

GRID LINES

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

Private participation in infrastructure in Europe and Central Asia

A look at recent trends

Maria Vagliasindi and Ada Karina Izaguirre

Eastern Europe and Central Asia is attracting more investment to infrastructure projects with private participation than any other developing region except Latin America. Members of the European Union (EU) and countries seeking membership account for most of the investment. The Russian Federation is emerging as a leader both in attracting private activity and in sponsoring projects in neighboring countries. Telecommunications and energy are the leading sectors. But new regulatory challenges are emerging as a result of exclusivity periods in telecommunications and greater market concentration and vertical reintegration in energy.

Investment commitments to infrastructure projects with private participation (hereafter, *investment*) in Eastern Europe and Central Asia amounted to US\$35 billion in 2005.¹ That was more than twice the average for the previous four years and the highest in 1990–2005 (figure 1).² The growth was driven by payments to governments, with divestiture revenues and license and concession fees amounting to US\$18 billion.

Due to this growth and to declining investment in other developing regions, Eastern Europe and Central Asia ranked second in investment after Latin America in 2001–05, accounting for 27 percent of the total in developing countries. As a share of regional GDP, investment grew from 0.8 percent in 2003–04 to 1.6 percent in 2005.

Twenty-nine projects reached financial closure in 2005, just three more than the average for the previous four years. Two factors explain the divergence in trends between investment and transactions. First, growth in 2005 was unusual

because it was driven mainly by five projects of more than US\$1 billion each (the Turk Telekom and Slovenske Elektrarne divestitures, the Budapest airport concession, the Ataturk airport lease, and the greenfield Maritza East I power plant in Bulgaria), together accounting for 40 percent of investment. Second, additional investment in projects implemented in previous years accounted for 46 percent of that year's investment.

The process of accession to the EU has been a key driver of regulatory and market structure reforms facilitating private participation in infrastructure. Countries that joined the EU in July 2004 accounted for 50 percent of the investment and more than 30 percent of the projects in the region in 1990–2005.³ Bulgaria and Romania (which joined the EU in 2007), along with Croatia and Turkey (which gained EU candidate status in 2004), attracted 25 percent of the investment and 10 percent of the projects. The remaining countries in Southern and Eastern Europe claimed 3 percent of both. And the countries of the Commonwealth of Independent States (CIS) accounted for almost 60 percent of the projects but only 20 percent of the investment. Russia attracted most of this activity.

Maria Vagliasindi is a senior economist and Ada Karina Izaguirre is an infrastructure specialist in the Bank's Finance, Economics, and Urban Development Department.

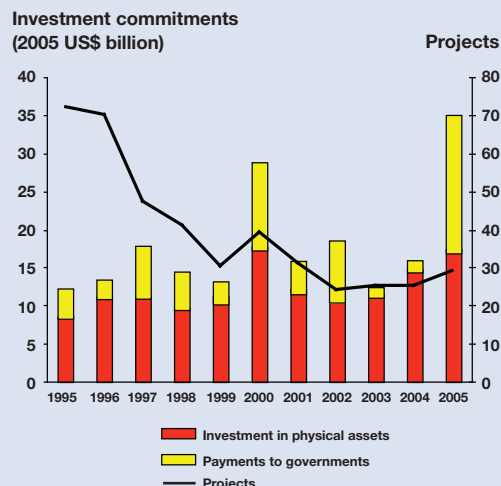
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FIGURE 1

A surge in investment in 2005

Private participation in infrastructure in Eastern Europe and Central Asia, 1995–2005



Source: World Bank and PPIAF, PPI Project Database.

Note: Investment data are for projects reaching financial closure in 1990–2005.

Telecoms led private activity

Telecommunications accounted for 70 percent of regional investment in the 1990s and in 2001–05. In mobile telephony, private participation had extended to the majority of the region's countries by 2001, when the former Yugoslav Republic of Macedonia opened its mobile market to private operators. In fixed-line telephony, private participation has lagged, especially in the low-income countries of Central Asia (World Bank 2006).

A big issue in many contracts has been the balance between creating competitive markets and maximizing government proceeds. In the 1990s many included exclusivity periods to make telecommunications companies more attractive. An extreme example relates to the sale of the Armenian ArmenTel to the Greek OTE in 1997: ArmenTel received 15 years' exclusivity for both fixed-line and mobile services, terms were renegotiated in 2004.

Exclusivity arrangements were sometimes justified on the grounds that they made it possible to impose conditions on the operator, such as obligations to install new lines. But enforcing those conditions has proved difficult. Moreover, they tend to reduce the benefits of competition—for example, slowing fixed-line rollout by as much as 40 percent (Wallsten 2004). Not surprisingly, on key performance indicators Armenia lags behind

most CIS countries, including those that have not privatized their dominant operator.

Since 2000 many countries divesting public telecommunications operators have chosen other options. The privatization of the Bulgarian Telecommunications Company, for example, included new mobile licenses.

Private activity in energy expanded

Energy lagged behind telecommunications, accounting for 23 percent of regional investment in 2001–05, 2 percentage points less than in the 1990s. But the sector's share of projects grew by 13 percentage points, to 50 percent in 2001–05.

Activity in 2001–05 was distributed across the main business lines. Of the 65 energy transactions closed, 26 involved independent power producers, 22 electricity distribution companies, 15 natural gas distribution companies, and the other 2 transmission assets in electricity or gas. Private activity in the sector expanded to six new countries (Azerbaijan, Bosnia and Herzegovina, Bulgaria, the Slovak Republic, Tajikistan, and Ukraine) in 2001–05, bringing the total to 22.

Among developing regions, Eastern Europe and Central Asia has become the most active in bringing private participation to electricity distribution—the most politically sensitive and challenging electricity subsector because it usually requires raising tariffs to achieve full cost recovery while mitigating the impact on vulnerable consumers. The region accounted for 22 of the 33 transactions involving electricity distribution in 2001–05. Those 22 transactions involved 31 distribution companies, in countries as diverse as Azerbaijan, Poland, the Slovak Republic, and Tajikistan. None had been canceled by 2005.

With this private participation have come lower distribution losses, an improvement that utilities had not been able to achieve prior to the involvement of the private sector (EBRD 2004; World Bank 2006). In Moldova, for example, divestitures led to reductions in distribution losses of more than 30 percent in three years. In Albania a management assistance contract brought significant reduction in three years.

New regulatory challenges have emerged, however. Even countries originally intending to unbundle the sector and introduce competition in generation and distribution have seen setbacks due to a lack of bidders or a series of asset sales to the same

New regulatory challenges are emerging in telecoms and energy

investor. In Georgia, for example, the withdrawal of a Western investor left the Russian RAO UES as the sole nonstate owner of major power sector assets. In Hungary RWE and EdF acquired generation and distribution assets in a series of tenders, raising questions about the capacity of the regulatory regime to cope with the consequences of vertical reintegration. The Polish government is merging some unbundled public companies to create stronger vertical units before privatization.

The European Commission has launched inquiries and is reviewing proposals to introduce “ownership unbundling” as a remedy against possible collusion and excessive concentration (EC 2007).

Mainly water management contracts

Private activity in water and wastewater occurred in 16 countries with 65 contracts signed, half in the 1990s and half in 2001–05. But the sector’s share of regional investment dropped from 3 percent to 1 percent because of the proliferation of management and lease contracts and the reliance on public investment for capital expenditure.

Countries as diverse as Armenia, the Czech Republic, and Russia closed management or lease contracts in 2005, confirming the trend. Several factors have contributed to the pervasiveness of such contracts: Water utilities have a history of charging low tariffs. Those in EU members and candidate states face the cost of complying with EU drinking water quality and environmental standards. And publicly owned utilities are eligible for grants or concessional loans from the EU.

Limited activity in transport

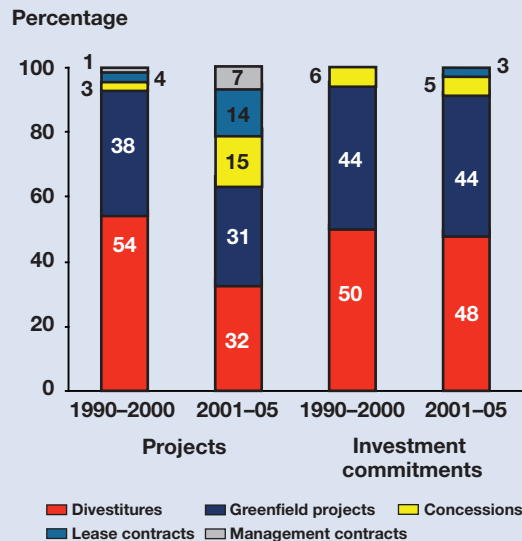
Private activity in transport was limited to 11 countries, with 55 contracts signed in 1990–2005. Transport claimed less than 5 percent of regional investment except in 2005 (thanks to the Budapest and Ataturk airport transactions). In 2005, eight projects reached financial closure and were located in Albania, Hungary, Poland, and Turkey.

Most projects involved seaports (21) or airports (19). The port subsector saw new management contracts for Riga port in Latvia and many in the CIS, the divestiture of some assets in Russia, and new greenfield contracts in Turkey. Armenia, Hungary, Poland, Russia, and Turkey introduced private activity in airports. Croatia, Hungary, and Poland did so in the road sector. In railways, reform has focused on commercializing and restructuring

FIGURE 2

Divestitures predominant

Distribution of activity in infrastructure projects with private participation in Eastern Europe and Central Asia by type, 1990–2005



Source: World Bank and PPIAF, PPI Project Database.

Regulatory reforms pay off in attracting private investment through divestiture

public utilities, though Estonia divested its railway system. But the divestiture was canceled in 2006.

Divestitures dominant

Divestitures remained the most common type of transaction in the region—thanks largely to activity in energy and telecommunications—followed by greenfield projects (figure 2). While divestitures accounted for a smaller share of projects in 2001–05 than in the 1990s, their share of investment remained almost unchanged thanks to additional investments in existing projects.

A fundamental condition for divestitures has been the introduction of an effective regulatory framework that promotes tariff reforms and third-party access to the network. Regional experience shows that such a framework can help lower the risks to investors and attract private investment through divestitures. Countries classified as high reformers in infrastructure regulation have had more divestitures on average than low reformers (figure 3).

This is powerful evidence that reforms pay off in attracting and keeping private investment through divestiture, the mode resulting in the greatest transfer of risks to private operators. In addition, adopting the most transparent process to select

private investors and aligning risks to return provide a powerful incentive to improve performance, bringing the ultimately desired improvement in quality, cost, and service reliability.

New regional sponsors emerge

While Western European sponsors have maintained a strong presence in the new EU member countries, utilities from other transition economies have become more prominent among the top 10 sponsors. Most notable are three from Russia (Russian Communal Systems in water, RAO UES in electricity, and Gazprom in gas transmission and distribution), and more recently Czech CEZ group in electricity and Turkey's Akfen Holding in transport.

Russian activity has been significant. The three largest Russian mobile operators (MTS, Vimpelcom, MegaFon) have expanded into Belarus, Kazakhstan, Tajikistan, Ukraine, and Uzbekistan. RAO UES has been moving into difficult electricity markets, in some cases using debt swap arrangements when Western investors have pulled out. The company now holds assets in several CIS countries, including Armenia, Georgia, Kazakhstan, and Ukraine. Gazprom's reach extends into the Baltic states and Bulgaria.

What lies ahead?

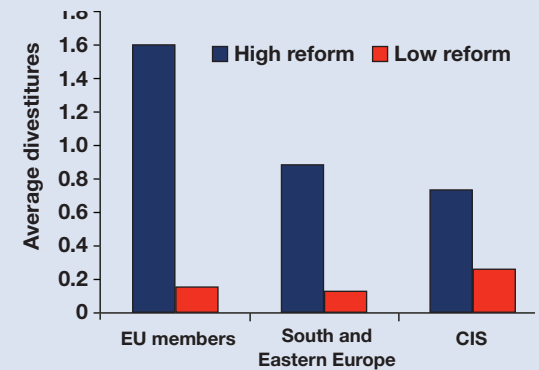
In the region, as in the rest of the developing world, private activity remains concentrated in a few countries. EU members and EU accession countries have attracted the most investment, while others (except for Russia) account for a marginal share. Better regulation and greater political stability are among the key reasons for the differences. Both have helped reduce investors' perception of risk to levels comparable to those of Western economies.

But new challenges are emerging even in countries that have adopted EU directives. In energy, reintegration of previously unbundled structures will create new difficulties for regulatory regimes. Greater concentration in electricity and gas markets already raised concerns in the international

FIGURE 3

More effective regulatory reforms attract more divestitures

Average annual infrastructure divestitures in high- and low-reform countries in Eastern Europe and Central Asia, 1990–2005



Sources: World Bank and PPIAF, PPI Project Database; EBRD 2006.

Note: High-reform countries are those with a score of 2 or above on the EBRD infrastructure transition indicator, low-reform countries those with a score of less than 2.

policy arena, with a number of inquiries launched by the European Commission about anticompetitive effects and the impact of price increases on consumers. The use of exclusivity periods in telecommunications has led to similar concerns.

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Notes

1. The note uses the World Bank's definition of the region.
2. Investment data are in real terms (2005 U.S. dollars using the U.S. consumer price index). The data are from the Private Participation in Infrastructure (PPI) Project Database and include projects that reached financial closure in 1990–2005. The investment data refer to commitments and include private and public contributions. For more information, see the Web site (ppi.worldbank.org).
3. Countries in Eastern Europe and Central Asia joining the EU in July 2004 were the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia.

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