it has recently issued a declaration to the Internal Market Council<sup>1</sup> in line with the proposals to modify procurement regulations and an Interpretative Communication on Concessions<sup>2</sup>. These Guidelines have been developed to integrate these important documents and are fully based on them.

While the benefits of partnering with the private sector in PPPs are clear, such relationships should not be seen as the only possible course of action and are indeed complex to design, implement and operate. Many alternative sources of financing are available, including “public-public” institutional arrangements which should not be discounted in the hope that PPPs offer a miracle solution. Therefore PPPs should be carefully assessed in the context of the project, the public benefit and the relative gains to be achieved under various approaches. Not least the national characteristics, individual

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<sup>1</sup> COM(2000)275 final

<sup>2</sup> JOCE C/121 of 29 April 2000

macro-economic situations and the local policy framework must also allow and facilitate PPPs.

The European Commission has a particular interest in promoting and developing PPPs within the framework of the grants that it provides. It has expressed its willingness to assist in the development and implementation of PPP projects and use grant financing to leverage such arrangements. However the use of grants will impose additional conditionalities on projects particularly given the Commission's financing objectives, constraints and over-riding requirement to protect the public interest.

The Guidelines are designed to assist the project designer to match the objectives of the public and private sectors.

These Guidelines seek to address the issue of developing successful PPP projects in the CC's on a general level with specific reference to grant financing of transport and environmental infrastructure projects. They present a brief introduction to PPP concepts, discuss key conceptual issues and present a working guide to PPP development. Above all they are an attempt to bridge a perceived gap in our understanding of the practicalities of implementing PPPs in the Candidate Countries.

### **Scope and Purpose of the Guidelines**

The Guidelines do not aim to provide a detailed guide to project design, appraisal and implementation but rather to focus on a number of critical issues influencing the successful integration of public grants, private funds, IFI loans (such as the EIB or EBRD) and European Commission financing. Reference is made to a number of analytical techniques which are well known and documented. These are not presented with the objective of promoting a standard methodology but rather in an attempt to highlight areas in which particular care and analysis needs to be observed. The Guidelines are not designed to provide an exhaustive list of PPP structures nor present any structures as having the endorsement of the Commission.

The Guidelines present five thematic parts dealing in turn with:

- PPP structures, suitability and success factors
- Legal and regulatory structures
- Financial and economic Implications of PPPs
- Integrating grant financing and PPP objectives
- Conception, planning and implementation of PPPs

*Part One* "Alternative PPP Structures" presents four broad categories of PPP structures each with increasing degrees of private sector involvement. It is stressed that while it is generally recognised that PPP presents an effective alternative to mobilising and using financial resources and that there are private sector efficiencies to be harnessed, they remain an evolving concept and do not represent the only or preferred solution to project financing. Indeed the terminology debate surrounding the definition of PPP categories itself mirrors the evolution of PPP approaches and the evolving regulatory environment defining PPP in Member States. As such PPPs must be carefully matched to the individual project characteristics. Guaranteeing benefit from PPP requires recognition of the relative strengths and weaknesses of each type of structure and the aims and

objectives of each party. Of particular importance is the role of the public sector which may transform itself from a service provider to an overseer of service contracts.

*Part Two* “Legal and Regulatory Structures” defines the legal environment for PPP projects. The importance of effective legal structures is stressed together with the fact that PPP implementation may require a review of existing legal provisions to ensure compatibility. PPPs will operate in a complex legal environment characterised by the interaction of the EU Acquis Communautaire, national, regional and municipal legislation, detailed project contractual documents and importantly, specific, procurement regulations. The legal situation in many CC’s is still evolving making careful legal due diligence an absolute requirement.

*Part Three* “Financial and Economic Implications of PPP” addresses the topic of risk management and its financial impact on a project. As the prime responsibility of the public sector is to ensure value for money for society, several techniques and considerations are presented for determining and assessing value. Grant financing is recognised as a useful tool in project financing but carries certain risks. Grants should be carefully matched to the actual needs of the project and beneficiary to minimise any negative effects, ensure project viability and value for money.

*Part Four* “Integrating grant financing and PPP Characteristics” addresses the relative strengths and weaknesses of grant financing and the opportunities offered. The ability to use grants in a PPP depends on the ability to meet the conditionalities attached and the ability to provide sufficient safeguards to protect the grant providers’ objectives. This section will also include a specific discussion of integrating European Commission grants into PPPs.

*Part Five* “PPP Conception, Planning and Implementation” considers the PPP project cycle with the objective of providing a detailed discussion of the issues encountered and possible solutions. It does not aim to provide a comprehensive guide but rather to focus on key issues likely to impact on effective design and implementation. These issues are considered separately below.

## **Key PPP Issues**

During the development of the Guidelines a number of key issues were identified as influencing the design of projects and their implementation. These are characteristic of grant financing in general and specific to cooperation with the European Commission. Their recognition and integration at an early stage is designed to facilitate both readier project acceptance by the Commission and more effective implementation.

*Ensuring open market access and competition.* A key requirement of Commission financing and indeed as part of the Acquis Communautaire, is that PPPs should not impact negatively on the operation of open markets nor on the clear and transparent rules of these markets. This issue is particularly relevant with respect to tendering and selection procedures for private partners, the use to which grants are put and the provisions made for renewing contracts (with special reference to the length of concession agreements). While regard must be taken to ensuring that private parties are able to realise financial returns by guaranteeing sufficient opportunity to generate revenues, this must be matched with a concern to avoid the creation of non competitive or closed markets. An impact is clearly on the designed duration of



concession contracts but also procurement procedures must respect the current body of Directives and above all the principles and rules of the Treaty setting out the need for open and fair competition, transparency and proportionality.

*Protecting the public's interest.* The European Commission's objective in developing control mechanisms is foremost to protect the public's interest. This manifests itself in many forms and will impact on project design, scope and implementation. Most notably Commission grants will require the adoption of European norms, quality and performance standards together with effective monitoring and management systems in local public sector partners. There will also be a degree of reassurance obtained at the tender, evaluation and contracting stages including the possibility for grant renegotiation particularly sensitive to sustainable local capacity if required. However there is also an important role for the public to play and therefore the creation of independent consumer groups and associations acting as "watchdogs" will be encouraged.

*Ensuring full compatibility between PPP arrangements and State Aid Rules.* Provision of grant financing must be matched to the real need for grants. In particular care must be taken that grants do not provide an unfair assistance to construction or operation thereby constituting unacceptable State Aid under the EU's interpretation.

*Defining the right level of grant contribution.* A particular concern of the European Commission is to ensure that its grants closely match real needs. This is not only to ensure financial efficiency but also that the maximum use is made of limited funds. A further concern is to achieve an effective balance between the desire to facilitate project realisation and, in the public's benefit, to limit the private sector's ability to achieve undue profit from grants. This requires careful calculation of actual financing requirements to achieve project viability. Consideration also needs to be given to avoiding the possibility that grants constitute incompatible state aid.

*Selection of the most suitable PPP type.* PPP arrangements should not be entered into merely for the sake of undertaking a PPP project. A detailed review of the costs and benefits of private sector involvement versus public alternatives must be undertaken to ensure that a PPP enhances the public benefit. The degree of private involvement needs to be carefully matched to the objectives and needs of the project and the public. Appropriateness, cost, the ability to effectively implement and manage should be the paramount considerations in selecting a PPP structure.

*Success and constraint factors.* The characteristics of projects, partners and implementation arrangements will create a series of constraints. These must be fully recognised and integrated. A PPP must be regarded as an active partnership requiring a degree of flexibility from each side. However the extent of flexibility must also be clearly defined to ensure that project boundaries are clearly known. The management of public grants imposes transparent rules on how private sector partners can be selected, how financing can be used and the benefits which parties can expect from the project, together with performance and quality requirements. However the European Commission can also play a valuable role in assisting public beneficiaries to protect the interests of their public.

*Timing.* Successful PPP design requires that all parties are brought together at an early stage. This is particularly important for the European Commission which, because of the need to carefully justify its use of grants, must undertake careful analysis of proposed PPP arrangements to ensure its objectives are met. Early Commission involvement and sharing of functions is therefore crucial and preferable if a grant is foreseen. Four situations can be considered where timing is a crucial issue in relation to grant attribution, namely; where a PPP exists, where a PPP is already under negotiation but a grant is required to enable it, where a Commission grant is awarded and a PPP is entered into and finally where a PPP is desired regardless of a grant. In each situation a Commission grant may be possible but certain pre-conditions must be met allowing the Commission to satisfy its requirements.

*Recognition of European Commission grant financing objectives and the best use of grant financing.* Grant financing, while attractive, carries a number of constraints. Grants have specific financing objectives, conditionalities and limitations. The project and its' different partners must be able to effectively integrate and accept these and manage their consequences.

*Future requirements.* PPPs are a developing concept and in some cases have required substantial reform of legal and financial systems in Member States to make their application possible. It can be expected that CCs will face similar difficulties in developing further effective frameworks within which PPPs can operate. This requires possibly actions to define the role of the public sector, institutional capacity building at all levels including the allocation of qualified and motivated staff to specialised PPP units, reduction of market risk through user-oriented strategic approaches and development of private sector investment facilitation mechanisms. Additionally the 'paying public' i.e. the consumer must also be integrated and given the power to influence PPP design and operation. This 'bottom up' influence is crucial to the sustainability of the PPP approach and will require coordination with NGOs, consumer associations and the public.

These Guidelines aim to highlight some of the important issues that need to be considered and addressed and will be supplemented with in-country training and further activities to strengthen implementation capacity.

Relevant authorities in Candidate Countries and Member States have the final responsibility for deciding on whether to use PPP or other financing vehicles.

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## PART 1 ALTERNATIVE PPP APPROACHES

### PART 1 – SUMMARY

- **PPP arrangements are growing in use and acceptance as an alternative and effective method to mobilize additional financial resources and benefits from private sector efficiencies**
- **PPP is not the only method to deliver project financing and realisation. It does not provide a ‘miracle’ solution nor a quick fix and should only be used where appropriate and where it is able to deliver clear advantages and benefits.**
- **A multitude of PPP structures exist and must be selected according to project type, needs and sector. There is no single perfect model.**
- **Each type of PPP has inherent strengths and weaknesses which need to be recognized and integrated into project design**
- **Each partner to a PPP has responsibilities. The Public sector must transform it’s role from a service provider to manager / monitor of private contractors.**
- **Guaranteeing and enhancing public benefit from PPPs will depend to a large degree on effective management and monitoring systems**
- **This Part will address:**
  - **PPP structures**
  - **Suitability of alternative structures**
  - **Requirements of PPP parties**
  - **Success factors for partnerships**

## 1 INTRODUCTION

While the assumption that the public sector is responsible for the delivery of basic services remains deeply entrenched in many countries, the methods by which these services are created, procured and delivered are changing. This reflects a greater need and desire for the public sector to work with and harness the benefits of the private sector.

There is a broad range of options for involving the private sector in the financing, physical development, and operation of transport and environment projects traditionally the domain of the public sector. As depicted in Figure 1, Public-Private Partnership (PPP) approaches are arrayed across a spectrum. At one end, the public sector retains all responsibility for financing,

constructing, operating and maintaining assets, together with the responsibility for assuming all associated risks. At the other end, the private sector assumes all of these responsibilities. The vast majority of PPP approaches fall in the middle of spectrum, with risks and responsibilities shared between the public sector and its private partners according to their strengths and weaknesses.

The aim of this section is to provide an overview of the variety of financing and operational PPP structures that are currently used and which could be matched to the needs of CCs and the use of Commission funding to leverage additional sources of capital that would not otherwise be available. This all-important phenomenon allows projects to be built with smaller levels of support from both grant financing

programmes and public resources in recipient nations.



**Waste Water Treatment Plant – Poland**

**The water and waste water sectors have gained considerable experience in implementing PPP type projects**

By moving beyond pure grant financing and supporting projects that limit private participation to simple outsourcing agreements, the Commission can demonstrate the potential of PPPs in markets which have limited experience with partnerships. In this context the European Commission can play an important role in demonstrating that when implemented under the right conditions, PPPs encourage efficiency and provide access to new capital funds. By limiting the need for public investment, PPPs can also help Candidate Countries (CCs) to implement much needed projects sooner by avoiding the need to wait for future government budget cycles for funding.

It should be noted that while these Guidelines refer to the specific situation of Commission grant financing, many issues are taken from general experience and are applicable to a wide range of scenarios. It is however not the purpose of the Guidelines to prejudge any future activity or initiative of the Commission in the field of PPP development or the application of grant financing either within the Member States or

the CCs. Indeed the Commission has noted<sup>3</sup> that “the issues relative to service concessions and public private partnerships merit a detailed analysis in order to evaluate whether specific legislation is required to permit more effective access to these arrangements by economic operators and to guarantee to these operators to rights afforded by the Treaty”. This is not the purpose of these Guidelines.

## **2 WHY PPP**

- **PPP have developed in part due to financial shortages in the public sector**
- **PPPs have demonstrated the ability to harness additional financial resources and operating efficiencies inherent to the private sector**

Recent years have seen a marked increase in cooperation between the public and private sectors for the development and operation of environmental and transport infrastructure. In the European Member States this has resulted, in part, from the privatisation of utilities, the development of large multinational utility operators and a general review of how public spending is undertaken including recent caps on spending limits to meet the Maastricht criteria requiring a diversification of funding sources.

While initial projects have often been in the water and road sector, with the construction of toll roads (representing clearly defined financial returns); there is a growing acceptance that PPP arrangements can be used to meet infrastructure and service needs in a wide variety of sectors.

Success of PPP projects, the increasing availability of private sector funds able to adopt a higher risk profile; and a generalised global trend to privatise utilities has resulted in attempts to introduce the PPP concept in the transforming economies of the Candidate

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<sup>3</sup> COM (2000) 275 final

Countries (CCs) of Central Europe. This is based on the existence of:

- An enormous financing requirement in the environment and transport sectors to upgrade and extend networks in line with the accession requirements and effective service provision
- An equally large financial shortfall in available public funds and the ability of international institutions to cover costs. This requires not only the identification of additional funding sources but also attention to the more effective use of public funds and to increasing their impact.

Additionally there is a growing realisation that cooperation with the private sector, in PPP projects, is able to offer a number of advantages, including:

- **Acceleration of infrastructure provision** - PPPs often allow the public sector to translate upfront capital expenditure into a flow of ongoing service payments. This enables projects to proceed when the availability of public capital may be constrained (either by public spending caps or annual budgeting cycles), thus bringing forward much needed investment.
- **Faster implementation** - the allocation of design and construction responsibility to the private sector, combined with payments linked to the availability of a service, provides significant incentives for the private sector to deliver capital projects within shorter construction timeframes.
- **Reduced whole life costs** - PPP projects which require operational and maintenance service provision provide the private sector with strong incentives to minimise costs over the whole life of a project, something that is inherently difficult to achieve within the

constraints of traditional public sector budgeting.

- **Better risk allocation** - a core principle of any PPP is the allocation of risk to the party best able to manage it at least cost. The aim is to optimise rather than maximise risk transfer, to ensure that best value is achieved.
- **Better incentives to perform** - the allocation of project risk should incentivise a private sector contractor to improve its management and performance on any given project. Under most PPP projects, full payment to the private sector contractor will only occur if the required service standards are being met on an ongoing basis.
- **Improved quality of service** - international experience suggests that the quality of service achieved under a PPP is often better than that achieved by traditional procurement. This may reflect the better integration of services with supporting assets, improved economies of scale, the introduction of innovation in service delivery, or the performance incentives and penalties typically included within a PPP contract.
- **Generation of additional revenues** - the private sector may be able to generate additional revenues from third parties, thereby reducing the cost of any public sector subvention required. Additional revenue may be generated through the use of spare capacity or the disposal of surplus assets.
- **Enhanced public management** - by transferring responsibility for providing public services government officials will act as regulators and will focus upon service planning and performance monitoring instead of the management of the day to day delivery of public services. In addition, by exposing public services to competition, PPPs

enable the cost of public services to be benchmarked against market standards to ensure that the very best value for money is being achieved.

International interest in PPPs is attributable generally to three main drivers:

- **Investment in infrastructure** - economic growth is highly dependent on the development and enhancement of infrastructure, particularly in utilities (such as power, water and telecommunications) and transport systems. Furthermore, in many countries there is an urgent need for new social infrastructure such as hospitals and healthcare equipment, prisons, education facilities and housing. For many governments this is seen as the most pressing area for private sector involvement.
- **Greater efficiency in the use of resources** - the experience of privatisation has shown that many activities, even those traditionally undertaken by the public sector, can be undertaken more cost effectively with the application of private sector management disciplines and competencies.
- **Generating commercial value from public sector assets** - significant amounts of public resources are invested in the development of assets such as defence technology and leading edge information systems that are then often used for a narrow range of applications within the public sector. Engaging private sector expertise to exploit these assets in a wider range of applications can lead to the realisation of substantial incremental value for the public sector.

However while certain advantages do exist and can be harnessed, PPP should not be regarded as representing a miracle cure nor indeed a quick fix to infrastructure and service development. PPP should be

regarded as an option amongst a range of possible tools to be applied only where the situation and project characteristics permit it and where clear advantages and benefits can be demonstrated. Indeed consideration of PPP should not preclude other options including the traditional public – public models.

### **3 PPP STRUCTURES**

- **Many forms of PPP exist and are continuously being developed to suit project characteristics**
- **Main defining feature is the degree of private control over and involvement in financing**
- **There is no unique model nor do the Guidelines suggest the development of one. Each project will define what is suitable and what is required**

The following, *non-exhaustive*, discussions describe a number of possible PPP structures. It should be understood, however, that the PPP process is extremely dynamic and that the particulars of most arrangements are tailored to the specific circumstances involved. At the same time, many of the individual components used to design and structure specific partnerships (i.e. contract terms, in-kind contributions, financing facilities, or grants) can be used with a number of different PPP approaches. There can therefore be no one generic or ‘best’ model of PPP structure, nor does the Commission make any recommendations as to the suitability of individual structures.

A PPP is a partnership between the public sector and the private sector for the purpose of delivering a project or a service traditionally provided by the public sector. PPPs recognise that both parties have certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.




The overall aim of PPPs is therefore to structure the relationship between the parties, so that risks are borne by those best able to control them and increased value is achieved through the exploitation of private sector skills and competencies.

In order to work successfully with the private sector, public bodies need to be clear about the fundamental principles and objectives behind PPP. Under PPP arrangements, private sector contractors become long term providers of services rather than simply upfront asset builders, combining the responsibilities of designing, building, operating and possibly financing assets in order to deliver the services needed by the public sector. As a result, central and local government agencies become increasingly involved as regulators and focus resources on service planning, performance monitoring and contract management rather than on the direct management and delivery of services. The result is that the public mission is delivered through the private sector.

Designed appropriately, PPPs can generate substantial benefits for consumers and taxpayers. The scope of potential benefit will, however, depend on the type of project being undertaken and the exact terms of the contract governing the PPP. It is important to note that public bodies have a critical role to play in the management and regulation of PPP during their design, construction and operation. PPPs also require effective contract monitoring procedures to ensure

that contractual obligations continue to be met in terms of both quality and timing. These issues are the subject of the following sections.

It is also essential to recognize that the nomenclature used to describe the partnership process has not been standardized. There are several terms often used interchangeably – turnkey and build-operate-transfer (BOT), for example. There are also single terms that are used loosely and can be applied to situations that are fundamentally different. For example, BOT can be used to describe procurements that involves private financing, as well as those that do not. As such, it is necessary for PPP practitioners to delve beyond the terms and concepts and become familiar with the way in which the partnership process itself works. Indeed the terminology debate surrounding the definition of PPP categories itself mirrors the evolution of PPP approaches and the evolving regulatory environment defining PPP in Member States.

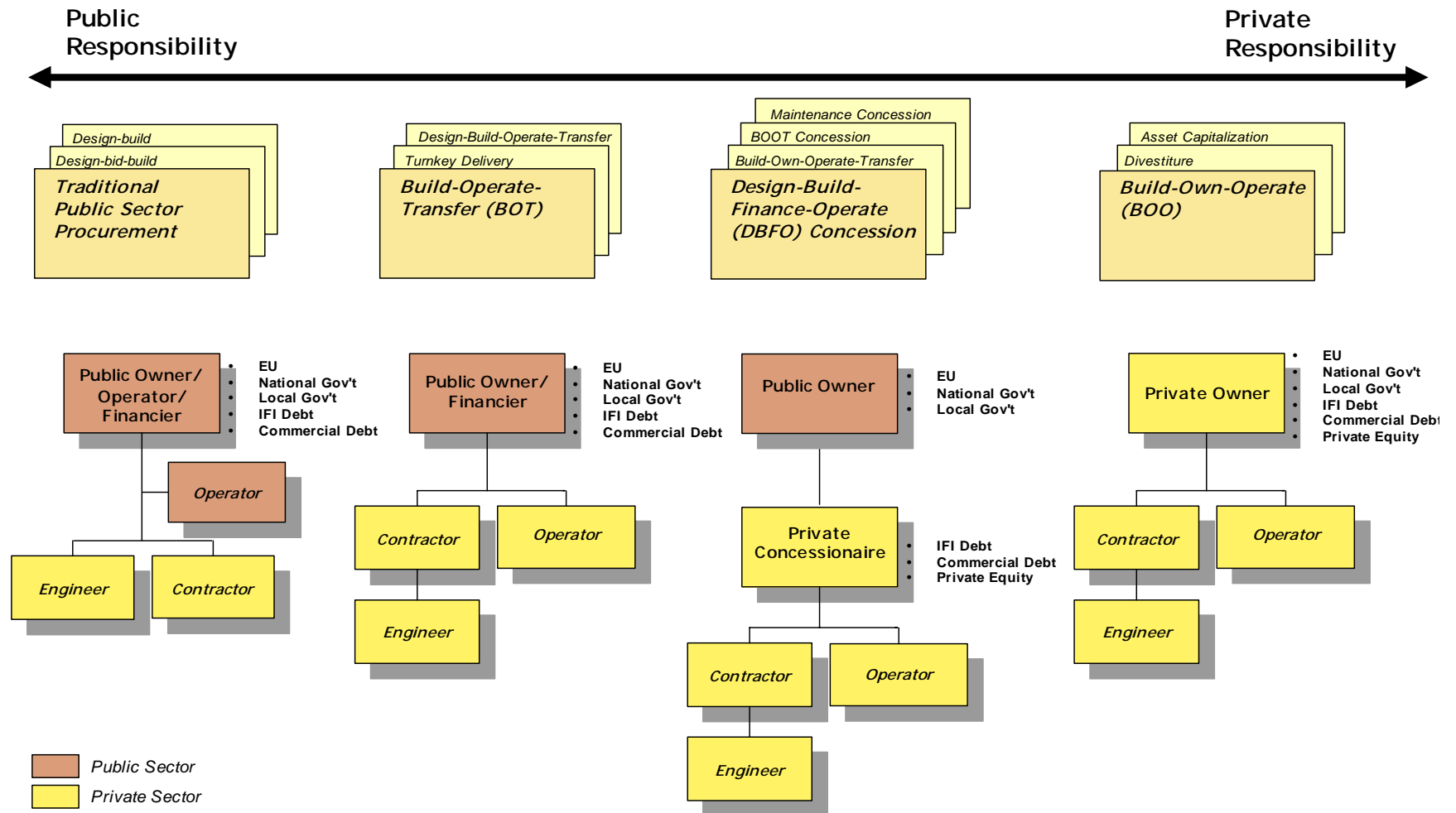
 ***A significant body of text now exists describing PPP structures and their applicability. The bibliography presents some of these including useful contact points for further information***



**The Channel Tunnel - linking France and Britain.**

**The Project, costing approximately Euro 15 billion, met with considerable delay, cost overruns and financing problems. In a major overhaul of project organization – increased responsibility was given to the private sector to manage the construction and financing process.**

Figure 1  
Project Procurement Options



At present, Community Law does not have a specific definition of PPP. Each type of arrangement is defined by individual Community Legislation governing operational structures and procurement. However the Commission's Interpretative Communication on Concessions<sup>4</sup> suggests that the principal criteria for distinguishing concessions from other PPP type structures is the extent of risk transfer to the private party. This criteria will then also allow each type of PPP to be defined and related to the relevant legislation and methods for selecting private parties. While the choice of PPP structures is limitless in terms of financial and legal forms, the Commission is of the view that all PPPs can be defined in relation to the rules governing the choice of private partners and the selection and application of public procurement procedures. As a result PPPs, whether for works and / or services, are:

- Covered under the detailed provisions of Public Procurement Directives
- Covered by the rules and principles of the Treaty as set out in the Interpretative Communication and jurisprudence.

While it is not possible at this stage to define all possible types of PPPs according to the application of public procurement of concession rules, it is extremely important for PPP sponsors to develop a detailed understanding of the Commission's perspective and to correctly categorise their choice of PPP structure before entering into contractual arrangements.

The following sections present various forms of PPP relationships moving from minimal to maximal private sector involvement. These definitions are based on internationally recognized nomenclature but unlike a 'legalistic' definition of PPP or procurement derived from the Procurement Directives, these are based on the extent of risk and responsibility transfer to the private party.

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<sup>4</sup> JOCE C/121 of 29 April 2000



*Further assistance and clarification on the Commission's interpretation can be obtained directly from DG Market and DG Competition.*

### **3.1 Opportunities for Private Involvement in Traditionally Procured Projects**

Traditionally, governments in most CCs have relied on public procurement to develop their infrastructure systems. With this approach designated government agencies, such as a ministry or public authority are vested with responsibility for developing certain types of infrastructure. These agencies typically elaborate master plans prioritizing needs and then arrange the financing, design, and construction of individual projects. Once a project is completed it is then operated and maintained by the agency, together with the other assets under its care.

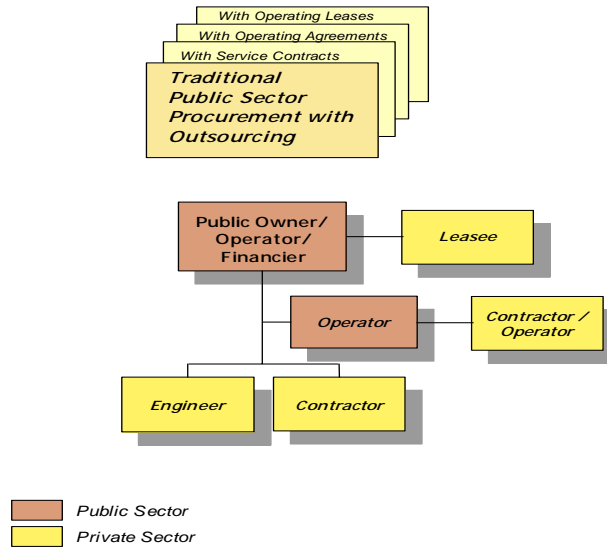
Under the traditional public procurement model, government agencies can utilize the services of the private sector for design and construction, with the award of individual contracts made on a competitive basis.<sup>5</sup> However, private sector participation usually does not extend beyond these functions. There are a number of ways in which greater private sector participation can be introduced as depicted in figure 2.

Three approaches for outsourcing former public functions to the private sector are described below. These mechanisms present opportunities for the private sector to participate in varying degrees in the maintenance, operation and management of infrastructure improvements.

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<sup>5</sup> In certain cases in CCs design and construction functions may have been fulfilled by publicly owned companies, or directly by agency staff.

Figure 2  
*Private Participation  
Options with Traditional  
Public Sector Procurement*



### 3.1.1 Service Contracts

Public agencies can enter into service contracts with private sector companies for the completion of specific tasks. Service contracts are well suited to operational requirements and may often focus on the procurement, operation and maintenance of new equipment. These tasks could include areas such as toll collection, the installation, maintenance and reading of meters in the water sector, waste collection or the provision and maintenance of vehicles or other technical systems.

Service contracts are generally awarded on a competitive basis and extend for short periods of time of a few months up to a few years. They allow public agencies to benefit from the particular technical expertise of the private sector, manage staffing issues, and achieve potential cost savings. Nonetheless, with service contracts management and investment responsibilities remain strictly with the public sector. While they afford certain benefits, service contracts cannot address underlying management or cost issues affecting poorly run organizations.

### 3.1.2 Operation and Management Contracts

Public operating agencies utilize management contracts to transfer responsibility for asset operation and management to the private sector. These comprehensive agreements transfer involve both service and management aspects and are often useful in encouraging enhanced efficiencies and technological sophistication. Management contracts tend to be short term, but often extend for longer periods than service agreements. Contractors can be paid either on a fixed fee basis, or on an incentive basis where they receive premiums for meeting specified service levels or performance targets.

Management contracts may be used as a means to transfer responsibilities for a specific plant, facility or service provided by an infrastructure owner. They may have a more broad reaching scope involving the management of a series of facilities. Nonetheless, responsibility for investment decisions remains with the public authority.

Operation and management contracts often provide a good opportunity to encourage greater private sector involvement in the future. They are particularly appropriate in sectors undergoing transition from public ownership where existing regulatory and legal frameworks may not allow greater private participation. They can be helpful in generating trust between the public and private sectors in markets where there has been little experience with PPPs. They also provide a means for private companies to test the waters in potentially risky markets with limited risk exposure. While operation and management contracts should be expected to improve service quality, they cannot be expected to improve service coverage or encourage tariff reform.

### **3.1.3 Leasing**

Leases provide a means for private firms to purchase the income streams generated by publicly owned assets in exchange for a fixed lease payment and the obligation to operate and maintain the assets. Lease transactions are different from operations and management contracts in that they transfer commercial risk to the private sector partner, as the lessor's ability to derive a profit is linked with its ability to reduce operating costs, while still meeting designated service levels.

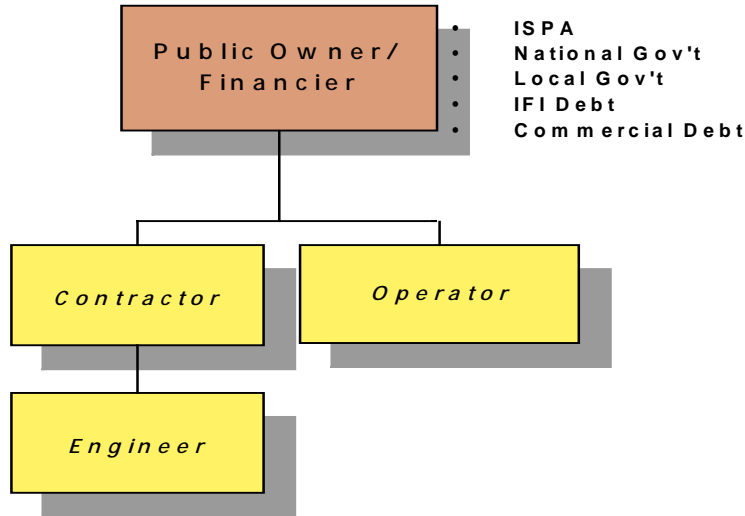
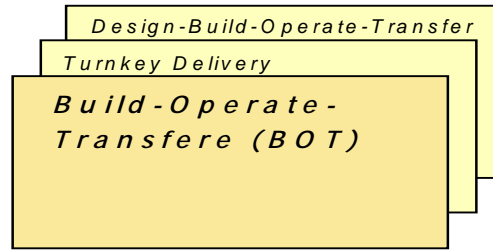
Leases are similar to operations and management contracts in that the responsibility for capital improvements and network expansion remains with the public sector owner. However, in certain cases the lessor may be responsible for specified types of repairs and rehabilitation. Under the right conditions, private companies entering into lease agreements might also make targeted

capital improvements in order to improve operating efficiencies and profit levels. However, responsibility for planning and financing overall investment and expansion programs remains with the public sector owner. Lease agreements can be expected to extend for a period of five to fifteen years. They are suitable only for infrastructure systems that generate independent revenue streams, and are often used in the public transport and water sectors.

Traditional procurement can also be used to cover the design and build functions either bundled or separately. As with the examples above, ownership of assets remains with the public body and the private sector is responsible only for well-defined tasks adopting limited responsibility.

### **3.2 Integrated Project Development and Operation Opportunities**

The functions described above involve instances where limited responsibilities normally assumed by the public sector are passed to private companies. However, the functions involved are at once discrete and relatively isolated – a fact which limits the potential benefits that the owner can derive from its partnership with the private sector. Integrated partnerships involve transferring responsibility for the design, construction, and operation of a single facility or group of assets to a private sector partner. This project delivery approach is practiced by several governments around the world and is known by a number of different names, including “turnkey” procurement and the “build-operate-transfer” (BOT) system.



The advantage of the BOT approach is that it combines responsibility for usually disparate functions – design, construction, and maintenance – under one single entity. This allows the partners to take advantage of a number of efficiencies. First of all, the project design can be tailored to the construction equipment and materials that will be used. In addition, the contractor is also required to establish a long-term maintenance program up front, together with estimates of the associated costs. The contractor’s detailed knowledge of the project design and the materials utilized allows it to develop a tailored maintenance plan over the project life that anticipates and addresses needs as they occur, thereby reducing the risk that issues will go unnoticed or unattended and then deteriorate into much more costly problems. The benefits of this “life cycle costing” are particularly important as most infrastructure

owners spend more money maintaining the systems than on development. In addition, the life-cycle approach removes important maintenance issues from the political vagaries affecting many public maintenance budgets, with owners often not knowing how much funding will be available to them from year to year. In such cases they are often forced to spend what money they do have on the most pressing maintenance needs rather than adopting a more rational and cost effective preventive approach.

The public sector awards BOT contracts by competitive bid following a transparent tender process. Tenderers respond to the specifications provided in the tender documents and are usually required to provide a single price for the design, construction and maintenance of the facility for whatever period of time is specified.<sup>6</sup>

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<sup>6</sup> Depending on the terms of the tender, Tenderers may be given some flexibility in preparing payment schedules.

Tenderers are also required to submit documentation on their qualifications, thereby allowing evaluators to compare the costs of the different offers as well as ability of the Tenderers to meet their specified needs.

While the potential exists to reap substantial rewards by utilizing the integrated BOT approach, project sponsors not accustomed to this approach must take great care to specify all standards to which they want their facilities designed, constructed, and maintained. With a BOT approach the public sector relinquishes much of the control they typically possess with more traditional project delivery, and unless needs are identified up front as overall project specifications, they will not generally be met.

It should also be noted that an integrated BOT approach alone does not relieve public sector owners of the burden of financing the related infrastructure improvements. From design through operation, BOT contracts can extend for periods of up to twenty years or more. They involve the construction and

operation of major infrastructure systems, such as wastewater treatment plants or mass transit systems.

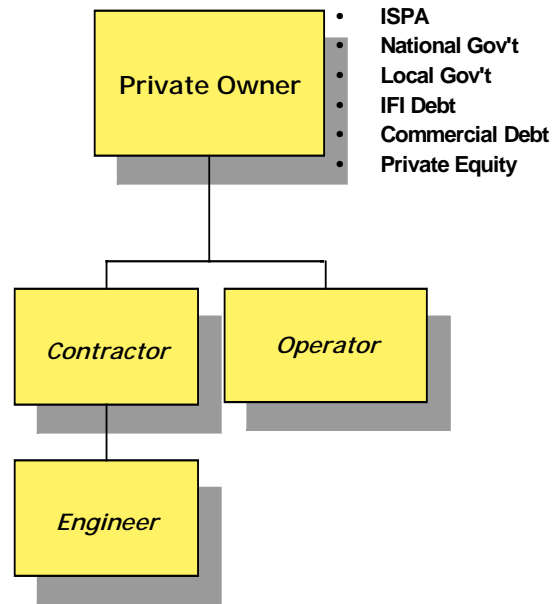
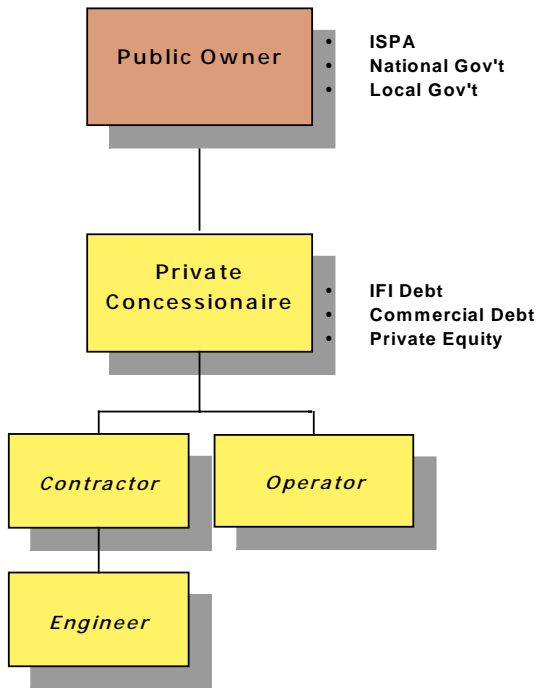
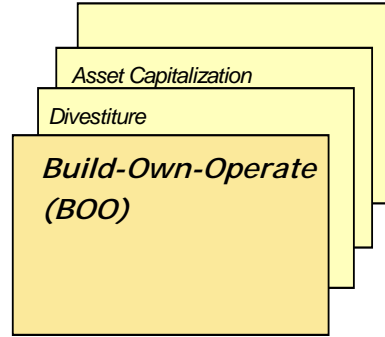
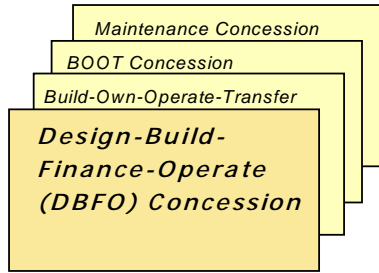
### **3.3 Partnership Project Development and Investment Opportunities**

The structures described above provide new opportunities for the private sector to perform tasks that would otherwise be undertaken by the public sector. However, PPP arrangements can also involve private sector financing for projects that would otherwise be fully financed by the state. These types of PPP arrangements are particularly attractive as they afford all the implementation and operational efficiencies described early, together with new sources of capital. Access to additional sources of capital allows owners to implement important projects sooner by avoiding the need to wait for future government budget cycles for funding.



**The Vasco de Gama Bridge – Portugal**

**Portugal is considered a reference on how coordinated efforts can develop an economy. In particular experience of project financing show the benefits of public and private partnerships as for example the financing of the Vasco de Gama Bridge**



**3.3.1 Concessions**

The primary vehicle for PPP opportunities involving direct private sector investment is the design-build-finance-operate (DBFO) concession agreement. These agreements enable a private investment partner to finance, construct, and operate a revenue generating infrastructure improvement in exchange for the right to collect the associated revenues for a specified period of time. Concessions can be awarded for the construction of a new asset or for the modernization, upgrade, or expansion of an existing facility.

Concessions often extend for a period of 25 to 30 years, or even longer, and are awarded under competitive bidding conditions. Under a concession approach the ownership of all assets, both existing and new, remains with the public sector. It is their responsibility to ensure that the assets are properly used and maintained during the concession period and that they are returned in good condition when it is over.

Concessions are generally awarded based on following criteria:

- The end price offered to users
- The level of financial support required from the government and other grantors
- Ability to implement the project.



The Commission is currently reviewing its definition and approach to concessions given the interest shown in their application in the Member States. This is addressed in greater detail in Part 2 particularly with respect to safeguarding open market access and fair competition;

Oversight of the award, implementation, and operation of PPP concessions is a complex task. As such, it is often common practice for governments to establish dedicated, stand-alone state agencies or special purpose vehicles (SPV) with the sole responsibility of overseeing PPP projects. Implementation agencies are likely to require staff with sophisticated financial and legal experience that goes beyond that of many public infrastructure owners. This is particularly important for CCs where the infrastructure investment market is still considered risky due in part to incomplete legislative and institutional structures, let alone the lack of comprehensive experience in project financing, structuring and implementation.

### **3.3.2 Private Divestiture**

Private divestiture involves the sale of assets or shares of a state-owned entity to the private sector. Divestitures can be approached in many different ways, and can be either partial or complete. Divestiture is also often an integral part of the transformation of state-owned enterprises in CCs and can be used as a vehicle to transfer the ownership of assets from the central government to local governments and / or to private utility companies. The following discussion on divestiture addresses the sale of assets to private investors only.

#### **3.3.2.1 Complete Private Divestiture**

In the case of a complete divestiture, the entire assets of a utility would be sold either to a single investor, a group of investors, or possibly through a management buyout. In

certain cases a divestiture can also be accomplished by making shares in the company available for purchase on the national stock market. A complete divestiture is similar to a concession in certain ways, as it gives the private investor complete control over investment in, and the operation and maintenance of whatever assets the company possesses. However, unlike concessions, divestiture also gives the private sector ownership of the assets themselves, and that ownership is permanent. As such, the government relinquishes further control with a divestiture approach, maintaining only a regulatory role, protecting consumers from monopolistic pricing and, in some cases, perhaps requiring a minimum maintenance and investment regimen.

Divestiture is likely to be particularly sensitive when it involves assets of national significance, such as a water resources or highway networks. In addition to ideological impediments, there may well also be constitutional and legislative issues to be overcome. However, in cases where local managerial capabilities are strong and where there are local investors who may be interested in supporting such a venture, divestiture may provide a way to achieve private sector efficiency gains while keeping control over the assets – and the revenues they generate – within the country. This has proven an effective strategy with the privatization of former state motorway authorities in Portugal and Italy, for example, or water resources in Slovenia and Estonia.

#### **3.3.2.2 Partial Private Divestiture**

With a partial private divestiture, the government would retain ownership of a certain portion of the former public company's assets. This is often a more attractive alternative to those governments or authorities who wish to maintain a certain level of control in the management of the assets. In such cases, the interplay of

responsibilities between the public and private sectors is blended. A partial divestiture is an excellent way for the public sector to attract private capital and encouraging improvements in operational and management efficiency, while also protecting the public consumers as well as assets of national significance. The individual arrangements for sharing responsibility for management and investment decisions depend on the division of assets, as well as the sharing of costs. Therefore, they would need to be established on an individual basis. It is likely that the public sector would transfer as much of the costs as possible to its private partner. However, in order for a partial divestiture to be attractive to private investors there would have to be a reasonable scope for making a fair profit on its investment.

#### **4 THE SUITABILITY AND EFFECTIVENESS OF ALTERNATIVE PPP STRUCTURES**

- **Each PPP structure has strengths and weaknesses which must be recognized and integrated**
- **PPP does not provide a ‘quick fix’ and should be applied only where suitable and when clear benefits and advantages can be demonstrated**
- **PPP structures must be adapted to sectoral and project context**
- **Desired impacts and benefits will influence PPP selection and design**

Table 1 summarises the advantages and disadvantages of the four main groupings of PPP relationships. It also provides suggested sectoral applications which are further discussed below. The selection of a suitable PPP arrangement is a complex task and must be based on individual project characteristics and needs (this is discussed further in Part 5).



*Considerable experience has been gained in Member States with the different PPP forms and in a broad range of sectors. This experience can be accessed directly from the Member State PPP units details of which can be found in the reference section.*

#### **4.1 Suitability to Transport Projects**

Some of the most important issues that will influence the selection of a preferred form of PPP for projects in the transport sector are the size and scope of the project, the ability to apply user tolls and the extent of risk transfer required. Major and minor roads schemes or mass transit systems are well suited to traditional design and build contracts, as operating costs in a typical scheme are low when compared to the capital costs of construction.

Traditional procurement contracts are essentially an extension of the existing conventional approach, endeavouring to transfer design and construction risk to the private sector through fixed price contracts. In such instances responsibility for maintaining the infrastructure will remain within the Public sector. In some instances, the construction of, particularly, a major road scheme may be funded in part or in whole by user tolls. For example, bridges and tunnels are particularly suited to user tolling where there is a clear benefit to be gained from choosing the tolled route over a different alternative route. In such circumstances, the public sector must decide whether to transfer responsibility for financing the project and collecting tolls to the private sector contractor.

Different types of PPP contracts are already being implemented in Europe. Toll motorway concession contracts are suitable where the private sector contractor will finance a major road scheme, collect user tolls and bear the risk associated with traffic

demand. BOT contracts are more suitable where the private sector will receive user fees paid by the public sector, but the public sector will finance the project and accept the risk associated with demand. Shadow toll DBFO contracts are likely to be more suitable where the private sector contractor will accept some of the risk associated with traffic demand, but user tolls are not applied. A number of major roads projects have been undertaken in England, Finland, Scotland, Spain and Portugal on this basis and the private sector contractors are paid on the basis of *Shadow Tolls*. However, there are also a range of disadvantages associated with this approach including the greater level of demand risk retained by the public sector and the fact that as motorists do not pay for the economic cost of infrastructure provision, infrastructure investment may not be rationally allocated.

Minor projects are more suited to traditional design and build contracts and are not likely to be suitable for other forms of PPP unless bundled together into a larger contract with a significant operating element.

**Table 1: Advantages and Disadvantages of PPP Relationships**

PPP Type	Main Features	Application	Strengths	Weaknesses
<b>Contracting</b>	<ul style="list-style-type: none"> <li>Contract with Private party to design &amp; build public facility</li> <li>Facility is financed &amp; owned by public sector</li> <li>Key driver is the transfer of design and construction risk.</li> </ul>	<ul style="list-style-type: none"> <li>Suited to capital projects with small operating requirement.</li> <li>Suited to capital projects where the public sector wishes to retain operating responsibility.</li> </ul>	<ul style="list-style-type: none"> <li>Transfer of design and construction risk.</li> <li>Potential to accelerate construction programme.</li> </ul>	<ul style="list-style-type: none"> <li>Possible conflict between planning and environmental considerations.</li> <li>May increase operational risk.</li> <li>Commissioning stage is critical.</li> <li>Limited incentive for whole life costing approach to design.</li> <li>Does not attract private finance</li> </ul>
<b>BOT</b>	<ul style="list-style-type: none"> <li>Contract with a private sector contractor to design, build and operate a public facility for a defined period, after which the facility is handed back to the public sector.</li> <li>The facility is financed by the public sector and remains in public ownership throughout the contract.</li> <li>Key driver is the transfer of operating risk in addition to design and construction risk.</li> </ul>	<ul style="list-style-type: none"> <li>Suited to projects that involve a significant operating content.</li> <li>Particularly suited to water and waste projects.</li> </ul>	<ul style="list-style-type: none"> <li>Transfer of design, construction and operating risk</li> <li>Potential to accelerate construction</li> <li>Risk transfer provides incentive for adoption of whole life costing approach</li> <li>Promotes private sector innovation and improved value for money.</li> <li>Improved quality of operation and maintenance.</li> <li>Contracts can be holistic</li> <li>Government able to focus on core public sector responsibilities.</li> </ul>	<ul style="list-style-type: none"> <li>Possible conflict between planning and environmental considerations.</li> <li>Contracts are more complex and tendering process can take longer</li> <li>Contract management and performance monitoring systems required.</li> <li>Cost of re-entering the business if operator proves unsatisfactory.</li> <li>Does not attract private finance and commits public sector to providing long term finance.</li> </ul>
<b>DBFO</b>	<ul style="list-style-type: none"> <li>Contract with a private party to design, build, operate and finance a facility for defined period, after which the facility reverts to the public sector.</li> <li>The facility is owned by the private sector for the contract period and it recovers costs through public subvention.</li> <li>Key driver is the utilisation of private finance and transfer of design, construction &amp; operating risk.</li> <li>Variant forms involve different combinations of the principle responsibilities.</li> </ul>	<ul style="list-style-type: none"> <li>Suited to projects that involve a significant operating content.</li> <li>Particularly suited to roads, water and waste projects.</li> </ul>	<ul style="list-style-type: none"> <li>As for BOT plus:</li> <li>Attracts private sector finance;</li> <li>Attracts debt finance discipline;</li> <li>Delivers more predictable and consistent cost profile;</li> <li>Greater potential for accelerated construction programme; and</li> <li>Increased risk transfer provides greater incentive for private sector contractor to adopt a whole life costing approach to design.</li> </ul>	<ul style="list-style-type: none"> <li>Possible conflict between planning and environmental considerations.</li> <li>Contracts can be more complex and tendering process can take longer than for BOT.</li> <li>Contract management and performance monitoring systems required.</li> <li>Cost of re-entering the business if operator proves unsatisfactory.</li> <li>Funding guarantees may be required.</li> <li>Change management system required.</li> </ul>
<b>Concession</b>	<ul style="list-style-type: none"> <li>As for DBFO except private party recovers costs from user charges.</li> <li>Key driver is the <i>Polluter Pays Principle</i> and utilising private finance and transferring design, construction and operating risk.</li> </ul>	<ul style="list-style-type: none"> <li>Suited to projects that provide an opportunity for the introduction of user charging.</li> <li>Particularly suited to roads, water (non-domestic) and waste projects.</li> </ul>	<ul style="list-style-type: none"> <li>As for DBFO plus:</li> <li>Facilitates implementation of the <i>Polluter Pays Principle</i>; and</li> <li>Increases level of demand risk transfer and encourages generation of third party revenue.</li> </ul>	<ul style="list-style-type: none"> <li>As for DBFO plus:</li> <li>May not be politically acceptable</li> <li>Requires effective management of alternatives / substitutes, eg alternative transport routes; alternative waste disposal options)</li> </ul>

#### 4.2 Suitability to Water Projects

## 4.2 Suitability to Water Projects

Public Private Partnerships have existed in the international water sector for a number of years. For example, private sector concessions for the development and operation of water supply and treatment plants have been common place in France for at least forty years, leading to the growth of the large and diversified French private sector utility companies. The European Union Drinking Water Directive and the Urban Waste Water Directive have resulted in a substantial change in public sector responsibility within the water industry. In order to meet the requirements of the Directives, many countries will have to invest substantial amounts of capital in new water supply and waste water treatment facilities. As a result, countries that have not yet involved the private sector in water supply or waste water treatment, are now considering the potential to make use of private sector skills and finance to satisfy the requirements of the Directives.

The considerations that will shape the selection of a preferred form of PPP for projects in the water sector are similar to those in the transport sector and include the size and scope of the project (including its operational content), the ability to apply user charging and the extent of risk transfer required.

The construction of water supply or waste water networks under PPP arrangements is likely to be linked to the level of information available on the extent, composition and performance of existing networks. If information is not sufficient traditional procurement arrangements may be more suitable. On the other hand, water supply and waste water facilities are likely to be very suited to BOT and DBFO contracts. They may also be suited to Concession contracts where there is an opportunity to introduce user charging. However, water supply and waste water facilities are considered to be less suited to traditional procurement design and build contracts as the public sector would retain

the risks associated with operating increasingly complex treatment processes, without having had a role in the design of those processes.

## 4.3 Suitability to Waste Projects

More recently, the use of PPPs has been stimulated in sectors where there has been a significant increase in the burden of traditional public sector responsibilities and this is particularly true with regard to the disposal of municipal waste. Increasingly, for economic and environmental reasons, public authorities are reducing their reliance on landfill which has been the traditional means of disposing of waste. New methods of waste disposal such as waste to energy schemes and recycling plants require substantial investment and specialised technical know-how.

The considerations that will shape the selection of a preferred form of PPP are similar to those for the transport and water sectors and include the size and scope of the project (including operational content), the ability to apply user charging and the extent of risk transfer required. Projects in the waste sector are likely to be very suited to the more developed forms of PPP where a significant amount of operating risk can be transferred to the private sector. In addition, under a Concession contract, the private sector can be asked to finance the project, collect user charges (in accordance with the *Polluter Pays* principle) and accept the risk associated with waste volumes. This is now being widely applied in the UK.

Table 2 summarizes the ability of the PPP structures to meet a range of desirable performance indicators. The various PPP structures are arrayed in increasing order of private participation from top to bottom on the table. It can be seen that as private sector participation increases, so too does the potential for achieving a wide variety of infrastructure goals. However, it also needs to be recognized that greater private sector participation in infrastructure

development also brings with it increased implementation constraints, particularly when private investment is involved. These constraints may well become further

complicated when Commission grant funding is involved.

**Table 2  
The Effectiveness of Alternative PPP structures**

	Improved Service	Enhanced Operational Efficiency	Enhanced Risk Sharing	Life Cycle Costing	Accelerated Implementation	Leveraging of Public Funds	Implementation Constraints
<b>Private Outsourcing</b>							
Service Contracts	Possible	Yes	No	No	No	No	Low
Management Contracts	Yes	Yes	No	No	No	No	Moderate
Leasing	Possible	Yes	Some	Possible	No	No	Moderate
<b>Integrated Private Development</b>							
BOT	Yes	Yes	Some	Yes			High
<b>Private Investment</b>							
DBFO Concessions	Yes	Yes	Yes	Yes	Yes	Yes	Very High

As demonstrated, private outsourcing arrangements have the ability to affect service improvements and gains in operational efficiency. However, their ability to enhance risk sharing or capture more important life cycle costing efficiencies is limited. These latter indicators can be somewhat enhanced with certain types of leases, but the extent to which this is possible depends both upon the required service standards and the duration of the lease agreement. Given that they do not involve private sector capital investment, outsourcing partnerships have no ability to accelerate project implementation or leverage public funds. Therefore these approaches are best suited to situations where improvements in operational efficiency are desired, but where there is little need for major capital improvements.

Like outsourcing, BOT arrangement can enhance both operational and service indicators. In addition they also bring about extensive life cycle cost benefits. Although certain risk elements are shared, pure BOT structures do not involve private investment and therefore cannot be expected to leverage funds.

The BOT approach is appropriate when owners need to embark on new capital projects and hope to achieve greater operational efficiencies. They can also streamline both implementation costs and the implementation process as a whole. BOT projects can prove a useful first step in moving towards future partnerships involving private investment, as they provide the opportunity to demonstrate the types of savings and efficiencies private sector involvement can bring to infrastructure development.

PPPs involving private investment provide the potential to achieve all the cost and operational efficiencies associated with the BOT approach. In addition, the benefits leveraging and accelerated project implementation are also added. As such, investment partnerships have the potential to deliver maximum benefits to the public sector. However, these arrangements also introduce legal and regulatory concerns, and require sophisticated management on the part of the government to insure that its requirements are met. Therefore, in order to justify the considerable effort involved in resolving such issues, investment partnerships are often best suited to larger and more costly projects.

## 5 REQUIREMENTS OF THE PPP PARTNERS

- **PPP requires active participation of all partners**
- **All partners must recognize and address the objectives and characteristics of each other**

It is important to recognize that the different participants in PPP projects have distinct goals and requirements that must be met in order for them to be able to participate in an effective partnership. While certain goals are complimentary; others are not, and as the number of players increases, so too will the complexity of establishing a fair playing ground for the various participants.

Table 3 identifies the different players that may be involved in partnership projects and arrays their likely requirements when operating under the partnership structures discussed earlier. Predictably, as the level of private sector participation increases, so do the number of participants and the requirements of all partners, public and private alike.

For private sector participants, the first requirement for any type of involvement is the potential to derive a reasonable profit. In addition, in return for greater risk exposure, the private sector will also require the potential for commensurate increases in profit potential. Similarly, before committing its own capital in the development of projects, it will require clear legal and regulatory structures, and will want to see the potential for future economic growth, together with reasonable levels of political support and stability.

While the public sector supports efficiency improvements, the private sector's motivation for profit introduces conflicts of interest with beneficiary governments, which are committed to promoting equity and maximizing the well being of their citizens. However, governments are generally willing to allow their private

partners to make a reasonable profit in exchange for improving service and efficiency, leveraging its own financial resources, expediting project implementation. Beneficiary governments may also be concerned about the overall ease of implementation when using outside or donor funds to support partnership projects.

It is also important to recognize that the Commission introduces its own set of requirement attached to its financing. In such cases, the improvements afforded by the project will have to meet European standards and also provide other societal benefits which may not always be easy to quantify in economic terms. Like beneficiary governments, the Commission is eager to achieve gains in efficiency and leverage existing financial resources, but as a donor of grant funds it is also interested in avoiding unfair private sector profit levels, as well as maintaining transparency in the award of all contracts. Furthermore, the Commission also seeks to protect its grants by maintaining some control of the funds after they have been released to the beneficiary.

Finally, partnerships involving private investment are also likely to require loans and guarantees provided by international financial institutions (IFIs), such as the EIB (see box) and commercial banks. Such institutions will require rigorous and conservative financial analysis in exchange for their participation. They will also need clear proof regarding the certainty of outside and State funding, as well any equity contributions to be made by the private sector. Lenders will also need proof of the technical ability of the private operator, as well as the beneficiary government's ability to oversee the implementation and operation of the project. In addition, lenders will require that clear regulatory and legal structures be in place to govern investment partnerships, and they will also be interested in the general stability of the political environment in the beneficiary nation. It should be recognized that as regular participants in PPP infrastructure partnerships, IFIs and commercial banks

are well versed in the potential pitfalls and in turn have developed comprehensive financial modeling and due diligence practices that will have to be satisfied

before their participation can be assured. Examples of the different requirements of the parties in various PPP arrangements are set out in table 3.

**The EIB (European Investment Bank) has supported the development of about 100 PPPs to-date in most EU countries for a total amount of signed loans over EUR 15 billion. On the basis of its multi-sectoral know-how, geographical spread and PPP-deal making experience, EIB is well positioned to assist both public authorities and private investors in the CEEC to successfully implement PPP projects. In doing so, it seeks to provide significant added value to all interested parties by sharing its experience, applying best practice and offering long-term funding on attractive terms. In this way, the Bank not only aims to bring about the successful financing of PPPs but also to ensure value-for-money to the public sector as a whole.**



**Table 3. Requirements of PPP Partners under Different PPP Arrangements**

<b>Private Sector Requirements</b>	<b>Service Contracts</b>	<b>Management Contracts</b>	<b>Leases</b>	<b>BOT Agreements</b>	<b>DBFO Concessions</b>	<b>Partial Divestiture</b>	<b>Full Divestiture</b>
Fair Profit	Required	Required	Required	Required	Required	Required	Required
Reward for Risk Mitigation	–	–	Desirable	Desirable	Required	Required	Automatic
Clear Legal / Regulatory Structure	–	–	Required	Required	Required	Required	Required
Growth Potential	–	–	Desirable	–	Desirable	Desirable	Desirable
Political Support	–	–	Desirable	Desirable	Required	Required	Required
Political Stability	–	–	–	Desirable	Desirable	Desirable	Desirable
<b>Beneficiary Government Requirements</b>							
Leveraging Funding	–	–	–	Yes	Important	Important	Important
Accelerating Project Implementation	–	–	–	–	Important	Important	Important
Improving Service Levels	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Improving Service Coverage	–	–	–	Important	Yes	Yes	Yes
Efficiency Gains	Important	Important	Important	Important	Important	Important	Important
Ease of Implementation	–	–	Desirable	Desirable	Desirable	Desirable	Desirable
<b>Commission Requirements</b>							
Attaining European Standards	–	–	–	Relevant	Relevant	Relevant	Relevant
Maximizing Societal Benefits	Relevant	Relevant	Relevant	Important	Important	Important	Important
Transparency / Open Competition	Relevant	Relevant	Relevant	Important	Important	Important	Important
Reasonable Control of Grant Funds	–	–	–	Required	Required	Required	Required
Avoiding Undue Private Profit	–	–	–	Required	Required	Required	Required
Efficiency Gains	Desirable	Desirable	Desirable	Important	Important	Important	Important
Leveraging Private Funds	–	–	–	–	Yes	Yes	Yes
<b>Lender Requirements</b>							
Rigorous Financial Analysis	–	–	–	–	Required	Required	Required
Conservative Cost/Revenue Assumptions	–	–	–	–	Required	Required	Required
Certainty of Grant and State funding	–	–	–	–	Required	Required	Required
Clear Legal regulator structure	–	–	–	–	Required	Required	Required
Technical Ability of Owner/Operator	–	–	–	–	Required	Required	Required
Political Stability	–	–	–	–	Desirable	Desirable	Desirable

## 6 ACHIEVING SUCCESSFUL PARTNERSHIPS<sup>7</sup>

- **Successful implementation depends on recognition of partner's objectives**
- **PPPs require careful consideration of control and management systems through project agreements**

What are the necessary elements to achieve successful partnerships in the infrastructure arena? First, it is essential to recognize exactly what a partnership is. A partnership is an agreement between two or more parties to work together towards a common goal. Partners share joint rights and joint responsibilities, and when these are not met partnerships do not work. Partnerships require the will of all parties involved to work together. They also rely on clear and carefully crafted agreements defining the rights and obligations of the parties involved and establish a framework for responding to new situations as they arise. Concession agreements must also be tailored to the laws and regulations governing the award. As such, it is essential for governments to develop clear legal and regulatory formats that identify the various steps in the process, together with rights and obligations of all involved. In CCs, as has been the experience in Member States, this may well involve the promulgation of new laws.

Similarly, effective user fee policies are also essential components of the partnership process. In certain cases utility fees may have been subsidized in the past and infrastructure PPPs may be undertaken in conjunction with the liberalization of tariffs. If this is the case, proposed tariff structures will require careful review in terms of their overall affordability, their ability to gain public and political support, and their ability to

finance the needed improvements. The establishment of a reasonable tariff level is a delicate task at best and involves close interplay between expected utilizations levels, public acceptability, market conditions, and government support.

Efficient organization and streamlined decision making are also critical to the ability of beneficiary governments to launch successful PPP projects. One of the most effective steps beneficiary governments can take to support successful infrastructure partnerships is the establishment of special-purpose authorities charged with overseeing their implementation. Such authorities usually work with consultants to organize and execute planning and feasibility studies, conceptual design work, and in many cases establish financial demand model. Special purpose authorities can assume responsibility for liaison with all parties, as well other government departments. Often these agencies also negotiate with development banks and other potential funders. Once individual projects have been identified, the authority procures them on behalf of the government and then oversees their construction and operation. While the presence of a development authority can never guarantee success, it does streamline and organize government involvement, helps develop government expertise, and encourage consistent policy.

Successful concessions rely on a series of checks and balances. A well-crafted agreement uses checks and balances to create co-dependence and transparency, while enabling all the parties involved to achieve their goals. Without the participation of any one of these actors it would not be possible to develop these projects on a partnership basis. This reality forces all of the participants to be receptive to the needs of its fellow partners and to work together towards a joint solution and work through new issues as they arise. This dynamic may be further reinforced when IFIs are involved.

Partnership is achieved by providing credibility for the private partner risking its money and legitimacy for the

<sup>7</sup> This section draws on *Achieving Public-Private Partnership in the Transport Sector*, Benjamin G. Perez, Diebold Institute for Public Policy Studies: New York City, 2002.

government sponsoring the project. Legitimacy is achieved by ensuring that partnership projects meet the needs of the paying public, produce desired additionalities, and reinforce wider financing goals. It is also achieved by rewarding for the successful negotiation of risk and providing the private partner with a reasonable return on its investment. However, if the rewards are too high then that legitimacy is undermined. Legitimacy is also undermined when investors are more interested in the profits derived from lucrative construction contracts rather than the successful operation of a concession itself once it is built. As an independent grantor, the Commission can be used to foster credible and legitimate relationships between beneficiary government and private investment partners, both through its direct participation and through the objectives and conditionalities attached to grants.

Achieving partnership also requires strong political support. Traditionally when there has consensus that an infrastructure project should be built, governments have allocated the necessary resources to procure it themselves. When governments look to the private sector for funding this may be a signal of lackluster support. However, because of the risks involved, the un-conventionality of the approach and the need to maintain legitimacy, partnership projects are likely to require stronger political and government support. Moreover, as risks and challenges increase, so must the government's support and commitment. In addition to providing financial resources, the Commission can play an important role in maintaining critical government support for PPP projects in beneficiary nations.



**Toll Station on Hungarian Motorway**

**Successful implementation of motorway toll schemes depends not only on demand for services but effective partnering of all parties, comprehensive project agreements and a commitment to project success**

## PART 2 LEGAL AND REGULATORY STRUCTURES

### PART 2 - Summary

- **PPP are defined and governed by a complex interaction of national and municipal legislation and regulation and project contractual documents**
- **Commission grants and the accession process add the EU *Acquis Communautaire* and grant conditionalities to the legal environment**
- **While cooperation with the private sector is welcomed the Commission must fulfill its objective of safeguarding the public interest and the correct use of funds. This implies contractual and implementation conditionalities**
- **The legal situation in CC's is still evolving therefore full legal due diligence and careful contract design are crucial for all parties**
- **An effective and sustainable institutional structure is essential for promoting and fostering successful PPPs**
- **This Part will address:**
  - **The legal hierarchy**
  - **National legislative and regulatory issues**
  - **Project contractual issues**
  - **Procurement specific issues**
  - **Institutional requirements**

## 1 INTRODUCTION

The objective of this section is to identify and define the relevant statutory, regulatory and contractual issues affecting successful PPP relationships. A distinction is made between EU, national and project specific issues in order to capture both statutory and contractual matters. In all instances a key requirement for successful PPPs is that sufficient clarity, continuity and security is provided to safeguard the interests of all parties, including the Commission.

Although on individual projects the Commission will be a contractual party only to a designated National Authority as in the case of ISPA the NIC and the National Fund (through respectively the Financing Memorandum and the Memorandum of Understanding) it directly influences both the national legal structures through the *Acquis Communautaire* and the individual project

contracts through conditionalities it imposes. Additionally; and through its association with the accession process, it will have a wider indirect policy impact on a broad set of legal and regulatory criteria. For this reason it is imperative to the effectiveness of PPP development that regard is taken to the impact of Commission conditionalities.

As stated in the ISPA Manual, "*The involvement of private finance in the development of infrastructure is an important objective of Community policy...The use of ISPA resources in a public-private partnership requires verification of the existence of an appropriate legal framework and of appropriate regulatory conditions for this partnership, including the following aspects:*

- *Equal opportunity for all relevant companies in the same sector;*
- *Respect of competition rules in awarding concession;*

- *Respect of competition rules in awarding the investment contracts;*
- *Respect of conditions of the concession (service to consumers, maintenance, etc.);*
- *Absence of disproportionate remuneration on capital.*

Additionally ISPA characteristics imply:

- That while, the Commission it is a project funder it does not necessarily enjoy the same rights as other, notably private sector financiers. Grant financing implies a lack of equity participation or ownership of assets and hence a lower status of debtor (unless provided for contractually).
- The Commission continues to require ex-ante control of projects (under the ISPA programme) and the use of specific procurement procedures. This imposes certain restrictions on how projects can be implemented and possibly on how private operators / investors can be selected and integrated.
- Conditionalities on contractual arrangements must be matched with sufficient flexibility to allow the possibilities of private sector involvement.

On top of these considerations the evolving (and incomplete) nature of regulatory systems in CCs needs to be

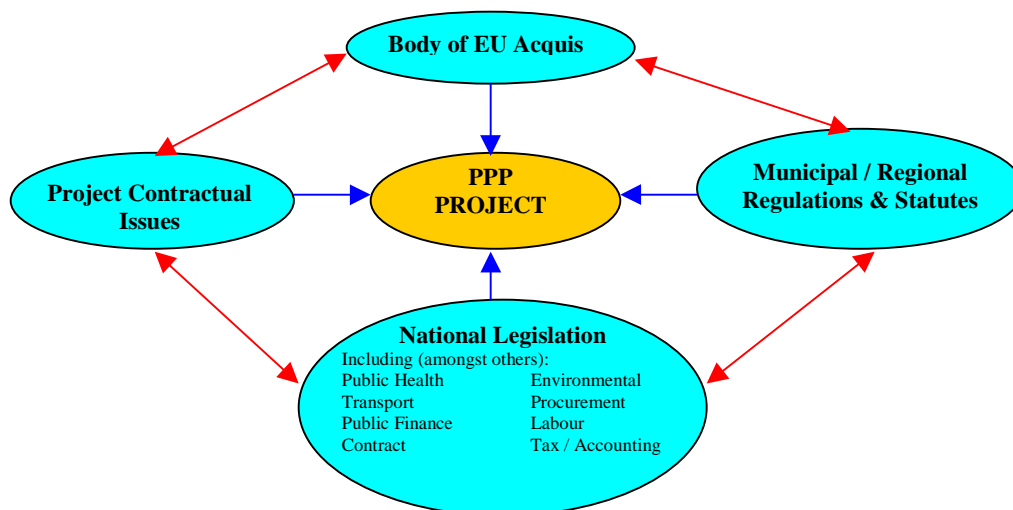
accounted for both in terms of risk generation and effective PPP management.

Bearing this in mind two checklists can be developed to ensure national and project level issues are effectively identified and addressed.

## 2 LEGAL HIERARCHY

- **Development of PPP in Candidate Countries requires the integration of a complex legal hierarchy involving EU, national, municipal and contractual issues**

PPP investments are influenced by a hierarchy of legal regimes as depicted by diagram 1 below. Each must be accounted for when developing a PPP both to guarantee the ability to access funds but also to ensure the long-term legality and viability of the project. The following chapters investigate each and will stress that the legal environment in many CCs is currently such, with the continuing reform and harmonisation process, that particular attention must be given to ensuring that legal risks are properly identified, accounted for and attributed. Additionally given the long term nature of PPP projects, the requirements of the EU Acquis Communautaire must also be integrated.



### 3 NATIONAL REGULATORY AND LEGISLATIVE ISSUES

- **Successful PPPs depend on the effectiveness of the national and municipal legislative and regulatory structures**
- **Legal due diligence is required to define the constraints to PPP implementation and to define project scope**
- **EU Directives must be integrated**

The effectiveness and impact of a PPP depends, to a large extent, on the regulatory mechanisms used to influence and guide the parties and in particular the private sector decision making process. Because of these critical interactions it is preferable to ensure the development of effective legislative and regulatory provisions before developing PPP relationships. In this area the Commission, can provide valuable policy contributions particularly in the current situation of regulatory transition associated with the accession process and reform of legal and operating structures in the CCs.

The analysis of a national and sectoral regulatory framework has four main purposes:

1. to identify elements that could impede private sector participation, affect

- Legal capacity of parties and legal requirement of the State to provide services
- General legislation allowing or restricting private sector involvement particularly by foreign companies
- Existence and legal basis of cost recovery mechanisms
- Ability to provide guarantees
- Property issues of land and infrastructure
- EIA requirements
- Land acquisition
- Planning permission requirements
- Licenses
- Need for project specific statutory requirements
- Potential conflict with EU Directives
- Transparency of laws

viability or distort advantages to be gained

2. to consider the need for restructuring of current operators ahead of a PPP with respect to their legal status and the flexibility of their mandate and articles of association
3. to identify the need for and design sector specific regulation making private sector participation possible and effective including the development of institutional structures to oversee and regulate private operators
4. to identify which regulations need to be incorporated into PPP contracts, to identify their impact and to identify if safeguards against regulatory risk need to be included

While the accession process and exposure to Commission financing has meant the development of certain statutory and regulatory structures to accommodate the Acquis, these are not necessarily sufficient or appropriate for a PPP relationship. It should be noted that all Member States have had to, or are undertaking legislative reform to ensure their ability to use PPP arrangements. The Commission also is undertaking review of its approach towards PPPs as demonstrated by the Commission Interpretative Communication on Concessions Under Community Law (2000/C 121/02) and its desire to reform procurement procedures. In particular the following issues must be investigated:

- Administrative coordination
- Dispute settlement provisions
- Forms of possible state financial support
- Competition and antitrust regulations
- Potential impact of employment and social security laws
- Currency and profit repatriation rules
- Public sector borrowing restrictions
- Tax and accounting liabilities
- Adequacy of selection and procurement procedures
- Legislation governing project agreements and operational issues
- Property law
- Intellectual property law
- Transfer of know-how and technologies
- Adequacy of oversight and monitoring provisions and authority to regulate services

National legislative structures will not always be conducive to PPP arrangements, but certain methods can be adopted to facilitate their introduction, including:

- choosing a private sector arrangement that reduces risks associated with the deficiencies of the legislative structure, for example using a fee based management contract for distribution or BOTs for bulk supply, if collection performance or requirements for providing subsidised services pose unacceptable revenue risk to the private partner
- choosing a private partner best able to manage legislative / regulatory risk, for example in the case of adverse foreign currency or profit repatriation rules then contracting local companies may be more viable
- incorporate explicit safeguards in contracts
- encourage the development of effective regulatory and watchdog mechanisms

Experience has shown that early development of conducive and consistent national legislative and regulatory structures greatly facilitates the identification, development and implementation of PPPs. A particular requirement is to establish the roles and responsibilities of all parties and ensure that effective systems are in place to regulate and monitor PPPs to derive the desired value for money and necessary transparency in implementation.

When designing and evaluating PPP projects particular attention needs to be given to the integration of the uncertainties caused by an evolving national legislative and regulatory structure and the reform process affecting many of the CCs, as for example the privatisation of utility operators. Focus should be placed particularly on:

- the impact of legislation on the ability to guarantee open and fair competition particularly with respect to the selection of utility operators. It is

often the case that reform or privatisation will impose an operator or partner, which has not been selected on a competitive basis nor perhaps identified at the project design stage

- the potential change in legal status and rights and obligations of parties. This includes consideration of potential changes in the ownership of assets
- the extent and effectiveness of public sector oversight and monitoring regulations and systems in ensuring compliance with contract conditions

## 4 PROJECT CONTRACTUAL ISSUES

- **Contracts will define the parameters of the PPP relationship and limit the activities of all parties.**
- **Contracts need to provide sufficient flexibility and control to ensure objectives of all parties are met and that differences can be resolved to the benefit of the project**
- **Keeping things simple is often more effective than being over prescriptive**
- **The Commission will directly influence the design of contractual documents despite the fact that it is not a party to individual project contracts**

A PPP will involve numerous parties and therefore a corresponding number of contractual arrangements. While the nomenclature may change, the main contractual documents include:

- Project Agreement – this is the main legal document setting out the rights and obligations of the Contracting Authority and the Contractor. Many model contracts exist but changes will need to be made to account for national and project specific requirements.

- Performance Specifications – these will include all of the technical, financial and service requirements of the Contracting Authority and must be specifically referred to in the Project Agreement as constituting an integral part and defining the parties obligations in relation to them.
  - Collateral Warranties – these provide for direct links between the Contracting Authority and the individual sub-contractors appointed by the Contractor. Their main purpose is to give the Contracting Authority the benefit of an independent obligation in relation to the work carried out by sub-contractors. They will also allow for step-in rights.
  - Direct Agreements – these regulate the relationship between the Contracting Authority and outside funders including the Commission through the Financing Memorandum.
- Other contractual documents of importance include; construction and operating contracts and financial security and guarantee arrangements. It is crucial that these documents are prepared in a transparent manner and that clauses are fully understood by concerned parties.
- The following discussion is meant to provide a brief understanding of the issues which contracting parties will be negotiating . This section is not designed to provide a model contract.

Heading	Detail
General provisions of the agreement	<ul style="list-style-type: none"> <li>• Legislative approaches</li> <li>• Governing law</li> <li>• Conclusion of the project agreement</li> </ul>
Organisation of the concessionaire	<ul style="list-style-type: none"> <li>• Legal form</li> <li>• Capital</li> <li>• Applicable accounting standards</li> </ul>
Project site, access and easement	<ul style="list-style-type: none"> <li>• Ownership of project assets</li> <li>• Land acquisition for the purposes of the project</li> <li>• Easement and transit arrangements</li> </ul>
Financial arrangements	<ul style="list-style-type: none"> <li>• Financial obligations of the concessionaire</li> <li>• Tariff setting and tariff control, including <ul style="list-style-type: none"> <li>○ concessionaire’s authority to collect tariffs</li> <li>○ tariff control methods, ie rate-of-return method, price-cap method</li> <li>○ policy considerations on tariff control</li> </ul> </li> <li>• Financial obligations of the contracting authority, including <ul style="list-style-type: none"> <li>○ direct payments</li> <li>○ purchase commitments</li> </ul> </li> </ul>
Security interests	<ul style="list-style-type: none"> <li>• security interests in physical assets</li> <li>• security interests in intangible assets</li> <li>• security interests in trade receivables</li> <li>• security interests in the project company</li> </ul>
Assignment of the concession	
Transfer of controlling interest in the project company	
Construction works	<ul style="list-style-type: none"> <li>• review and approval of construction plans</li> <li>• variation of project terms</li> <li>• monitoring powers of the contracting authority</li> <li>• guarantee period</li> </ul>
Operation of infrastructure	<ul style="list-style-type: none"> <li>• performance standards</li> <li>• extension of services</li> <li>• continuity of services</li> <li>• equal treatment of customers or users</li> <li>• interconnection and access to infrastructure networks</li> <li>• disclosure requirements</li> <li>• enforcement powers of the concessionaire</li> </ul>
General contractual arrangements	<ul style="list-style-type: none"> <li>• subcontracting</li> <li>• liability with respect to users and third parties</li> <li>• performance guarantees and insurance</li> <li>• changes in conditions</li> <li>• exempting impediments, force majeure</li> <li>• breach and remedies</li> </ul>





***Substantial work has been carried out by a number of organisations to develop model contract forms. The bibliography provides a number of contact points. In all cases it must be remembered that generic documents must be adapted to the characteristics of the actual situation***

Although the Commission will not be a direct party to a contract between project beneficiaries and the private sector, funding being supplied directly to a National Authority, interaction with the Commission and the ISPA regulations are, currently, such that approval of an ISPA grant will be conditional on satisfactory arrangements being made to safeguard Commission interests. While the Commission recognises the continuing evolution of the PPP concept and the need for a degree of flexibility; to safeguard its interests, scrutiny of contractual documents should aim to:

- safeguard the public interest. Commission sponsored projects must be designed to provide effective public services and contractual arrangements should guarantee the continuation of services in a manner which addresses the public's need.
- ensure contract fairness. The contract needs to produce conditions of 'fairness' amongst the parties which includes an equal distribution risks and benefits. In particular price setting mechanisms need to be transparent and equitable, the private sector should not benefit from unreasonable profits, as a result of the grant contribution, and dispute resolution needs to be effective.
- promote effective regulation and monitoring. This is an overriding requirement to ensure that contract terms are respected and the interests of all parties maintained.
- ensure contractual flexibility to meet changed circumstances. This is covered particularly by Article 8 of the

ISPA Financing Memorandum in which the grant conditions may be changed if substantial changes to the status of the project occur within the first 5 years. This covers in particular the transfer of assets from the public to the private sector and hence a significant change in the financial conditions of the project.

Additionally it is crucial that the Commission be involved early on in the project preparation process to ensure that it is able to identify its requirements and integrate them into the project design process.

## **5 PROCURING THE PRIVATE CONTRACTOR**

- **Procurement conditionalities of grant providers often represent the main cause for project collapse**
- **A degree of flexibility is required but the Commission's objectives under procurement policy need to be respected**
- **Procurement options will change with accession**

The field of procurement is often the one with the greatest scope for conflict and PPP relationship failure, particularly if public bodies and IFIs with separate procurement procedures are involved. This is notably the case of the Commission which requires the adoption of specific procurement procedures for the use of its grants but which are not necessarily best suited to complex multi-party PPP arrangements. While these Guidelines treat the specific situation of Commission grants, some procurement issues are common to all funding institutions. Particular attention also needs to be given to the adoption of the correct Community procurement and contracting regime with reference to differentiation between concession and public procurement approaches.

This situation is further affected by the evolving legal and regulatory state in CC's which leads to uncertainty both in how to structure procurement procedures and who is responsible for what. The implications of the accession process will lend greater clarity to public procurement once CCs are obliged to adopt the EU Procurement Directives. However until such a time the development of PPPs (using Commission grants) must be adapted to the current procurement regulations and national legislation.

Above all it is necessary to remember that the PPP process aims to attract private sector finance and know-how and, in order to maximise the benefits of PPPs, to include this at the earliest possible stage of a project. In this respect traditional procurement rules present a conflict as the private sector, to compensate for early involvement, will require assurances or a privileged position in the implementation stage. This creates public sector concern based on the arguments that:

- any alternative procurement procedures will leave the public sector open to allegations of corruption, lack of transparency or unfair competition;
- the regulatory environment does not allow procurement other than that based on competitive bidding;
- the public sector does not want to be forced into an early relationship when all technical and financial parameters are not known;
- the private sector may derive unreasonable profits.

Current procurement rules (especially those of the Commission) are designed to ensure transparency, open participation and cost effective solutions based on fully specified tender conditions. However for complex PPP arrangements (particular complex DBFO and concession projects) this may not prove to be the best option as:

- these procedures are usually designed to operate under conditions of certainty;

- they prohibit extensive informal consultation and communication between the parties (which is essential to the development of partnerships);
- they are focused on lowest price whereas PPPs may also target other factors;
- they force tender specifications to be complete and therefore leave little room for variations.

Several procurement alternatives are being developed<sup>8</sup> which have minimum criteria based on:

- tender specifications which state the desired end goal but leave the bidders to propose solutions;
- strict performance criteria and monitoring systems which bind contractors to their bids;
- compensation for private sector participation in bids to those not selected;
- provisions to renegotiate contract terms over the contract life.

Until such time as the Commission develops a unified approach, the selection of procurement procedures with particular reference to the selection of private contractors, must be based on a clear separation of contracts which are covered by the 'specific' provisions of the public procurement Directives and those covered by the rules and principles of the Treaty (as defined by the recent Interpretative Communication on Concessions).

## 5.1 Choice of Procurement Procedure

The choice of procurement procedure must be completed at an early stage of the project and must be agreed to by the main parties in particular the funders; and if involved, notably the Commission.

This section will set out two types of procurement procedures based on pre and post accession of CCs. This distinction is

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<sup>8</sup> Refer to the UNDP Joint Venture PPP for Urban Environmental Services Project or the FIDIC Silver Book



The FIDIC suite of Contracting Books

important as currently grants can incorporate only those procurement procedures authorised by the Practical Guide to Contract Procedures<sup>9</sup>. Upon accession CCs will adopt the EU Procurement Directives and will face a different set of issues. To account for the long lead times in project development both situations are described. This section focuses particularly on the need to:

- respect procurement regulations to ensure effective grant allocation
- provide sufficiently flexibility in procurement to maximise the benefits of a PPP relationship
- integrate the characteristics of different types of PPP relationships and seek to adapt procurement to the underlying needs of the relationship and the project

### 5.1.1 Pre-accession Phase

Procurement procedures are currently defined by the ISPA Regulations, the Practical Guide to Contract Procedures and Title IX of External Aid Regulations. These must be used for the application of ISPA grants with little scope for derogation even if PPP schemes are

<sup>9</sup> These Guidelines are based on the currently available Practical Guide but note the on-going revision of the Guide

considered. According to the ISPA Manual “*Commission sources of finance can be integrated into private financing schemes..... Their integration must, however, not restrict the procurement of works, services or supplies during project implementation.*”

Two aspects must be considered. The first concerns the selection by CCs of private parties before the involvement of the European Commission, as for example the contracting of a private concessionaire for operations (whether through tender or privatisation). While this is obviously not a consequence of a Commission financed project, the selection and capacity of the private party will be of consequence to the approval of a Grant. As a result, National Authorities should aim, as a minimum, to fully integrate and be able to demonstrate the conditions of:

- Equal opportunity for all relevant companies in the same sector;
- Respect of competition rules in awarding concession;
- Respect of competition rules in awarding the investment contracts;
- Respect of conditions of the concession (service to consumers, maintenance, etc.);
- Absence of disproportionate remuneration on capital.

It is further recommended that an early adoption of the principles and procedures of the EU Procurement Directives, including the recent Interpretative Communication on Concessions Under Community Law (2000/C 121/02) is desirable to demonstrating the fulfillment of these conditions (these are set out in the following Post-accession section).

The second aspect concerns procurement with a Commission Grant. It should be noted that the Commission currently restricts the use of grants to the procurement of supplies, services and works and therefore does not envisage the application of grants in the form of other financial instruments. As a result a grant will be used to directly facilitate the realisation of physical infrastructure which

must be procured, according to the Practical Guide, using Open or Restricted Procurement Procedures (according to tender type and amount).

It is argued that the Open and Restricted tender procedures limit the development of PPPs in two ways:

- The prospect of competitive tendering, and hence the cost and uncertainty of contract award, reduces the incentive to the private sector to participate.
- The requirement of Open and Restricted procedures is to provide a fully specified project output against which tenderers compete, principally on price. It is argued that this limits the ability to seek innovative solutions based on a private sector approach and potential efficiency gains that this would entail.

The first argument is valid to a degree but can be qualified with respect to the type of PPP relationship targeted. Indeed it is rare to have a situation where some form of competitive tendering is not involved and is usually only found where a PPP project is being promoted by a private sector party. The uncertainty surrounding competitive tendering can be managed by providing up-front information on the scale of the tender, the scope of evaluation criteria and performance requirements. This can provide an effective guidance to companies on whether tendering is in their interest.

In order to avoid a too limited number of Tenderers, a degree of market sounding and informal consultation can be undertaken in order to ensure that the planned tender and project will attract sufficient interest. Should this not be the case, this should in itself be an important indicator for project design and appraisal and may require a re-assessment of project parameters.

It has been suggested<sup>10</sup> that the cost of tendering, particularly for large complex projects, could be partially covered by

Contracting Authority in order to share the risk associated with the tender process. It is believed that this should be considered only for very large projects where substantial conceptual work is required by Tenderers. However Tenderers should be given a measure of intellectual property protection, in that the materials developed in their tenders will not be exploited by any other party.

The argument that Open and Restricted tender procedures limit the ability to seek private sector innovations is valid if the requirement to provide completely specified projects at the tender stage is absolute. This limits competition to the financial considerations. However a number of important innovations are possible, within the procedures, to overcome this but require a preliminary identification of what the important desired values and benefits of the PPP relationship are. Possible innovations, including:

- If the project must meet certain technical standards (including EU standards) which limit the possibility for substantial technical innovations to be gained, the real value of a PPP will lie in financial considerations including cost structures, the degree of service provision and how risks are priced and managed. This therefore assumes that a fully technically specified project will be evaluated (after technical compliance) principally on the financial offer. In other words this will entail evaluation of, amongst others:
  - How **costs** are structured
  - In the case of concession type contracts, how **revenues** are structured
  - How **risks** are priced
  - What is the **value** of the private sector contribution and requirement of additional financing (including ISPA grant)

This in effect requires a detailed value for money assessment including some

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<sup>10</sup> Notably by the UNDP PPPUE

form of financial comparator. These are discussed further in Part 3.

- If there is the potential for both technical and financial innovation and value added from the private sector it is recommended to allow Tenderers to submit Variant Solutions. This requires that they submit a tender meeting the original conditions and a tender which proposes their alternative approach. It should be noted however that the evaluation of variant solutions must comply with strict guidelines and should be against a set of minimum standards required by the project.

In both cases the emphasis is to remain within the boundaries of existing procedures but to develop more comprehensive evaluation techniques that in effect allow Tenderers some flexibility and the project to harness private sector innovations and efficiencies.

#### 5.1.2 Post Accession Phase

On adoption of the European Acquis the procurement process is governed by a series of Directives. The first step entails deciding which Procurement Directives are applicable. Current Directives and their amendments, relate to four regimes:

- Works (Council Directive 93/37/EEC);
- Supplies (Council Directive 93/36/EEC);
- Services (Council Directive 92/50/EEC);
- Utilities (Council Directive 93/38/EEC).

The first three Directives are commonly referred to as the “Classic Directives”. Of importance is also the recent Commission Interpretative Communication on Concessions Under Community Law (2000/C 121/02). The first step in selecting the relevant Directive is to assess whether the project concerns the Classic Directives or the Utilities Directive. The Classic Directives cover the following categories:

- Works - this category covers the full range of building and civil engineering, contracts including the

supplies and services necessary to carry them out;

- Supplies - this category covers the procurement of products whether financed through purchase, lease, rental or hire purchase, including the supply, delivery, installation and operation of equipment and machinery; and
- Services - this category covers the provision of services including engineering, architectural and other professional services. It specifically includes sewage and refuse disposal services, sanitation and similar services.

Each Directive has contract value thresholds and prohibits the splitting of contracts to circumvent these. It should be noted that some uncertainty has existed as to the categorisation of projects into works or services. The main interpretation offered by the Commission and European Court of Justice is that if works are incidental to the services provided then the Service Directive is applicable. Incidental can be defined with respect to the main object of the contract or the predominant value of the component. It is suggested, based on jurisprudence, that the European Court of Justice favours the latter definition.

Concession contracts pose a similar interpretative issue. The European Commission has stated that if the recovery of costs is guaranteed by the contracting authority without the risk involved in the management of the construction, then the contract will be a works contract rather than a concession.

##### 5.1.2.1 Procurement Procedures

The Procurement Directives allow for a number of different procurement procedures, including:

- Open Procedure – whereby any interested party can tender.
- Restricted Procedure – whereby any interested party may submit a request

for pre-qualification and may tender if successfully pre-qualified.

- Negotiated Procedure – which is similar to the restricted procedure but opens the possibility for post-tender negotiations on contract specifications. This procedure can also be used for the selection of concession contracts.

The open procedure is generally not considered suitable for PPP due to scale and complexity issues. Generally if a contract is a works or services concession, or alternatively falls within the Utilities Directive, the negotiated procedure is available but subject to the provisions of the Treaty of Rome and national regulations. In all other instances a decision between restricted and negotiated procedures must be made.

The Works and Services Directives respectively set out specific circumstances in which the negotiated procedure can be used and go on to state that *"in all other cases, the Contracting Authority shall award their public works (services) contracts by the open procedure or by the restricted procedure"*. Whilst there are a number of grounds set out in the Directives for commencing a procurement using the negotiated procedure, there are only two potentially relevant bases for commencing a procurement with the negotiated procedure in the context of a PPP.

The first is *"in exceptional cases, when the nature of the works (services) or the risks attaching thereto do not permit prior overall pricing"*. The second applies only in the context of the Services Directive *"when the nature of the services to be procured is such that contract specifications cannot be established with sufficient precision to permit the award of the contract by selecting the best tender according to the rules governing open or restricted procedures"*. It should be noted that the validity of such cases only applies within the strict scope of the Directives.

The European Court of Justice has stated that the use of the negotiated procedure is

a derogation permitted by the Directives and as a consequence the onus will be on the Contracting Authority to show that the circumstances justifying its use apply. Additionally Contracting Authorities using the negotiated procedure or any other non specified procedure will need to demonstrate that the rules and principles of the Treaty have been respected. Internationally, the main drivers behind the use of the negotiated procedure have been the ability to:

- secure the best value for money;
- secure the optimum allocation of risk;
- encourage innovative solutions; and
- reduce tender or bid costs.

The practical reasons why the negotiated procedure is favoured for PPP projects are clear. Indeed, the European Commission has recognised the difficulties associated with using the restricted procedure. In a Communication of 1998 the European Commission stated that:

*"especially in the case of particularly complex contracts in areas that are constantly changing, such as high technology, purchasers are aware of their needs but do not know in advance what is the best technical solution for satisfying those needs.*

*Discussion of the contract and dialogue between the purchasers and suppliers are therefore necessary in such cases. But the standard procedures laid down by the traditional Directives leave very little scope for discussion during the award of contracts and are therefore regarded as lacking in flexibility in situations of this type"*.

If a negotiated procedure is permitted the Contracting Authority must ensure that the following principles are clearly adhered to:

- **equality of treatment** – this applies throughout the procurement process to the conclusion of a contract and therefore places limitations on the extent of possible negotiations.
- **transparency** – notably in the definition of procedures and

publication of tenders in the Official Journal or adequate alternatives.

- **proportionality**

In choosing the appropriate procedure, a Contracting Authority will have regard to a number of factors. These include:

- the scope and nature of the project;
- the degree of precedent available for reference and use;
- the degree of risk transfer proposed (particularly as regards statutory process risk);
- the role and influence of third party funders.

In a Design and Build or BOT contract, the case for the use of the negotiated procedure is difficult to make. There is ample precedent for using the restricted procedure successfully; there will usually be adequate project definition and the nature of the works or the risks attaching to them will usually permit overall pricing.

In addition, there is nothing to prevent a Contracting Authority from seeking the views of tenderers. Examples of issues on which the views of Tenderers should be sought include *force-majeure*, intellectual property rights, payment mechanisms and limitations on liability. Thus, even where a greater degree of risk transfer is proposed than in previous projects, the Contracting Authority is not necessarily left only with the option of using the negotiated procedure.

In the case of a DBFO contract, the Contracting Authority will be seeking optimal risk transfer in the context of the introduction of private finance. Where the restricted procedure is followed in DBFO projects, it may lead to the pricing of projects based on private sector costs of equity and debt without sufficient scope for innovation and an efficient allocation of risk to the private sector. A Contracting Authority can improve its judgment on the appropriate allocation of risk through regular and structured market sounding of private sector appetite for various types of project and the spectrum of risks and

rewards they represent. Some of the risks which may be difficult to specify in advance in contract terms are:

- demand or volume risk;
- elements of the statutory process risk;
- payment structures and mechanisms;
- maintenance costs impacted by demand or volume usage;
- financing proposals;
- compensation and termination clauses; and
- change of law risks.

Where the negotiated procedure is used, serious consideration should be given to limiting the areas or scope for negotiation thereby helping to reduce tender costs and the time expended leading to contract award. Efforts should be made to devise procedures that relate as closely as practicable to the restricted procedure, allowing the necessary flexibility to negotiate *only* on the key issues.

In summary, a Contracting Authority must give very careful consideration to the question of the procurement procedure to be used and take appropriate legal advice. It is permitted to commence a procurement using the negotiated procedure but only in very limited circumstances and its use will be reviewed very strictly in the event of a challenge. However, the factors which influence a decision in favour of the use of the negotiated procedure tend to exist in those projects where it is intended to utilise private finance or to achieve a greater degree of risk transfer than is normally anticipated. Where private finance is involved, the use of the negotiated procedure is likely to be appropriate for major projects so that optimal value for money proposals are received.

The European Commission is considering the introduction of a greater flexibility with the introduction of a *Competitive Dialogue* procurement procedure. This proposal is being developed in response to the criticism sometimes leveled at the existing system to the effect that procedures are excessively rigid and

formalistic and, where complied with strictly, can lead to malfunctioning in the award of contracts. To that end, it has published a draft proposal for a European Parliament and Council Directive to amend the Classic Directives proposing amendments with a view to making procedures more flexible. Additionally the Commission has made proposals to modify the classic Directives.

## **6 INSTITUTIONAL STRUCTURES**

Effective legal, regulatory and contractual conditions are crucial to PPP success but can only exist if supported by an efficient institutional structure which both facilitates PPP development and provides clear boundaries to protect the interests of all parties. Most Member States have realised that PPP development requires major institutional changes not least because the role and responsibilities of the public sector change from direct service provision to management and monitoring. However a further role is sponsor and developer of the PPP concept. To this end several Member States developed specialised PPP task forces.

Two principal models of intervention exist. The decentralised approach, as adopted by France, places responsibility at the regional level and within the concerned line Ministries. Other countries, such as the UK and Ireland, have selected a more centralise approach by creating one dedicated national PPP unit. In both cases countries have realised the importance of sourcing high calibre experts to create a nucleus able to drive the process. At the beginning such units focus particularly on developing capability, required legal and regulatory structures, market interest and pilot projects in order to test and demonstrate the value of PPPs. As experience is gained the role of such units changes to focus on assisting the selection of PPP opportunities, counselling, ensuring value for money, investor attraction and above all maintaining political support.

Such units and the public sector in general, have a key role to play in creating trust which in turn allows a reduction in risk and therefore cost, but importantly also the development of effective and sustainable partnerships. Trust must include the open exchange of information, the possibility to have non-conflictual dispute resolution and respect for the objectives of all parties.

Trust also implies a strong level of political commitment which must be developed, sustained and communicated by the necessary institutional structures. To this end, experience has shown the value in identifying a 'political champion' of PPPs able to provide an effective link between political priorities and institutional structures. Political support should be realistic and practical about what PPP can achieve and how it is to be implemented. There will be occasions where projects must be stopped (and indeed the public sector must play an active role in identifying these situations), but likewise a reasoned approach is required to identify when projects present greater long term interest as opposed to short term political gain. This requires institutional structures able and willing to effectively negotiate with the private sector. This includes taking the necessary time to correctly structure deals and where necessary to show willingness to renegotiate contracts to enhance benefits fairly for all parties.

An institutional framework is required to allow the public sector to change from being a direct service provider to an independent regulator, manager and monitor. Additionally it must provide the role of project promoter. All functions require an in-depth understanding of the motives of the private sector and therefore how a balance can be achieved between these and the objective of safeguarding the public's interest. Sustainable success of PPPs can be enhanced by including civil society in the monitoring / oversight structures. Implementation of PPPs as an alternative financing and service provision model must be seen to provide and demonstrate value for money and quality service provision. The public, as paying



consumers, are therefore a critical barometer of performance and suitability of PPP implementation and should be integrated into the monitoring process. This implies that PPPs are influenced both from the top down but also from the bottom up.

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### **Example of Civil Action Against a Planned Incinerator – Source BBC – 3 November 2001**

#### **“Incinerator protesters march again”**



Hull City Council - Protestors claim councillors have not consulted them

A campaign is underway to prevent the construction of a waste incinerator in the centre of Hull.

Hull City Council and East Riding of Yorkshire Council have signed a 25-year contract allowing the Waste Recycling Group (WRG) to burn 165,000 tonnes of rubbish a year in the new incinerator.

Hundreds of protestors who are concerned about the alleged health risks associated with incinerators are marching to the city council buildings to object to the plan.

WRG insists that the incinerator, proposed for Stoneferry in Hull, would be perfectly safe.

#### **'Highest standards'**

Clive Carr, managing director for the company's eastern division, told BBC News Online: "We would operate this plant to the very highest standards currently available in the UK and even in Europe.

"I believe those standards are high enough.

"The land it would be built on is derelict contaminated land, which would be cleaned up as a part of the construction process."

Under the 25-year contract Hull City Council and the East Riding of Yorkshire Council would pay WRG to take the waste, which would

produce electricity to be sold onto the National Grid.

#### **'Profit making'**

Campaigner Eric Wedge, 59, from the group "Hull Against the Incinerator", told BBC News Online: "People need to be aware about the lack of consultation which goes into these profit-making projects.

"Who picks up the tab with all the health problems I do not suppose they care.

"We have thrown down a challenge to the councillors who signed the contract.

"We want them to meet us on the Guild Hall steps on Saturday... we have collected 25,000 signatures, which is the largest petition ever got up in the city of Hull."

#### **Academic studies**

The protest group says academic studies support their viewpoint.

"We are about the only country in the western world that is advocating incinerators - other countries are stopping building them - France has closed 80% of its down, and America has not built one for five years."

Mr Carr said: "The UK Department of Health carried out a seven-year study into 14 million people and 72 incinerators, and found that if there was any cancer risk from incinerators it was so small that it wasn't measurable.

"The level of emissions that would be produced are equivalent to the levels of dioxins in urban soils.

The dioxins released on bonfire night are equivalent to that released from all the UK's incinerators in one year."

In August, 400 people attended a protest March against the incinerator proposals, and demonstrators entered Hull City Council wearing gas masks.

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## PART 3 FINANCIAL AND ECONOMIC IMPLICATIONS OF PPP

### PART 3 - Summary

- **PPP projects present a different risk profile to conventional projects**
- **Risk has a direct financial impact on the project as it is translated into financial terms by the private party**
- **Risk should be transferred to the party best able to manage it in the most cost effective manner**
- **A prime responsibility of the public sector is to ensure value for money in PPPs**
- **Several techniques exist to determine value for money – their use should be carefully evaluated against need**
- **Grant financing carries certain risks. The level of grant financing should be carefully matched to ensure that public benefit is maximized and adverse impact on private sector profits is minimised**
- **This Part will address:**
  - **Financial implications of risk and risk types**
  - **Ensuring value for money in a PPP**
  - **Optimizing grant contributions**

## 1 INTRODUCTION

The primary focus of this Part is to address the financial and economic implications of PPP relationships. It will focus primarily on three areas, being:

- The financial implications of risk in a PPP relationship
- Ensuring value for money from a PPP at the design and evaluation stages
- The optimization of grant contributions.

It is not intended to explain the different techniques of financial and economic analysis which are well known and integrated into accepted project preparation processes. Instead this Part will present additional issues to include in the analysis of projects which are characteristic of PPP relationships.

## 2 FINANCIAL IMPLICATIONS OF RISK

- **Risks are directly translated into financial implications**
- **Risk should be transferred to the party best able to manage it in the most cost effective manner**
- **Risk should not be transferred for the sake of doing so**

A risk is defined as any factor, event or influence that threatens the successful completion of a project in terms of time, cost or quality. A key principle of PPPs is that risk should be allocated to the party best able to manage it. The effective allocation of risk has a direct financial impact on the project as it will result in lower overall project costs and will therefore provide enhanced value for money if compared to traditional procurement methods.

The direct relationship between risk and financial impact lies also in the fact that the degree of risk transfer to the private

sector will influence the overall cost of the project to the public sector as all risk will be associated with a price premium. Therefore the objective must be to achieve cost effective risk transfer not simply risk allocation for its own sake.

The objectives of risk transfer include:

- To reduce long term cost of a project by allocating risk to the party best able to manage it in a most cost effective manner
- To provide incentives to the contractor to deliver projects on time, to required standard and within the budget
- To improve the quality of service and increase revenue through more efficient operation
- To provide a more consistent and predictable profile of expenditure

The following discussions address risk categories and allocation.

## 2.1 Revenue Risk

Revenue risk is the most fundamental of all unknown factors involved in PPP projects. Revenues flows are generally determined by two factors: utilisation levels, and tariffs. The availability of reliable historic information documenting demand and price elasticity levels varies among different sectors. In the water sector, for instance, a great deal of information is likely to be available. However, the cost of providing water may well have been subsidized in the past, making it more difficult to determine how consumers would behave in the face of unsubsidized pricing.

In the case of road projects, even with extensive investigation of past traffic trends, forecasts of future growth potential, and surveys of people's willingness to pay tolls, there is always a significant residual risk on the traffic levels that projects will actually attract. This risk is only reduced after a number of years of operation. In order to arrange project financing, certain assumptions

regarding usage and revenue levels must be made. While these calculations are usually intended to be conservative, overstatements are not uncommon. Moreover, unforeseen future events can also have dramatic impacts, such as the oil shocks of the 1970s, which were a major factor in the failure of the three private concessions in France.

Traffic risks are also amplified in CCs, where assumptions regarding economic growth and automobile ownership take on greater importance. Moreover, in countries, where automobile ownership and income levels are lower, and motorists often opt to drive on slower parallel routes rather than paying expensive tolls.<sup>11</sup>

For road projects, the adequate level traffic risks to be transferred to the private sector should be carefully analysed. Shadow toll or availability payment mechanisms should be considered instead of real tolling, which usually does not yield enough revenue to cover a significant percentage of investment costs.

### **French toll-road tempts investors with a smile**

**BBC - March 12 2002**

**France is trying to lure investors to the 2.8 billion (\$A4.7 billion) initial public offering of Autoroutes du Sud de la France. ASF had 1.9 billion in sales last year, mainly from its 2794 kilometres of highways that run along the Mediterranean coast. Meantime, ASF's network is attracting interest from other European highway companies.**

**ASF plans to add 318 kilometres of toll roads by 2009, according to information on its website. Its two main concessions run until 2026 and 2032. The company is allowed to raise tolls by 30 per cent more than inflation through 2006, says a recent report by Standard & Poor's.**

**Traffic on the existing network has grown at an annual rate of 5.7 per cent between 1997 and 2001, according to the company. ASF's 8.3 billion of debt may hinder expansion plans, even though the company would raise about 800 million from the offering, said S&P, which rates the company AA-**

<sup>11</sup> András Timár, "Road Projects in Transition Europe," *Transportation Equipment and Infrastructure Review*, Chapter 5, Euromoney Publications, Essex, UK, 1998, p. 19.

## 2.2 Choice of Private Sector Partner

Inherent risk is associated with forming a partnership with unknown partners. This is accentuated through a public procurement process which does not facilitate extended negotiation periods allowing a degree of knowledge and confidence to be established. The principle risks are that the private party proves insufficiently competent and / or is not able to deliver the services to the initial specifications. This can be because of a badly researched tender or because tenders were designed to win the contract in the hope of recovering costs at a later stage. In both instances the tender evaluation must aim to identify such situations.

A common concern of public bodies is that by granting a PPP contract they may be creating a monopoly situation for a private company or at least creating a situation of unfair competition or market access. This potentially impacts both on project costs but also the ability to introduce innovation into service provision.

EU Procurement rules stipulate open and fair competition. While this presents a commercial risk to the private sector, a more serious risk occurs with the existence of corruption and market and/or price fixing. This can only lead to financial loss for the public and unsuccessful bidders but also a long term reduction in market interest by the private sector if such practices are thought too prevalent.

## 2.3 Construction Risk

The capital construction cost of any project is one of the fundamental factors upon which financing is based, and when cost overruns are incurred, the financial feasibility of a concession can be jeopardized. Poor project definition, unknown geological conditions, or loosely defined safety specifications can have dramatic affects on capital construction costs. However, these potential problems can be mitigated with the completion of careful engineering studies before a

concession contract is actually signed. Construction delays also have detrimental effects on capital costs. While some delays can be minimized through careful construction management, they still have the potential to arise. Other external factors, such as timely delivery of right-of-way, for example, are more difficult to manage. External forces such as inflation, economic policy, embargoes, and political conflicts also have the potential to have dramatic affects on capital costs. Construction risk is nearly always assigned to the private party, which in turn is likely to include strong incentives for on-time completion of works in its construction contract.

## 2.4 Foreign Exchange Risk

Debt is a defining characteristic of nearly all concessions and, when money is borrowed abroad, foreign exchange fluctuations can threaten project viability. This risk can be exacerbated when governments require that concessionaires obtain a certain portion of their financing from foreign sources. Foreign exchange risk is greatest when weak currencies are involved, putting projects in emerging economies at greater risk. While accession to the EU and the ultimate adoption of the Euro will limit foreign exchange risk in most CCs, the dangers of currency fluctuations remains a serious detracting factor for PPPs in the CCs. In certain cases, foreign currency risk can be assumed by sovereign governments, export credit agencies, or international financial institutions in order to make concession projects more attractive to private investors.

## 2.5 Regulatory / Contractual Risk

Although governments negotiate contract terms and conditions with their concessionaires, they are not always successful in maintaining their commitments. This is particularly true of tolls and other user fees, which tend to be politically sensitive. This was the case in

France in the 1970's, for example, when the government reneged on its commitment to allow private concessionaires to set toll rates. This factor was critical to the demise of three out of the four private motorway operators in France. More recently a lawsuit sponsored by the Hungary Automobile Club was successful in its charge that the service on the M1/M5 Motorway was not commensurate with the high tolls charged, and the court of first instance ordered a 50 percent reduction in toll prices.<sup>12</sup> This decision led to an immediate suspension of disbursements by the European Bank for Reconstruction and Development and delayed construction for seven months.

These risks are more common than many project finance proponents like to admit. They can have substantial effects on existing concession agreements, and also weaken interest in future projects. Regulatory risk is exacerbated in countries where new and untested laws govern PPP projects, which is often the case in CCs. Such risks can be expected to be greatest in countries with comparatively little experience in project finance.

## 2.6 Political Risk

Assessments of the inherent strength and stability of local political institutions are common in the investment field and are reflected in bond ratings prepared by internationally recognized rating agencies. As political risk increases, so does the cost of obtaining financing. The long duration of most concession agreements and the common aversion to user fee increases, make PPP projects especially susceptible to political risk. This is exacerbated when new governments oversee unpopular projects instigated by previous administrations. Political risks are often assumed by host governments, but such an assignment can prove less than optimal in the face of lackluster political support for

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<sup>12</sup> John D. Crothers, "Project financing of toll motorways in central and Eastern Europe: a signpost for transition?" *Law in Transition*, Spring 1997, pp. 6-11.

an infrastructure partnership. IFIs and multilateral organizations such as the Commission can use their influence to help to counter political risk. Bilateral agencies such as export-import banks have also been known to provide political risk guarantees to private concessionaires from aligned countries.

## 2.7 Environmental / Archeological Risk

Infrastructure projects have the potential to provoke environmental concern, and governments and citizen groups are becoming increasingly vigilant in their efforts to mitigate potential impacts. Unforeseen environmental issues can



**Public protest can severely disrupt project implementation. However constructive public participation should be encouraged to optimize design, minimize protest and enhance public oversight.**

increase capital costs considerably and result in serious delays. Environmental risk is usually assumed by the private party. For this reason, most would-be investors undertake thorough environmental assessments and identify likely mitigation programs before entering into a concession agreement.

## 2.8 Latent Defect Risk

It is now increasingly common for governments to provide contractors / concessionaires with the right to pre-existing infrastructure systems as a way to help finance the construction of new infrastructure. In many cases, new projects may also involve upgrading and expanding existing systems. In exchange, concessionaires usually assume

responsibility for the maintenance of these facilities for the duration of their contracts. While seemingly attractive, this mechanism can be costly for concessionaires if the facilities they inherit have unknown structural faults. The risk of encountering unpleasant surprises can be minimized when thorough and well-documented inspections of the facilities to be transferred are completed before concession contracts are formalized.

## **2.9 Public Acceptance Risk**

Infrastructure projects have the potential to provoke vociferous protests among local communities; a fact which can prove fatal to private concessions. There are several notable examples of public acceptance risk in Europe. The Lyon Périphérique Nord concession was ultimately canceled due to wide spread public opposition, boycotts, and protests aimed at the project's high toll levels. Controversy has also surrounded routing of the A2 Motorway through greater Warsaw in Poland, and public protests to toll increases in Lisbon associated with the new Vasco da Gama Bridge concession brought traffic to a halt on Portugal's most heavily traveled roadway link, while images of the angry protests were broadcast around the world. The government quickly acquiesced to the protestors' wishes, reduced the tolls, and paid the concessionaire the difference using public funds. One protestor in the UK stopped construction on the Newbury Bypass single-handedly by lying in a hand-dug tunnel under the construction site for five days. These experiences demonstrate the very real threat that public acceptance risk can pose. Prudent investors need to make careful assessments of the approvals required for their projects, as well as public sentiment towards the projects before deciding to invest.

## **2.10 Sustainability Risk**

A principle objective of the public sector is to protect the public interest and ensure

delivery of value for money. Publicly procured and operated projects provide the tax paying public with the ability to control the quality through votes and taxes. The introduction of private operators may reduce this control if effective control or oversight systems are not developed. Along with the development of an effective public sector management and monitoring capability it is necessary to promote the development of consumer "watchdog" associations and allow for public consultation. This not only creates a direct link with the private operator but also develops a strong sense of consumer ownership or participation in PPP projects.

## **2.11 Hidden Protectionism**

Infrastructure provision is generally perceived to be within the domain of the public sector, and the public can be skeptical when private actors are involved. Such skepticism can be exacerbated when investors are from an outside and more affluent country and have the potential to make a profit on their investment. When such a reaction occurs among the populace, it can also have repercussions in the political arena, making it more difficult for foreign investors and their host governments to resolve conflicts. Foreign investors would be negligent if they ignored this issue, and should investigate the experiences of other outside investors in the countries where they are considering doing business. It can be argued, for example, that this dynamic had negative repercussions on the now defunct M1/M15 motorway concession in Hungary. This risk is borne by the concessionaire and it is best countered by consistent government support. It is however ironic to note the often inconsistent approach of public bodies to foreign participation. Particularly there is often less objection to arrangements developed through direct agreements than when public procurement is involved. It is through the latter that nationality and foreign participation most often becomes an issue.

Detailed methodology to analyse risk is presented in Part 5. It is important to note here that although the full quantification of all risk facilitates analysis it is not always possible, effective nor desirable. Risk quantification often involves complicated and costly models based on questionable assumptions. This is particularly the case where data is not complete or risks do not have a direct impact. In such cases the cost of risk quantification and the likely value / accuracy of data should be matched against the importance and likelihood of the risk occurring. As such it is recommended to firstly undertake a qualitative assessment of risk focusing on impact and likelihood of occurrence. This should permit the prioritization of risks and hence the quantification of the most important ones. Part 5 discussed some common analytical methodologies.

The allocation of risk should reflect the specific characteristics of the project and the strengths of each party. However the cost of risk transfer must not be neglected as, given the nature of PPPs, the achievement of value for money will often depend on the level and cost of risk transferred to the private sector. It is also good practice to investigate the extent of risk transfer (and the financial implications) in other associated contracts. Given the interdependence between project components and contracts it is likely that a significant transfer in a separate component can have a financial impact on others and hence should be identified and accounted for.

### 3 ENSURING VALUE FOR MONEY IN A PPP

- **PPPs should be used only if they provide better value for money than traditional methods**
- **Value for money assessment techniques are complicated and require quality data and should be used after careful reflection**
- **However value for money must be a primary objective in maintaining the public interest**

PPPs should only be adopted as a procurement and implementation option if they are reasonably expected to deliver enhanced value for money over traditional methods. Value for Money Assessment (VFM) is therefore crucial to deciding the suitability of a PPP, in general, and the suitability of a particular project design. Additionally, as discussed in Part 2, given certain restrictions on procurement procedures, the evaluation stage of a tender becomes crucial in deciding which tenderer is able to offer the best solution, which is a function of value for money provided.

#### 3.1 Factors Determining Value for Money

Factors determining value for money will obviously vary from project to project and between sectors. Generally, however, PPP will generate value improvements in a number of areas including:

- Reduced life cycle costs
- Better allocation of risk
- Faster implementation
- Improved service quality
- Generation of additional revenue

A recent survey commissioned by the UK Treasury Taskforce on PPP identified that from a public sector perspective, there are 6 key drivers of value for money in PPP projects including: risk transfer, long term nature of contracts, the use of output based specification, competition, performance measurement and incentives and private sector management skills.

The average percentage saving in net present cost terms of using PPPs was estimated at 17% over the contract duration.

#### 3.2 Assessing Value for Money Potential

Value for money (VFM) generation potential should be investigated with particular reference to:

- The scope of the project including the balance between asset provision and service delivery
- The potential for cost effective risk transfer particularly with respect to demand and residual value risk
- The scope for user charges, third party revenues and alternative asset usage that might reduce project costs

Traditionally this type of information is gathered from market analysis and reference to previous projects and historical data. However if these sources prove insufficient or substantial concerns exist it may be necessary to undertake a **shadow bid**. This can be done in one of two ways:

- Estimating the cost savings required – this involves adding the additional costs of a PPP approach (including the cost of private finance, profit margins, tendering costs and the cost of public sector regulation) to a financial comparator (defined as the comparison of the cost of the preferred PPP tender with the cost of delivering the project through traditional public sector procurement methods) and then making a valued judgement on the potential of the private sector to eliminate these additional costs
- Actual Bid – this involves developing an actual bid for the PPP project and comparing it to the estimated cost of traditional public sector procurement costs.

It should be noted that the above concerns assessment for the potential of a PPP to generate value for money. Actual assessment can only take place at the end of the procurement stage but should be done before the conclusion of contractual arrangements.

### 3.3 Parameters for the Final VFM Assessment

The achievement of value for money in a Public Private Partnership procurement is, in part, evidenced through effective competition between potential suppliers

and, on projects that involve public money, through a value for money assessment of the costs and benefits of the preferred PPP tender.

The nature of the value for money assessment undertaken at the end of the procurement process depends on whether the PPP project is financially free standing, generates the majority of its revenues from third parties, or is reliant on public finance. The nature of the value for money assessment for each type of project is summarised below.

#### 3.3.1 Financially Free-Standing Projects

Financially free-standing projects require the Contractor to recover all costs through charges on the final users of the service. The public sector plays a facilitating role but no public money is involved. It is therefore the responsibility of the Contractor to determine whether the project is commercially viable and suitable for investment.

The Contracting Authority should satisfy itself through project appraisal that a Concession contract is the preferred form of PPP for the project, and that the application of user charges is appropriate. The Contracting Authority should determine its preferred approach to the setting of user charges, and develop a payment mechanism that will deliver government policy, the objectives of the project and protect the public interest. Value for money is achieved through the competitive tendering process which is based on the economically most advantageous offer principle.

#### 3.3.2 Concession Contracts with Public Grants

The issues set out above for financially free-standing projects also apply to those projects where the public sector provides grant financing and / or subventions but the revenues come principally from user



charges (ie the public sector is a minority funder).

However, such projects do involve the investment of public money and there is therefore a need to ensure that the project represents the best use of the public funds. For this reason the benefit gained from applying the funds to the PPP project should be compared with the benefit gained from applying them to an alternative project that would otherwise not proceed. Policy priorities will be an important consideration in this regard. Public subvention could take a number of forms, including capital grant and revenue support.

### 3.3.3 Projects where the Public Sector is the Main Financial Contributor

In the case of projects where the public sector is the sole or main funder a detailed value for money assessment is recommended at the end of the procurement. The assessment should compare the costs and benefits (in monetary and non-monetary terms) of the preferred PPP tender with the costs and benefits of traditional procurement, or under certain circumstances, with other comparable measures.

## 3.4 Elements of the Value for Money Assessment

A value for money assessment comprises two key elements:

- Monetary comparison - comparison of the cost of the preferred PPP tender, with the cost of traditional public sector procurement, expressed in terms of discounted cashflows over the life of the PPP contract (the Financial Comparator). Under certain circumstances other quantifiable measures may be used as the basis for a Financial Comparator; and
- Non-monetary comparison - comparison of all the factors that are difficult to quantify in monetary terms,

but their value to government and the wider public is significant. Examples include speed of project delivery, quality of service, and security of supply.

### 3.4.1 Parameters Required for the Monetary Comparison

The monetary comparison could take one of four forms depending on the characteristics of the project. The four forms of monetary comparison can be summarised as follows:

- Financial Comparator - involving a comparison of the cost of the preferred PPP tender with the cost of delivering the project (to the standards set out in the initial output specification) through traditional public sector procurement;
- Best available alternative - for projects where the cost of traditional public sector procurement is difficult to determine, the cost of the preferred PPP tender should be compared with the best available alternative costing;
- Price benchmarks - involving a comparison of the preferred PPP tender with reliable, comparable and independent price benchmarks or unit costs (for example, standard costs per volume); and
- Comparable PPP projects - involving a comparison of the preferred PPP tender with the cost of other comparable existing PPP projects.

### 3.4.2 Financial Comparator

The Financial Comparator is a technique employed particularly by the UK Private Finance Initiative to assess the value for money provided by a preferred PPP option and selected tenderer. It is developed based on the preferred PPP option to provide a fully costed estimate of delivering the project (to the standards set out in the initial output specification) through traditional public sector procurement, presented in terms of a

discounted cashflow analysis. In practice, if the preferred PPP option results in the transfer to the private sector of all services included in the preferred option arising from the Project Appraisal, then the differences between the Financial Comparator and the preferred option will be limited.

The Comparator is based on a hypothetical project contract in which the public sector undertakes all functions (design, build operate etc) based on actual costs incurred on similar projects. It should include all risks and the value of any assets to made available to the project. Care needs to be taken to avoid double accounting particularly with respect to public sector costs that would not be part of a PPP contract.

The costs expressed in the assessment should be presented in real terms in a

discounted cashflow analysis and over a range of applicable discount rates. The Net Present Value (NPV) of the public sector project is compared with the NPV of the PPP option. If the difference in NPVs is positive then the PPP alternative is considered attractive. A further refinement entails making the cash flow calculations stochastic through the use of ranges instead of mean values and the application of Monte Carlo analysis. The result is a probability distribution of the NPV of the PPP option as compared to the public procurement option. This distribution would also indicate the possible spread in the output and again a positive value means the PPP is the more attractive option.

A suggested layout of the model is provided below:

### Example of Financial Comparator Model

Item / Year	0	1	N+1
<b>Opportunity Costs</b>			
• Land			
<b>Capital Costs</b>			
• Construction			
• Etc			
• Residual Values			
<b>Recurring Costs</b>			
• Structural maintenance			
• Operational costs			
• Etc			
<b>Net Cost Before Risk</b>			
	<b>NPV of Capital and Opportunity Cost</b>		
	<b>NPV of Recurring Costs</b>		
	<b>NPV of Total Costs (without risk)</b>		
	<b>Equivalent Annual Cost</b>		
<b>Risk Analysis</b>			
• Design risk			
• etc			
<b>Net Cost After Risk</b>			
	<b>NPV of Total Costs</b>		
	<b>Equivalent Annual Cost</b>		

It should be noted that developing a financial comparator is often a time consuming and expensive task and the results are only as good as the baseline information provided. While it is undoubtedly a useful tool a careful

assessment needs to be made as to its need given project scale, available information, cost and the usefulness of alternative methods.

### 3.4.3 Best Available Alternative

Ideally, the Financial Comparator should be based on the same services and service levels as the preferred PPP option. However, for projects where there is no track record of public sector procurement, the cost of the public sector providing the service levels defined in the output specification may be difficult to determine and subject to a high level of uncertainty.

In such circumstances, the Financial Comparator should be based on the best available alternative costing, which will most likely relate to the provision of services to a lower or alternative standard. The best available alternative may relate to the cost of current provision.

It is essential that the service levels assumed by the Financial Comparator are clearly recorded in the PPP Assessment so that, at the end of the procurement process, the differences between the preferred private sector tender and the Financial Comparator can be understood and evaluated.

### 3.4.4 Benchmarking and Comparison

A Financial Comparator may not be required for projects that involve the provision of services for which there is a well established market. In such circumstances, the financial comparison could simply involve a comparison of private sector bids against reliable, comparable and independent price benchmarks or unit costs (for example, standard costs per volume). The use of price benchmarks or unit costs is likely to be most applicable to outsourcing type contracts.

### 3.5 Parameters Required for the Non-Monetary Comparison

The monetary comparison will not take into consideration all of the factors that contribute to value for money. Many factors will be difficult to quantify in

monetary terms, but their value to government and the wider public is significant. Examples include speed of project delivery, quality of service, security of supply and equity issues such as the accessibility of services. Consequently, the monetary comparison should not be approached as a pass fail test, and should be complemented with a value for money assessment of the costs and benefits of the preferred tender in non-monetary terms.

The costs and benefits of the preferred tender may be usefully compared with the costs and benefits of traditional procurement in non-monetary terms through the use of impact statements or a weighting and scoring matrix.

### 3.6 Results of the Value for Money Assessment

The results of the value for money assessment that is undertaken at the end of the procurement process determine whether establishing a PPP with the preferred Contractor will deliver improved value for money compared with traditional procurement, or indeed other Tenderers. The value for money assessment is therefore the fundamental tool in deciding whether or not to proceed with a PPP contract.

## 4 OPTIMISING THE GRANT CONTRIBUTION

- **Grant financing can have positive and negative impacts**
- **Grants, like the entire project financing package, should be matched to actual needs**
- **A compromise has to be reached between permitting project realization, enhancing private sector profit levels and maximizing social benefit**

An inherent characteristic of grant financing is that beneficiaries have little

incentive to optimise the amount they request. Additionally in the specific case of the ISPA application process introduces a certain element of rigidity in that the grant amount is determined at the project design and application stage and is approved before procurement. This together with procurement procedures that do not facilitate price negotiations make it difficult to adapt grants to real requirements unless an effective negotiation phase is foreseen.

Grant financing has two principal impacts, namely:

- an immediate impact on project financial viability by reducing costs (or increasing revenues)
- an impact on Local Authority (ie Municipal) budgets by reducing demand on funds and allowing budget transfers to other requirements
- an impact on the private sector contractor's perception of project viability

Assessing the level of required grant financing is complex and must give regard to the objectives of and impact on each of the parties in a PPP, not simply 'the project' itself. A basic principle should be to provide grants only up to that amount which allows the project to be realised and operated in a sustainable manner. This assumes that a range of financing options are considered for realisation and that the project is considered over its useful financial life.



Is the scale of investment matched to actual needs ?

The overriding consideration must be to match grants to real project needs thereby avoiding the potential for a “**Ferrari syndrome**” in which over ambitious designs are financed and implemented. The ISPA Programme currently bases the calculation of a grant on the revenue generating capacity of the project with regard to an equitable tariff policy, no unreasonable profits to the private party and the maximisation of co-financing opportunities. A Discounted Cashflow Analysis is used to assess the projects' ability to generate revenue to cover costs without a grant and specifically what, if any, percentage of capital costs can be covered. The grant represents the 'financing gap' between forecasted revenue generation and required revenue generation.

An alternative has been to calculate the Internal Rate of Return if this is below an acceptable level then the grant contribution should represent that amount required to raise the IRR to an acceptable level.

Both approaches are well known. However both represent a certain number of difficulties not least of which is the definition of an acceptable IRR and the level of affordability to sustain required user charges and tariffs.

Alternative methods include:

- the Commission has also made a distinction between project types and has assigned fixed rates of grant assistance to each. This obviously provides no incentive to optimise grants or undertake financial engineering
- an holistic approach to financing would look at the financial analysis of the project but also the financial situation and in particular the debt absorption capacity of the project beneficiary. This would allow a more precise assumption on the amount of debt that a project can assume both with respect to the projects viability and the ability of the project

beneficiary to finance debt. As a result grants are set to a level which allows realisation of the project but assumes that the first priority of financial engineering will be to assume the maximum [efficient] level of debt. In this approach soft loan investment funds have often been successfully used which blend commercial loans and grants to provide soft loans thereby promoting debt financing but nevertheless reducing the overall debt burden.

- greater emphasis can be placed on determining more accurate estimations of the IRR and ability to pay. Both, currently, suffer from a lack of consistent and reliable data in the CCs which makes benchmarking the figures very difficult. This is a result both of insufficient availability of data and inconsistencies in analysis as is often witnessed in project appraisal work. This situation can be expected to improve with greater experience of project implementation and application of user charges, however for the moment greater expenditure on project financial analysis would seem to be the only alternative.
- a facility that is not sufficiently exploited at this time, due to restrictive procurement procedures, is to allow the private sector Tenderers define the required level of grant assistance. This is a useful benchmark where flexibility is given to Tenderers to suggest their optimum approach and where they are encouraged, through the tender conditions, to minimise their demand for grant financing.

A further element to consider when analysing the amount of effective grant to provide is the potential for conflict with EU policy and directives on State Aid (rules on State Aid are now applicable in CCs). Where a grant contribution to a PPP concerns payment to an economic operator for the provision of “services of general economic interest” (such as water and waste services but not the provision of transport infrastructure, which is regarded

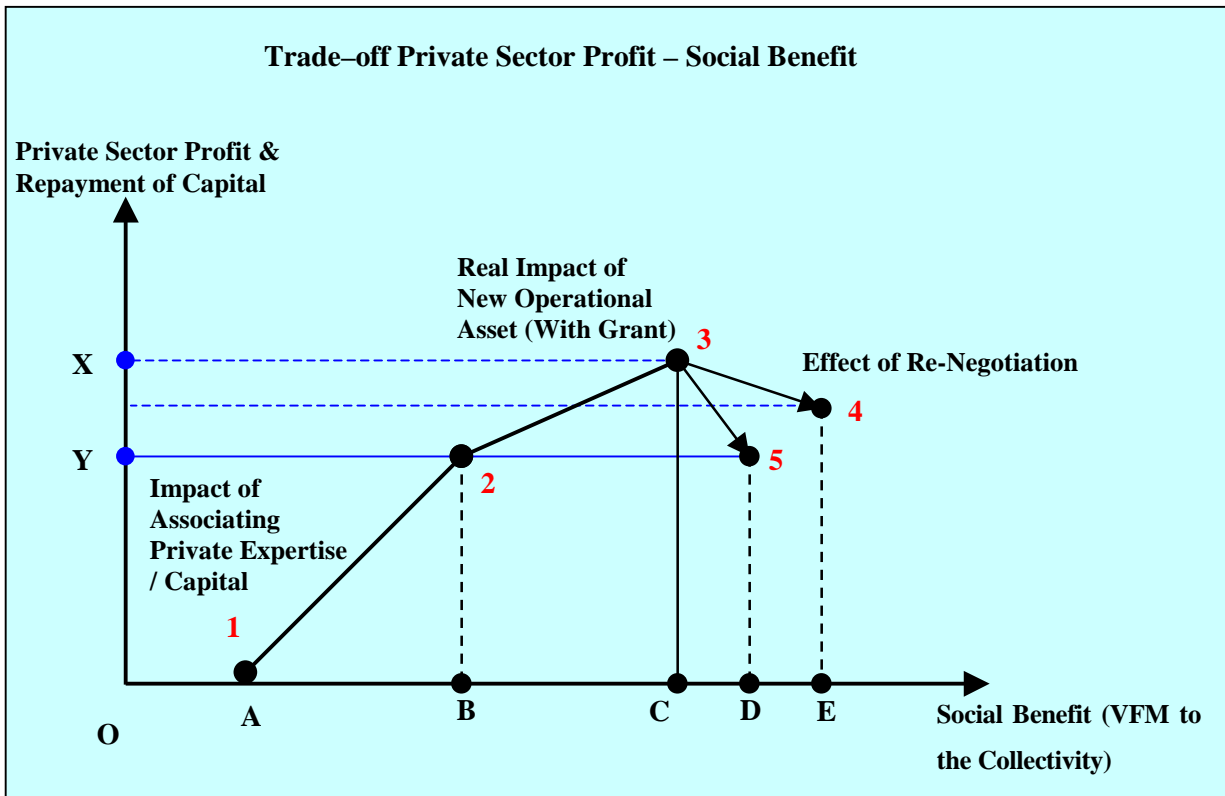
as a general, not selective measure) and where the public is charged for the services, any financial compensation from state resources for the provision of such services could be interpreted as constituting state aid. The precise limits of this restriction are still being defined by case law and awaiting a final ruling by the Court of Justice. The Commission has however published a recent report<sup>13</sup> which suggests that state aid rules are not breached (that is, any state aid is compatible) as long as grant contributions are correctly calculated and only serve to allow the operator to function and provide the services in a situation of "economic equilibrium". This would seem to support the absolute need to ensure both that, no unjustifiable excess profit is created by grant financing and that the project could not operate viably without the grant contribution. Additionally any renegotiation of grant contributions with private operators would need to follow the same logic. This situation is still evolving and the expected decision from the Court of Justice will need to be integrated into future grant design.

In all cases the prime objective of the Commission in protecting the public interest, should be to optimise the grant allocation in such a manner that the project is realised, is financially viable, sustainable and generates the maximum social benefit but which also limits [resulting] private sector profits to reasonable levels. This can be represented graphically in the following diagram.

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<sup>13</sup> Report to the Seville European Council on the Status of Work on the Guidelines for State Aid and Services of General Economic Interest

<sup>14</sup> COMP.A3/AA/D(2002) 293



The graphic can be defined as follows:

**On the Vertical - Private Sector Profit axis:**

- 0 → Y Private sector operating profit without grant contribution
- Y → X Increase in private sector operating profit with grant financing and increased efficiency of an operative asset (resulting from grant financing)
- Reduction from X towards Y = the redistribution of pure operating profit (resulting from grant financing) to enhanced social benefit and “fair” private sector profit margins as a result of re-negotiation

**On the Horizontal - Social Benefit axis:**

- 0 → A social benefit arising from a purely public sector project
- A → B increase in social benefit arising from private sector participation
- B → C marginal increase in social benefit from project realisation and grant financing contribution
- C → D or E increase in social benefit as a result of re-negotiation of redistribution of pure profit resulting from grant financing

- Point 1** represents a project financed purely from public sources
- Point 2** represents a project financed from private sources with public funds
- Point 3** represents a project financed under a PPP arrangement with a grant contribution
- Points 4 & 5** represent a desired outcome for the grant provider in their objective of maximising social benefit while limiting the impact on private sector profit margins resulting from grant financing.

# PART 4 INTEGRATING GRANT FINANCING AND PPP CHARACTERISTICS

## PART 4 – Summary

- Grant financing has strengths and weaknesses which must be integrated into the project.
- Grants should be used when required and matched to actual project needs
- Grants can be delivered in a number of methods depending on required impacts
- Grants have a strong conditionalities which may limit their application
- The ability to use grants in a PPP depends on the ability to meet conditionalities or provide sufficient safeguards to protect the Commission's interests
- The length of concession contracts is of particular interest to the Commission and must correspond to the spirit of the Procurement Directives
- This Part will address:
  - Justifications for grant financing
  - European Commission financing characteristics
  - Length of concessions

## 1 INTRODUCTION

The section will address the specific issues of integrating grant financing into a PPP package and more specifically how Grant objectives and conditionalities can be addressed.

The section will:

- Identify the pertinent characteristics of grant financing and offer solutions on what to finance (the issue of optimal grant size has been treated in Part 3)
- Identify the characteristics and benefits of PPP approaches and how these can be exploited under European Commission projects

## 2 JUSTIFYING GRANT FINANCING

- The impact of including grants in project financing needs to be carefully evaluated against their strengths and weaknesses
- Grants can impact positively on project viability but their use must also be justified in terms of real need

Grant financing has traditionally been employed by the public sector to realise infrastructure requirements which are not financially viable to other sources of financing (due to risk, viability or scale issues), or which present particular social characteristics requiring them to remain in the public domain. As a result grants may have different financing objectives and implementation procedures to classical commercial sources which in turn creates perceived barriers to successful cooperation between the two.

Due to the decreasing amounts of available public finance there has been considerable pressure to integrate grants into more

commercially orientated forms of financing and hence PPP relationships. These developments have been augmented by the trend of privatisation in utility service provision and the increased availability and application of private finance. These developments have forced a review of how grants are best used and particularly how the advantages of free funds can best contribute to an overall financial package.

Deriving the maximum benefit from grant financing requires an identification of their relative strengths and weaknesses. The following discussion presents a number of these but it should be borne in mind that, as with Commission funds, grants usually have conditionalities attached which do not necessarily relate to market (ie financial) necessities and therefore such an analysis must go wider than a simple cost – benefit analysis of financing instruments.

The most commonly cited advantage of grants is the ability to finance projects which would / could not otherwise be financed by commercial sources alone. This is most often the case with ‘social’ infrastructure which does not usually provide sufficient financial viability for commercial financing. This argument is valid provided that the investment costs together with operational and maintenance costs are included and therefore that the investment is sustainable over its useful (financial) life and provides a real social benefit.

The use of grants is, arguably, most valuable in co-financing applications where its objective is to increase the financial viability of a project to a level allowing the application of commercial financing. This leveraging function entails the use of grants to reduce the overall cost of the project or to enhance the value of the revenue stream. It is in this field that grants can be applied most intelligently to derive the maximum benefit and different methods of doing so are presented later.

The presence of grants, and by association a public or international body, often also assists in reducing certain types of project

risks and therefore project cost. Grants can be used directly to finance risk coverage or used as a guarantee mechanism. However the presence of the grant giving body and the willingness to commit public funds, additionally provides the private sector with a certain assurance regarding the seriousness of the project and sponsors.

The above two strengths are associated with the ‘leveraging’ effect of grants meaning that the availability of grants is usually conditional upon or enhances the availability of co-financing or is a facilitator to identifying other sources of funding. In this case grants have an important and complimentary role to play in PPPs as both tools aim to increase the value and volume of financing.

As stated above, conditionalities are usually attached to grants which are often wider than financial conditions. This can have the advantage of accounting for or realising socio-economic externalities particularly if these impinge on project viability and grants pay for them.

However grant financing also has a number of weaknesses which must be recognised if they are to be successfully integrated into PPP’s. Most importantly grants, in themselves, provide little incentive to efficiency enhancements usually associated with the pressures of commercial financing. Additionally the availability of free funds can cause a degree of dependency and ‘crowding out’ of alternative sources. This has been seen in the CC’s where a, natural, reaction has been to focus on free grants and national funds before considering other sources to the point of delaying investments or refusing to consider alternative financial sources.

A common complaint has also been the difficulty and cost of implementing grants which are usually subject to more lengthy and bureaucratic procedures. This has made their integration into commercial financing packages difficult. However it must be remembered that grants are usually public funds and therefore imply



stringent public accountability requirements.

## 2.1 Determining the Form of Grant Assistance

Grant financing usually focuses on the provision of services, supplies and works for the realisation of physical infrastructure. They therefore intervene directly on the capital costs side of a project by reducing costs and / or enhancing revenue streams.

Grant financing can be used in a number of different ways with the objective of optimising their impact. This objective is driven in part by the fact that the availability of grants is often limited, as is the case of the Commission budget relative to overall financing needs, and that grants should not be seen as an alternative to other sources of financing but rather as a constituent part of a financing package. As a result project designers must ask the question 'where, and in what form, will a grant have the most impact relative to the needs of the project' and 'how much funding should the grant provide' (this is treated in Part 3).

Alternative applications of grants include (but are not limited to) the following:

- Provision of regular, subsidy, payments to operational costs. This can be particularly useful in the first years of operation when cashflow is still developing but is not sufficient to cover all costs, particularly the cost of capital.
- Coverage of financial costs. This can include:
  - Reducing the cost of borrowing by effectively 'softening' loans
  - Providing loan guarantees
  - Financing risk elements
  - Subsidising taxation payments
  - Covering exchange rate losses
- Subsidising revenue flows. This is particularly useful if a policy objective is to keep user charges low. However this should not be considered a

permanent arrangement due to the introduction of inefficiencies.

- Financing the public sector's contribution in-kind.
- Assisting the financing of the public sector's financial incentives to the private sector.

Additionally the restrictions placed on grant financing by the potential to contravene State Aid rules as discussed in Part 3 chapter 4 must be integrated.

In all cases it is crucial to assess the real need for grants and to optimise the grant amount relative to this. While grants have many positive contributions, the negative impacts of grants on a project and public financing should not be forgotten.

## 3 COMMISSION FINANCING CHARACTERISTICS

- **Grant conditionalities influence the entire project cycle but are designed primarily to safeguard the public interest and guarantee the correct use of funds**
- **Of particular concern is the development of PPP relationships and procurement and hence at what stage the Commission becomes involved**

The ISPA objectives and implementation procedures are a good example of the conditionalities often attached to grants. Although focus is placed on technical and financial viability and sustainability criteria, nevertheless grant recipients must also fulfill numerous wider conditions. The recognition of their implications is crucial to the successful integration of Grants into PPP's.

ISPA has been designed as an instrument to assist the development and realisation of environmental and transport infrastructure with the specific recognition that it operates in economies which do not have

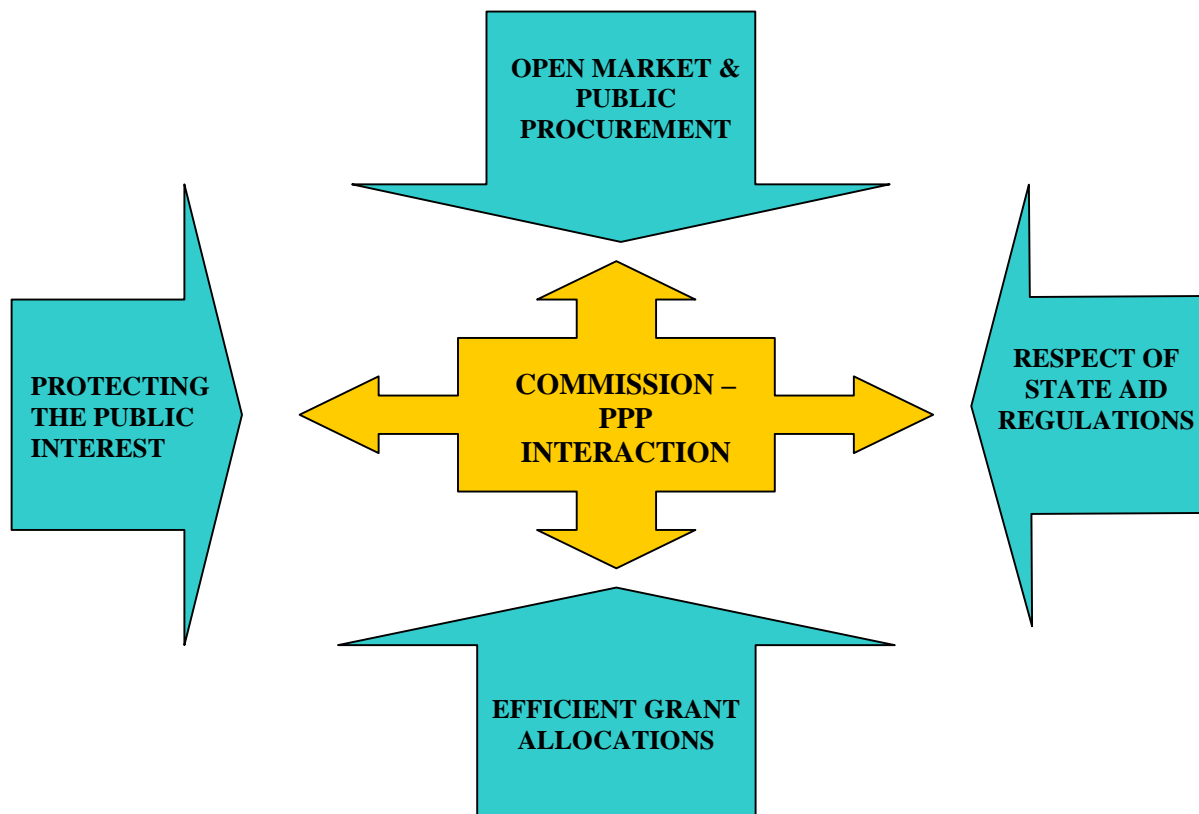
the financial means or investment climates to finance them themselves. It should be noted however that it was not designed to undertake the financing of these investments itself and indeed insists both on co-financing and encourages the possibility of using a diverse range of funding sources and mechanisms.

It is also important to note that the Commission is not directly a contractual partner with the project beneficiary but instead channels its funds through a national structure which is responsible for ensuring that the conditions of financing are respected. There is however an important difference with other EU funds in that ISPA [currently] maintains ex ante control over implementation. This results in a situation in which while ISPA is not directly [contractually] related to the project implementers it nevertheless exercises an enormous influence on the design and implementation of the project. While ISPA provides majority financing this situation can be justified but would

become less tenable if ISPA grants present a smaller minority of total funds.

The main characteristics, over and above the technical and financial project characteristics, defining ISPA financing (and hence potential cooperation with private sector partners) include the need for a project to enter into a defined list of financing objectives and priorities, the adoption of financing rules and Commission approved procurement procedures and ex-ante control of implementation. Additionally the Commission has certain needs which must be met in all projects including; transparency in implementation particularly with respect to procurement, early involvement, clear demonstration of public benefit and value for money including that grants are not unfairly benefiting the private sector and evidence that European standards are adopted in design criteria. The factors influencing a Commission grant to a PPP can be summarised in the following diagram.

### The Fundamental Commission – PPP Interactions



These influences derive from the principles of the European Union as enshrined in the Treaty and Acquis and from the objectives associated with Commission grant financing. They can be summarised as:

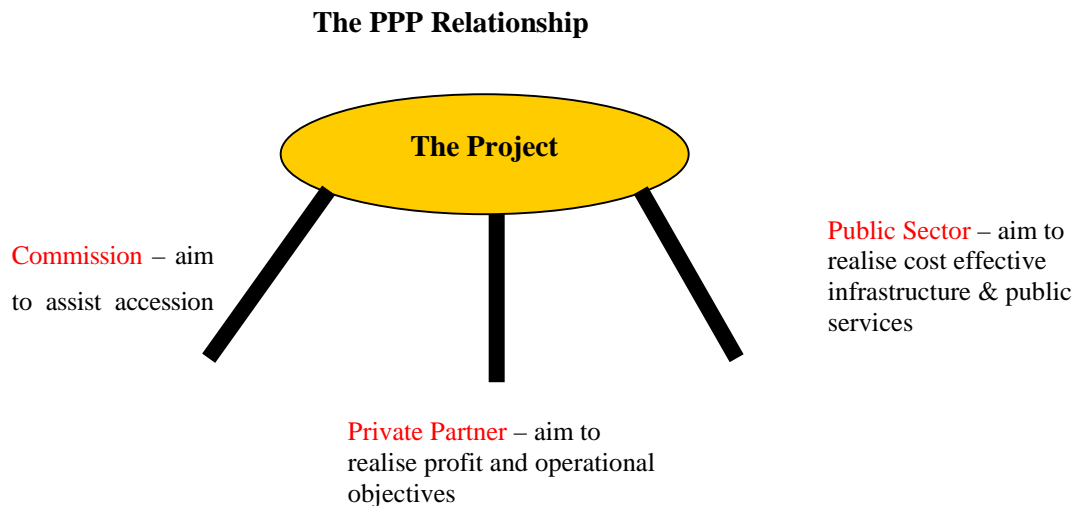
- Ensuring Open Market Access – this includes:
  - Fair and open participation of parties receiving equality of treatment
  - Application of transparent public procurement procedures
  - Application of the Public Procurement Directives
- Adherence to the principles governing State Aid – this includes:
  - Ensuring there is no over-compensation for services rendered
  - Grants matched to real needs
- Protection of the public’s interest – this includes:
  - Ensuring PPPs and grants deliver quality of service
  - Value for money must be demonstrated
  - Public participation in the oversight function should be included for sustainability
  - Windfall profits to contractors must be avoided

- Re-negotiation of contracts should be undertaken where required to re-balance contracts
- Implementation of PPP should not diminish focus on and responsibility for social consequences including employment and socio-economic development

- Defining the optimal level of grant financing – this includes:
  - Grants to be matched to real needs
  - Maximise use of limited funds
  - Do not distort market operation
  - Maximise leverage potential of grants
  - PPP are not to be treated as an accounting tool to move public expenditure ‘of balance sheet’.

### 3.1 Managing the Commission – PPP Relationship

PPP relationships function when the concept of a partnership between parties is fully recognised. This requires both joint cooperation and an understanding and integration of the aims and objectives of all parties. As such if the characteristics of one party are not addressed the partnership is unlikely to proceed effectively. This interdependency can be demonstrated by a tripod whereby if one leg is removed the structure collapses:



This section will deal with the problematic of integrating Commission objectives and conditionalities into a PPP relationship (the following section will address the specific issue of how to structure a grant). It is assumed that the problematic of integration lies in operating with the private sector as the Commission already has experience of joint or co-financing with other IFI's. Commission exposure to cooperation with the Private Sector will change with the increasing pace of privatisation of utility operators and the need to rely on private funding sources to complement limited public funds. As a result the Commission is already facing the existence of both local and foreign private operators. Although their intervention is predominately in the form of service contracts, the Commission is nevertheless increasingly finding itself

included in simple PPP relationships. This has raised the issues of:

- how will or was the private party selected and is this in-line with EU procurement Directives and procurement policy and hence acceptable
- what will be the impact of grants on the private sector financial balance
- is the continued viability and sustainability of the investment guaranteed
- will the EU's standards be fulfilled
- who will retain ownership of assets
- is public benefit assured

The main issues can be summarized as follows:

PPP Relationship	Issues	Required Activities	Outcomes	Risks
A PPP exists	<ul style="list-style-type: none"> <li>• selection process of private party</li> <li>• suitability &amp; competency of private party</li> <li>• financial status of parties</li> <li>• what is to be grant financed</li> </ul>	<ul style="list-style-type: none"> <li>• financial &amp; legal review of PPP contracts</li> <li>• due diligence of private party</li> <li>• justify lack of open competition</li> <li>• develop safeguard clauses under Art 8</li> </ul>	<ul style="list-style-type: none"> <li>• grant only for specific targeted applications</li> <li>• clearly defined impacts and outcomes</li> <li>• effective monitoring</li> <li>• renegotiation as required</li> </ul>	<ul style="list-style-type: none"> <li>• unfair competition</li> <li>• misuse of funds</li> <li>• generation of undue profit</li> <li>• reduced grant impact</li> <li>• reduced social benefit</li> </ul>
A PPP is under preparation and a Grant is requested	<ul style="list-style-type: none"> <li>• as above</li> <li>• existence of open and fair competition</li> <li>• expected private sector profit margins</li> </ul>	<ul style="list-style-type: none"> <li>• as above</li> <li>• influence selection process</li> <li>• develop penalty clauses</li> <li>• match grant to need</li> </ul>	<ul style="list-style-type: none"> <li>• harmonization of PPP and grant approaches</li> <li>• competitive tendering</li> <li>• grant conditionalities and monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• as above</li> <li>• loss of private partner if no match with Commission conditionalities</li> </ul>
A grant has been awarded and a PPP is entered into	<ul style="list-style-type: none"> <li>• as above</li> <li>• potential conflict with the Commission conditionalities</li> <li>• safeguarding public interest</li> </ul>	<ul style="list-style-type: none"> <li>• Invoke Art 8 if required</li> <li>• Renegotiate grant</li> </ul>	<ul style="list-style-type: none"> <li>• Revoke grant or renegotiated grant</li> <li>• Misuse of funds</li> </ul>	<ul style="list-style-type: none"> <li>• As above</li> <li>• Revocation of grant</li> <li>• Project unsustainable</li> </ul>
A PPP is desired regardless of Grant award	<ul style="list-style-type: none"> <li>• is grant necessary</li> <li>• can public benefit be enhanced</li> <li>• are EU Directives respected</li> </ul>	<ul style="list-style-type: none"> <li>• Cost benefit analysis of project</li> <li>• Assess public benefit</li> </ul>	<ul style="list-style-type: none"> <li>• Project impact not maximized</li> </ul>	<ul style="list-style-type: none"> <li>• Over reliance on private sector</li> <li>• Private sector exploitation</li> <li>• Reduce social benefit</li> <li>• Lack of competition</li> </ul>

It should be noted that these issues are usually raised at the beginning of a project but also during project implementation particularly with the current trend of privatisation. Methods must be developed

allowing the effective integration of Commission grants into the PPP process focusing particularly on changes to contractual terms between parties, for ISPA notably through the Financing

Memorandum; and changes to selection and procurement procedures. This requires recognition of the fact that as the complexity of PPP relationships increases, the Commission may find itself no longer in the position of majority financier and therefore imposing its current conditionalities may create inefficient barriers to project realisation. Additionally, as discussed in the following section, the use of grants may also change in terms of what is financed thereby further removing the Commission from physical project implementation.

In order to define such methods, each of the 4 categories of PPP relationships (defined in Part 1) will be analysed in terms of changes required to ensure:

- that no undue financial benefit accrues to the private sector as a result of grant financing
- that there are clear justifications for the application of grants in particular with respect to demonstrating value for money
- that there is transparency and fairness in selection and procurement procedures
- that the Commission is able to benefit from an early involvement in project design and implementation
- that effective monitoring systems and procedures are available

### 3.1.1 Traditional Public Sector Procurement

This basic type of PPP relationship essentially involves service contracting for well defined tasks with ownership of assets and the management of financing remaining in public hands. As such there should be no conflict with current ISPA regulations and indeed the Commission is already commonly involved in these relationships.

Two issues remain outstanding:

- given the increased private sector interest in providing services in CC

markets it is questionable whether greater attention should be paid to the size of grants in relation to possible commercial financing which in turn is relative to the debt capacity of the project and the beneficiary. Attention should be placed to avoid crowding out commercial / alternative financing sources. Related is the issue of whether grants could not also be used to directly finance the application of commercial loans to project implementation.

- increasingly projects are faced with changing circumstances in terms of ownership, privatisation, project conditions. It is obviously the Commission's interest to maintain the value of conditionalities it imposes. The Financing Memorandum, Article 8, makes provision for changed circumstances during the first 5 years of the project. With increasing private sector participation it is however important to ensure that potential benefits from changed circumstances are not lost.

### 3.1.2 BOT Projects

The pertinent feature of this group of PPP relationships is that while ownership of assets and responsibility for funding management remains with a public body, the assets have a private operator who derives financial returns from their operation and hence (direct or indirect) charging of users. As a result the concerns of undue financial gain and value for money are particularly relevant.

While the procurement process can essentially remain the same, the advantage of these relationships is gained through the grouping of contracting, engineering and operational functions to derive life cycle cost benefits. The real issue therefore becomes one of how to design procurement and particularly evaluation, procedures to ensure that all efficiencies of the BOT approach are captured. Part 2 demonstrated that given the restrictions of the current ISPA procedures, some

flexibility can nevertheless be introduced either by allowing variant solutions in tenders and / or by placing more emphasis on evaluation techniques which identify the full range of costs and benefits.

This approach allows project beneficiary to organise a tender which takes advantage of life cycle cost benefits resulting from the tender competition while also respecting the need for presenting full technical specifications. This would assume that the Commission is satisfied with:

- Technical and financial performance criteria
- Evaluation methodology and criteria
- A minimum number of participants in the tendering process
- Adequate transparency and openness in the procedures.

To further ensure that the project meets implementation criteria, the Commission should play an active role in the development of the evaluation criteria (which in itself is a useful analytical tool for project design).

Given the time difference between grant approval and project implementation, such evaluation criteria will also better define the need for grant financing. It is therefore recommended that the results of the evaluation process be integrated into the Financing Memorandum and the grant adjusted accordingly. This could provide a mechanism to more accurately match grant contributions to actual need.

Concerns of undue financial gain to private parties can be addressed by stipulating the expected financial returns to operations either by defining payments to contractors or setting maximum user fee charges. Indeed it is now common practice to limit user charges and build in incentives for additional profits to be raised through efficiency gains thereby reducing the burden on fees. This should be supported by flexibility in the FM to reduce overall grant contributions should

financial projections prove better than initially forecasted.

The monitoring function is particularly important in this relationship as the public body changes from being an operator to a manager and must therefore develop adequate monitoring and oversight capabilities to ensure that the contractor delivers against contract specification. The existence of these capabilities would allow the Commission to ensure its value for money, public benefit and monitoring requirements. Two further functions can be introduced. The Commission should be present at the evaluation of the private contractor to ensure the fairness of the procedure against specifications. Additionally the current role of ISPA supervising engineer could be transformed to an independent monitor of the BOT contract until such time as the national monitoring structures are able to effectively adopt this function.

A number of further issues have been raised as a result of recent experiences, these include:

- The need to investigate the ownership structure of all assets and whether transfer of assets is envisaged in any part of the infrastructure chain. This is important as ownership or leasing arrangements of one piece of related infrastructure can cross – subsidies the operations of a private concessionaire and can therefore impact on the financial conditions of the project
- An holistic approach needs to be taken to the investigation of Municipal finances both to analyse the overall debt capacity, ensure that finances are sustainable and that the grant is not being used as a transfer payment
- The selection of private concessionaires prior to the ISPA project remains an important issue. Justification for selection should be assisted if local authorities respect the spirit of EU Procurement Directives and make specific reference to the requirements of the Treaty of Rome in their selection. This is not always the

case and the Commission may be required to undertake a separate analysis of the arrangements and the value for money provided by the concessionaire. It is therefore advisable to include the Commission at an early stage of any procedures if a grant is to be applied for.

### 3.1.3 DBFO and Concession Agreements

The comments relative to BOT relationships are also relevant for DBFO and concessions as the public sector entrusts operations to a private party but additionally the financing responsibility is shared in that the private concessionaire brings an equity participation and / or privately identified financing sources. Asset ownership however remains (ultimately) with the public sector. Given the high degree of interest in concession contracts in the Member States, the Commission is currently investigating these to ensure there are no possibilities for infringing competition and market rules. It's Interpretative Communication sets out its argumentation as discussed in Part 2.

A DBFO must demonstrate the ability to make sufficient financial returns to warrant private financing in a qualified risk environment. This raises the question of the best role for grant financing being either in the realisation of infrastructure or the realisation / facilitation / leveraging of a financing package (see next section).

Even more so than with BOT schemes, there are efficiencies to be gained by ensuring that funds are pooled and managed by the concessionaire. Because of the implied derogation of responsibility an even greater degree of preparation is required with particular attention to the definition of performance criteria which will both ensure that conditionalities are met but which do not stifle private sector initiatives to enhance efficiencies. The answer to this apparent contradiction may lie in the use of more effective evaluation

techniques, notably the application of a public / financial comparator at project design and procurement evaluation.

Additional issues include:

- Undue profit concerns can be addressed by setting financial return guidelines in the tender specifications and limiting the extent of user fees although this may be difficult in concession arrangements where the private party assumes majority financing. As with BOT schemes opportunities for additional profit should be included as incentives for efficiency gains.
- Value for money must be addressed through the minimum performance criteria and standards to be implemented.
- Transparency is addressed through the selection procedure, agreed upon beforehand with the Commission and through the application of a public comparator to assess the bids.
- Effective monitoring systems are particularly crucial as the public sector is normally further removed from operations than under BOT schemes. The FM must include provisions for changing the terms of the grant in relation to the regular findings of the monitoring process. This ensures that an additional performance guarantee is placed on the private party.



***As a general rule, Municipalities wishing to integrate ISPA financing into a proposed PPP are advised to include the Commission at the earliest possible stage to ensure that conditionalities can be fully integrated with minimal disruption to the project.***

## 4 LENGTH OF CONCESSIONS

- **The length of contracts is of major concern to the Commission in its desire to achieve open and fair competition**

An issue which impacts both on private sector participation in projects and the Commission's ability to approve PPP arrangements is the duration of concession agreements. Private operators will naturally aim to maximise the length of concessions to safeguard their cashflow and the viability of their investment. The Commission on the other hand aims to promote open competition and fair market access, reduce the possibility of monopolies and ensure the public benefit. These objectives would suggest shorter concession agreements.

These issues have been addressed recently by the Commission in its Interpretative Communication on Concessions Under Community Law (2000/C 121/02) which results from the growth of concession arrangements in the EU Member States and the potential for conflict with fair competition / open market Directives.

A number of considerations can be taken into account when designing concession agreements both when the Commission is directly or indirectly involved, including:

- At the tender evaluation stage there must firstly be a clear demonstration of value for money from a concession arrangement which should be a priority factor in approving it. It is argued that currently not enough effort is placed in identifying value for money and where further efficiency gains or cost savings can be achieved.
- A common complaint of the private sector concerns the perception of fairness of concession tenders. In other words is the tender fair enough to warrant the investment in developing a tender. This can be

overcome, in part, by increased efforts to publicise the purpose and organisation of tenders and to ensure greater openness and transparency in procedures. This should also include highlighting cases of private sector corruption. It is therefore argued that a perception of fairness will create greater interest in concession tenders and facilitate their organisation on a more regular basis.

- As a general rule the lower the amount of risk assumed by the private party and the lower their financial contribution, the shorter should be the concession period.
- A common tool is to impose a maximum cap on user charges but to support the concessionaires cashflow with subsidies (or shadow charges). While this does not promote the implementation of effective tariff systems or the polluter pays principle it does allow social considerations to be integrated into the financial implications of concession duration.
- Another common tool is to separate the concessionaires revenue stream between user charges and an incentive payment relate to cost savings realised through increases in operational efficiency. This allows greater justification for longer concessions because the concessionaire is incentivised to take a long term operational approach to meet his revenue targets.
- Several countries, particularly in the solid waste sector, have taken the approach that where the former public utility has been privatised and has been awarded the first concession, the period of the first concession should be very short (in the region of 5 years maximum) to reflect the fact that there has been an unfair competitive advantage and that the concessionaire probably received the concession at a very low price. This gives sufficient time for the private sector to analyse



the concession and prepare for the next tender and for the former public utility to restructure itself sufficiently to compete in a fair market.

These considerations recognise that the duration of concessions can be reduced provided that sufficient knowledge is available on the ability to meet a reasonable cashflow to the private sector and that tender conditions are recognised to be fair and open thereby stimulating private sector interest.



Heavy commuter traffic crossing the river in Bratislava means that the four existing bridges cannot adequately cope. The new Košická Bridge is expected to meet 18% of traffic crossing the river, and ease congestion.

On 10 September 2001, the European Investment Bank (EIB) and METRO Bratislava signed an agreement on a EUR 45 EIB loan for the new bridge. METRO is a special-purpose company owned by the City of Bratislava and the Slovak Republic.

The loan agreement fixes the financing parameters and reduces uncertainties for all parties involved. It contains concrete commitments and may serve as a roadmap for the planners. The conditions in the agreement have furthermore facilitated the terms of reference for studies and the formulation of tender documents for the works themselves.

Disbursement of the funds remains subject to the successful completion of an ongoing Environmental Impact Assessment, including identification of mitigation measures, adequate public consultation and public tendering procedures in line with international standards. The tender process has now started and, subject to completion of remaining actions on the EIA, works are expected to begin in Spring 2002.

## PART 5 PPP CONCEPTION, PLANNING & IMPLEMENTATION

### PART 5 – Summary

- **PPP projects require careful design, effective support structures and a good understanding between partners**
- **Previous Parts have discussed thematic issues. This Part presents a guide for the development of PPP projects with a grant financing element**
- **Particular focus is placed on addressing 8 key PPP issues, namely:**
  - **What are the objectives of grant financing and what is their best use**
  - **Selection of the most suitable PPP type**
  - **Success and constraint factors**
  - **Ensuring open market access and competition**
  - **Timing – including when the Commission should be involved**
  - **Defining the right level of grant contribution**
  - **Protecting the public's interest**
  - **Future requirements**
- **This Part will address:**
  - **Project identification**
  - **Project appraisal**
  - **Design & agreement**
  - **Procurement**
  - **Implementation**

## 1 INTRODUCTION

Based on the previous thematic Parts, current Commission objectives and procedures and best practice examples, this section presents a detailed guide for :

- Deciding whether a PPP relationship is feasible for a particular project
- Selecting an appropriate PPP structure
- Designing the PPP relationship
- Implementing a PPP project

Such a guide, by necessity, includes many aspects of the PPP process which are not directly relevant to the function and responsibilities of all concerned parties / PPP practitioners. However these are included to ensure that, through their detailed knowledge, Commission staff are able to effectively stimulate the PPP process and influence the process, where necessary, to ensure the inclusion of Commission objectives in the design and therefore facilitate early approval. This is

also in-line with the Commission's desire to be involved early on in the PPP process development and design.

It is important to stress that there is not one method to analyse PPP's, rather this guide will present a logical progression based on the project cycle with suggested methodologies to structure thought and analysis for decision making. Again the Commission will, in most cases, not be required to undertake detailed project analysis as this is normally the responsibility of project sponsors or consultants. They should however be aware of the different methodologies used behind presented information or to stimulate the required studies.

## 2 PRACTICAL CONSIDERATIONS

The development of a successful PPP requires attention to a large variety of issues. As PPP is a developing concept the first stage must be to create a supporting institutional structure able to develop, guide and manage PPPs on behalf of the public sector. This will entail the development of supporting national and local legislation and regulations enabling PPPs, the development of institutional capabilities and importantly the creation of effective management and oversight structures.

Practical issues associated with PPP development include the following:

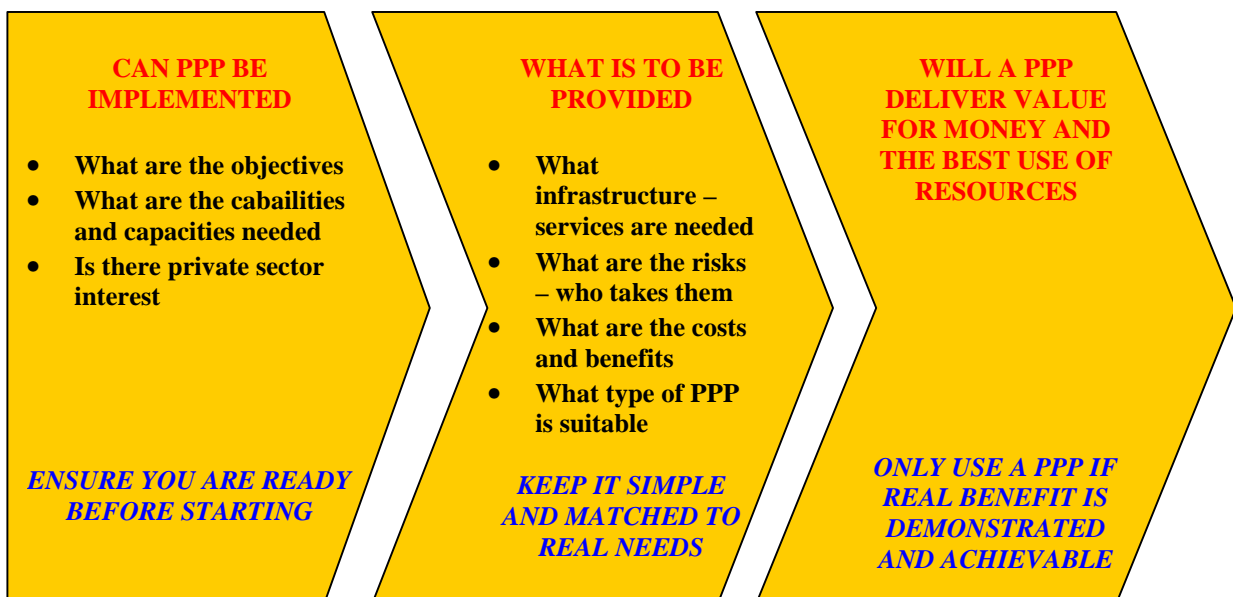
- selection of the most suitable PPP structure for the local setting and project characteristics
- developing systems and structures which reduce complexity and wherever standardise the approach
- ensuring that the structures are manageable both in terms of size and complexity
- ensuring that a full understanding of the timing is achieved
- the public sector should be realistic about the skills and experience it has

to develop and implement PPP – integrate private sector expertise if required

- PPPs must demonstrate additional value for money over and above traditional procurement systems and must be designed to maximise benefits to all parties according to their objectives
- All parties must recognise and understand their objectives. The public sector has wider concerns than the private sector who will not deliver “free gifts” through the PPP process
- Effective institutional and regulatory structures must be developed to manage and monitor PPPs. The Public sector should be clear that some control must be given to the private sector
- The paying public should be integrated into the monitoring / oversight function
- Trust must be established between all parties if a partnership is to be created

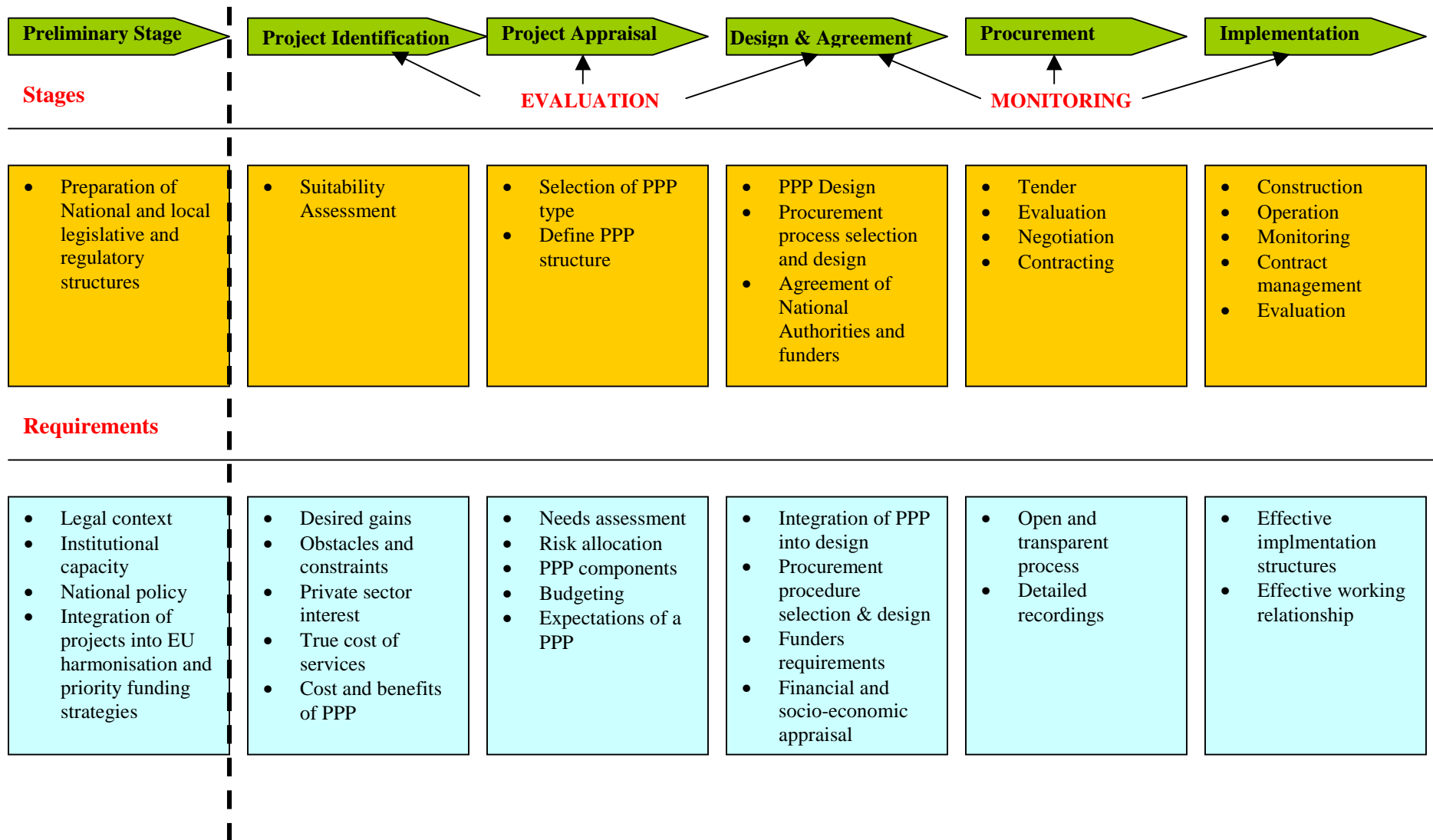
The following roadmap can be envisaged to the development of an effective enabling framework for PPP implementation. This is followed by the critical path to practical PPP development which forms the basis of this chapter.

### Roadmap to Successful PPP Development



PPP Project Cycle

Time Line



### 3 IS A PPP FEASIBLE - IDENTIFICATION

- **Effective PPP development requires effective regulatory and strategic structures to be in place**
- **The suitability of a PPP approach to project realisation should firstly be assessed given the capability and capacity of the public sector to implement PPPs and derive benefit**
- **Suitability of PPP approach includes whether there is sufficient private sector interest and whether PPP is the best delivery method**

Prior to the decision process a number of preconditions must exist within national / local authorities as defined in the Preliminary Preparation Stage. These include:

- Identification of who is responsible for PPP and who has authority and responsibility including for ultimate decision making and regulation.
- Developing (whether in-house or accessing externally) the necessary expertise to design, tender, evaluate, implement and monitor PPP.
- Establishing policies to guide decision making including ensuring that the necessary legal and regulatory structures are in place to allow PPP.
- Establishing procedures that enables the effective evaluation and delivery of PPP services.
- Developing a policy for PPP in current and future services in order to introduce a coherent planning process which encourages early identification of PPP opportunities.
- Integrating projects into EU harmonisation and priority funding strategies.

The Commission has a valuable role to play in this process particularly in aspects

of institutional strengthening and ensuring the effective development of PPPs.

The objective of this phase is to assess whether a PPP approach is suitable for a particular project. The responsibility for this assessment and final decision should lie with the National Authority as project beneficiary and project sponsor (for convenience in this Part the term “National Authority” is assumed to imply the relevant national body responsible for identifying, developing and implementing PPPs whether this be on a national or local level). However the private sector will need to be considered in that a basis for viable PPP relationships is that the private sector finds an interest in the project. Additionally the Commission as a promoter of the PPP approach has a valuable role to play in encouraging this assessment, which is still often neglected in CC’s.

The potential for applying PPPs will reflect local authority policy, expectations and openness to cooperating with the private sector. This in turn will determine the criteria to be applied and to their respective weightings. This first stage will assess the desirability and suitability of procuring a project as a PPP. Essential questions that must be asked include:

- What are the potential obstacles and constraints to PPP opportunities
- Would the private sector be interested in the opportunities
- Is PPP the best method to deliver the required services / infrastructure

#### 3.1 Obstacles and Constraints

Potential PPPs can be hindered by several constraints and obstacles which must be considered by National Authorities. The main ones include:

FACTOR	COMMENT
Local and national government policy	<ul style="list-style-type: none"> <li>• Does the policy environment favour PPP application and the different components required for a PPP</li> <li>• Is PPP consistent with other government policies ie land use, social policies etc</li> </ul>
Extent of legislative authority	<ul style="list-style-type: none"> <li>• Is there a or sufficient legislative authority for entering into PPPs</li> <li>• Is there sufficient legislation to support the management and supervisory role of the public sector in a PPP</li> <li>• Are there sufficient authorisations and what are the limits to enter into debt agreements</li> </ul>
Taxation framework	<ul style="list-style-type: none"> <li>• What is the tax status of a PPP</li> <li>• What are the possibilities to offer tax exemptions to private parties</li> </ul>
Reporting and accounting requirements	<ul style="list-style-type: none"> <li>• How are PPPs treated in national authority accounts</li> <li>• What are public disclosure requirements</li> </ul>
Financial issues	<ul style="list-style-type: none"> <li>• Can private sector financing compete with public financing</li> <li>• What is the effective cost of borrowing</li> <li>• Is the project financial self sufficient or can become so</li> <li>• What financial support mechanisms are available</li> </ul>
Technical and organisational issues	<ul style="list-style-type: none"> <li>• Is there sufficient data to allow design and preparation</li> <li>• Can competitive tendering be assured</li> <li>• What quality control mechanisms exist</li> </ul>
Political and social considerations	<ul style="list-style-type: none"> <li>• Is the national authority regarded as creditworthy</li> <li>• Is there strong political commitment to the PPP approach</li> <li>• Will a PPP be socially acceptable</li> </ul>
Ability to integrate different forms of funding	<ul style="list-style-type: none"> <li>• Will a PPP be acceptable to existing sources of financing ie Commission and what factors are likely to have to be integrated into designs ie procurement rules</li> </ul>

### 3.2 Private Sector Interest

The private sector will be interested in some projects more than others based not only on purely financial considerations. National authorities have a major role to play in adding to the value of a project. Generally the private sector will give priority to projects which demonstrate:

- Sufficient demand
- Revenue generating and development potential
- Strong viability
- Strong political commitment
- Meet internal development criteria

A crucial issue, which must be addressed by the national authority, is the management of risk. While considering

the principal that the party best able to manage a risk should adopt it, it should also be remembered that the degree of risk transfer to the private sector will determine the extent of return required by the private sector.

Various market factors will need to be analysed including existing and future demand. Various techniques are used to determine financial viability but at this stage a simple cash flow analysis may be sufficient to determine whether private interest is possible.

### 3.3 Is PPP the Best Delivery Method

Crucial to the selection process of a PPP is whether it will provide value for money

and above all additional value than traditional public procurement methods. Two considerations are important:

- The national authority should establish the true cost of providing a service with the purpose of benchmarking or shadow bidding potential private costs
- The benefits and costs should be systematically analysed considering both quantifiable and non quantifiable items

The factors determining value for money will change between projects. A number of common methods for PPPs to generate better value for money exist including:

- Reduced life cycle costs
- Better allocation of risk
- Faster implementation
- Improved service quality
- Generation of additional revenue

Other project specific factors will usually be identified by considering the experience of similar projects and quantifying project specific characteristics.

It should be noted that this, preliminary, value for money assessment can only provide an understanding of the potential value of using a PPP approach. Final assessment can only be made at the end of the procurement process.

## **4 SELECTING AN APPROPRIATE PPP STRUCTURE – PROJECT APPRAISAL**

- **Selection of a PPP requires assessment of what deliverables are actually required**
- **Risk allocation will be affected by the type of PPP selected**
- **A decision is required as to what parts of the project to include in a PPP**

There is no one method for deciding which type of PPP approach will best serve the needs of a project as this depends on the

project characteristics and public perception of the need for PPP. It is however important that the selection of an appropriate PPP form be undertaken at an early stage to facilitate effective project design and achieve early buy-in of the parties.

Part 1 presented the main types of PPP relationships with their respective advantages and disadvantages. Selection of the most appropriate type will require, as a minimum, consideration of the following items.

### **4.1 Needs Assessment**

The main focus in a needs assessment is to define the service needs and to determine the objectives to be achieved through the PPP. These objectives must be quantifiable, measurable and specific in order to assist in analysis and the future preparation of the procurement process. For this purpose and for future monitoring after the completion of the project, it is extremely important that the national authority's needs and objectives are clearly stated.

### **4.2 Risk Allocation**

A major component of any PPP is risk allocation. Who will assume risks in the delivery of a service or in the construction, operation and maintenance of infrastructure is often the central question in a PPP. The national authority should attempt to reduce risks but it should also be aware that risks are inherent in most projects and servicing initiatives.

There is some debate as to how much risk should be transferred from the public to the private sector. Generally, the more risk transferred to the private sector partner, the more financial reward the private partner will demand. Risk should be allocated to the party who can best assume it in the most cost effective manner.

From the standpoint of the national authority, there are several political risks that need to be addressed. These include:

- loss of control in the provision of infrastructure or in the delivery of a service
- potential reduced service quality for service users

There are also a number of other risks inherent with infrastructure or service delivery projects that need to be analyzed and understood by both public and private sector partners. Examples include risk associated with:

<ul style="list-style-type: none"> <li>• fire, flood, etc.</li> <li>• changes in financing costs</li> <li>• reduced demand for service or failure of demand to increase as projected</li> <li>• design errors</li> <li>• construction-related problems, including failure to meet the schedule and/or quality issues</li> <li>• ownership transfer</li> <li>• environmental liability</li> <li>• non-compliance with regulations and permits, or changes in regulations</li> <li>• value of assets at end of partnership, change of ownership</li> </ul>	<ul style="list-style-type: none"> <li>• employment practices and changes in labour legislation</li> <li>• performance monitoring</li> <li>• technology issues (failure of existing technology, inappropriate choice of technology)</li> <li>• force majeure (that is, dealing with major change arising beyond the control of either party, including acts of God, natural disasters, court orders, war)</li> <li>• insolvency of private sector partner</li> <li>• inflation/currency strength</li> </ul>
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#### 4.3 Components of Service Delivery to Include in Public Private Partnerships

The national authority must decide which components of a servicing initiative are best addressed through a PPP and which are best kept in the public domain. Consideration should be given to the following questions:

- **Project design** - Can the private sector bring more innovation and efficiency to the design process than the public sector? This is an important consideration. The objective should be to develop designs that provide value for money and lower overall life-cycle costs of the project, not only the capital cost.
- **Procurement and construction** - Who can secure goods and services required for the project or servicing initiative most quickly and competitively? Who is in the best position to construct the facility?

- **Financing** - Who can secure the most competitive financing?
- **Ownership** - Who should own the facility or service? Do the benefits of public ownership outweigh the benefits of private ownership?
- **Operations and maintenance** - Who is in the position to operate the service cheaper and more efficiently? Will the inclusion of operations or maintenance as part of the public private partnership enhance the original objectives of the national authority?
- **Marketing** - Who would do a better job promoting the use of the service?

Many of the components of service delivery are logically bundled together, such as design-construction, ownership-financing, and operations and maintenance. It is important to consider bundling to determine whether combining various components leads to greater value for money than providing individual components. The choice of which components of service delivery should be



provided will determine the form of PPP to be used. In selecting the preferred form, it is always important for the national authority to confirm that the approach is consistent with the overall national and local policies relating particularly to:

- ownership of services and facilities
- impact on local government staff and public sector employees
- risk management
- financial policies (e.g., debt)
- economic development

#### 4.4 Budget Refinement

Before a tender is issued, the national authority needs to determine or refine the project's budget. In many cases, this is completed by determining what the project would cost if it were built strictly by the public sector. This process is used for a number of reasons:

- It will determine if a PPP will actually save money for the public sector. Unless a proponent's solution is innovative and would result in a significant improvement in service or cost savings, it is unlikely that a national authority will participate in a PPP arrangement.
- It will provide potential partners with a "benchmark" on which they need to

improve in their proposals. Again, if the proposal comes in at a higher cost than proposed by the national authority, the expectation is that the private partner will provide an improvement in quality of infrastructure or service for users.

- It will determine if the national authority can afford to be involved. If it cannot build a much-needed project on its own, assistance from the private sector may be required.

Costs are not the only consideration. The national authority must also benchmark quality of service, technology and implementation time. The preparation of a "shadow bid" will allow the national authority to evaluate and compare proposals from potential private partners on a fair and equitable basis. More often than not, national authorities do not make a full accounting of the cost involved in providing a service. Administration, overhead and maintenance costs can often be separate budget items. These costs are then not directly attributed to the services that create them.

When the true or actual cost of an infrastructure project or a service is being analyzed for benchmarking, the following components need to be examined in detail:

<ul style="list-style-type: none"> <li>• Program-associated capital costs</li> <li>• Salaries and benefits of all employees directly involved in the provision of the service</li> <li>• Allocation of the salaries and benefits paid to administrators, accountants and human resources employees who deal with the specific service</li> <li>• Telephone, fax, courier, Internet, computer network costs</li> <li>• Training</li> <li>• Utilities</li> </ul>	<ul style="list-style-type: none"> <li>• office equipment</li> <li>• postal costs/courier expenses</li> <li>• cost of office supplies used</li> <li>• advertising and promotion costs</li> <li>• public relations costs</li> <li>• travel, meals and accommodation allowances</li> <li>• cost of outside consulting contracts</li> <li>• proportion of overhead incurred by the service through space needed in the local government building, use of a central accounting system, payroll, engineering department, procurement, clerical staff</li> </ul>
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In infrastructure projects, both capital and operating costs must be considered in developing a benchmark cost.

#### 4.5 Basic Conditions Expected in a Partnership

The basic conditions expected in a partnership must be included in the future tender document. They will form one of the building blocks on which bidders will build their submissions. The national authority should consider the following aspects of the proposed PPP and establish their requirements:

- preferred length of the partnership
- ownership of assets during and after the partnership
- treatment of public employees who may be displaced by the partnership
- performance specifications, standards and expectations, including the roles and responsibilities of both partners
- how both partners' performance will be measured
- a definition of an "adequate rate of return"
- profit and cost sharing provisions
- performance bond requirements

It is important for the national authority to keep in mind that these conditions are not set in stone. Rather, they are subject to change in the negotiation process with the preferred partner. These conditions provide an indication to prospective partners of what the national authority is seeking in the partnership arrangement.

## 5 PPP DESIGN & AGREEMENT

- **PPP design must consider the needs of all parties and how best to achieve delivery**
- **Particular attention is required for the design of procurement procedures and contract management / monitoring systems**

The previous sections aimed to determine whether a PPP is feasible and what form it should take. The detailed design will focus on what will be achieved and how. This discussion will be limited to the

design analysis relative to PPP relationships and will not treat basic project technical and financial design. Sequential steps will be considered, including:

- completion of project design relative to PPP structure selected, including:
  - technical performance standards
  - financial assessment to ensure viability
  - design of future contract forms
- selection and design of tendering process, including:
  - type of tender process
  - tender procedures
  - evaluation procedures
  - negotiation procedures
  - contract award procedures
- implementation conditions, including:
  - monitoring and oversight conditions
  - redress and re-negotiation
- integrating the Commission, including:
  - consultation and approval requirements

The majority of these tasks should be completed by the National Authorities. However it is considered crucial that the Commission be consulted and included in the process as it is at this stage that the grant eligibility criteria need to be integrated into the project and that the future approval of projects is pre-determined.

### 5.1 Completion of Project Design

Project preparation must ensure that it addresses the specific needs of PPP relationships.

#### 5.1.1 Technical Design

The main considerations to be integrated include:

- is the private sector able to deliver the technical standards set for the project
- is the private sector in a position to introduce technical innovations and improvements for the project
- what tender process is best able to provide the technical standards (see following section on procurement process design)
- what are the minimum technical standards to be used for tender evaluation and performance monitoring
- how will performance monitoring be undertaken
- what are the operation and maintenance arrangements including upgrading and emergency service provision

### 5.1.2 Financial Design

This component entails three headings:

- risk assessment and allocation
- financial appraisal
- socio-economic appraisal

#### 5.1.2.1 Risk Assessment

Risk assessment and allocation is core to a PPP relationship. Each party will value risk differently with the private party applying higher discount rates and therefore more weight on costs and benefits. It is essential that there is a common understanding on the scope and implication of risks between the parties in order to properly cost the project. This

section is based on the presentation of risk in Part 3. Risk assessment is based on three steps:

#### Risk Identification

The principal risks will have already been identified during the preliminary stages and can be categorized as described in Part 3.

A common error in risk identification is to inadvertently duplicate risk. For example to risk of failure to deliver a service may not be independent of other risks such as process design deficiency or of inadequate resourcing or skill levels. Risks may be inter-related and have a common result.

#### Risk Assessment

It is common to assume that all risks can be or should be quantified. While this may be possible it often requires considerable effort which does not necessarily produce results with a high degree of certainty nor is in proportion with the risk or size of a project. As a result it is recommended to undertake a preliminary qualitative risk assessment.

This enables the potential significance or impact of risk to be considered and prioritized. This should be conducted in two stages:

- assessment of the potential impact of a risk – this is a subjective measure of how sensitive the project is to a particular risk, classified (for example) into high, medium and low impact as demonstrated in the following table:

**Assessment of the Potential Impact of Risk**

Scale of Impact	Description	Value (% of Project Cost)
High	Critical to continued service	> 50%
Medium	Serious impact	5% - 50%
Low	Small impact	< 5%

- assessment of the probability of occurrence – this is a subjective indication of how likely the risk is to occur, classified, for example, into high, medium and low probability as demonstrated in the following table:

### Assessment of the Probability of Occurrence

Probability	Description	Value (% of Project Cost)
High	Likely to occur	> 10%
Medium	Occasionally occurs	1% - 10%
Low	Unlikely but possible	< 1%

The probability and impact of each risk can be combined in a single matrix to provide a measure of the qualitative value of each risk as follows:

### Assessment of the Significance of Risk

		Probability		
		H	M	L
Impact	H	1	1	2
	M	1	2	3
	L	2	3	3

1 = greatest significance / impact

This method allows a qualitative assessment and indication of the most important risks that are likely to require quantification

Risk quantification will express the potential impact of a risk in financial terms and will allow the identification of a cost effective risk allocation and management strategy. This is also required to permit the functioning of comparative analysis during the evaluation process. As discussed above the time and effort devoted to risk quantification should reflect:

- project size and complexity
- the number of significant project risks
- the need for a financial comparator
- the type of procurement process

A number of methods exist to quantify risk involving increasingly rigorous analysis as presented in the following table:

### Risk Quantification Approaches

Method of Risk Quantification	Method of Analysis	Suitable Projects
Range of values for selected risk factors (eg min and max demand)	<ul style="list-style-type: none"> <li>• sensitivity analysis for individual risks</li> <li>• scenario analysis for combinations of risk</li> </ul>	<ul style="list-style-type: none"> <li>• projects where there is no data to facilitate more detailed analysis</li> <li>• projects for which there is no flexibility in how risks are managed</li> <li>• projects which will go ahead regardless of the risk analysis</li> </ul>
Point estimates	<ul style="list-style-type: none"> <li>• root square methods</li> </ul>	<ul style="list-style-type: none"> <li>• projects for which rough estimates of the probability and value of risk is known and risks are independent and follow normal distributions</li> </ul>
Consider full range of outcomes	<ul style="list-style-type: none"> <li>• Monte Carlo analysis</li> </ul>	<ul style="list-style-type: none"> <li>• Projects for which there is a reasonable understanding of the likely probability and value of risk</li> <li>• Monte Carlo analysis is the most suitable method where a rational cost contingency needs to be estimated, where the likelihood of various outcomes needs to be understood, where several ways of managing risk need to be compared or where risks combine in complex ways</li> <li>• It is recommended for large complex projects</li> </ul>

## Risk Allocation

The guiding principle of risk allocation is that risk should be allocated to the party best able to manage it. However, there may be cases where the price charged by a Contractor for taking on a risk exceeds the value to the Contracting Authority of transferring the risk. Cost effective allocation of risk between a Contracting Authority and the Contractor will result in lower costs of construction and operation for infrastructure projects, and will provide enhanced value for money when compared to traditional procurement. However, if risks are transferred inappropriately to the appointed Contractor, value for money will decline as the premium demanded by the Contractor for managing the risk will outweigh the benefit to the Contracting Authority.

At the design stage, the price charged by a Contractor for taking on a risk will not be known. The risk assessment should therefore focus on determining, in principle, whether the Contracting

Authority or the Contractor is best able to manage the risk, or whether the risk should be shared. In considering the most appropriate allocation of risk, the following issues should be taken into account:

- the capacity of the Contracting Authority to manage the risk and its ability to control it;
- the capacity of private sector contractors to manage the risk and their ability to control it; and
- the preferred allocation of risk, given any public interest issues.

The preliminary allocation of risk should reflect the specific characteristics of the project and the underlying strengths and capacities of each party. The degree of risk transfer to the private sector will vary on a project by project basis and will be informed by the precedent reviews and analysis and the selected PPP relationship as demonstrated by the following table.

### Typical Allocation of Risk

Risk Category	Allocation	Comment
Planning Risk	May be retained by Contracting Authority for pilot projects. However, there may be occasions when transfer in whole or part is appropriate or unavoidable	
Design and Construction Risk	Transferred to Contractor through payment mechanism	Contractor bears risk of cost and time overruns. Contracting Authority retains risk of changes to Output Specification
Operating Risk	Transferred to Contractor under DBO, DBFO and Concession contracts through payment mechanism.	Deductions are made from payments for failure to meet service requirements
Demand Risk	Often retained by Contracting Authority or shared. May be transferred under DBOF and Concession contracts where the Contractor can control demand and forecast revenues with reasonable certainty.	An example of demand risk transfer is when the Contractor recovers its costs through user charges (e.g. road tolls).
Residual Value Risk	Retained under DB and DBO contracts May be transferred under DBFO and Concession contracts to ensure fitness for purpose throughout the duration of the contract	Contractor carries residual value risk if asset not automatically transferred to Contracting Authority at end of contract
Other Financial Risk	Other financial risk Often transferred (or shared) under DBFO and Concession contracts	An indexation mechanism may be used
Legislative Risk	Legislative risk Often retained (or shared). Government is often best placed to control regulatory and legislative risks	Key issue is whether the regulatory or legislative change is discriminatory in respect of the specific project or sector

One of the areas in which risk transfer is most problematic is statutory process. As a general rule, the Contracting Authority is best placed to manage the statutory process by virtue of its legislative basis, experience and resources. In general, private sector parties internationally have indicated an unwillingness to accept planning risk, especially in the roads sector, identifying the following difficulties:

- a lack of familiarity with the statutory processes and procedures;
- uncertainty regarding the cost and timescale of such processes and their ability to manage this;
- the reluctance of funders to finance the costs and risks associated with the statutory process; and
- the need for price adjustment and/or negotiation to cater for changes arising during the statutory process.

Notwithstanding these reservations, there will be occasions when transfer of statutory process in whole or in part will be appropriate or unavoidable.

#### 5.1.2.2 *Financial Appraisal*

The active involvement of the private sector markedly changes the importance and nature of financial appraisal, relative to schemes that are undertaken solely in the public sector. While both public and private sectors have reason to be concerned about the outcome of the financial assessment, their perspectives will usually be different. This will cause them to focus on different aspects of the process, giving more emphasis to some and less to others and possibly using different model parameters. The key areas of concern for both groups may be summarised as:

- Financial viability.
- Distribution of revenues.
- Assessment of risk.

While the financial viability is clearly a major concern for private sector

participants in a PPP, it is also significant for the public perspective. If the project is financially non-viable and has to be abandoned or significantly amended, attaining the social objectives of the public sector may be compromised. The winners and losers in financial terms are also an issue for both sectors. Significant redistribution of financial wealth may be seen as socially unacceptable, or may prompt active lobbying to amend or abandon a proposal. Each of these is a public as well as a private concern, for example, if a road PPP may seriously undermine the financial health of railway operators. Finally, the involvement of the private sector boosts substantially the importance of understanding and responding to the risk profile of a project, but again is not solely a private sector concern.

#### **Financial Viability**

The principals of financial analysis are well known and fully integrated into the grant application process so will not be reproduced here. It must be stressed that the financial viability of a project must be clearly demonstrable to potential investors and all lending organisations. The project must have clear and defined revenues that will be sufficient to service principal and interest payments on the project debt over the term of the loans and to provide a return on equity which is commensurate with development and long term project risk taken by equity investors. ***It is therefore important to realise that the financial plan may have a greater impact on the terms of a project than the physical design or construction costs.***

PPPs are often characterized by more complicated financial engineering in the sourcing and combination of different financing types. In structuring a financial loan package a number of aspects could be taken into consideration to reduce (future) financial uncertainties as much as possible. These include:

- Maximisation of long term debt ;
- Maximisation of fixed rate financing;

- Minimisation of refinancing risk.

### **Distribution of Revenues**

Another very important further dimension that is of concern to many private sector companies is the timing of the cash flows deriving from a project. While this is in part a reflection of aversion to risk it is also a legitimate additional concern that, where a project is very large relative to the financial base of the company undertaking it, the company may literally run out of money before the inward cash flows from the project start to materialise. The company's capacity to borrow may not be enough to bridge the gap between expenditure and revenue generation.

In project financing it is the future cash flow that is the basis for raising private finance. Project financial appraisal should therefore be thought of as a continuous process that takes place throughout the early stages of a project right from the emergence of the need for the project and up to the point when the decision to sanction or abandon the project is made.

While it should be stressed that it would not normally be the public sector's responsibility to undertake this continuous monitoring of a project's financial viability, it is in the public sector's interest to ensure that private sector partners are doing so and to create an environment in which, should potential problems be identified, early discussion and resolution can take place. At the early stages of a project it is important that the significant risks are identified and their effect on the project considered. Thus good management of a project by the private sector should:

- achieve the triple constraints of specification, budget and schedule;
- be able to manage the liquidity (cash flow) of a project, and not consider only long-term profitability;
- involved in a continuous assessment of project risks;

- perform continuous monitoring of project's financial viability, involving an interactive process with the public sector.

### **Assessment of Risk**

Risk assessment was presented in the previous section. In this section only the issues necessary for the financial analysis are highlighted. Generally when considering an investment under conditions of risk, investors will require a higher rate of return to compensate them for taking on that risk. In financial appraisal terms this is undertaken by using a risk-adjusted rate which adds a risk premium on the discount rate that would be required to take on the investment with zero risk to take account of the riskiness of the investment under consideration.

Practical methods for incorporating risks in the financial investment analysis of PPP projects include the following:

- reducing the minimum payback period;
- raising the required rate of return of the project investment;
- adjusting cash flows for the cost of risk reduction; and
- adjusting cash flows to reflect the specific impact of a particular risk.

The allocation of residual risk in PPP projects is primarily the role of the promoter. In choosing the appropriate policy for risk transfer the promoter must consider the basic rules for risk allocation as already presented previously. An issue could arise that needs to be treated with caution: if risks are likely to occur in the early years of the project, then the remaining period is relative "risk free". Thus, it must be appropriate to reduce the risk premium paid to the private sector (either as Government finance or through user charges), to avoid accumulation of unnecessary profit by the private sector. A solution to this could be the introduction of two types of discount rates: one for the "risk period" and the other (being lower) for the "risk-free period".

Care also should be exercised by the public sector not to undertake risks that will be ultimately a burden to the taxpayer in real terms. Hence, it might be more appropriate for the public sector to forego some revenues than make actual payments. On the other hand, the charging of the user by the private sector to cover possible risks, must be done in such a manner to observe the marginal cost principle for pricing, and of course to avoid the possible non-accepted loss of forecasted traffic volumes, caused by increases in user charges above the level the user is willing to pay. There are mechanisms to safeguard this: in most cases, in the agreements the public sector sets upper limits for the user charges (tools), during the period of concession and presents detailed guidelines how they will be updated in the future.

### 5.1.3 Socio-Economic Appraisal

It is not the purpose of this section to discuss socio-economic analysis which is well documented and included in the ISPA application process. Instead this section will highlight several issues which arise through PPP relationships and which need to be incorporated into project design particularly if grant financing is maintained. These factors include:

- equity considerations relative to the choice of PPP schemes. A project is usually considered desirable from a societal perspective if aggregated benefits exceed total costs. This should include an element of how benefits and costs are distributed over society groups. Of particular concern is the implementation of user charges both in terms of their level and how they are charged. In this respect the Commission has a particular concern that the introduction of private sector participation does not lead to undue profit nor to unjustifiable application of charges
- equity consideration relative to the provision of services. Transport and

environmental projects will often include an element of ‘social service provision’ in the sense that they provide services to non profitable areas. PPP arrangements must ensure service coverage is maintained and that an equitable balance is achieved between profitable services and social service provision

Socio-economic appraisal should be undertaken from the perspective that the Commission’s main objective is to protect and enhance public benefit. Therefore socio-economic appraisal needs to clearly define what impact the grant will have, how it can be measured and verified. It also needs to identify the risks and institutional weaknesses which may hinder the maximization of public benefit thereby facilitating the development of effective monitoring systems and public oversight / “watchdog” institutions to work with the private sector.

## 5.2 Contract Form Design

Part 2 presents the issues surrounding contractual arrangements and contract forms. At this stage of the PPP process it is crucial to ensure that a draft contract form is prepared and is ready to be integrated into the following design of the tender process.

In particular attention needs to be paid to the following issues:

- the draft contract must address and incorporate all the design features prepared in the preceding sections as it will constitute a part of tender process
- the draft contract must include the conditions of grants both in terms of conditionalities attached to the grant and the procedures under which the grant will be allocated and disbursed

With respect to the last point it is crucial that a draft contract is approved by the Commission before the tender process as project approval will be dependant upon Commission approval of contracts. This is



particularly the case with PPP arrangements going beyond simple service and works provision. This issue is further elaborated on in the following section.

### **5.3 Selection and Design of Procurement Process**

This section will describe the different procurement systems available to a PPP relationship. It should be noted that at this stage the Commission must be fully integrated not only because of the procurement conditionalities attached to a Commission grant but also in an effort to comply with EU Procurement Directives.

As set out in Part 2 it is anticipated that there is scope for conflict between the current Commission procurement regulations and achieving the maximum benefit from a PPP relationship. However it should be noted that the Commission regulations do not absolutely preclude the adoption of alternative procurement systems provided that certain minimum conditions are maintained and that the Commission is involved at an early stage of the design and decision making process. This section applies to procurement relative to an ISPA grant. In the case of procurement by the national / local authority in advance of an ISPA grant (but related to the ISPA project) it is recommended that the Commission strongly recommends the adoption of either EU Procurement Directives or as a minimum the conditions of the Treaty of Rome. This is to ensure that there is no scope for a conflict of interest with an ISPA grant.

Part 2 identifies two types of procurement processes currently allowed in the pre-accession phase. suited to different types of PPP relationships. While the Open and Restricted Procedures do not pose any particular difficulties for basic PPPs involving only private sector service, works or supply procurement, they may be limiting for more complex approaches. As a result Part 2 proposed several methods to introduce a greater degree of flexibility to

allow the private sector to present options based essentially on reinforcing evaluation methodology and making use of variant solutions.

In selecting the appropriate process the National Authority will have regard for a number of considerations including:

- The scope and nature of the project
- The degree of risk transfer proposed
- The degree of precedent available to support the choice
- The role and influence of third party funders (in particular the Commission)

In BOT type arrangements there is both ample precedent for successful restricted procurement and there is usually sufficient project definition in technical scope and costing.

In the case of more complex DBFO type of concessions, the national authority will normally seek maximum / optimal risk transfer. Use of the restricted procedure may lead to the pricing of projects based on private sector costs of equity and debt without sufficient scope for innovation and an efficient allocation of risk to the private sector. The argumentation for using more sophisticated evaluation techniques and / or variant solutions includes:

- Ability to secure the best value for money.
- Ability to optimize risk allocation
- Encouragement of innovative solutions.
- Generally lower tender or bid costs.

The key to tender process selection lies in the degree to which it is possible to define the project. The greater the definition of the project, the greater the case for using a restricted process.

## 6 IMPLEMENTATION CONDITIONS

- **A degree of flexibility is required throughout implementation corresponding to the different needs of all parties**
- **However project structures need to be sufficiently robust to allow effective monitoring and to ensure that the public interest is guaranteed**

As discussed in Part 4 the Commission through its principle of ex-ante control, has a major direct and indirect role to play in the implementation of projects both from the perspective of implementation monitoring and in creating the required institutional structures to facilitate implementation. Indeed effective implementation structures are a pre-condition to the allocation of grants.

PPP relationships will require changes to the implementation systems associated with classical grant financed projects. This is primarily because the role and responsibilities of the parties change with increased private sector involvement. The most important of these is the transformation of the public sector role from operator to a management and regulatory function. This requires both the development of effective regulatory systems and monitoring practices. This entails a strengthening of national legislative, regulatory and institutional capacities to provide an effective framework for PPPs.

It is further suggested that the role of ISPA Consultant Engineer be developed to establish an independent monitoring function allowing the monitoring of projects beyond the current construction phase. Indeed as PPP relationships become more complex the value for money and correct use of grants issues extend in duration to include operations over the period of the concession. Therefore in order to facilitate the approval of the Commission for grant financing it is proposed to extend the

period of active monitoring to the life of the concession (if feasible) and to associate non-compliance or non performance issues with a disbursement of funds (ie approval of the interim payment) or indeed repayment of the grant. In this way the Commission maintains effective control over the use of grant funds but links this control to the function which the national authorities must undertake.

The remainder of this section is dedicated to practical contract and performance management issues.

### 6.1 Contract Management

The implementation of any public sector infrastructure project requires a significant level of proactive management of the interface between the National Authority and the Contractor in order to ensure that the service is provided in accordance with the precise requirements set out in the Project Agreement and Output Specification. In a conventional project, project management covers the procedures and organization needed to take a project through the planning, design, procurement and construction stages before handing it over to operational staff to deliver the service. In the context of a PPP project, two separate management processes must be considered:

- Project management - dealing with the development of a project up to and including award of contract, generally along the lines of conventional project management, but with additional expertise reflecting the changed nature of the process; and
- Contract management - describing the procedures and organisation required to ensure that the appropriate service is provided from the date of contract award to the end of the operating period.

In a PPP project that involves a transfer of operating activity to the private sector, contract management extends throughout

the term of the contract. The overall objective of contract management is to ensure the actual delivery of a service that represents value for money and typical contract management responsibilities include the ongoing monitoring of performance, the management of change, the authorisation of payments and the maintenance of records and reporting. Contract management responsibilities may also include the discharge of statutory duties in relation to reporting to National Authorities.

### 6.1.1 Performance Management

Performance management forms part of the contract management function and relates to the monitoring of service delivery and the assessment of performance relative to the standards defined in the Output Specification. Since payment for services will be based upon the achievement of specific objectives, this is a critical matter that will determine whether or not the Contractor is in compliance with the contract terms and therefore the amount of payment due.

The transfer of risk in the Project Agreement must be confirmed on an ongoing basis by the performance monitoring carried out. This will ensure that the level of service required by the Output Specification is delivered and if a compliance failure is identified, this will be reflected both in payment penalties and in an obligation on the Contractor to remedy the default. It follows that any failure to implement effective performance monitoring arrangements may result in performance risk reverting to the Contracting Authority with a consequent

loss of value for money. Effective performance monitoring and management of the risk transfer element of the contract is critical from the point of view of service delivery and value for money. Where monitoring shows under-performance by the Contractor, the contract manager must ensure that the obligations of the Contractor under the terms of the Project Agreement are properly enforced. The onus on Contracting Authorities in relation to the effective management of PPP contracts will be critical to ensuring satisfactory long-term service delivery and risk transfer. Performance monitoring will involve a variety of significant tasks. These tasks are usually set out in the Project Agreement and are likely to include:

- the review and analysis of measurements of specified parameters carried out by the Contractor relating to load conditions and the performance of a facility;
- the review of quality control and quality assurance procedures to ensure that quality systems are in place and effective;
- the independent monitoring by the Contracting Authority to verify that the monitoring undertaken by the Contractor is accurate and valid; and
- the independent calibration of measurement equipment used in the delivery of the service to verify its accuracy.

Key issues arising in relation to the contract and performance management of PPP projects will include:

- the identification of the skills and expertise required to effectively manage the implementation of a PPP project and to ensure that these resources are put in place early in the process;
- the ability to ensure effective and non-reversible transfer of risk;
- the impact on Contracting Authorities of PPP projects in terms of the availability and long-term retention of the expertise and resources needed for contract management;
- the procedures for reviewing PPP projects, especially in the pilot phase, with a view to learning lessons as experience is gained; and
- the nature of the ongoing relationship between the Contracting Authority and the project funders including the Commission. In a project involving private finance the funders will also have a long term role in ensuring that the service is delivered satisfactorily and that the payment stream is secure.

### 6.1.2 Principles of Contract and Performance Management

The implementation of public sector infrastructure projects using the PPP approach is intended to deliver cost effective, reliable and timely services at agreed prices and to agreed quality standards, consistent with legal standards, financial probity and management accountability. The success of this process will be significantly aided by the maintenance of a good relationship between the Contracting Authority and the Contractor. The expertise developed by the Contractor during the procurement stage should be maintained through implementation and operation in order to ensure consistency of approach and a detailed understanding of the process. In doing so, care must be taken with regard to the items set out below:

- contract management structures should be established during the procurement stage in parallel with the project management function in order to ensure a full understanding of how the specifics of the service and the monitoring systems are reflected in the contract documentation.
- personnel will require a detailed knowledge of contract documentation in order to provide for continuity in achieving effective service delivery.

At the outset, it will be necessary for the Contracting Authority to establish realistic financial and resource budgets to cover the costs relating to contract management and performance monitoring. While arrangements can be made to have these costs covered by the Contractor, it is usually considered more satisfactory that each party bear its own costs in order to avoid any possible conflict of interest. In addition, while the PPP approach is designed to allocate risk to the Contractor, competent contract management is necessary to ensure that this risk transfer is effective.

### 6.1.3 Project Agreement

The contract management and performance monitoring duties associated with a PPP project will be derived substantially from the terms of the Project Agreement. The Project Agreement will include specific provisions in relation to:

- **Monitoring** - provisions on contract management covering the monitoring to be undertaken by the Contracting Authority and the financial consequences of under-performance.
- **Risk management** - management of the risks to be retained by the Contracting Authority or which fall to the Contracting Authority for management due to substandard service delivery by the Contractor.
- **Change management** - provisions in relation to change management, covering items such as technical developments, changes in law, changes in volumes and changes in Contracting Authority requirements.
- **Under-performance** - a Contracting Authority may have to enhance the scale, nature and frequency of its management and monitoring capability where there is continued under-performance by a Contractor.
- **Interdependence** - some projects may be dependent on delivery of certain enabling services by the Contracting Authority, for example, the operation of water or drainage networks, the delivery of waste, or traffic management in a roads network. This may require organisational interfaces, information flows and the meeting of key milestone dates or objectives, to be included in the Project Agreement.

Over time, the under resourcing of the contract management function can lead to the inadvertent re-acceptance of risks that have been allocated to a Contractor through the earlier procurement process. In this way, the Contracting Authority may end up with liabilities in respect of asset condition or service performance not previously expected or envisaged. Major difficulties can arise in relation to the

satisfactory performance of a Contractor under a PPP project where the obligations of the Contractor are not rigorously policed and insisted upon by the Contracting Authority from the outset. Typical problems that can arise include:

- a failure to ensure quality control of construction may lead to asset defects in the long term;
- a failure to maintain plant and equipment may similarly result in increased liabilities for the Contracting Authority at the end of the contract;
- a failure to manage the interface between the Contracting Authority and the Contractor may lead to the blurring of responsibilities or even the transfer of performance liability. This might occur, for example, if poor management of the network caused unacceptable load conditions at a sewage treatment works;
- a failure to implement independent monitoring or equipment calibration may result in a failure to detect unsatisfactory performance or an overpayment for service delivery; and
- a failure to resolve issues or disputes promptly may lead to more serious conflict and a loss of control of the contract.

#### 6.1.4 Relationship Management

In practice a flexible but controlled range of contacts may be required to manage effectively the day to day delivery of the required services. It will be important to ensure that such arrangements are properly managed so as not to confuse the respective contractual responsibilities of each party. Underlying these arrangements will be specific provisions in the Project Agreement to be administered by the contract management team, covering all aspects of service delivery and payment. These will include:

- **Output Specifications** - establishing the required levels of performance and the associated information requirements for judging service

performance, all of which must be capable of objective measurement;

- **Payment** arrangements - enforcing and monitoring the payment mechanism, including the conditions required for the commencement of payment and the basis for ongoing certification (frequency, measurement basis, variations, and specific conditions);
- **Financial performance** - reviewing the ongoing financial performance and position of the Contractor against the forecasts set out in the financial model and enforcing and monitoring any arrangements for revenue sharing or profit capping;
- **Monitoring** arrangements - involving the defined monitoring obligations of the Contracting Authority and the Contractor, the provision of facilities for monitoring by the Contracting Authority, and the procedures for determining compliance;
- **Security and insurance** - monitoring compliance with specific conditions in relation to insurance policies, indemnities, tax clearance certification, safety procedures and systems;
- **Management of interactions** - managing all of the interfaces between the operations of the Contractor and those of the Contracting Authority. These interfaces may cover network management issues, the effects of new planning and development and the regulation of existing development (for example, waste collection and discharge licenses);
- **Dispute resolution** - providing mechanisms for problem solving and dispute resolution where and when appropriate;
- **Compliance** - setting out the arrangements for dealing with non compliance by the Contractor

including enhanced monitoring, proposals for rectification and payment deductions;

- **Contingency for default** - arrangements to cover default on the part of the Contractor or its subcontractors where the continued delivery of the service is at risk, including step-in rights;
- **Change management** - implementing and managing the procedures and protocols for dealing with changing requirements over the life of the project; and
- **End of contract conditions** - dealing with maintenance, the condition of the assets at the expiry of the contract period and the ability of the Contracting Authority to re-tender for the provision of the service.

#### 6.1.5 Quality Monitoring

In a conventional infrastructure project, monitoring involves direct sampling, analysis and compliance determination by the Contracting Authority. In a PPP project, these quality management processes will be performed differently in that the Contractor will be expected to provide for performance monitoring and quality management as part of its role. The Contracting Authority will then be entitled to independently verify the information produced by these systems as considered necessary.

The role of the Contracting Authority will therefore be to audit these systems, with planned and random spot checks, to ensure that performance is being measured and reported reliably, accurately and comprehensively. Similarly, detailed approval of drawings or other design arrangements may not always be regarded as essential provided the quality assurance system established by the Contractor is demonstrated to be effective. Nevertheless, it is in the interest of the Contracting Authority to ensure a robust

and high quality facility to minimise the risk of operational problems later.

Equally, the Contracting Authority will not normally interfere in relations between the Contractor and its subcontractors. However, the Contracting Authority will also wish to be satisfied that the Contractor retains proper control of the project and that its contract management arrangements are generally robust. For these reasons, it is usual to retain a technical adviser during the construction stage to monitor and confirm that the Contractor is complying with the Output Specification and to review the testing and commissioning process. The level of resources applied to this task will depend upon the complexity of each individual project but will always be less than in a conventional project. Where private sector finance is involved, the contract manager will also need to liaise closely with the representatives of the funders, including sharing of information and joint presence at meetings with the Contractor. It is important to note that both the Contracting Authority and the funders have a common interest in the quality of the asset and the required standard of service commencing on time.

#### 6.1.6 Dispute Resolution Procedures

Formal dispute resolution procedures for the efficient and cost effective determination of issues arising during the contract should be put in place as an alternative to legal procedures. The contract manager must endeavour to resolve matters in dialogue and discussion wherever possible. Where this fails and more formal dispute resolution procedures are invoked (such as conciliation, arbitration and litigation), the contract manager should have comprehensive records of all relevant issues and be capable of giving evidence and generally supporting the Contracting Authority throughout the process.

## ANNEX 1.

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## ANNEX 2. NOTES FROM THE WORKSHOP

### **Working session on the draft guidelines: Building a Valuable Approach for PPP-ISPA projects, Brussels, 4<sup>th</sup> July 2002.**

The final agenda of the day is annexed with the actual speakers

The high quality presentations were thorough and informative whereby a range of ideas, incentives, examples and experiences in connection with PPP were shared. A number of points were raised that reveal a degree of consensus on what exactly preparations for PPP should involve. The debate and workshop not only contribute to the preparation of the guidelines, but also the wider debate on the Cohesion Fund and Structural Funds, as well as at Commission level – enhancing the discussions relating to aspects of PPP and Public Procurement, Competition and State Aid.

#### **1. Common themes emerging in the presentations:**

There is a body of experience that has developed in a number of countries to date providing a strong basis for the elaboration of suitable PPPs. There emerged a convergent understanding that good PPPs due to their complexity, need to be well prepared, and require political backing at a high level. The public authority remains accountable but through early and well apportioned risk sharing the full range of benefits of PPPs can be harvested.

Most of the presentations cited not only the positive financial aspect, but also the benefits the private sector can bring in terms of innovation, greater efficiency, and value for money. Task forces, new legislation and political commitment are driving forces for the process, however, caution should remain in that PPPs cannot be seen as a quick fix solution and should be developed only for appropriate projects.

A major emphasis also centred on the need for success stories in Candidate Countries as well as early evidence of success in the development of PPP projects (although the need for good preparation and the application of rules on the duration of projects under Community funding was a concern).

At the European level, there is a role for support, simplification of legal issues and sharing of know-how. Furthermore, PPPs must fit well in the domestic sphere, being tailored to the institutional arrangements present in a specific country. The legal aspects of PPP frameworks were discussed at length. The treaty provisions, principles and legislative frameworks provide for sufficient flexibility of interpretation which can facilitate the designing of PPP guidelines in order to achieve compatibility with Community rules and yet being conducive for effective Private interventions. In this way it is possible to envisage for ISPA a role of innovator in providing a structural architecture for PPP in the practice of Community funding feeding into Cohesion and Structural Funds but also into Pan and Trans European projects in Transport Energy Environment.

#### **2. The working session on the guidelines:**

The discussions issues are outlined below. The main points moved between analysis and more policy-oriented statements and questions. The range of themes included eligibility in relation to the legislative basis, the need for a regulatory framework, the peculiar of marginally viable communities in the CEEC and the viability of PPP, as well as the political and pragmatic sides of PPP.



### Discussion on Key PPP Issues:

- First of all it was expressed that the guidelines have no legal value nor can they be taken as a blueprint approach to specific. In relation to this a point was raised urging for a concrete understanding of what form of PPP would be **eligible** for ISPA finance. However, it was recognised that there are no detailed rules at present – only general principles and treaty provisions, which are fundamentally **flexible**. As stated in art 6 of the EC Regulation 1267/99 the definition is on “...*public equivalent expenditures by bodies whose activities are undertaken within an administrative or legal framework by virtue of which they are regarded as equivalent to public bodies*”
- The Spanish experience of PPP, which began in 1995 was outlined where PPP accounts for 25% of total operations in the transport sector. This has led to the building up of a ‘Concessionary Culture’ in Spain - the first country to have PPP in Cohesion Fund projects. Various speakers agreed on the need for a European regulatory framework as a way to promote additional investments and to oversee the whole concession business: this is not a tool, rather a *requirement*.
- The question of whether PPP is financially suitable for two thirds of the CEEC population who live in small towns was raised. More specifically, what can be done to aid sewage treatment in these areas and how is it going to be possible to subsidise this?
- Similarly, in relation to **smaller communities** – aggregating the population is not always possible for many reasons. Economies of scale at plant level are not available. Through ISPA however, the Water Framework Directive provides for ‘groups of projects’ - a relatively new dimension, to increase the economic viability of projects which help maintain the population patterns of these areas.
- A more pragmatic attitude to PPP is emerging . Returns are reasonable for the private sector, yet certain areas go less comfortably with PPP – such as services that directly touch the public on a daily basis. Regulation provides the basis for an ongoing balance between quality and cost. Accountability and the right of appeal of the regulator is therefore a useful tool for PPP in terms of range and diversity.
- There is a need to develop momentum and a need to develop early successes. Basic problems must be resolved at the beginning, otherwise programmes will be overwhelmed: good selection is essential as to demonstrate achievements on expectations. In the transport sector, many priority projects have not progressed because they have not been convinced of their basic viability and there are fundamental doubts – therefore, the issue to address is what can be done to improve project viability and ensure a sound basis for PPP?
- Concerning the **TENs** cross-border projects are an area of legal complexity and may deter private investors.
- On the issue of the **renegotiation** of contracts: a World Bank study on concessions in contracts in Latin America was highlighted whereby 50% were renegotiated. Problems can arise here if a bilateral monopoly is created where the outcome is based on bargaining strength – this may not be in the public sector favour. Robust National Regulations, internal negotiating capacity to achieve fair re-negotiation is necessary. The private sector can gain from re-negotiation but also the public sector can ensure good deals for consumers.

- One speaker underlined the usefulness of PPP for gaps in finance especially in CCs. There are limits with rules, however, the guidelines are exhaustive. It was pointed out that state procurement and competition rules should not be understood in terms of ‘eligibility’, rather compliance with the EU rules as they are laid out. There is a need for seeking the right balance – changing the situation and ensuring legal stability with an obligation to ensure the public interest.
- Concerning ‘windfall profits’ - ISPA should ideally increase social benefit – seek a way to renegotiate down the windfall profit if any. Complex and broad is the role of a public body that retains responsibility and necessitates control efficiency to monitor to ensure business in the public interest. Consumers can act as a counterweight and controlling mechanism within civil society to ensure sustainable delivery of service.
- In the case of the UK: re-financing of a concession already in place to share benefits disproportional in favour of Government (due to the regulatory framework) but also for the Private Partner (so to retain its interest).
- The benefits going to the private sector from the UK experience must be built into the design of the contracts. The nature of discussion should focus on – how to design good PPP (independent of ISPA) and how to combine PPP and grants? Good projects are the issue and then PPP is the option. It was again advocated the need for simple guidelines that should give clarity on the eligibility of projects for the grant and how much would be given. On the issue of small towns: Phare and EBRD are looking at this issue – the strategic and structural concerns for delivery that are involved which do not necessarily involve PPP, since the difficulties involved with a PPP as a regional service provider may be too great to organise on that level.
- There is an emerging consensus and Member State experience is being built upon where the ideological debate seems to have now settled. Questions relate to this for the EC and ISPA; One commentator has emphasized that private sector interest had to be decided early – and that ISPA has already begun. What practical conclusions from the guidelines vis à vis projects for the ISPA Committee and the political awareness of this can be made? With consensus: will ISPA and furthermore Cohesion and Structural funds projects systematically go hand in hand with PPP?
- The rate of assistance and how this is handled in the bidding process could give rise to the creation of perverse incentives i.e. with an efficient bidder not as much ISPA grant is needed so that the city has no incentive. There is a need for concrete guidelines on this aspect to avoid paradox situations.
- In Candidate Countries and from the business community in Member States – there is a shared interest to upgrade major infrastructure through these projects. The opportunity to participate in this is the reason for PPP and for the guidelines which become the basis for facilitation.
- One concern relates to the upper limit of CCs in absorbing projects. A number of factors come into play here such as project management in a given sector, period, country and indeed the macro economic conditions which are all involved.
- The guidelines like a ‘map’ are not to be seen as the solution nor as definite or static position of the European Commission and they represent a decision to ensure the focus remains on the public interest.

### 3. What next

- The final version of the guidelines after careful incorporation of all comments consistency checks and final editing will be distributed to selected audiences and available on the ISPA website at the INFOREGIO.
- Dissemination seminars will be organised in Candidate Countries to enhance the practical nature of the Guidelines without pre-empting specific decisions on individual projects. Contribution from the member states would be useful i.e. Designing laws for the concession or assistance (if required) for the establishment of the task force for PPP.
- Specific task assignments through experts will continue organised by the ISPA Directorate to analyse specific cases and propose appropriate solutions in line with the principles enshrined in the guidelines which were re-stated in the closing remarks of the Director General of DG REGIONAL POLICY Mr Guy Crauser:
- ensuring open market access and equal fair and transparent competition under the public procurement directive;
- protecting and safeguarding the public interest;
- ensuring compatibility between PPP and State Aid rules;
- defining the right level of grant contribution and the right PPP formula tailored to the specific circumstances.

**Working Session on the  
Draft Commission PPP Guidelines for ISPA  
Building a Valuable Approach to PPP**

Brussels, Thursday 4 July, 2002

Centre Borschette  
Rue Froissart 36  
1040 Bruxelles

Agenda

<b>Time</b>	<b>Topic</b>	<b>Speaker</b>
9:30	Registration	
10:00	Welcome, Introduction and objectives of the Workshop	Mr L. Riera, Director ISPA DG Regional Policy
10:20	Opening remarks: Incentives for PPP in Poland	Ministry of Transport – Poland Mr P. Vonau
10:40	PPP Experience of the EBRD in ISPA countries: the role of the international loan providers	EBRD Mr Robin Earle, Senior Banker Mr Chris Shugart, Senior Banker
11:00	PPP Experience of the EIB in ISPA countries: success story	EIB Mr T. Barrett, Director
11:20	PPP Experiences and Lessons form Member States – the value of PPP from the perspective of the Grant Provider and budgetary authorities	Italy, Mrs V. Leone, Legal expert PPP, Ministry of Economy France, Mr J-M Etienne, French Government UK, Mr M. Gerrard, Partnerships UK Ireland, Mr E. Kearns, PPP Taskforce
12:30	Presentation of Draft Guidelines	PB Consortium – Mr S. Murray, Consultant
13:00	Lunch	
14:30	Summary and issues for working session. <u>The Role of Grant Providers in PPPs: the key issues</u>	Mr U. Bassi, DG Internal Market Mr A. Baron, DG Energy and Transport Mr O. Slocock, DG Competition Mr R. Ridolfi, Coordination DG Regional Policy/ISPA
15:15	Working Session on Key PPP Issues from the draft guidelines	<i>Facilitated by PB Consortium, Mr Riera, Mr Ridolfi</i>
16:30	Summary of Workshop Results	Mr L. Riera
17:00	Closing Remarks	Mr G. Crauser, General Director DG Regional Policy
17:15	End of workshop	