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Sharing knowledge, experiences, and innovations in public-private partnerships in infrastructure

Private participation in transport

Lessons from recent experience in Europe and Central Asia

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Facing fiscal constraints, many governments in Central and Eastern Europe and Southeastern Europe have pursued private finance for transport infrastructure more to move investments off budget than to improve efficiency and services. Results have been mixed—and suggest a need to focus more on public-private partnerships (PPPs) that can achieve value for money. Today's economic environment will reduce the potential for PPP projects in the short term. Some PPP projects at an advanced stage of procurement may need additional public support, while ambitious projects may need to be phased to reduce their scale to what the market can absorb.

The economies of Central and Eastern Europe and Southeastern Europe were among the first in the broader region of Europe and Central Asia to follow the global trend of public-private partnerships (PPPs) in the funding of infrastructure projects. Drawing on a new report (Cuttaree and others forthcoming), this note briefly reviews trends and experience in the use of PPPs in the transport sector in these economies and summarizes key lessons learned.

Trends in PPP investment

Private participation in transport infrastructure in the region of Central and Eastern Europe and Southeastern Europe got off to a good start in the early 1990s, but never took off during that decade. Investment in PPP transport projects remained low in 2000–03, then rose from 2004 onward, though the growth was driven by only a few countries and transactions (figure 1).² Still, the contrast between the 1990s and the mid-2000s is significant. Investment in PPP transport projects in the region in 2001–07 was more than twice that in 1994–2000 (figure 2).³ By comparison, global

investment in PPP transport projects increased by only about 32.4 percent during the same period.

About 87 percent of the investment took place in just four countries: Hungary, Poland, Croatia, and Bulgaria. Growth in 2005 was exceptionally strong, driven by two transactions: the Budapest International Airport in Hungary and the A1 Gdansk–Torun Motorway in Poland. These two transactions alone accounted for about half the region's total PPP investment in 2000–06. Despite these outlier transactions, the group of economies with PPP investment was more diversified in 2001–07 than in the earlier period.

Experience with PPP projects

The first attempts to implement PPP projects in the transport sector in Central and Southeastern Europe faced obstacles that led in many instances to delays, protracted negotiations, renegotiations, and cancellations. Among privately managed road projects, several factors contributed to these problems:

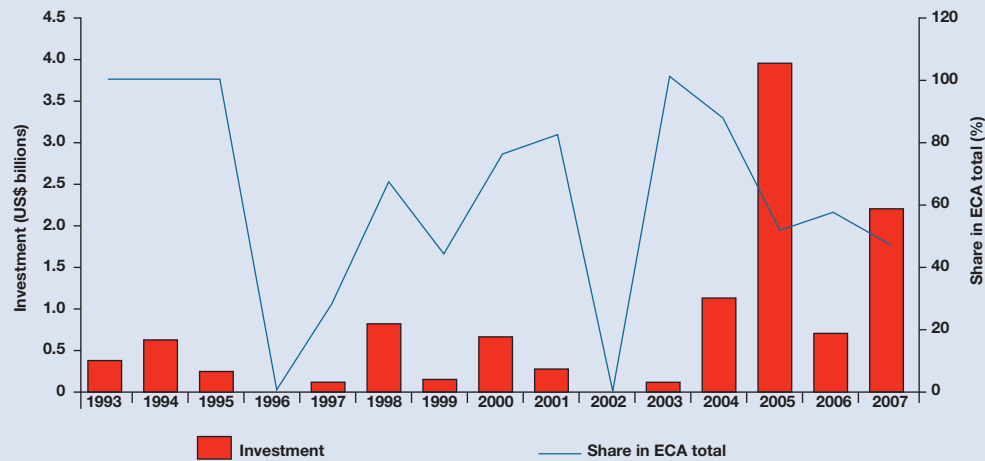
- *Lack of robust feasibility studies.* Most of the unsuccessful projects lacked a solid feasibility study carried out before procurement. For the Zagreb–Macelj Toll Motorway, for example, financial viability discussions were not held until negotiations were under way with the selected consortium. The negotiations failed to reach financial closure as a result of disagreements between the government and the consortium on the public sector contribution.
- *Optimistic traffic forecasts.* In the early years optimistic traffic forecasts hurt several

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FIGURE 1

Investment started slowly, then rose from 2004 on

Investment in PPP transport projects in Central and Eastern Europe and Southeastern Europe, 1993–2007



Source: World Bank and PPIAF, PPI Project Database.

Note: Data for 2007 exclude Estonia and the Czech Republic. ECA = Europe and Central Asia.

concessionaires because they bore the demand risk. In the absence of minimum traffic or revenue guarantees, lenders sometimes requested an independent traffic review, delaying and potentially preventing financial closure. In other cases concessionaires had to bear the cost of lower traffic, which often led to financial distress. Projects that failed or never materialized because of lower-than-expected traffic include the Czech Republic D5 motorway in 1993, the M1/M15 toll road in Hungary, the Pitesti–Bucharest–Constanza motorway in Romania, and the A4 Zagreb–Gorican motorway in Croatia.

- *Public resistance to tolls.* With a PPP scheme and in the absence of shadow tolls, users had to pay a larger share of the cost, in a region where road use had been largely free. In some cases users responded to tolls by switching to parallel roads, further contributing to traffic and revenue shortfalls. And in some cases, such as the M1/M15 highway in Hungary and the Trakia motorway in Bulgaria, increases in toll rates, even when justified by inflation or traffic levels, led to legal action or public resistance.
- *Changing financial support mechanisms.* In response to public resistance to tolls, some governments introduced a vignette system, in which the toll is collected by selling motorway stickers (vignettes). In Hungary, for example, direct tolls in the M5 Toll Motorway Project were replaced by a general motorway vignette and the payment of availability fees to the concessionaire. These shifts transferred a significant traffic risk burden

to the public sector. Moreover, to make the new system politically acceptable, vignette rates were set at low levels and could not compensate for the heavy capital investments undertaken. In Poland, where the vignette system was introduced for the national road system in 2006, the state has been unable to settle a dispute with the concessionaire for the A4 Toll Motorway Project on the level of compensation for lost revenue.

- *Noncompetitive procurement.* Many countries started their road concession program with limited competition and sometimes (often after a change in government) had to cancel negotiations or renegotiate. Without competitive procurement, negotiations typically take longer and can result in lower value for money. And international financial institutions, because of their procurement rules, were prevented from advising on the structuring and cofinancing of projects, leading to unnecessary delays and cost increases.
- *Subsequent revision of legal and regulatory framework.* Projects were often implemented in isolation from the sector policy, with the need for specific laws or regulations considered only late in the process. In the A1 Toll Motorway Project in Poland, for example, the decision to amend the Toll Motorway Act, which defined the legal framework for private participation in the sector, was made only at the procurement stage. In part because of that, it took nearly seven years to advance from selection of the concessionaire to signature of the concession agreement.

Early attempts at PPP projects faced obstacles that often led to delays and other problems

Key elements for success

The experience with transport infrastructure in Central and Southeastern Europe in the past 10–15 years shows that, to be successful, a PPP scheme must have strong government support and long-lasting political engagement. Analysis of the experience points to other critical elements.

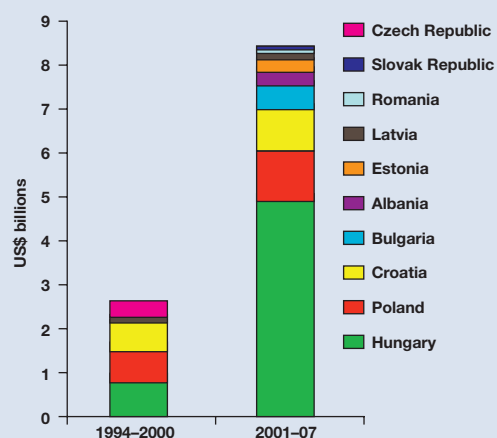
Project selection and design

- *Modesty and realism in planning and implementation.* Some vast and complex projects had to be reduced in scale because they were too large for the market to digest. Size and complexity increase project risk, making it more difficult to attract private investment in a country lacking a positive track record. For large motorway projects, a phased approach to construction could mitigate some of the problems resulting from scale.
- *Comprehensive feasibility studies.* International experience confirms that preparing comprehensive feasibility studies, with robust financial and economic analysis, can help avoid problems and delays during procurement. Particularly important are providing accurate estimates of traffic and (where there are user charges) users' willingness to pay and determining the public sector's contribution. Sensitivity analysis is critical for determining the resilience of the financial model to changes in assumptions.
- *Value-for-money analysis.* The value added by private participation in transport infrastructure is greater efficiency and savings rather than pure off-balance-sheet investment. Thus the focus in the region needs to shift from looking at how much investment can be attracted to looking at how much value or savings is derived from private participation. The key measure is value for money, a concept based on the idea that PPP proposals should provide at least as much value as traditional public sector procurement.
- *Appropriate risk sharing.* Appropriate allocation of risk between the public and private sectors can increase the value for money of a PPP project and ultimately reduce the financial contribution from the government, the tariff required from users, or both. By contrast, transferring the maximum risk to the private sector generally increases the total project cost and the risk of project failure, as happened in the early PPP projects in the region. Some risks, such as construction delays, cost overruns, or operational setbacks, can usually be transferred to the private

FIGURE 2

Investment was up sharply in the 2000s—and more diversified by economy

Investment in PPP transport projects in Central and Eastern Europe and Southeastern Europe by economy, 1994–2000 and 2001–07



Source: World Bank and PPIAF, PPI Project Database.

The focus in PPP schemes needs to shift to achieving value for money

sector, as was also done in the region. Inflation and foreign exchange risk is usually accepted by the public sector.

- *Adequate return for lenders and sponsors.* Return on investment determines the attractiveness of a project to the private sector. The return is always adjusted for the risk profile of the project. A riskier undertaking is expected to yield a higher return, to compensate for the operational, commercial, financial, legal, or political uncertainties. Potential concessionaires and their lenders also expect a sufficiently high debt service coverage ratio to provide cushion for debt repayment.⁴

Procurement and contract monitoring

- *Open and competitive procurement.* Economies in the region have often opted for limited competition in procurement. Taking the noncompetitive route leads to less public acceptance and thus paves the way for a possible reversal of decisions when there is a change in government. As noted, it also precludes participation by international financial institutions.
- *Caution with unsolicited proposals.* Growing interest in large infrastructure projects usually brings a rash of unsolicited proposals from potential financiers. These offers may come with disputable claims about their benefits or about the confidentiality of proprietary technology. The reality is usually very different, and the information asymmetry between a weak public sector,

the potential bidder, and large, well-informed contractor groups can lead to the public sector conceding far more than it should.

Legal and institutional framework

- *Appropriate and stable legal and regulatory framework.* The role of the legal framework is to create a favorable environment for attracting private financing and to put in place checks and balances that will ensure that a PPP project delivers its expected value to the public. Because PPPs are legal arrangements between the state and the private sector, the legal and regulatory framework is paramount in creating transparency, clarity, and investor interest and avoiding lengthy negotiations and renegotiations.
- *Central unit to lead preparation.* PPPs are complex projects requiring extensive coordination between public agencies. Countries with successful PPP programs tend to have a central PPP unit, based in a line ministry, to lead project preparation. Several countries in the region have such a unit. Also important is to engage experienced PPP transaction advisers to support the government.
- *Role for international financial institutions.* International financial institutions can offer risk mitigation instruments, such as guarantees, that insure the private sector against government performance risk. In this way they can help mobilize new sources of financing while lowering the financing costs and extending maturities. They can also offer favorable loans with longer repayment terms. And they can help governments master the complexities of PPPs by providing technical assistance and capacity building and disseminating best practices.

Conclusion

Choosing between a PPP and traditional public procurement is a critical policy decision. Governments with weaker public finances and limited fiscal space may be especially attracted to PPPs.⁵ In Central and South-eastern Europe many governments have championed private

finance for transport infrastructure as a way to disguise public expenditure and push it off budget—rather than as a way to optimize risk allocation or promote innovation or efficiency. This in part reflects genuine macroeconomic and fiscal constraints. But PPP schemes are useful even in the absence of such constraints, as a way to achieve greater value for money than the government can in providing goods and services on its own.

In the short term the international economic situation will reduce the potential for PPP projects. But governments can still achieve value for money by involving the private sector. Those with PPP projects at an advanced stage of procurement should take a close look at the financing options available and carefully consider their fiscal implications. These PPP projects will probably need additional public support during construction and operation because the private sector may be unable to raise long-term debt in local currency and demand for some services may decline in the short term. Phasing projects might reduce them to a scale that the market can absorb. Finally, contracts should be written so as to allow governments to capture the benefits of the economic upturn, especially if they give additional support to the private sector.

Notes

1. As defined here, Central and Eastern Europe comprises the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, while Southeastern Europe comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, Romania, and Serbia.
2. For information on trends in private participation in infrastructure in Europe and Central Asia, see Vagliasindi and Izaguirre (2007).
3. Amounts are recorded in nominal terms. The increase in real terms would be smaller.
4. Debt service coverage ratio is the cash flow available for servicing debt in a given period (usually six months or one year) divided by the debt service (principal and interest) for the same period.
5. Fiscal space is the ability of a government to take on new borrowing to support its expenditure choices, given its current income, current expenditures, and existing debts.

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