

# NEVER MIND THE BALANCE SHEET

The dangers posed by public-private partnerships in central and eastern Europe



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# Foreword

*“The reality is that PFI, or “public private partnership” as the government now prefers to call it, is a scam. (...) Far from introducing market disciplines, it has become an official licence to fleece the taxpayer. Far from reducing the public sector borrowing requirement, PFI is, as the Accounting Standards Board has noted, simply an “an off-balance sheet fiddle”. Most alarmingly, the ministers I have spoken to simply do not understand how it works.”<sup>1</sup>*

**George Monbiot, UK author and investigative journalist.**

Encouraged by consultancy companies, think-tanks and international financial institutions (IFIs), more and more countries in central and eastern Europe (CEE) are undertaking public infrastructure projects using public-private partnership (PPP) arrangements.

Most recently, European Commission president Jose Manuel Barroso has commented on how the European Commission plans to tackle the economic crisis, citing a package of measures that includes the “need to find innovative funding for a wide range of transport, energy and high technology networks which can provide jobs in the short-term and also contribute to sustainable growth in the long-term. A better use of public-private partnerships is one way forward.”<sup>2</sup>

If these remarks signal a need for a qualitative improvement in PPPs rather than simply a quantitative hike in the number of them, then it is not before time – the experience with PPPs so far has not been encouraging. While a few obvious failures such as the M1/M15 motorway in Hungary, the Trakia Highway in Bulgaria and the Horgos-Pozega motorway in Serbia have hit the

headlines, many more PPP projects have proven to be poor value for money for CEE taxpayers. At the same time, the long-term cumulative impact of PPPs on public budgets has hardly been discussed at all.

The financial crisis should serve as an alarm call about the perils of taking on long-term inflexible budget burdens, and indeed the increased difficulties in obtaining loans are likely to slow down infrastructure projects. However, ‘build now, pay later’ might seem increasingly alluring to cash-strapped governments reluctant to give up their infrastructure plans.

Public debate on this issue is seriously hampered both by the secrecy surrounding PPP deals and by the perception that the issue is complicated and tedious. Yet the debate about PPPs is too important to be left to ‘experts’, who have too often not ensured that the taxpayer receives good value for money in PPP projects and who often have a direct interest in promoting PPPs.

CEE Bankwatch Network, as a public interest group monitoring the investments of the IFIs, is concerned at the increasing number of poor value for money PPP projects in CEE, and at the planned spread of PPPs to Russia and Central Asia. In particular the fact that IFIs have not succeeded in ensuring value for money in some of the projects they have financed is of great concern, given that they are public banks that ought to work in the public interest. The IFIs should be instrumental in ensuring the sustainability of government spending commitments as well as transparency and value for money in individual projects.

This report sets out to provide CEE public interest groups, such as environmental, consumer and transparency NGOs and trade unions, with an easily understandable guide to the issues surrounding PPPs in the region. It aims to demystify the claims made in favour of PPPs and enable wider public engagement on the topic. Public authorities need to learn from previous mistakes, and close scrutiny by civil society organisations is necessary to ensure that any projects undertaken via the PPP model do in fact represent good value for public money.

Case studies from a variety of CEE countries are presented, showing the issues that have arisen to date with PPP projects. However since the number and variety of PPPs in the region has been limited so far and has particularly focused on motorways, the study also presents evidence from the UK – the world ‘leader’ in PPPs – where, amidst great controversy, hundreds of PPP projects have been implemented in various sectors in the last two decades.

The UK experience shows that although CEE countries face particular problems in infrastructure development, such as incoherent planning, corruption, lack of transparency and public participation, as well as an excessive penchant for prestige projects, these problems still exist in PPPs in more established democracies, albeit sometimes in different forms. It cannot therefore be assumed that these problems will be ironed out within a few years in CEE.

Instead the use of PPPs in infrastructure needs to be seriously reviewed, but this will only happen with greater public pressure on decision-makers. It is hoped that this study will contribute to greater debate taking place.

# Executive summary

In recent years public-private partnerships (PPPs) have been heavily promoted in central and eastern Europe (CEE), often giving the impression that where infrastructure is concerned, PPPs are the only game in town. Yet behind the plethora of conferences, workshops and publications, few CEE countries have implemented more than two or three PPP projects, and even fewer truly successful projects.

Discussion on the topic in CEE has mainly been limited to technical discussions about how to best implement PPPs rather than about whether to implement them at all. In contrast PPPs have been fiercely criticised in their birthplace the UK, raising the question of whether the CEE countries are in danger of rushing headlong into a discredited policy.

This report aims to open the debate by presenting CEE Bankwatch Network's concerns about PPPs and examining under what – if any – circumstances PPPs could make a useful contribution in CEE.

PPPs can be problematic at the individual project level and due to their cumulative impacts on public budgets. The main motivation for using PPPs in CEE has been the possibility of moving infrastructure investments off the government balance sheet, thus appearing to mobilise private financing and avoid large increases in public debt. However this is misleading as PPPs do not bring in extra money, but constitute expensive commitments for the public sector for around the next thirty years that can lead to public service closure or higher charges for the public.

In addition, new international accounting guidelines will move most PPPs back onto public balance sheets in countries which decide to align their national accounts with the guidelines, thus removing their main attraction. Thus far in CEE criticisms have focused on identified problems with individual projects, but the impacts of PPPs on public budgets needs to be examined much more closely.

The other main justification for PPPs has been the idea that the private sector is more efficient at construction and providing services, but more and more evidence is emerging that many of the claims made for PPPs are false or based on questionable assumptions.

In particular, the claim that construction through PPP is much more likely than publicly procured construction to be completed on time and on budget is frequently cited, yet the evidence presented is unfounded. Calculations to compare the costs of a PPP with public procurement – where they take place at all – have often been biased in favour of PPPs.

The extra costs of PPPs have sometimes been justified by the transfer of risk to the private sector. Yet there are a range of cases – such as the Zagreb wastewater treatment plant and several motorway projects – where very little risk has been transferred, at great cost to the taxpayer.

Fortunately, some motorway deals featuring the PPP model such as the Trakia Highway in Bulgaria and the

Horgos-Pozega motorway in Serbia have been stopped before the majority of the damage had been done, but the planned St. Petersburg Western High Speed Diameter suggests that lessons have not been thoroughly learnt. The main mechanisms supposed to provide incentives for the private sector to reduce costs – competition and bundling – are undermined by the lack of real competition in many PPPs and the high rates of return built into the deals. Moreover, efficiency can sometimes clash with the goal of providing effective public services, making PPPs manifestly unsuitable for a variety of sectors, including healthcare, education, rail networks, water services and prison services.

There has been insufficient evaluation of PPPs and their impacts, and where attempts have been made the quality of the discussion has been undermined by the lack of real information available to the public. While occasional scandals emerge about the very high rates of return that PPP deals and the refinancing of projects permit for the private sector, in general this information is considered commercially confidential. The public is not able to see how much the same project would have cost if it was publicly procured, nor usually how much a PPP programme will cost them over the next thirty or so years.

The international financial institutions (IFIs), in particular the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB), have supported several PPPs in CEE with

public loans, but have played an insufficient role in promoting the public interest and ensuring that proposed PPPs do in fact offer value for money. IFIs need to actively ensure the long-term sustainability of government debt and budgetary commitments and make sure that their project financing does not contribute to major constraints on public spending during the coming decades. On this point, ensuring much greater transparency for the public about the real costs of PPP projects is vital.

This report recommends that public authorities take a step back from PPPs and examine carefully the evidence for themselves before stepping into more projects.

If further PPPs are undertaken, it is crucial that they are carried out with safeguards in place to avoid overcommitting public funds, to ensure a genuine and fair choice is made between the different procurement options, and to avoid undue profits for the private sector at public expense.

The IFIs must also take a more proactive role in ensuring that the public sector obtains good value for money when PPP projects are proposed, and that a fair comparison takes place between various procurement options.

# Introduction

After decades of under-investment in public infrastructure and services in CEE, in recent years there has been a flood of new projects in all sectors, often financed by the IFIs and/or EU funds. However the need to improve infrastructure and services has had to be balanced with the need to keep government borrowing under control, particularly as a requirement of the so-called “Maastricht criteria”, which restrict the amount of debt a country can accumulate if it wishes to be a full member of the European Economic and Monetary Union.

Mainly as a result of this, governments in CEE have – to varying extents – been attracted by PPPs, consisting of a range of “Build Now, Pay Later” arrangements that appear (falsely) to enable investments in otherwise unaffordable infrastructure. PPPs are also being actively promoted by a range of institutions and think tanks, including the IFIs and the large international consultancy and law companies that would benefit from an increase in the use of complex PPP contracts.

Although it is often stated that PPPs are only one possible tool for financing, and that public procurement is likely to remain the most important financing method in the coming years, the stream of seminars, conferences and publications promoting PPPs often appears to suggest that PPP is the only game in town.

However, so far the experience with PPPs, both in CEE and elsewhere, has been distinctly mixed, and new international accounting rules are set to ensure that most PPP deals will no longer escape from inclusion on

government balance sheets, thus removing one of their main attractions for those countries which choose to adopt the new guidance.

While it is widely accepted that there have been some ‘teething problems’ with PPPs, this report suggests that there are wider and more systemic issues that have not been sufficiently taken into account by PPP advocates and governments, particularly in terms of the cumulative impacts of PPPs on public budgets during the coming decades. There is also doubt about whether the assumptions on which PPPs are based have been adequately justified and evaluated.

Using case studies from the CEE region and additional examples from elsewhere, this report argues that not only are there an unacceptably high number of ‘bad apples’ but that using a large number of PPPs in itself is likely to lead to affordability problems.

Many of the lessons come from the UK, where hundreds of PPPs have been implemented and there is much greater scrutiny of PPP schemes than in CEE. Yet most of the same issues can be applied in other countries. The conclusion is that rather than being accelerated, the development and rollout of PPPs in the region should be treated with caution and the likely impacts thoroughly and independently reviewed.



## What is a PPP?

Public-private partnerships involve commercial contracts between public authorities (state or local) and private businesses in the design, construction, financing and operation of public infrastructure and services that have traditionally been delivered by the public sector.

They involve either a partnership between a public entity and a private entity based solely on a contract, or the establishment of a project company involving both the public and private sector within a distinct entity.<sup>3</sup>

There is no agreed definition of PPPs but they are characterised by the following:

- The relatively **long duration of the contract**, on different aspects of a planned project: often around 25-30 years, and sometimes even longer.
- Financing comes in part from the private sector, but requires **payments from the public sector and/or users** over the lifetime of the project
- The private partner participates during the design, completion, implementation, and funding of the project while the public partner concentrates primarily on defining the objectives and monitoring compliance with these objectives.
- An attempt to **distribute risks** between the public partner and the private partner according to the respective ability of the parties to assess, control and cope with them.<sup>4</sup>

Typically, PPP projects in CEE involve:

- Transport infrastructure: highways, airports, rail, bridges and tunnels.
- Municipal and environmental infrastructure: water and wastewater facilities
- Public service accommodation: school buildings, prisons, student dormitories, and entertainment or sports facilities

They can also be found in other sectors too.

In legal terms, PPPs straddle the line between public works or services contracts and concessions. While public works and services are paid for through a fee from the public authority, concessions may also include the right to direct payment from users.<sup>5</sup> In PPPs, regular payment is made either by the public authority from its revenue budget, for example in hospital projects, or through direct payments by users, for example on toll highways, or by some combination of

the two. Sometimes payments are made by the public authority but are based on actual usage of the service, for example with 'shadow tolls' for highways. In other cases, payment is made by the public authority with the fees collected from users, for example fees for wastewater treatment.

The term PPP covers a wide range of contractual arrangements including:

- Design-Build-Operate (DBO)
- Design-Build-Operate-Transfer (DBOT)
- Lease-Develop-Operate (LDO)
- Build-Lease-Operate-Transfer (BLOT)
- Build-Own-Operate (BOO)
- Build-Operate-Transfer (BOT)
- Build-Own-Operate-Transfer (BOOT)

An important common feature of different PPP arrangements is that some degree of risk is supposed to be transferred to the private sector, though it will be discussed later how much this in fact takes place.

There are three main kinds of risk that arise in infrastructure projects:

**1) Construction risks**, mainly for physical infrastructure such as roads or railways: if the product is not delivered on time, runs up extra costs, or has technical defects. The risk is borne by the partner who pays for such unforeseen cases – usually the private partner.

**2) Availability risk**, mainly for services such as running prisons, hospitals or schools: if the private company cannot provide the service promised, or at the level promised. For example, it does not meet safety or other relevant quality standards. If the public sector is contractually allowed to withhold payments then the risk is borne by the private sector.

**3) Demand risk**, in cases where there are fewer than expected users of the service or infrastructure, for example on toll-roads, bridges or tunnels. If the public sector has agreed to pay a minimum fee irrespective of the demand, it is assumed to bear the demand risk.

Since there is no standard definition of PPPs, and the term is sometimes used for almost any arrangement involving the public and private sector, in this report PPPs are deemed to involve some degree of initial investment using finance raised at least partly by the private sector, rather than a simple concession to run an existing service.

Thus a concession to run a local bus service would not be regarded as a PPP but the construction and operation of a highway would, because the private sector is responsible for raising some or all of the finance and participating in several stages of the project (e.g. Design-Build-Operate or Build-Operate-Transfer). There is also a more complicated allocation of risks than a simple concession. Some of the same issues may apply to simpler concession arrangements, but are not dealt with here.

Although concessions have been in use for many years, PPPs in the form outlined above effectively began with the UK's Private Finance Initiative (PFI), launched in 1992 in order to allow private capital to be invested in public infrastructure projects. PFI involves the private company designing, building and operating infrastructure, with the costs paid by an annual fee from the public authority, rather than costs being paid directly by users.

By March 2008, 625 PFI projects had been signed in the UK, with a total capital value of GBP 58.7 billion.<sup>6</sup> PPPs in various forms have since been adopted by many countries, although the degree to which they are used varies widely. In CEE, PPPs have also been used since the early 1990s. However, as outlined below, only Hungary has launched a significant number of PPP projects.

## Reasons for using PPPs

### Hiding government debts

PPPs look attractive to decision-makers because they can sometimes move projects off the government balance sheet. According to Eurostat rules, a project is a non-government investment if the private sector bears the construction risk and either the availability risk or the demand risk.<sup>7</sup> Instead of up-front capital investments, PPPs use annual instalments from revenue budgets to pay for infrastructure, so governments do not need to directly take loans. However governments do often need to provide loan guarantees for the private sector, which can also add to public debt commitments.

Ironically, it is sometimes the same institutions which are cautioning governments on their need to cut public borrowing and at the same time promoting PPPs that contribute to increasing public budget commitments.

It is often claimed that PPPs enable projects to be realised now which otherwise would not be affordable. However this is extremely misleading as it implies that PPPs produce extra money out of thin air.

In fact no extra money is available, it is just borrowed from public budgets for around the next thirty years.

PPPs do not mean that governments spend less public money overall; it is just paid later than in traditional public procurement.

Given that much of the incentive to use PPPs depends on their being 'off-balance sheet', it is interesting to note that in November 2006 new guidance was published by the International Financial Reporting Interpretations Committee on how the private sector should account for PPPs.

The guidance is meant for the private sector rather than the public sector, but countries using the system will need to change their public sector accounting to mirror that of the private sector, otherwise the projects may not end up on anyone's balance sheet.

The guidance states that the PPP should be on the government's balance sheet when the public authority controls the services the operator provides with the asset, and stipulates who the services are provided to and at what price; and the public authority controls any significant residual interest in the asset at the end of the term of the arrangement.<sup>8</sup> For those countries that decide to adapt their national accounting systems to fit with this, almost all PPPs will be 'on-balance sheet', removing a large part of the incentive for their use. This *will* be the case in the UK but it is not clear how many CEE countries are planning to use this system.

### Efficiency

The second main reason for using PPPs is that the private sector is seen to be more effective at cutting costs in project implementation than the public sector, and thus the higher costs of private sector borrowing should be offset by the cost savings achieved.

The competitive tender and risk transfer should provide incentives for the private sector to make cost savings. As the private sector has long-term control of the facility, it has an interest in making sure that the construction is completed on time and on-budget and that the costs for the whole lifetime of the facility are adequately taken into account and reduced as much as possible.

'Bundling' the construction together with the operation of the facility is seen to provide cost reduction incentives that may not be present when construction is undertaken by a different party than the operation. This claim will be examined in more detail later.

## Overview of PPPs in central and eastern Europe

Although the first PPPs appeared in CEE as early as the early 1990s, in most CEE countries their use is still at a relatively early stage. So far Hungary has been the most enthusiastic PPP-user by number of active projects, partly as a result of the government's high debt, which in 2006 was at 65.6 percent of GDP and is not expected to fall below the Maastricht Criteria limit of 60 percent before 2011.<sup>9</sup> This has meant that PPPs have been seen as a means for the government to continue making investments while not having to increase the public debt.

The contract for Hungary's rather unsuccessful first PPP motorway project, the M1/M15,<sup>10</sup> was signed as early as 1993. Yet Hungary's inter-ministerial PPP Committee was formed only in 2003 and most of the projects are still under development. The main PPP programmes involve the construction of student hostels and sports facilities, and other such projects are being undertaken in road, rail, prisons, waste, wastewater and urban development.

The following offers a snapshot – not a comprehensive overview – of the type and extent of PPP projects being undertaken in CEE.

**Baltic states:** few projects are underway, yet the South Bridge in Riga, Latvia, is already causing a scandal due to its constantly rising costs.

**Bulgaria:** the few projects in progress so far consist of transport infrastructure projects, including the notorious Trakia Highway,<sup>11</sup> and concessions for Sofia's water supply and waste collection, that have attracted public discontent and numerous criticisms due to flaws in their implementation.

**Croatia:** PPPs have been used for some motorway projects, as well as the Zagreb wastewater treatment plant. Only a few new projects are underway.

**Czech Republic:** Much of the Czech water sector is managed by private companies and several PPP construction projects are under development in various sectors, especially roads. An attempt to build the D47 motorway by a PPP arrangement failed.<sup>12</sup> A highway toll collection system is being implemented and has attracted criticism for its poor preparation and irregular tender procedures. (See case study).

**Poland:** a section of the A2 motorway was built using a PPP and the Gdansk-Torun section of the A1 motorway was completed in 2006, with several other PPP road and rail projects under development.

**Romania:** the Bucharest water and wastewater treatment plant are under a PPP concession but most other projects are in the tendering stage and consist mostly of road and health projects.



The Hungarian M5 motorway, one of the earliest PPP projects in central and eastern Europe. The expected traffic levels failed to materialise and the state has had to buy back a share of the project and guarantee the income of the concessionaire.  
Photo: CEE Bankwatch Network

**Serbia:** a PPP was attempted for the construction of the Horgos-Pozega highway, but failed, and PPPs for Belgrade's waste and water are also being developed.

**Slovakia:** the D1 motorway is being developed as a PPP pilot project. The Slovak government has been strongly criticised for exempting several sections of motorways planned to be constructed with PPPs from the 'state expertise' assessment, which would help to ensure that the projects offer value for money.

Elsewhere in CEE, PPPs are at an early stage, with the modernisation of Tirana airport in **Albania** standing as one of the very few PPP projects in the Western Balkans. In **Ukraine** PPPs are expected to take off in advance of the Euro 2012 football championship, raising fears of hastily carried out projects without proper assessments and safeguards, while **Russia's** first PPP highway project, the St Petersburg Western High Speed Diameter, is causing concerns due to its rapidly growing costs.<sup>13</sup>

Assessing PPPs in the highway sector in Hungary, Czech Republic, Poland and Croatia up until 2005, German researchers Brenck et al. concluded that:

"Due to the adverse institutional conditions prevailing in the transition period, high transaction costs, and unrealistic demand expectations, PPPs in CEE countries have been less successful than in other countries, and certainly less successful than initially hoped for. In general, they seem to have been less successful than traditional procurement would have been."<sup>14</sup>

An important question is whether ensuring the success of PPPs in CEE is mainly a question of gaining experience – which would imply a need to put more effort into institution-building and developing projects – or whether PPPs contain just many potential pitfalls that they should be used sparingly if at all?

## Snapshot of IFI involvement in PPPs

The IFIs are public banks whose shareholders are their member states. As well as contributing to their specific mandates, therefore, their investments must protect the public interest and promote sustainable development, in both the environmental and economic sense.

The IFIs promote PPPs not only by making direct equity and loan investments into PPP projects, but also by making private sector participation part of

otherwise public projects and by using their advisory capacity to promote private sector participation. The most important IFI role in PPPs in CEE is played by the European Bank for Reconstruction and Development (EBRD), with the European Investment Bank (EIB) also financing some projects.

There is increasing interest in using EU funds for PPP projects, however very few projects in the CEE region have involved EU funds so far.<sup>15</sup> The World Bank is also very active in promoting PPPs around the world, through its investment projects as well as through its Public-Private Infrastructure Advisory Facility (PPIAF).<sup>16</sup> The World Bank and International Monetary Fund are often prominent among those advising CEE countries to drive down their public debt,<sup>17</sup> while at the same time the IFIs promote PPPs, thus exposing CEE economies to hidden debts for several decades to come.

## The European Bank for Reconstruction and Development

The EBRD has an explicit mandate to encourage economic and political transition in the former Soviet Union countries and the Eastern Bloc satellites through development of the private sector.<sup>18</sup>

Since its establishment in 1991, the EBRD has been involved in assisting the borrowing countries in creating the legal environment for private investment. Perceiving concession laws as the cornerstone of the legal framework for mobilising private investment, the EBRD has offered technical assistance, expertise and assessment capacities to governments to reform their laws on concessions. This engagement has characterised the bank's involvement in the legal preparation of the CEE countries for PPPs, a process which has been slower in some countries than initially expected.

The EBRD has been involved in PPPs in the transport sector since 1993 and the municipal and environmental infrastructure sector since 1996. The EBRD admits that "*Within the Bank's countries of operation, few countries met the above conditions [for financing PPPs], although the Bank has financed PPPs in 15 countries.*"<sup>19</sup> A list of its PPP projects can be found in the tables in Annex 1, though not all of these are PPPs within the definition given above, as they include operational contracts and leases.

During the expansion of its focus to the Western Balkans, the Caucasus and Central Asia, the EBRD has become a vocal advocate of PPPs in countries such as Albania, Georgia and Kazakhstan. The EBRD has also

undertaken serious efforts to develop PPPs in Russia with the Western High Speed Diameter road project potentially becoming its flagship project.

Over the past ten years, the evaluation unit at the EBRD has assessed the success of 14 PPP projects that the bank has financed in power and energy, municipal infrastructure and transport. The evaluation department judged the projects on the basis of the bank's achievement of attracting and maintaining private sector involvement and ensuring legal protection of the private partner and commitment of the public agency. Based on these criteria, the evaluation concluded that the EBRD has had uneven success in PPP projects.<sup>20</sup>

### The European Investment Bank

The EIB – the EU's house bank, which is supposed to follow EU policy – has financed PPP-type arrangements in the EU countries since 1987 when it financed the Anglo-French Eurotunnel project.

Until 2002 its PPP investments consisted almost entirely of transport projects. By the end of 2003 the EIB had signed loans for PPPs worth EUR 13.7 billion for transport projects, making up 93 percent of the Bank's PPP investments.<sup>21</sup> Most of these were for motorways, tunnels and bridges. In subsequent years, however, the share of health and education investments dramatically increased, making up around half of EIB PPP investments by 2004.<sup>22</sup> Almost all of the EIB's PPP investments have been within the EU, with only three projects in CEE: (see table overleaf)

The EIB makes the majority of its investments within the EU, so it is unsurprising that it has not been involved in as many CEE PPPs as the EBRD.

In addition, unlike the World Bank and the EBRD, the EIB states that it *"reflects EU policy on how public projects are procured and has no preference as to whether a project is implemented using conventional public-sector procurement or via a PPP. The Bank may be perceived as*



The EBRD, EIB and World Bank are all interested in financing the EUR 6.9 billion St Petersburg Western High Speed Diameter PPP. Photo: Save Yuntolovo Public Environmental Movement

Country	Date	Project name	EIB loan amount
Poland	2000 (signed 30/10/2000)	A2 motorway (Warsaw–Berlin)	EUR 275 million
Hungary	2006 (signed 28/03/2006)	M6 motorway (Budapest–Dunaujvaros)	EUR 200 million
Hungary	2008 (signed 01/08/2008)	M6 (Dunaujvaros–Szekszard)	EUR 200 million

*supporting the use of PPPs but its actual position is one of neutrality between the two procurement mechanisms. Its involvement in PPPs is a reflection of how a number of its clients want to procure their projects. Similarly “PPP” is not an eligibility criterion for the EIB.”<sup>23</sup>*

The EIB’s supposed neutrality on PPPs follows EU law: “Community law on public contracts and concessions is neutral as regards the choice exercised by Member States to provide a public service themselves or to entrust it to a third party.”<sup>24</sup> However, particularly in the case of the Trans-European Transport Network, the EU and EIB do actively encourage PPPs<sup>25</sup> through their Loan Guarantee Mechanism for PPP projects in the Trans-European Transport Network.

Moreover in September 2008 the EIB and European Commission launched a new European PPP Expertise Centre (EPEC) for public authorities working on PPPs.

The Centre does not aim to give advice on individual projects but instead to provide policy and programme support and network activities to identify best practice in areas of concern to its members.<sup>26</sup> While the Centre’s mission is not specifically to promote PPPs, the fact that resources are being put into training public authorities to carry out PPPs rather than into improving public procurement or other financing possibilities is likely to have the effect of promoting PPPs.

**The role of the IFIs in financing PPPs in CEE is explored further in the section on *Working for whose good? The role of the IFIs in PPPs.***

# Concerns about PPPs

## Build now, pay heavily later

One of the chief misconceptions about PPPs is that they somehow mobilise extra financial resources for projects that would otherwise have to wait several years to be implemented. This irresponsible claim encourages decision-makers to carry out projects that may not be affordable – it may be several years before anyone realises the damage done. Whatever the merits of individual projects, PPP programmes threaten to accumulate significant burdens on public budgets and restrictions on public spending for around three decades until the contracts end.

As an EBRD report has noted:

*The particular time schedule of investments and payments in PPP contracts – with payments typically starting only after the completion of infrastructure, several years after signature of contracts – implies that these contracts, if improperly dealt with, are a powerful instrument for keeping public expenses out of the books, for under-evaluating them and for biasing decisions in favour of PPP schemes that accelerate investment and delay payments by the public sector to the private partners. This creates the possibility of undertaking inefficient projects, or efficient projects that are too much of a burden for future generations to pay, future generations that were not included in the decision process.”<sup>27</sup>*

Unfortunately, far from promoting a precautionary approach with transparent public accounting for future expenditures, many PPP advocates aim to gain experience through increasing the ‘deal flow’ of PPP projects. This ‘quantity brings quality’ theory is at odds with minimising the cumulative impacts of PPPs on

public budgets and with ensuring that PPPs are only used where they really bring benefits.

So far there has been little discussion in the CEE countries about the future budget burdens that may be caused by PPPs. As a recent World Bank paper points out:

“EU8 countries ... have only limited information on the risks involved in PPPs and limited understanding of the long-term fiscal cost of PPPs. Moreover, these countries make very little of such information publicly available. PPP contracts and their content are considered confidential. This makes it difficult for policy analysts to assess the long-term fiscal cost of PPPs – and for the public to exercise appropriate pressure on policymakers for fiscal prudence.”<sup>28</sup>

The affordability of PPPs is already a serious issue in the health sector in the UK, and in CEE has been identified as a problem in both Hungary and Croatia. While Hungary is undertaking numerous PPP projects, those in Croatia are fewer but have been criticised for their poor value for money.<sup>29</sup>

The money that UK hospital trusts receive from the government includes “an element for capital costs based on 5.8% of trust income. However, the capital costs of trusts with PFI schemes average 8.3%, with the result that they are under-funded. The problem is even more serious for trusts with large or multiple schemes. Trusts with operational PFI schemes with capital values of over GBP 50 million have average capital costs of 10.2% – a shortfall in income of 4.4%. This under-funding has created serious

*financial difficulties for many trusts, which can only be reconciled by further service reductions.”<sup>30</sup>*

In Hungary, “as in other countries, PPPs seem to be motivated by fiscal constraints while they should be pursued only if they offer value for money... without properly appraising and prioritising projects and analysing solutions for the whole road network, Hungary may be embarking on a too ambitious road sector development programme, thereby burdening future government budgets with large contingent liabilities.”<sup>31</sup>

Describing PPP schemes in Croatia, the same review notes that:

*“Croatia has certainly advanced with high speed in the area of PPP ventures, which have driven motorway densities to record levels. Yet, it is uncertain whether this strategy is sustainable given its large medium- to long-run fiscal burden. In fact, public debt is not negligible, and international financial institutions have argued strongly in favour of more fiscal discipline, including a cut in expenditure on highways.”<sup>32</sup>*

Various methods for carefully accounting total long-term government commitments have been proposed.<sup>33</sup> Yet the questions remain: how much future commitment of funds is too much? Is it justified to commit other people to pay significant sums of money for the next thirty years on something they might never have considered a priority?

Although financing projects always leads to some commitments, the time period in question is generally much longer for PPPs, with a corresponding greater potential for today’s decision-makers to create a long-lasting burden.

## Project planning problems

Infrastructure schemes in central and eastern Europe – whether PPPs or not – often suffer from governance problems that significantly increase the chances of them failing to live up to expectations.

Some of these schemes consist of resurrected plans from several decades ago when neither value for money nor nature protection was an issue and the geopolitical landscape looked entirely different from today. While there are some improvements, even those projects conceived more recently are often not the result of thorough and systematic planning but a combination of clumsy and unimaginative planning, lobbying, and

personal interests. Corruption remains a problem in the region, and tender processes – when they are carried out at all – continue to be far from satisfactory.

Too often public officials lack experience with balancing the wishes of the private sector with the best interests of taxpayers; as a result the costs of projects often rise. Administrative capacity in CEE countries is generally considered to be low, yet trained and knowledgeable staff within public authorities are essential for developing PPP schemes. Low capacity results in failure to protect the public interest, lack of control over projects and in the end lower quality of services provided under the PPP scheme. Many officials are insufficiently committed to wide consultation and consideration of all alternatives. Public access to information is often poor and consultation processes are invariably carried out as a formality, at a late stage, and with no real intention of taking public opinions into account.

The novelty with PPPs is that they can, when handled badly, multiply these problems.

Due to the complexity of PPP arrangements and contracts, and the possibility of hiding behind ‘commercial confidentiality’ as an excuse for failing to provide public information, there is very little space for public scrutiny during the preparation of the projects. Where there have been successes in stopping poor deals, such as the Trakia Highway in Bulgaria and the Horgos-Pozega motorway in Serbia, these have mostly taken place after the contracts have been signed, representing a waste of time and money for everyone.

Even in countries with a more developed freedom of information culture than exists currently in CEE, information about PPPs is hard to come by. The UK Commons Select Committee on Health has recommended that:

*“While there clearly exists a tension between the imperatives of commercial confidentiality on the one hand and openness in the decision making process on the other, we believe that the Government has to give the lead here and insist that, in privately financed but publicly funded projects with such long-term revenue consequences, the balance should be tilted firmly in favour of greater openness.”<sup>34</sup>*



## The stages of a PPP – How things are supposed to flow

This outline is based on UK guidance documents for its **Private Finance Initiative (PFI)** programme. The experiences outlined in this report show that not all stages have been carried out in some CEE PPPs, resulting in a high likelihood that the public authorities have failed to achieve good value for money.

### Initial planning

The need for investments in a certain service sector needs to be critically assessed by the public authority to identify where improvements are needed and what project investments this will entail.

### Outline Business Case

A 'business plan' needs to be prepared on behalf of the public authority, in which the project and procurement options are decided on. This should include assessments of:

- The affordability of the project
- Which option offers best value for money: a 'reference project' is developed, which is the PPP option against which the future bids should be evaluated, and this should be compared with a publicly-financed variant of the project, called the **Public Sector Comparator**, to see whether a PPP option or public option offers better value for money.
- What outputs are needed from the project.
- Which risks are involved in the project and which party should bear them.
- The timeline for the implementation.
- Whether there is likely to be sufficient interest from private companies in the project and whether there are a sufficient number of private companies with the relevant skills to ensure that real competition takes place.
- Service requirements and standards.
- The payment mechanism that would be appropriate.
- Proposals for the monitoring of the project.

### Publication of tender notice

After the tender notice has been published, an information pack about the project and pre-qualification questionnaire may be distributed to companies that respond. The questionnaire is aimed at establishing whether the company has the technical and financial capacity to deliver the project.

### Pre-qualification of bidders

From the pre-qualification questionnaire, a list of the pre-qualified bidders is made, with an explanation of the reasoning behind the decisions.

### Shortlisting of bidders

If there are still several pre-qualified bidders, further shortlisting may take place aimed at identifying which bidders are most suitable to undertake the project.

### Issue of Invitation to Tender/Negotiate (ITN) and receipt of bids

The shortlisted bidders are sent the ITN, which is a more developed version of the information pack, including the **output specification, payment mechanism** (including performance standards) and **model contract**.

### Evaluation of bids and best and final offers

After the bids submitted in response to the ITN, two bidders may be invited to submit a Best and Final Offer, or this stage may be omitted if the ITN bids allow the choice of a preferred bidder.

### Approval of Final Business Case and preferred bidder

The preferred bidder is appointed, preferably along with a reserve bidder in case agreement cannot be reached with the preferred bidder. When the terms of the contract are more or less clear, a Final Business Case is prepared for approval by the relevant decision-makers.

### Negotiations and contract award

The negotiations with the preferred bidder are not supposed to result in major changes to the project, yet in a number of cases this has happened, since the negotiations essentially take place under monopoly conditions. The signing of the contract is known as the **commercial close** of the project, and should happen as close as possible to the **financial close**, the stage at which financing contracts are signed.

### Project implementation

Payments to the company implementing the project typically begin after the construction phase has ended and the infrastructure is ready to use. The PPP may take the form of a **concession**, in which the project company is entitled to charge users directly for the duration of the contract (e.g. for a highway, where the company collects tolls directly from users) or a **unitary fee**, in which the public authority pays the project company an amount defined in the contract (e.g. for hospitals). The unitary fee may be fixed, as for schools and hospitals, or may depend on the number of users of the infrastructure (e.g. shadow tolls for highways).

## Value for money?

Assuming a project is thought to be affordable, most practitioners agree that value for money should be the driving factor in any decision to use a PPP. However it is far from clear that this sentiment ends up being realised.

There is no standard definition of value for money, and the methods for assessing it are subjective and open to manipulation. Indeed it is counterintuitive to suppose that the private sector can build and operate infrastructure more cheaply than the public sector given that:

**1) PPPs involve equity (shares) plus bank loans to provide funds for the Special Purpose Vehicle (project company), which is much more expensive than public sector borrowing.** The overall finance cost for Scottish PFI schools between 1998 and 2001, for example, was 7–13 percent per year,<sup>35</sup> whereas the public sector loan board rate was 4.2–5.9 percent.<sup>36</sup>

**2) Unlike public authorities, private companies expect to make a profit on their investment.** In the UK, construction firms traditionally receive rates of return of 1.5–2 percent on contracts but expect margins of 7.5–15 percent on PFI building schemes, and if they are also equity holders in the project company they may expect 10–20 percent.<sup>37</sup>

**3) The preparation of PPPs is long and costly.** For the Edinburgh Infirmary hospital PPP in Scotland, the bidding costs alone were GBP 7.4 million or 3.8 percent of the total investment cost. The UK National Audit Office estimates that on average the bidding costs account for 2.5–3 percent of the total project costs.<sup>38</sup>

Due to the low number of projects and poor transparency, we do not have similar figures for any CEE country, but there is no reason to suggest why they should be any different. Indeed the private sector may expect higher profits as a compensation for working in a less developed and therefore higher-risk environment.

These increased costs are supposed to be offset by the efficiency gains from using the private sector, however, it is not clear to what extent these efficiency gains: a) exist, and b) are desirable for the objectives of providing public services. (See section on Public services: Cutting costs or cutting corners?)

Since it is not possible – though is generally attempted nonetheless – to make a general claim that PPPs offer better value for money than public procurement, an

**important tool in assessing whether a PPP could be cost-effective is a Public Sector Comparator (PSC) calculation**, which attempts to compare the costs of a PPP with that of the same project carried out through public procurement. However experience shows that often no such calculation is made.

In EIB-financed projects, the bank relies on the project promoter to carry out a PSC and does not usually check whether it has been done, or whether it has been done well: *“Only the projects in two countries had been the object of a formalised PSC process, although a third had used an ad hoc system. The Bank did not normally review the PSC, although the assumed cost and benefit figures were often used for the Economic Return (EIRR) calculation.”*<sup>39</sup>

Even where PSC calculations are carried out, such as in the UK, the outcomes cannot be relied on. **The UK’s PSC calculation has been widely criticised for rigging calculations in favour of PPP schemes.** The National Audit Office’s deputy comptroller and auditor-general Jeremy Coleman has been one such critic, dismissing some calculations as “utter rubbish” and “pseudo-scientific mumbo-jumbo.”<sup>40</sup>

The UK government has tended to prejudice the results of the PSC assessment before it has even begun by making it clear that public funding will not be available. This gives a clear message: *“If at first you don’t succeed, do the sums again until the Private Finance Initiative works out cheaper than the public sector option.”*<sup>41</sup>

The Centre for European Policy Studies has also observed that *“...the conventional Public Sector Comparator index has shown a set of shortcomings due to its limited ability to take into account qualitative elements. The PSC focuses only on costs and therefore seldom enables a full evaluation of the expected benefits of a PFI/PPP option when compared with alternative options. Moreover, its findings are somewhat easy to manipulate.”*<sup>42</sup>

Even with the alleged manipulations it is interesting to note that the UK PSC has not come out very convincingly in favour of PPPs in certain sectors. A report by the Institute for Public Policy Research in 2001 found that calculations for the road and prison sectors showed much better value for money than for schools and hospitals,<sup>43</sup> with the PFI hospitals examined all showing a saving of only 0–4.2 percent, and many schools also showing less than 5 percent savings until the practice of bundling several school projects together was adopted to take advantage of economies of scale.<sup>44</sup>

The UK framework for assessment of value for money has in recent years been revised to place less emphasis on the PSC calculation, an approach criticised by some as untransparent and unlikely to avoid the previous pitfalls.<sup>45</sup> While the UK PSC has several faults, and the methodology needs to be clear and publicly available to enable scrutiny and improvements, such a calculation does need to be carried out. However the PSC calculation must be done in good faith, not just to justify a pre-decided course of action.

In many CEE PPPs there is no evidence of value for money assessments having been done at all, and, where it does take place, the methodology is not publicly available.

This is sometimes justified by the claim that there is no way of using public funds anyway, so it is PPP or nothing. However this claim should be treated with caution, as there is still no convincing evidence to suggest that a PPP is affordable if a publicly procured project is not.

A PSC also only makes sense if the possibilities being compared are actually similar. However, **sometimes**

**PPP projects have been developed to be larger than necessary in order to make it more appealing for the private sector to participate.** This may happen, for example, in road projects – where building a highway may be preferred to rehabilitating and upgrading an existing road – or in incinerator facilities, where operators, being paid per tonne of waste treated, have a natural incentive to build a large facility rather than a small one.

Other examples are the Zagreb Wastewater Treatment Plant in Croatia (see case study) and the Walsgrave hospital in Coventry, UK, which was originally planned for renovation at a cost of around GBP 30 million, but, when no public funding was made available, ended up being demolished along with Coventry’s centre hospital and rebuilt at a cost of GBP 174 million (later rising to GBP 400 million).<sup>46</sup> The private consortium would be paid GBP 36 million a year for 25 years, plus a one-off equipment grant of GBP 25 million, and would be given the land on which the city centre hospital stood. A local health authority report on the project concluded that it had been “*progressively tailored to fit the needs of private investors.*”<sup>47</sup>



The Zagreb wastewater treatment plant has been criticised for offering poor value for money. Photo: UZOR

## Efficiency through competition?

The main claim justifying PPPs in spite of their higher financing costs is the increased efficiency from the competitive tender and the private sector's supposed operating efficiencies. However, in practice, PPPs have been plagued by a lack of competition, resulting in increased costs that may have wiped out the 'value for money' justifications for using PPPs in the first place.

In several PPP cases in CEE, there has not even been a competitive tender, for example in the following highway projects: Czech D47, Croatian Bina Istra and Zagreb-Macelj, and Bulgarian Trakia.

### D47 motorway, Czech Republic

In 2001, the Czech government directly awarded a Build-Operate-Transfer (BOT) concession for the construction of an 80 kilometre stretch of the D47 motorway between Lipnik nad Bečvou and the Polish border, via the city of Ostrava, to Israeli investor Housing & Construction. The concession contract was signed, but the project was cancelled in 2003 by the consequent government due to criticism of the direct concession award and the perception that the private partner was demanding too high a price.

According to the contract, the state would pay the investor over EUR 5 billion (CZK 125 billion) for construction and operation of the motorway over the course of 25 years. The government was forced to pay some EUR 20 million for breach of contract and in the end the Minister of Transport announced that the project would be carried out by the public sector.<sup>48</sup>

Despite its reservations over the project, the EIB was ready to finance construction of some segments of the motorway. In 2004 the Czech government, unhappy about the bank's preference for the less expensive upgrade of the existing R48 highway than the construction of a totally new route, put the EIB's offer on hold.

### Croatian motorways: Bina Istra and Zagreb-Macelj

The Bina Istra (Istrian Y motorway) and Zagreb-Macelj (Slovenian border) are the only two motorways constructed using PPPs in Croatia so far, with the Zagreb-Rijeka motorway being

constructed by a concessionaire owned entirely by the Croatian government. The two PPP concession contracts were negotiated with single bidders, making it *"unlikely that they offer best value, though this is not easy to confirm, due to the lack of best value reviews undertaken to date, and the lack of available time and data/records to carry out a more detailed benchmarking exercise at this stage."*

In an overview Atkins consultants pointed to poor quality guarantee systems in the concessions contributing to a lack of value for money and user benefits. In both cases the Croatian government (or HAC, the government-owned motorway company) owns 49 percent of the project company, and the state supports the project in the event that projected traffic volumes fall below certain levels. Additionally, the project finance packages have relied heavily on Croatian government support, which effectively guaranteed debt service to project lenders, regardless of how the schemes perform. It is therefore questionable how much of the risk has been transferred to the private sector.

The government's involvement in the concession companies also means that the schemes still involved public borrowing and therefore an increase in public sector debt.<sup>49</sup>

While the IFIs do not usually finance projects where no competitive tender procedure has been implemented, competition in PPPs has often been limited. For example, in the UK between 2004-2006, 33 percent of tenders attracted only two viable bids, leaving the risk of competition being entirely absent if one of the bidders dropped out.<sup>50</sup>

The St. Petersburg Western High Speed Diameter case (see case study) shows that where a tender results in only one bidder, IFI finance may still be forthcoming, in spite of the strong negotiating position for the bidder resulting from the distinct lack of competition.

Even if there are several bidders, the 'preferred bidder' stage, in which negotiations are carried out with one selected bidder to fine-tune the details of the contract, often opens the possibility for increasing the price or changing the specifications of the project – so called 'deal creep' – thus eroding the value for money of the project.<sup>51</sup>

In a UK survey it was found that in one third of projects 'major changes' were made during the preferred bidder

stage. A survey of the capital costs of 15 English PFI hospitals at the Outline Business Case stage<sup>52</sup> (the stage before the tender procedure at which the PPP option is compared with the public one) and at the contract stage shows an average increase in cost of 114.6 percent.<sup>53</sup> This would appear to contradict Article 29.6 of the EU Directive on procurement, which states that:

*“These tenders may be clarified, specified and fine-tuned at the request of the contracting authority. However, such clarification, specification, fine-tuning or additional information may not involve changes to the basic features of the tender or the call for tender, variations in which are likely to distort competition or have a discriminatory effect.”*<sup>54</sup>

Confounding this issue is the difficulty for inexperienced public authorities to ensure they obtain value for money from deals. This is a particular problem in CEE countries as they often have trouble carrying out a fair competitive tender procedure in a straightforward public procurement, not to mention much more complicated PPPs. Public authorities may either try to save money on expensive consultants at the risk of ending up with an unfavourable deal, or they may try to ensure a good deal by splashing out on experts from large international law and accounting firms. However the same firms may also be working for the private sector player in the same or other projects, and there is no guarantee that they have the public interest at heart.

While some kind of preferred bidder stage needs to be retained in order to keep the costs and length of the bidding procedure down to a manageable level, much more concrete steps need to be taken to reduce the risk of ‘deal creep’.

The public sector needs to have a clear idea of how much change in the project is too much, and needs to have clear triggers and a clear strategy for walking away from the procedure if the private partner becomes too demanding. The public partner can also request written confirmation that the prices offered will not change for a specified time period, providing the specification remains unchanged.<sup>55</sup>

## Efficiency through meeting deadlines?

Part of the potential efficiency of infrastructure projects consists of completing the construction on time and on budget.

It is commonly claimed that 88 percent of PFI schemes have been delivered on time,<sup>56</sup> whereas 70 percent of non-PFI projects were delivered late and 73 percent over budget.<sup>57</sup> However these statistics have been exposed as fictitious.

They are supposedly derived from five reports, yet only one of them, by Mott MacDonald, contains comparative data. This report fails to show anything because it compares only 11 of out the 451 PPP projects whose construction was completed by that time. The public sector samples are also irregular and from differing time periods, so the study did not compare like for like. The UK Treasury has refused to release its own report, and two reports by the National Audit Office did not set out to compare PPP with conventional procurement, and were based on information from PFI project managers themselves.

The final study, by the Agile Construction Initiative, supposedly the source of the 70 and 73 percent figures, does not contain any data to back these claims.<sup>58</sup> The UK Treasury’s responses failed to produce any new arguments, instead standing behind the discredited evidence.<sup>59</sup>

An EIB evaluation of its involvement in PPP projects did find that, of the conventionally procured projects assessed in its previous evaluations, 60 percent had been completed more than one year late, and that the 15 PPP projects assessed performed well in comparison.<sup>60</sup> However, it stated that the completion of projects on time, on budget and to specification “*reflected the use of fixed-price, fixed-term turnkey construction sub-contracts. These are common in PPP structures, but could also have been applied to public procurement.*”<sup>61</sup>

While timely completion is important, even if it was more comprehensively proven to be more frequent in PPPs, it cannot be the sole justification for PPPs given the the likelihood of PPPs costing more overall – after all, other kinds of financing and contracting arrangements would presumably also be able to deliver on time and on budget if the budget was bigger in the first place.

## Public services: Cutting costs or cutting corners?

So far there are few operational PPP projects in CEE for services such as hospitals, schools, and prisons, where relatively non-measurable psychological factors such as the quality of human relations and the quality and atmosphere of the building itself can make a tremendous

difference to the overall performance of the institution. However, in Hungary in particular, the number of such projects is increasing, and in Croatia a project is underway to construct several schools under a PPP scheme.

Experience from the UK shows that as the number of such projects increases, so does the scope for decline in the quality of services. Relatively little attention has been paid by PPP promoters as to whether this transfer of traditionally public-sector functions to the private sector will benefit the delivery of services.

There has, as the EIB's Armin Riess puts it, been "a sometimes uncritical, if not ideological presumption that private sector participation in the provision of public services can do no harm."<sup>62</sup>

If the design, construction and operation of a facility are bundled together in a PPP contract, the private sector partner theoretically has more incentive to make cost reductions than if three separate companies were contracted by the public sector to perform each stage. However this depends on the rates of return that the deals already have built into them. This is usually kept secret but cases from the UK suggest that margins are often already so high<sup>63</sup> that there is little additional incentive to cut costs. Another question is the degree to which cost cutting is desirable, as it may involve a decrease in the quality of service that cannot be foreseen or measured by contractual obligations.

Examining whether some sectors are more suitable for PPPs than others, Riess suggests that the bundling construction and operation of services into a PPP contract, along with private ownership, provides a cost-cutting incentive, which may be of benefit in some cases, but may in some services result in a decline in the quality of service that is impossible to prevent by means of foresight in the contract. Among the services he names as potentially harmed by bundling are information technology, education (core services), health (core), prison services (core), and railway networks.<sup>64</sup>

This is either because of rapid technological advances that cannot be foreseen by contracts (IT and core healthcare) or because performance is difficult to measure in some services (healthcare, education, prisons) and people have limited knowledge or possibilities for avoiding under-performing schools or hospitals. Rail networks are seen to be of questionable merit as PPPs due to the high need for public safety taking precedence over potential cost-cutting.<sup>65</sup> In practice there have been very few PPP projects including the core of healthcare

and education activities, but more for prison services. IT PPPs in the UK are generally agreed not to have been very successful.<sup>66</sup>

Prison PPPs have often included some core services and have been highly controversial. A UK National Audit Office report found that the performance of PFI prisons varied and was comparable to the sample of public prisons studied, however it also highlighted the difficulties of comparing public with PFI-run facilities.<sup>67</sup> Serious doubt has been cast on whether the provision of services in prisons by the private sector can be adequately measured, as the companies risk paying performance penalties whenever incidents such as assaults or the smuggling in of drugs take place in the prison, and there is therefore an incentive to under-report such events. Several PFI prisons also seem to have problems with recruiting and retaining suitable staff.<sup>68</sup>

In reality, it has not only been PPPs in core services which have caused problems, but also the use of PPPs for accommodation in the health and education sectors, which has resulted in some unwanted 'efficiencies':

*"the high cost of PFI schemes has presented NHS [National Health Service] trusts with an affordability gap. This has been closed by external subsidies, the diversion of funds from clinical budgets, sales of assets, appeals for charitable donations, and, crucially, by 30% cuts in bed capacity and 20% reductions in staff in hospitals financed through PFI. Though NHS funds have increased since 1999, there is no evidence that much has flowed through to baseline services."*<sup>69</sup>

The shortfalls caused by having to pay for the PFI hospitals also affect publicly-owned hospitals because PFI capital and service costs are to a large extent fixed, and it is therefore easier to make cuts in the non-PFI hospitals. In other words, **non-PFI public services suffer because of the affordability problems caused by PFI projects.** In South-East London, where the problem is particularly serious, the local Strategic Health Authority specifically advised that cuts should be focused, where possible, on district general hospitals without major PFI commitments.<sup>70</sup>

There have also been problems with the design and construction of PPP buildings. For example at the Princess Margaret Hospital in Swindon, UK, the recovery room is located 80 metres from the operating theatre.<sup>71</sup> The UK Commission for Architecture and the Built Environment (CABE) has also drawn attention to flaws including:

- leaking plumbing; rooms so small that doors hit beds; atrium too hot to work in (Cumberland Hospital, Carlisle)

- dated design that hinders the application of new technology (Calderdale Hospital, Halifax).<sup>72</sup>

CABE has pointed to widespread problems: *“CABE’s experience is that the vast majority of PFI buildings commissioned to date have not been designed and built to a high enough standard and public service delivery suffers as a result.”*<sup>73</sup>

For example a CABE assessment of the design quality of new secondary schools in the UK found that 9 out of 10 of the most poorly designed schools were built under PFI.<sup>74</sup> Poor quality construction is not unique to PPPs, but the use of turnkey, fixed price contracts and the fact that user or public authority payments begin only once the infrastructure is available for use may incentivise hurrying the design stage to the extent that not enough care is taken. The question is whether the benefits of providing incentives for speedy construction outweigh the risks of hurrying the design.

In theory, the quality of service can be maintained through contractual obligations and sanctions for non-performance. However contracts can never foresee all eventualities and sanctions have resulted in a low level of payment deductions.<sup>75</sup>

“...the UK experience also highlights the need to increase the means of effectively monitoring and influencing the performance of the private sector. To this end, credible sanctions, performance measurement and payment deduction provisions have to be designed and carefully implemented. Most importantly, contract termination must become a credible threat.”<sup>76</sup>

Yet it is hard to see how this can be done, as the public authority has an interest in the project company continuing to function. If the company collapses, as Metronet did in the London Underground PPP, the public authority will either have to re-nationalise the project, support the company or bear the expenses of re-opening the PPP. Thus the public authority is naturally reluctant to enforce heavy penalty payments or terminate the contract.

In CEE this problem is likely to be even more acute, as there is too little public access to information about projects to ensure that the maximum possible assurances have been provided in the contract to ensure high levels of service. In addition, experience has shown that monitoring capacity and enforcement is in general at a very low level in many CEE countries, whether for environmental, corruption or other violations. It is therefore unrealistic to expect PPP performance standards to be strictly enforced.



The contract for the National Palace of Arts in Budapest has been criticised for its failure to define penalties in case of underperformance by the project company.

This suggests that PPPs should be avoided for particularly socially or environmentally sensitive services such as health care, schools, prisons and water supply as there is a potential temptation to cut corners, and there are inadequate enforcement mechanisms to ensure that this does not happen.

## Efficiency through risk transfer?

In theory, risks in PPPs are transferred to the party most able to limit and control the risk. In practice, however, whenever the private sector takes on risk, it expects a considerable rate of return for doing so.

In PPPs the private partner is responsible for completing construction or other infrastructure investments on time and for making the infrastructure available for use. In some cases the public authority takes on the payment risk, committing to pay a fixed sum for the public use of the infrastructure (eg. for hospitals), while in some cases there is a 'demand risk', where the price paid for the infrastructure depends on the number of users – and if there is an insufficient number of users, the investment is at risk.

Poorly allocated risk has been one of the largest problems in CEE PPPs. Sometimes it has led to contracts guaranteeing profits at the cost of taxpayers (for example in the Trakia Highway and Zagreb wastewater treatment plant cases), while at other times it has led to dramatic disappointments for the concessionaire and subsequent attempts to extract income guarantees from the public sector. The renegotiation of contracts puts governments in a weak position as admitting the failure of a project negatively affects the image of the country and its ability to attract foreign investments. It may therefore lead to the public sector taking on much more risk than is really justified, with visible impacts on public accounts in the long run.<sup>77</sup> Where renegotiation has not succeeded, some projects have been taken back into the public sector.

### M1/M15 and M5 motorways, Hungary

One of the best-known examples of failed PPPs in CEE is the M1/M15 motorway which was structured as a Design-Build-Finance-Operate (DBFO) but had to be re-nationalised when the traffic turned out to be 50 percent below forecast and the toll system failed to cover the expected costs. The project's lenders – including the EBRD – refused to finance the completion of the M15 section and got ten per cent lower returns than expected. In the end, the financial risk was transferred back to a special purpose public sector company in 1999.<sup>78</sup>

The contract for the M5, running from Budapest to the Hungarian-Serbian border and partly financed by the EBRD, was signed in 1994 as a 35-year BROT (build, rehabilitate, operate, transfer) concession agreement. By December 1995, the agreement was modified because the investors did not trust the traffic forecasts, effectively leading to a state-guaranteed return on the concessionaire's investment. In 1997, a few months after the opening of the motorway, it became clear that traffic levels were lower than expected mainly because of the availability of a non-tolled parallel road. Further negotiations led to an agreement that the concessionaire no longer carries traffic risk and is certain to earn a rate of return of 12 percent. In 2004 a new contract was signed, with the State Motorway Management Company acquiring 40 percent of the shares for an estimated EUR 82 million.<sup>79</sup>

As well as showing the difficulties of assessing demand risk – a risk which does not exist if the road is not tolled – these cases show that CEE governments have often been too hasty in building motorways where there has not been a clear and realistic justification, and that PPP road projects cannot usually succeed without significant support from the state, undermining one of the main reasons for choosing PPPs.

### A2 Motorway, Poland

The A2, linking Warsaw with Poznan and the German border at Slubice, is the largest transport project in Poland with the involvement of the private sector and has a total financing need of EUR 870 million. A 150 kilometre stretch connecting Nowy Tomysl and Konin was awarded as a BROT (Build-Rehabilitate-Operate-Transfer) project in 2000 with a concession for 40 years. Construction began in 2001 and was completed by 2005, but few people are willing to pay the toll. At least 60-80 percent of trucks are estimated to bypass the tolled stretch of the highway.<sup>80</sup> At the time of writing the government and the concessionaire are negotiating compensation payments.

It is worth observing that the most problematic projects in terms of risk transfer in CEE are often toll highways: *"The exclusive reliance on tolls has proven to be a failure. The evidence supports the theoretical prediction that tolling small stretches of highway networks causes inefficient traffic relocation and seriously affects the profitability of the concessionaires' investments. In the event, renegotiations of remuneration schemes, even the restructuring of entire projects, became necessary in many cases."*<sup>81</sup>





The Nowy Tomysl - Konin stretch of the Polish A2 motorway, completed in 2005, has failed to attract the expected levels of traffic

The persistent over-estimation of traffic figures by CEE decision-makers not only leads to difficulties with the concessionaire's income or the public budget's expenditures, but also leads to attempts to increase the amount of traffic using the motorways,<sup>82</sup> in contradiction with the environmental objective of reducing road traffic and increasing the modal share of other means of transport.

The unfortunate conclusion of poor risk transfer is that taxpayers always end up footing the bill, whether through guarantees for the concessionaire's level of income or through the expense of renationalising the project. While it is regularly recognised that PPP toll motorways often suffer problems, if payments are to be based on availability instead, a way has to be found to ensure that the fees are derived from vehicle tax or fuel tax and not from those who do not own a car.

Whatever solution is found, the private investor needs to take on a significant part of the financial risk of the road's operation. However in countries such as Russia, where the tax structure would not enable vehicle or fuel taxes to be ring-fenced for availability fee payments, it is unclear how this can happen and there is a real threat of past mistakes being repeated, with low risks and guaranteed profits for investors.

## Excess profits through refinancing

Among the most scandalous aspects of PPPs has been the issue of re-financing gains. Re-financing involves the private partner paying off its original loan by taking out

a new loan after the construction of the infrastructure is completed. Since most of the risks for the project have been removed at this stage, financing is available at much lower interest rates than before the construction, and thus the price of the project decreases. However, the fee that the public sector has to pay is calculated to cover the original, higher price loan, and unless there are relevant clauses in the contract to include gains for the public sector from refinancing deals, there is a danger of excessive private profits. Most early PPP contracts did not have any specification on sharing the gains with the public sector.

Several scandalous cases have cropped up in the UK such as the Norfolk and Norwich Hospital in which the Octagon consortium gained GBP 82 million and the investors' rate of return increased from a predicted – and already high – 19 percent to 60 percent. The public sector did get GBP 34 million, but had to agree to a contract extension in return, plus it was to gain the money over the period of the contract rather than immediately.<sup>83</sup> Following this the UK government gradually implemented a policy of ensuring that the public sector gets 50 percent of any refinancing gains, however it is not clear that this has brought private sector gains down to a level which is in any kind of proportion with the risks undertaken during the project.

So far in CEE there has been little coverage of this issue, but it nevertheless needs to be dealt with. PPP contracts should always ensure that the public sector gains a minimum of 50 percent of any refinancing benefits, preferably with a ceiling for maximum gains by the private sector.

# Working for whose good? The role of the IFIs in PPPs

The presence of IFIs in PPP projects is governed by their mandate of providing loans, technical assistance and guarantees to countries for projects that promote social and economic development. IFI-financed PPP projects should hence bring public benefits and deliver goods and services for affordable prices or tariffs.

At the same time, IFI lending is ruled by the operating principles of economic and financial soundness. The multilateral banks therefore strive to ensure that PPP projects are financially robust and economically and technically viable. Finding a balanced match between financial soundness and providing good value for money and services for the public has proved to be one of the key challenges for IFI involvement in PPP schemes.

IFI financing should provide 'added value' to projects they finance. As part of this principle of additionality, the IFIs should lend only to those projects where other financing is not available on reasonable commercial terms. Apart from their typical role of debt financiers, IFIs also act as brokers attracting private financing and increasing the credibility of projects to private parties by undertaking political risks associated with the business climate in the host country. However, the IFIs have run into problems justifying the additionality of their lending in some projects.

The EIB's involvement in PPPs – mostly in western Europe so far – raises questions about the extent to which the EIB may be displacing commercial lending, as an evaluation of its PPP projects found that: *"There is only one case (out of 10 evaluated in-depth) where the project could not have proceeded without the EIB's participation, or*

*at least not without being substantially revised."*<sup>84</sup> Article 18 of the EIB's statute stipulates that it may only finance projects where other financing is not available on reasonable terms, so it is highly questionable whether the EIB should have participated in most of the projects.

Over the course of project appraisal, the IFIs should first assess the basis for a project through a cost-benefit analysis. They also look at risks and review the project documentation and contractual and financial agreements. They also examine the projects against their own environmental and social requirements. The due diligence assessment conducted by the IFIs should ideally guarantee project soundness for consumers, commercial fairness to both the contracting party and the private sponsor and good financial standing for the bank.

The choice of concrete projects depends on the particularities of the mandate and policy objectives of the individual IFIs in a specific country or a sector.

In general, the IFIs enter PPP projects with the aim of improving infrastructure and raising the quality of public services in sectors such as transport, waste and water management, education or administration. In CEE countries PPP projects have usually taken place in countries with a weak legal framework and inadequate experience. In such cases, the IFIs may provide parties engaged in a PPP project with additional support from the government donor funds ("technical cooperation or assistance") aimed at improving legislation, the managerial know-how and technical standing of the parties through the help of consultants.

In order to exercise influence over the project design, the IFIs should enter the projects at an early stage in order to ensure a thoughtful and open project development process. The IFIs need to play a role in ensuring that all project components have been included in the project, in order to avoid cost increases later. This was a particular issue for example in the Zagreb wastewater treatment plant, where works which should have been carried out as part of the original project were added later, causing significant price increases.

It is crucial that public authorities undertake an assessment of whether PPP really offers value for money compared to traditional public procurement, and if so, which kind of PPP would be most appropriate. The case studies presented in this report show that the choice of project and the decision to use a PPP has not always been based on clear or balanced evidence, and the IFIs should have a key role in using their experience to ensure that the public sector will get good value for money. The methodology and calculations need to be publicly available in order to ensure that the calculation is being carried out using realistic assumptions, and the IFIs need to ensure that this is done.

However, as we have seen above, the EIB stated in its evaluation of PPP projects that it does not normally

review the Public Sector Comparator calculation, a serious omission for a bank that should work in the public interest.

Neither does the EBRD regard itself as having a duty to ensure value for money for the public sector:

*“While host governments might seek a more pro-active stance from [the] EBRD, in particular with respect to confirming the fairness of a transaction, if [the] EBRD were to undertake such work, then we could expect to be drawn into controversy, particularly as time passes and perceptions and expectations change. By issuing such opinions, the Bank may even undermine its ability to act as honest broker in any future disputes, in case an aggrieved party takes exception to a fairness opinion and then perceives the Bank as partisan.”<sup>85</sup>*

This is unacceptable. Contracts already contain arrangements for dispute settlement, and the EBRD should concentrate on ensuring that best practice is being followed and that the public authority will get value for money and a quality project. Of course public authorities should be able to do this themselves, but experience has shown that this often does not happen, due to inexperience, and individual and political interests.



The World Bank has admitted it made a mistake in trying to insist on the employment of a foreign management operator in its Lviv water project

There have even been cases in CEE in which, far from ensuring that the public gets value for money, the IFIs have apparently pushed private sector participation as part of projects without any real justification and even sometimes without support from the relevant public authority. This practice is unacceptable and the IFIs must prioritise the ensuring of value for money for the public sector above promotion of the private sector.

#### **Lviv water project – PPP, like it or not**

In 2001 the World Bank approved a USD 24 million loan for the Lviv Vodokanal (LVK) water company to improve the regularity and quality of the city's water supply, and to institutionally strengthen the water company. The loan was used alongside a USD 6 million grant from the Swedish International Development Agency.

The World Bank tried to insist that Lviv Vodokanal employ a foreign, private management operator, which the company objected to, and later this was changed to employing a foreign management advisor, which similarly failed to impress. The World Bank's evaluation admits:

*“LVK has been strengthened as an institution by the project's institutional component. However, the strengthening is hardly the direct result of the Management and Operations Improvement Advisory Services that were not extended after about three years. The MOIA adviser only produced the recommendations in paper [sic] which LVK considered that they knew them already. It is doubtful whether such foreign technical assistance was effective in the short term, particularly considering its cost (...).”*<sup>86</sup>

The evaluation spells out the lessons learned:

*“It is important for the Bank to carefully assess the merits of its demands on the Borrower when there are clear signs of resistance. In the particular case of the Bank's insistence that the Lviv Vodokanal employ a foreign, private management operator it was obvious that the Client did not favor such a solution. The subsequent substitute of a management contract by expensive, foreign management advisory services was not well advised either given the explicit, strong reluctance of the Borrower to employ a Management Operator.”*<sup>87</sup>

#### **Tbilisi Water – an unfinished multiple sell-off saga**

After an earlier World Bank-financed privatisation of Tbilisi Water failed in 2003<sup>88</sup>, in 2007 the EBRD announced its interest in providing up to EUR 15 million financing to a water supply project for the Georgian capital, Tbilisi, which was a mainly public sector project but involved the preparation of a PPP for the Tbilisi Water Company.<sup>89</sup> A pre-feasibility study prepared by Mott MacDonald showed that recent changes in the management of the company had led to significant improvements in its financial viability,<sup>90</sup> so it is not clear why such a move was being promoted.

Enquiries by Bankwatch's Georgian member group, Green Alternative, revealed that representatives of the company knew nothing about this plan, and nor did Tbilisi City Council, which is supposed to initiate such privatisations according to Georgian law.

Shortly afterwards a series of decisions and presidential decrees were taken which sold off the company to a mysterious and completely inexperienced Swiss company known as Multiplex Solutions, which resulted in the EBRD stepping back from the project. The EBRD claims that the PPP proposal was a technical suggestion rather than an obligation,<sup>91</sup> however it is unclear why such an expensive preparation would be undertaken if there was no intention of implementing it.

The IFIs also have a key role in ensuring the integrity of the procurement process and overseeing that projects are competitively tendered in accordance with international procurement rules. This has usually been carried out more satisfactorily than ensuring value for money, however there are still cases in which the IFIs need to send clearer signals to public authorities about unsatisfactory tendering. In cases such as the Western High Speed Diameter, where only one bidder entered the final round of the tender, but no complaints were made about the process, the IFIs need to be aware that whatever the reason for a lack of competition, it is very likely to work against the public interest, as the public authority is put in an extremely weak negotiating position.

The IFIs need to be particularly alert to the 'preferred bidder stage' of the tendering process, and, like public authorities, need to set clear limits on the cost increases and specification changes that they are willing to accept, and to be ready to walk away from a project if the public is no longer getting good value for

money. The publication of draft and signed contracts would dramatically assist public scrutiny of projects in this regard, and the IFIs should re-think their criteria for allowing the withholding of documents on grounds of commercial confidentiality.

During the implementation of the contract, the majority of the responsibility lies on the public authorities to ensure that the concessionaire is fulfilling its responsibilities, that any penalties are applied, and that the standard of the public service is at a satisfactory level. However the IFIs should refrain from lending for PPP projects – especially in sensitive sectors such as water supply and healthcare, where we would not recommend PPPs at all – where the public authority’s enforcement capacity is low and this is not likely to be carried out effectively.

While public authorities should undertake their own evaluation of PPP projects, both soon after the completion of the initial investment, and later, when the service has been operating for a few years, the EBRD and EIB need to carry out their own evaluations of individual projects. The EBRD has itself recognised the need to carry out two evaluations for certain projects:

*“MEI [municipal and environmental infrastructure] projects may require two separate evaluations at different stages. Due to the nature of concession-type projects, which are associated with longer maturities, there should be evaluations at two stages. In order to generate and feed back lessons from the preparatory and early implementation stages, a lead time of about two years after Bank investment is considered appropriate. However, for gaining more insights into a maturing concession, a ‘second look’ evaluation five to seven years after the initial investment would complement the earlier one.”<sup>92</sup>*

These should be available to the public, with the project named, as the World Bank’s Implementation Completion Reports are.<sup>93</sup> Care needs to be taken to involve a wide range of stakeholders in such evaluations, as there have been examples of evaluations, such as an EBRD evaluation that appeared to deal with the Sofia water project in Bulgaria,<sup>94</sup> and the World Bank evaluation that dealt with the Yerevan water project in Armenia,<sup>95</sup> where evaluations have appeared too generous to projects which had been heavily criticised by various stakeholders.<sup>96</sup>

# PPP case studies in central and eastern Europe

## Case study: Trakia highway,<sup>97</sup> Bulgaria

### Key issues:

- *Poor risk allocation with little risk for private sector*
- *Lack of competitive tender*
- *Unduly high costs for public budget and excess profit for private sector*

In 2000, the EIB approved a loan of EUR 100 million for the construction of the Orizovo-Stara Zagora and Karnobat-Bourgas sections, totalling 75 kilometres, of the east-west Trakia Highway in Bulgaria.<sup>98</sup>

In March 2005, when more than 40 percent of the EIB loan for Trakia was not disbursed, the Bulgarian government awarded a 35-year concession to a consortium to build and operate 188 kilometres of the motorway. This consortium consists of two Bulgarian companies, Avtomagistrali s.p. (with 25 percent of shares) and Technoexportstroi s.p. (24 percent of shares), and three Portuguese companies: MFS - Moniz Da Maia, Serra And Fortunato, "Lena Engenharia E Construcoes, S.A, and Somague Concessoerirs E Servicos, S.A (together owning 51 percent of the shares).

### Handouts to the concessionaire

According to a clause in the concession contract, the EIB could give another loan of EUR 100 million for the completion of the Trakia motorway if the government wishes. **The concession was awarded with no tender process**, and the contract gave the consortium excessively generous conditions:

1) The concessionaire won the right to collect tolls from already-built road sections as well as already-built roadside facilities, although this involves no construction risk.

2) The agreement included a clause guaranteeing that the Bulgarian state would pay compensation to the company if there was not enough traffic for the company to make a profit. Thus the private sector carries no demand risk.

In the Trakia Highway case even the government's own figures led to the conclusion that it would have to pay compensation to the consortium for at least 23 years after the completion of the motorway.

Moreover, other studies, carried out for example by the Spanish consulting firm Europistas, show that compensation may have to be paid for the entire duration of the concession. According to Transparency International, 25 650 vehicles per day need to use the motorway, each paying 2.5 euro cents per kilometre. Yet according to an official forecast from the Central Laboratory for Roads and Bridges for 2010, traffic rates are likely to vary as follows:

- 6400 vehicles/day on the Kalotina-Sofia section;
- 11 000-21 000 vehicles/day on the already constructed sections;
- 13 000 vehicles/day on the Orizovo-Stara Zagora section;
- 7500 thousand/day on the Sliven-Karnobat section.

3) According to the contract the concessionaire owes a concession payment only if its income exceeds its expenses, including the right to 12 percent profit. In addition, payment is only due from the year following the first year when income exceeds expenses.

4) The value of the contract is subject to some uncertainty, as the government cited EUR 717 million as the total investment cost but cited EUR 590 million as the construction costs. The cost of construction is EUR 2.7 million per kilometre for relatively flat terrain without tunnels and viaducts, which Transparency International states is 2-3 times the normal market price.

### **Mixed messages from the EIB**

In May 2005 the EIB press office announced that it would not extend its support for the construction of the Trakia Highway. EIB spokesman, Dusan Ondrejicka, said that according to the bank's mandate it can only finance projects that have undergone proper concession procedures in line with EU rules. Later the same month, on a visit to Sofia, the EIB's vice-president, Wolfgang Roth, said that there was unfair competition in choosing the concessionaire for Trakia, thus the bank would not participate if the contract with the present concessionaire was not changed. In July 2005, Oli Rehn, EU Enlargement Commissioner, said that the Trakia deal did not comply with EU procedures. He advised other accession countries to not follow Bulgaria's bad example.

Ongoing negotiations about the deal followed, as the EIB is seeking to increase its portfolio in Bulgaria and has seemed reluctant to pull out of the deal. In October 2005 Roth announced that the EIB would decide about the Trakia project only if the Bulgarian Supreme administrative court backed the deal.

### **Repercussions for the government**

Meanwhile, corruption allegations surrounding the Trakia deal were one of the reasons why the National Movement Simeon II (NMSII) party lost the parliamentary elections at the start of 2005. However, the new governmental coalition was formed by the socialists, ethnic party and NMSII, thus the new government could not keep pre-election promises about breaking the deal, as the coalition partners had to compromise in order to move ahead together. In view of the political situation, the Supreme administrative court repeatedly postponed its decision.

### **Renegotiations**

In May 2006 Eurostat decided that the contract allows state support for private investors. This contradicted the previous analysis by the Bulgarian Committee for the Protection of Competition. Thus the Bulgarian government had to start re-negotiations of the contract. After another year of renegotiations the new Trakia contract was sent to Eurostat for approval. In parallel, the Bulgarian government was negotiating with the EIB for extended support.

In October 2007 Eurostat approved the new Trakia contract. However, MEPs from the GERB party announced that Eurostat was not given the annex to the contract, which contained clauses for state support to the private investor. The EC requested more changes to the Trakia contract.

In January 2008 a series of corruption scandals erupted, revealing nepotism and bribery in the Bulgarian road administration. As a result Brussels blocked EU funds financing for infrastructure. The renegotiations that followed made the conditions less interesting for the private investor, who was now expected to gain much less and to provide financing for the project by May 15, 2008, according to the second annex to the contract.

### **Back to square one**

As the Portuguese investors failed to provide investments, the deal with them has been cancelled. Currently the two new options for the construction of the Trakia Highway are: the state builds it from its own budget (with possible EIB support); or the state attracts new private investors. Bulgaria's prime minister, Sergey Stanishev, has even said that financing may come from the partially paid debt from Iraq. However experts consider this option to be non-viable.

Meanwhile the costs of the project are expected to have risen so much as to make it unattractive for any private investor to engage in conditions worse than the ones offered initially to the Portuguese companies – i.e. EUR 2.7 million/km.

This case shows clearly that private investors were only keen as long as the deal was profitable for them, i.e. unfair to the state partner and, therefore, taxpayers. Ultimately the attempted PPP only delayed the implementation of the project, and has involved spiralling costs that are causing an increased burden on the state budget.

# Case study: Zagreb Wastewater Treatment Plant (CUPOVZ), Croatia

## Key issues:

- *Poor risk allocation leading to high fees for residents and businesses*
- *Lack of transparency*
- *Oversized project*
- *Controversial charging system*
- *Long contract locking city into unfavourable arrangement*

The Zagreb Wastewater Treatment Plant, which opened in phases between 2004 and 2007, was intended to improve water quality in the River Sava. No one disputed that some wastewater treatment was needed in the city, but the project which was developed has been highly problematic and has cost Zagreb's residents dearly.

The plant is run by Zagrebačke Otpadne Vode (ZOV), which built and will operate the treatment plant for 28 years, before transferring its operation to another party, under a BOT (Build-Operate-Transfer) arrangement. ZOV is 97 percent owned by a consortium consisting of RWE Aqua GmbH, a subsidiary of German utility RWE AG, and WTE Wassertechnik, a subsidiary of the Austrian utility EVN AG. The remaining three percent is owned by Vodoprivreda Zagreb, a municipal company of the City of Zagreb,<sup>99</sup> which is being partially privatised.

## Price lottery

In 2001 the EBRD approved a EUR 55 million loan for the project, with a further EUR 115 loan from German bank Kreditanstalt für Wiederaufbau (KfW).<sup>100</sup> However the total cost of the project has risen several times and is still shrouded in mystery. Some of the quoted prices include:

- EUR 176 million (Decision by City Assembly, 2001)<sup>101</sup> (DM 352 000 200)
- EUR 292.7 million (EBRD, end 2003).<sup>102</sup>
- EUR 220 million (Spring 2007),<sup>103</sup>
- EUR 253 million (City Council, December 2007)<sup>104</sup>
- EUR 326.7 million (EBRD, end 2007<sup>105</sup> – increase due to capacity increase and main collector upgrade)<sup>106</sup>
- EUR 265 million (City Council, May 2008)<sup>107</sup>

There is a huge variation between the costs published by the EBRD and those quoted by the City Council, raising suspicions that the City Council is still not revealing the full costs. The contract has never been released.

The justifications given for the price rises include a package of seven measures, mainly involving an increase in capacity, costing EUR 19.2 million,<sup>108</sup> fourteen other extensions to the project worth EUR 15.2 million, and the need to cover the main drainage channel leading to the plant, costing EUR 16.3 million.<sup>109</sup>

The covering for the malodorous channel, which runs through a low-income suburb of Zagreb, was mentioned in the EBRD's 2001 press release,<sup>110</sup> so it is unclear why the City Council did not approve expenses for it until several years later. Totalling around EUR 50.7 million, **these justifications fail to account for most of the price discrepancies.**

An additional cost arises from the fact that the project does not include final treatment or disposal for the sewage sludge resulting from the treatment process. Although anaerobic digesters are part of the project, these have been built so as not to be sufficient to completely process all of the sludge. **This seems to have been done on purpose to try to justify the construction of a waste incinerator proposed by Novum, a sister company of WTE Wassertechnik, on the same site as CUPOVZ.** The incinerator was not included in the Environmental Impact Assessment and its costs, estimated to range between EUR 170 and EUR 290 million, are not included in the CUPOVZ project.

## “Totally unsuitable” project

The cost increases are of even greater concern given that the Expert Commission appointed by Zagreb City Council to examine the project described it as “totally unsuitable for the current state of the sewage system and drainage conditions of Zagreb”, and indicated that it would not lead to the improvements expected.<sup>111</sup> The Commission stated that the drainage system in Zagreb first needed to be renewed in order to separate stream water from the neighbouring mountain from the city's wastewater, in order to avoid having large





Zagreb wastewater treatment plant. Photo: UZOR

fluctuations in the quantity and level of dilution of the water. The Commission also expressed concern that the cost of CUPOVZ would place a heavy financial burden on residents.<sup>112</sup>

The Commission instead proposed to:

- carry out a proper analysis of the River Sava's water quality before proposing appropriate solutions, and gradually build facilities whilst carrying out further research and training
- separate the streams from the drainage system to improve the functioning of the water treatment equipment
- install a simple mechanical system (around ten times cheaper) whilst upgrading the city sewer system<sup>113</sup>
- build a retention system to prevent storm water flowing straight into the Sava.

The Commission was ignored by the City Council and disbanded.<sup>114</sup>

The decision to include the Domovinski Bridge in the project was also controversial, as it added an estimated EUR 27.6 million to the cost of the project,<sup>115</sup> which

would be borne by citizens through their water bills, even though they already pay taxes meant for road infrastructure. The Expert Commission also stated that the bridge was unnecessary, since it was possible to have a smaller treatment plant on the south side of the river.<sup>116</sup>

### Who wins, who loses?

In 2004 the City started to pay ZOV monthly fees for the wastewater treatment plant, which have to be paid irrespective of how much money has been collected from residents and businesses. Although the idea of PPPs is to transfer some risk to the private sector, in this project the public sector bears the demand risk, while the company bears the much milder availability risk. This means that ZOV has just to ensure that the plant works whereas the City Council (ie. taxpayers' money) has to cover the shortfall when residents and businesses do not pay their bills, thus there is little risk for ZOV.

The monthly fees totalled EUR 28.1 million for 2004 alone,<sup>117</sup> although only the mechanical part of the plant was in operation, and only from April of that year onwards.

According to the state auditor, between April 2004 and the end of 2006 the City of Zagreb had already paid ZOV 75.5 percent of the basic fixed costs of the plant's construction,<sup>118</sup> raising the question of why the city could not have raised the funds to carry out the project through normal public procurement.

The City of Zagreb was due to pay ZOV a total of EUR 44.79 million in 2007, rising to EUR 48.12 million in 2010, with **a total fee in 2007-2010 of EUR 294.15 million**<sup>119</sup> – much more than the price of the original investment.

Since mid-2004, when the mechanical part of the plant began to operate, there have been several price rises for water and wastewater services, for both businesses and residents.

For non-household users, the fees are now more than 250 percent of what they were before CUPOVZ began to operate, and for households they are more than 200 percent the level of early 2004.

While price rises can be justified to some extent to cover worthwhile investments and improvements in service,

the questionable size and functionality of the project coupled with rapid price rises has resulted in protests from businesses and trade unions, particularly as the most recent price rises – estimated to immediately increase the average household water bill each month by EUR 6.2–7.6<sup>121</sup> – coincided with increases in waste collection and public transport fees in Zagreb, and rising food and oil prices worldwide. In April 2008 a committee appointed by the government to examine price increases in Croatia reached an agreement with Zagreb City Council and made a token reduction in total water price for households to HRK 11.22 per cubic metre.<sup>122</sup>

Several companies are refusing to pay their increased bills. By 27.08.2004, only HRK 20 million out of a total HRK 53 million owed by industry had been paid.<sup>123</sup> One of the most vocal critics of the price rises has been petrochemical and plastics manufacturer Dioki, which claims that it is charged for the amount of water which enters its plant, not the amount that comes out and requires treatment. In other words, it pays for the treatment of 150 million cubic metres of water per year when it claims that only 100 million cubic metres enters the drainage system. By the end of 2007 the City of Zagreb had launched two seizure orders for

#### Price rises for water and wastewater services in Zagreb, 2004–2008<sup>120</sup>

Date	Increase	Total fee for non-household users	Total fee for households
Baseline: Early 2004	-	HRK 11.07/m <sup>3</sup>	HRK 5.45/m <sup>3</sup>
Official courier: 09/17.05.2004. Entered force 01.05.2004	New fee for CUPOVZ: Households: HRK 1.734/m <sup>3</sup> Other users: HRK 7.026/m <sup>3</sup>	HRK 18.10/m <sup>3</sup>	HRK 7.19/m <sup>3</sup>
Official courier: 01/30.01.2006. Entered force: 01.02.2006.	Increase for water supply and sewerage services of 39.3 percent for household and 17.7 per cent for other users.	HRK 19.29/m <sup>3</sup>	HRK 8.39/m <sup>3</sup>
Official courier: 18/21.12.2006. Entered force: 01.01.2007	Increase in fee for CUPOVZ by 63.3 percent Households: HRK 2.83/m <sup>3</sup> Other users: HRK 11.47/m <sup>3</sup>	HRK 24.71/m <sup>3</sup>	HRK 9.73/m <sup>3</sup>
Official courier: 18/31.12.2007. Entered force: 01.01.2008.	Increase for water supply and sewerage services of 49.9 percent for household and other users.	HRK 28.69/m <sup>3</sup>	HRK 11.85/m <sup>3</sup>

more than HRK 30 million against Dioki. Dioki responded by publishing a paid advertisement in several daily newspapers in December 2007 entitled “We want a clean bill for the treatment plant,” listing its reasons for dissatisfaction. Other companies using water for cooling or manufacturing beverages are similarly dissatisfied.<sup>124</sup>

In 2006 the City Council started to cover some of the company’s debts using the city budget, ie. taxpayers’ money, after ZOV threatened that it would not be able to continue with the works it was carrying out.<sup>125</sup> The City has been unable to raise around 30 percent of the total fees from bills.<sup>126</sup>

In late 2007 opposition parties in Zagreb City Council – HDZ and HSL – tabled an amendment to reduce the amount paid to ZOV. However this was rejected, as Council members were unwilling to break Zagreb’s

contractual obligations.<sup>127</sup> Around the same time, Deputy Mayor of Zagreb, Ivo Jelusic, told the Poslovni Dnevnik business daily that the City Council would try to change the contract with ZOV.<sup>128</sup> It is difficult, however, to imagine ZOV agreeing to this.

**While the City Council could be penalised for its incompetence in the next local election, unless some serious action is taken, ZOV will be in power in Zagreb until 2028.**

# Case study: Electronic road toll system, Czech Republic

## *Key issues:*

- *Poor strategic planning*
- *Dubious tendering procedures*
- *Deal creep*

Following the Czech Republic's accession to the European Union and the introduction of electronic highway toll systems in the neighbouring countries – Austria and Germany – the volume of truck traffic passing through the country has increased, resulting in an acceleration of the selection process to supply and operate the electronic road toll system. The Czech government was looking for a supplier – in a relatively short time span – able to: provide the technology and implement the system; finance initial construction costs and accept payment in annual instalments; supply certain operation-related services; and take over some of the risks.

Officially, the project was not considered to be a PPP project because the relevant legislation (Concession Act) was still missing at the time. Yet in light of all the project characteristics, it is clearly a PPP project.

The following overview includes a brief summary of the tender process for selection of the consultant, supplier and auditor of the electronic toll system; subsequent changes in contract documentation; the launch of the system and subsequent changes in the overall concept; and a detailed description of a number of problems and discrepancies that have occurred during the implementation of the electronic toll system.

## **Questionable tender procedures**

### **Selection of consultant**

In 2005, the Czech government decided to introduce a toll system on selected categories of roads. In February 2005, the Czech Ministry of Transport announced a tender competition for advisory services in the selection of an electronic toll system provider. Only one contestant entered the competition and in June 2005 was awarded the contract: the consortium of Deloitte and Bovis Lend Lease.

### **Selection of supplier**

As early as July 2005, the Ministry of Transport announced a tender for the supplier of the electronic toll system. During Phase 1, the system was supposed to cover approximately 1 000 kilometres of motorways and expressways by 1 January 2007. Phase 2 required the implementation of the e-toll system by 1 January 2008 on approximately 1 100 kilometres of first class roads. Four companies entered the open bid procedure. Although the specification documents claimed to be technology-neutral, only contestants who offered microwave technology entered the competition. The evaluation committee excluded three of the bidders for not meeting the qualification criteria or submitting incomplete offers.

The only remaining bidder – the Kapsch consortium – was offering a price that exceeded the offers of two of the excluded bidders (Mytia and Autostrade) by 25 percent but met the qualification criteria and submitted a complete offer. Kapsch was awarded the project, yet the contract was not signed until March 2006 due to an investigation by the Czech Anti-Monopoly Office which was initiated by two of the excluded contestants. The price of Kapsch's services and deliveries was CZK 22.1 billion (EUR 883.8 million) and the period of contract execution and operation was 10 years.

The Anti-Monopoly Office did not find any misconduct in the procedures of the evaluation committee that could have had an influence on the selection of the winner. The defeated competitors turned to the Czech courts of justice as well as the European Commission, but both institutions more or less confirmed the decision of the Anti-Monopoly Office.

### **Selection of auditor**

At the end of 2006, a tender competition for an independent auditor of the enforcement system was announced. The collection efficiency rate was determined at 95 percent. In case of lower efficiency, Kapsch is to remunerate the government for the loss. If the efficiency is higher, the distribution of profit between Kapsch and the government is 50:50. However, the tender competition was cancelled, due to the technical impossibilities of its requirements. There was no supervision of system efficiency during the first month of its operation.



Kapsch's toll collection system. Photo: Mirek Patrik, Děti Země

Starting from February 2007, the government temporarily appointed – without a tender competition – the company LogicaCMG to supervise the system. The Anti-Monopoly Office investigated the situation but did not find any misconduct. A new open bid procedure was announced in June 2007 and the contract was awarded to the winning bidder LogicaCMG for five years.

### Changes in contract documentation

Following the contract signature with Kapsch, Appendix No.1 to the contract appeared, signed in June 2006, which considerably changed the original agreement, requirements and the winning bid proposal. The Appendix was a reaction to delays in the contract signing caused by the appeal by defeated competitors. The Anti-Monopoly Office investigated the Appendix and it was likely that it would have been found illegal. However, in September 2006 there was a change in government and new management appeared at the Ministry of Transport. Before the Anti-Monopoly Office could decide on the invalidity of Appendix No.1, Appendix No.2 was signed in December 2006, which eliminated the most problematic points. These concerned namely

time limits, the penalty for not meeting the toll collection criteria, and the cost of temporary technical solutions enabling the launch of the system on 1 January 2007.

### Launch of the system

The electronic toll system was launched on approximately 1 000 kilometres of Czech motorways in January 2007. During 2007, plans for the implementation of the second phase – the tolling of selected first class roads, i.e. approximately 1 100 kilometres – gradually subsided. The contracting authority (the Ministry of Transport) started to realise that it would be almost impossible and very costly to implement a microwave-based system to such an extensive road network by 1 January 2008, as the costs related to construction and operation would be higher than the revenues.

### Changes in overall concept

In December 2007, Appendix No.3 was signed as a result of problems connected with a lack of strategic thinking and realistic expectations while signing the

original agreement between the Ministry of Transport and Kapsch. In the Appendix, the ministry practically changed the entire concept of the road tolls and included it into a so-called Integrated Transport System. In future phases, the system will be adapted so that it could be used for other applications (e.g. monitoring of traffic, traffic management, information on traffic, traffic lights etc.). The Appendix binds Kapsch to implementing the interface for a future satellite-based toll collection system, and implementing the microwave system on all future motorways by the end of 2017. The Appendix will result in further contracts for Kapsch worth CZK 3.5 billion (EUR 140 million) for the implementation of a traffic management system for the D1 motorway and for putting into operation e-toll gates for oversized vehicles.

In September 2008, the winner of a tender for consultancy services for future phases of the electronic toll system was announced: Deloitte Advisory, the company that helped to design the first phase of the project.

### Problems and discrepancies

The above events reveal that there was no long-term planning that would take into account the realistic growth and development of road traffic and the relevant necessary services. This lack of strategy has been reflected in all phases of the e-toll implementation process. There were several discrepancies in the process of selection of consultant and supplier, in the negotiation of contractual terms, in the selection of the independent auditor and in the additional conclusion of several appendices.

The tender competition procedures were investigated by the Czech Anti-Monopoly Office several times; appeals were filed with the Czech Police as well as courts of justice; the tender was reviewed by the European Commission and a special commission of inquiry was established by the Czech parliament. It would seem that many wrong doings must have taken place. Yet the control institutions are of a different opinion: according to their outcomes, the discrepancies and mistakes in the process did not have any influence on the ranking of the offers or on the final selection of the winner.

The above description is by no means a comprehensive summary of the events connected with the introduction of an electronic toll system in the Czech Republic during 2005-2008. Yet a number of problematic points in the process are not in doubt:

- **Unclear political responsibility**  
As in many other PPP projects, there was a change in political representation during the process. The overall concept was changed. There is nobody to bear the actual political responsibility for mistakes and discrepancies that occurred in the process.
- **Lack of strategy**  
The tender specifications included unrealistic requirements (the original objectives were impossible to achieve with the use of the chosen microwave technology etc.). Frequent changes in terms and requirements (three additional appendices to the original contract) point to a complete lack of strategy and long-term planning on the part of the Ministry of Transport.
- **Problematic role of external consultants**  
A report by the Czech Parliament's Commission of Inquiry reveals that all decisions of the contracting authority were based on consultants' advice. Interestingly, the consultants only had a very short time for the preparation of tender documentation – from June to July 2005. At the time of the tender announcement there was no legislation requiring the checking of possible prejudice of consultants. There was no evidence of consultant prejudice, yet there is an obvious lack of a professional approach to such a complex project.
- **Questionable performance of evaluation committee**  
The report by the Czech Parliament's Commission of Inquiry further reveals that members (alternate members) of the evaluation committee did not undertake the evaluation in a way that would correspond with the importance and complexity of the project, nor with public needs. However, there was no evidence of any prejudice or tampering with the results.
- **Questionable technology-neutral tender specifications**  
A number of control institutions confirmed the technology-neutral character of the project specifications. Yet the requirement to supply non-discriminating and easy-to-install onboard units put satellite-based systems at a disadvantage – not even one company offering satellite technology entered the competition.
- **Tough conditions**  
A combination of uncertainty resulting from the lack

of relevant legislation at the time of bidding, tough conditions for not meeting the requirements in time and a short time for getting the system ready to operate could have discouraged some contestants.

- **No economic evaluation of the winning bid**

After the exclusion of economically favourable bids for not meeting the qualification criteria or submitting incomplete offers, no economic evaluation of the remaining bid was executed. This fact was also mentioned in the Anti-Monopoly Office statement.

- **Supplier's monopoly position**

The contract does not handle the possible abuse of the supplier's monopoly position. Similarly, the contract does not deal with the possibility of transferring the technology to another supplier or the possibility of contract termination, which

enormously increases transaction costs in case of a change in the supplier. The problem is only partially handled in Appendix No.3. It is not clear whether other companies will be able to compete in future project phases.

- **Questionable tender for independent control services**

The independent auditor plays a key role in the evaluation of the e-toll system's efficiency. The first tender was cancelled and the contract was awarded directly (without a tender) to a certain company for eight months. The new tender procedure resulted in the selection of the same winning company, this time for five years. There are certain doubts concerning the methodology of efficiency checks as the auditor must inform the evaluated party where the checks will take place.

# Case study: Art and PPP: The Palace of Arts, Budapest, Hungary <sup>129</sup>

## Key issues:

- **Bad planning leading to time overruns**
- **Poor value for money**
- **Lack of sanctions for under-performance**
- **Unclear payment structure**

The Palace of Arts, situated on the banks of the Danube in Budapest, was built via a public- private partnership carried out by the Ministry of Education and Culture (NKÖM) starting in 2000. The building's construction was part of a property development programme initiated by the private investor, TriGránit. – Besides the Palace of Arts, TriGránit is involved in several other significant property investments in the same area of the city.

At the time, Budapest had no concert halls of international standards, and primarily due to a lack of state resources it was chosen to implement this project as a PPP.

Although the first contract between the state and the private investor was described as a PPP contract, it was – more accurately – a financial leasing. According to the plans, the investment was to be carried out through a project partnership, established mainly with funds from the private partner but also from NKÖM. The state would have paid back the development costs – amounting to a maximum of 31.3 billion HUF (EUR 125 million) – through the 10-year rent of the building and by selling its business share of the project partnership. The operation and professional running of the building were defined outside the contract as the state's responsibility, without ensuring any kind of financial cover.

Neither prior to nor after the signing of the contract was any impact study (including economic calculations) carried out. No cost analysis was carried out either. As a result, the details of the investment have been continually changing.

During the project's implementation the state party initiated the modification of the PPP contract. Based on the original contract there would have been no chance at all of obtaining the approval of the European Union to move the investment off the public balance sheet, as neither the demand risk nor the availability risk were transferred to the private investor.

In the modified contract the state undertook to enter a 30-year long contract instead of the 10-year long one. This involved purchasing the services and returning the development costs, covering the debt service and ensuring returns for the investor. The nominal value of the amount finally paid by the state is 206.9 billion HUF (EUR 827 million), instead of the original 43.9 billion HUF (EUR 175 million); and its net present value is 53.9 billion HUF (EUR 215 million) instead of the original 36.9 billion HUF (EUR 14.8 million).<sup>130</sup>

Even with the considerable extra expenditure, the objective was not obtained within the modified budget: Eurostat qualified the development as a state investment, and thereby an increase in the budget deficit could not be avoided.

It was not only the financial arrangements which changed: due to the lack of adequate planning, the technical specifications of the building also had to be modified. An extension of the floor space of the building became necessary, and its technical content had to be reduced. The various changes resulted in a time overrun of almost two and a half years.

For example, the State Audit Office of Hungary had several years earlier suggested installing heat recovery equipment, however this was cancelled due to the reduced technical content. According to the Audit Office, such installation would have enabled efficient and more economic energy management, while at the same time reducing the environmental impact of the building. The minister supervising the implementation questioned only this point of the report, saying that such an installation would cause significant extra costs. In its reply the State Audit Office of Hungary indicated that this extra cost reflects only the private opinion of the minister, which is not supported by any kind of calculation.

Apart from the direct financial profit related to the investment, further profit is gained by the private partner from the increased value of its properties located next to the Palace of Arts, where significant office building development is being carried out. The value of the offices has increased due to their location next to an institution with high prestige.



According to a report on the project by the State Audit Office of Hungary:

“Altogether the partnership of public and private spheres resulted in a multifunctional cultural project that is unique by European standards. However, the inadequate preparations and the resulting changes both in the function and the financing negatively influenced the efficiency and effectiveness of the implementation. The maintenance and operation of the project represents a budgetary expenditure worth of HUF 335.2 billion [EUR 1.3 billion] – without VAT – at a nominal value, for a period of 30 years.”

Based on the final contract, the running of the Palace of Arts has also been taken over by the private investor for 30 years. However there are also problems with this. Again, according to the State

Audit Office of Hungary: “Fees for the availability of service have not been detailed in the operation contract, and without the detailed specific costs and the specification of the planned quantity the grounds of such fees cannot be verified.”

Namely, we have no idea at all about what the private contractor spends the state funded money on. **Moreover, there are no sanctions specified in the contract regarding improper fulfilment of the project.**

# Case study: Western High Speed Diameter, St Petersburg, Russia

## *Key issues:*

- **Affordability**
- **Potential over-estimate of traffic levels**
- **Lack of competition**

The Western High Speed Diameter (WHSD) is a major toll motorway planned to cut through Saint Petersburg from south to north. The road is intended to lead trucks out of the city port, to provide a transit route for vehicles travelling to Moscow and Scandinavia and to alleviate the heavy inner traffic of the city. The construction, started in 2005, is supposed to be finished by 2011.

The motorway has already attracted a number of international banks – the EBRD, the EIB, the International Financial Corporation (IFC) and the Nordic Investment Bank (NIB) have each expressed an interest in providing loans for the road's construction.

Being one of the the first examples of a PPP as well as the first toll road in Russia, the WHSD motorway has been pushed by the Russian authorities as a strategic priority not only for the city but also for the whole country. It is promised that concessions will help to improve the parlous state of Russian infrastructure with lower financial contributions from the budget and bring high revenues for investors as well.

The WHSD is a test case for the Russian authorities' ability to balance public and private interests and develop complex PPP deals. However, for a supposedly flagship PPP that should pave the way for future projects in Russia, the WHSD has a lot of legal and financial question marks surrounding it.

## **Risks for the city budget**

Of the numerous potential ways to solve Saint Petersburg's transport problems, the WHSD seems to be the most ambitious and complicated option. The 46 kilometre road will have to cross the Gulf of Finland, with the required bridge height reaching 55 metres, and spanning an overall length of 26 kilometres. The road has already turned into a mega project, not only because of its complexity but also because of its price.

One would assume that a complex and expensive project such as the WHSD is a cornerstone of the Russian national

strategy on PPPs and thus a thorough assessment of its viability had been undertaken before it was presented for the bidding procedure. However, when inquiring about the results of cost and benefit analysis that would demonstrate that the predicted returns make the project fiscally affordable, Russian environmental groups learned that no such analysis has been undertaken.

It is widely recognised among PPP experts that using a PPP arrangement cannot transform an uneconomic project into an economically viable one, yet that seems to be precisely what the Saint Petersburg authorities are trying to do with the WHSD. Since 2006, the estimated WHSD construction costs have sky-rocketed from USD 2 billion to more than USD 9 billion. The costs may rise even higher as the prices of building materials continue to grow.

Half of this construction cost – USD 4.7 billion – is supposed to come from the concessionaire. The other half will be shouldered by the state. It has been decided that USD 3.1 billion will be allocated from the state Investment Fund, with an additional USD 1.4 billion to come from the Saint Petersburg budget.

State officials have attempted to make the concessionaire feel safe and comfortable about the project's returns.

Under the proposed conditions of the concession agreement, the possible lack of revenue from the 30-year exploitation of the road would be compensated to the company from the Saint Petersburg budget. Given that the construction cost is almost equal to Saint Petersburg's annual income in 2007, such obligations may result in serious financial problems.

This threat of budget burden has been acknowledged by experts at the World Bank, which has been a consultant on the project. According to a presentation in December 2007 by William Dachs, the head of the World Bank's PPP Unit, Saint Petersburg's potential payments under PPP guarantees are likely to amount to several billion dollars as, along with the WHSD motorway, the authorities have announced the building of the Nadzemny Express railway, the Orlovsky tunnel and the reconstruction



The Yuntolovo Nature Reserve provides a green lung for St Petersburg residents but is threatened by the Western High Speed Diameter project. Photo: Save Yuntolovo Public Environmental Movement

of the Pulkovo airport. Dachs also pointed out that budgeting for uncertain payments under guarantees is already a pressing problem for Saint Petersburg.

In June 2008 the Saint Petersburg government announced its intention to provide funding of USD 50 billion in development and modernisation of the city's infrastructure by 2020, likely to reflect Russia's energy wealth. However, the government's forecasts could prove to be wrong in the light of foreign predictions of deceleration of Russian economic growth in the decade from 2010 due to restraints on oil prices.<sup>131</sup>

### Traffic forecasts

According to the bidding documentation, the WHSD is expected to attract 120 000 vehicles per day by 2025, and the private operator's income is expected to be generated from direct toll payments by users. However, the traffic forecast made by the developer of the project may be too optimistic – this has already been the case with a number of toll roads in the USA and Europe. Given the inability of either the public or private sector

to control the demand risk, and the high-profile failures of the direct toll approach in several cases in central and eastern Europe (for example the M5 in Hungary), it is unclear why this approach has been chosen.

The World Bank's guidebook on toll roads and concessions states that in developing countries, where traffic levels are low or where construction costs are high, it is unlikely that the tolls will ever cover more than the operation and maintenance and perhaps part of the construction cost.

The Saint Petersburg city council has not ruled out ensuring revenues by allowing the concessionaire to use the scarce land along the road for commercial purposes. Yet most likely it would be taxpayers who would have to cover the majority of the costs in case of a shortfall.

### Concession process becomes a one-horse race

After a road show held in December 2006 in the EBRD's head office in London, it was announced that more

than 130 companies were interested in the WHSD concession. However, only four consortia pre-qualified in the tender to build and operate the road, with one bidder left at the last stage of the competition – the ZSD Nevsky Meridian consortium, led by the Russian multi-billionaire Oleg Deripaska. The reasons why the three other consortia did not qualify for the final stage remain unclear.

The fact that there was only one bidder in the final round of the tender process puts the city of Saint Petersburg in an extremely weak negotiating position, further increasing concerns about the value for money of the project. Experience has shown that competition is important for ensuring better value for money in PPPs.

Experts have listed a number of risks that could prevent companies from stepping into the project. One of the biggest problems is the lack of properly tested legal basis for PPPs in Russia. The law on concessions was passed by the Russian parliament in 2005, with amendments made in July 2008. A specific regional law on PPPs has also been approved by the Saint Petersburg regional government. Some argue the laws still contain loopholes and they are contradictory to be fully functioning documents. Due to the numerous legal issues, the bidding procedure for the WHSD took a year

and a half, and during this period the cost of the road tripled. The Lawyer magazine notes that one of the major sticking points is the uncertainty over the process for disputes. The possibility of attempting to settle a dispute in the Russian courts is giving even the most robust sponsors and lenders reason to pause.

The concessionaire will also have to deal with environmental and social issues that have not received much attention from the project developer so far. In Saint Petersburg, 40,000 people have signed a petition against the toll road, saying that it is unnecessary and would destroy the local environment. More than 90 scientists from the Russian Academy of Science have publicly supported this opinion, stating that a new thorough EIA of the project must be conducted before further construction takes place.

With a number of high-profile infrastructure projects piling up in the pipeline, the quality of preparation and implementation of the WHSD project will have a decisive role in shaping the Russian PPP agenda.

# Case study: Horgos-Pozega highway, Serbia

## Key issues:

- *Poor project design, with low economic viability*
- *Poor risk allocation with little risk for private sector*
- *Unduly high costs for public budget and excess profit for private sector*

The Xb branch of the Pan European Highway Corridor X highway runs from the Serbian-Hungarian border to the border with Montenegro, via Belgrade and Pozega in central Serbia. It is a continuation of the Hungarian M5 highway. The project comprises the upgrading of the existing dual carriageway from the Horgos border crossing to Novi Sad to a full highway status, and the construction of a full status highway from Belgrade to Pozega, some 160 kilometres south west of Belgrade.

The road was planned for construction under a BOT scheme (Build-Operate-Transfer), meaning that the concessionaire would finance, construct, and collect tolls on the road, and after 25 years would hand it over to the state. The cost of the whole project is expected to amount to EUR 1-1.5 billion. The building of the highway and the awarding of the concession to F.C.C. Construction from Spain and its Austrian subsidiary Alpine Mayreden Bau was approved in spring 2007, but Porr of Austria later took over F.C.C.'s share after F.C.C. withdrew.<sup>132</sup>

## Losses for Vojvodina province

From the outset, the construction of this road has appeared to be politically, financially and environmentally dubious. The first controversy involved the decision to grant the concessionaire the right to collect tolls on the existing Horgos-Novı Sad dual carriageway and Novi Sad-Belgrade motorway. This immediately meant that the **Vojvodina province would suffer losses amounting to a minimum of EUR 220 million over the life of the concession** (assuming a scenario in which there is no growth in traffic during the concession period).

According to Serbia's concession regulation, the Vojvodina administration should have been consulted about this project. Yet this did not happen even though the project was to be backed by income from the existing motorway in the territory of Vojvodina that commenced in the 1970s and was completed in 1988. Funding was secured through a USD 114.5 million

World Bank loan and an EUR 24 million EIB loan to the Vojvodina province, and subsequently repaid fully from the Vojvodina province budget, yet the right to collect tolls was to be handed over to the concessionaire which had played no role in financing this motorway

## Low feasibility

The feasibility of the project remains in serious question as the daily traffic predictions are low, never reaching more than 10-12 000 vehicles between Belgrade and Pozega – the only entirely new section of road due to be built and the reason for the whole concession. These figures are the reason why the concessionaire requested guarantees from the Serbian government that the difference between the desired EUR 200 million of annual profits and the real earnings from the toll fees would be covered from the Serbian budget and passed on directly to the concessionaire.

As early as 2005 International Monetary Fund experts warned that Serbia is not experienced in granting concessions and that the Horgos-Pozega contract could be damaging to the state.<sup>133</sup>

Ironically, with guarantees for the concessionaire's income, it is in the best interest of the concessionaire to have as low as possible daily traffic flows due to resulting lower maintenance costs. However it is in the state's interest to encourage as much traffic as possible, thus increasing the environmental impact of road transport. Regardless of what happens, it is a real win-win scenario for the concessionaire.

Following fierce pressure from the Vojvodina parliament, experts, the Commissioner for Information of Public Importance, the media and NGOs, the text of the contract between the Serbian government and concessionaire was published on the internet in August 2007, but with the essential parts on financial costs, guarantees etc missing. The resistance of the Serbian government and company to making this information public was a clear sign that the agreement is unfavourable for Serbia.

After the declaration on February 17, 2008 of Kosovo's independence, which sparked political instability in Serbia, the consortium at first failed to provide financial guarantees for the deal, claiming its financier, Deutsche Bank, had decided not to pursue the project.

Following the spring elections in Serbia, the new government decided to break the agreement with the chosen consortium due to the consortium's requests to extend the construction by four years, extend the concession period from 25 to 30 years and guarantee the concessionaire's income in case of low traffic levels. At the time of writing the concessionaire and government are in negotiations about the conditions for the termination of the agreement.<sup>134</sup>

However the government has not given up the project as such, but has decided to try to finance it from its own resources and with loans from the IFIs. Irrespective

of the likelihood that the project is uneconomic and detrimental to the public interest, the government is still diving headlong into the project due to its poor transport policy, its lack of strategy for the development of sustainable transport and a lack of public scrutiny over the growth of public debt.

# Conclusions and recommendations

Experience so far in CEE, as well as other countries that have frequently employed PPPs, suggests that the costs of these schemes and their cumulative effect on public budgets has not adequately been taken into account. Far from being used due to offering better value for money than public procurement, they have often been used as a means to evade restrictions on public borrowing and to defer payments to the period after the construction is finished.

The use of PPPs has already caused problems for hospital budgets in the UK due to the high costs fixed nature of PPP payments compared to other budget items. It also threatens to severely restrict public authorities' ability to control their finances in countries like Hungary, where a large number of PPP projects are being implemented, and Croatia, where a smaller number of projects have been undertaken but have been identified as offering poor value for money.

Like many CEE infrastructure projects, PPPs are too rarely the result of coherent sectoral policies and too frequently the result of tendencies by decision-makers and investors to measure their professional success by the volume of construction they have overseen. Even if a project clearly does need to be undertaken, the justifications for PPPs rely on questionable assumptions that are not always based on sound evidence. This is particularly the case for the assertion that a PPP will offer better value for money than a publicly procured project.

Experience has shown that the IFIs have so far not been sufficiently engaged in ensuring that the public sector would obtain value for money in proposed PPP deals. We

consider that public institutions such as the IFIs must use their experience more pro-actively to ensure that CEE taxpayers and service users will not be excessively burdened by PPPs and to ensure greater transparency of the deals.

It cannot be assumed that the higher cost of private financing, the long and expensive PPP preparation, and the need for the private sector to earn a profit will be offset by efficiency savings during the design, construction and operation of the facility. This is because the mechanism for ensuring that the private sector minimises its costs is the competitive tender, which in practice is not always very competitive, due to the frequency of only one or two consortia making bids and the risk of 'deal creep' bringing the costs up during the 'preferred bidder' stage. Many PPPs have not been sufficiently competitive in the tender stage and during the preferred bidder stage there has been no real threat that the preferred bidder will be excluded.

The Public Sector Comparator calculation used in some countries to assess whether a PPP offers value for money compared to a publicly procured project has been shown to use a number of dubious assumptions which tend to weight the calculation in favour of PPP. In any case, if a PSC is to be used effectively the publicly procured and PPP version of the project must be similar: PPP has sometimes offered incentives to develop larger projects than are really needed, in order to be attractive for the private sector to build and operate. However, in spite of the PSC's shortcomings, such a calculation does need to be carried out, and needs to be done with

a genuine choice between different options, to avoid encouraging the rigging of calculations in favour of a certain outcome.

Where efficiency gains are made, it is not always in the public interest. This is particularly relevant to sectors such as health, prison services, schools, and environmentally sensitive sectors such as water services. Experience has shown that trying to keep costs down in PPPs has resulted in a reduction in hospital beds and staff in the UK and a low quality of building design in all sectors.

One of the most frequently made claims for PPPs is that they deliver on-time and on-budget compared to publicly procured projects. This claim is based on hidden or biased evidence. However, even if it turns out to be true it cannot alone justify the use of PPPs – a project can still be poor value for money or unaffordable even if it is built on time.

Risk transfer has shown itself to be a particularly problematic area in CEE. Poor risk allocation has on the one hand led to contracts guaranteeing profits at the cost of taxpayers, and on the other hand it has sometimes led to disappointment for the concessionaire and subsequent attempts to extract income guarantees from the public sector. As it is not in the interest of public authorities for the PPP project to fail – both for financial and reputational reasons – the public sector is in a very weak position during any renegotiations and this may result in it taking on undue risks.

Finally, the unfair accrual of refinancing gains to private sector investors in PPPs, often amounting to tens of millions of pounds, has caused several scandals in the UK and needs to be seriously addressed in those CEE countries that are considering undertaking PPPs.

## Recommendations

Given all the disadvantages of PPPs as defined in this report, the number and type of projects for which they may bring real advantages is likely to be limited. CEE governments, IFIs, think tanks and consultants need to take a step back and consider whether their promotion of PPPs in the region may be encouraging unaffordable spending, placing a large long-term burden on taxpayers, and crowding out alternative financing arrangements.

The following recommendations aim to ensure that PPPs take place only where they are affordable and bring real benefits.

### Affordability

Considering the real danger of undertaking PPP projects which will impose a severe burden on public budgets in years to come, ceilings should be set on the total amount of future taxpayers' money each ministry or local authority is permitted to commit for PPP projects per annum. These would need to be based on a thorough analysis of what is likely to be affordable, which should take into account all planned budget burdens as well as allowing for unforeseen events.

- The fiscal cost of past PPPs should be disclosed<sup>135</sup> before new PPPs are undertaken.
- The annual stream of future PPP payments should be published in government accounts. It must also be clear which budget the annual costs are paid from and what the cash costs to the government and the public will be.

### Effect on public services

- PPPs should not be used in certain sectors due to the difficulty of measuring performance and the threat of a decline in service due to cost cutting. These sectors include the operation of hospitals, schools, and prisons, as well as public water supply and resources and railway networks.

### Value for money

- When a decision is due to be taken on whether to undertake a PPP, this must be done on a level playing field, with other options open. Governments, IFIs and consultancy companies must not imply or dictate that PPP is the only possibility for a certain project. Where public funding for the project would not be an option, it is not likely that PPP would be affordable either, and authorities should prioritise the most important projects, or scale down projects to a more affordable size.
- On the institutional level, this means that procurement should be approached as an integrated topic including a range of public and private possibilities, i.e. public authorities need to set up not *centres of PPP expertise but centres of procurement expertise* in order to avoid a myopic focus on promoting PPPs where they may not be the best option.
- An affordability assessment for each project needs to be carried out and to be publicly available. This must include a full assessment of the risks for users, taxpayers, workers and the government, including if the project fails.
- A Public Sector Comparator (PSC) calculation must be carried out and the results must be made



publicly available.<sup>136</sup> The methodology for the calculation must be publicly available and explained, and must avoid overly flexible categories (such as 'risk transfer' in the UK PSC calculation) that can be easily adjusted to weight the calculation in favour of PPPs.

### Transparency and accountability

- Draft PPP contracts must be published in order to allow suggestions for changes to limit fiscal risks before the contract is signed.
- In order to limit opportunities for corruption and inflation of projects, all tender documents, bids and contracts, including financial details, must be published. So far these have usually been regarded as commercially confidential, but if the public is to get good value for money then this practice must end.

### Tender procedures

- Tender procedures must not only be carried out according to EU procurement rules but if there is only one bidder the procedure should be stopped, as there is an extremely low chance of obtaining value for money. If there is no evidence that a new tender would bring different results, the project should be redesigned.
- Ceilings need to be set for the maximum cost changes allowed during the preferred bidder stage, whether the changes are a result of new specifications or not. No substantial changes should be made to the contract, and 'substantial' needs to be clearly defined either on the EU or national level. The public sector also needs to have a clear strategy and clear triggers for walking away from the negotiations if the private sector becomes too demanding in other areas such as risk transfer or the penalty system. If major changes are made the PSC calculation should be done again and the tender procedure re-opened.

### Contracts

- Fines for poor performance in some areas must automatically exclude the payment of bonuses for good performance in other areas.
- PPP contracts should always ensure that the public sector gains a minimum of 50 percent of any refinancing benefits, preferably with a ceiling for maximum gains by the private sector.
- The contract must include a clause allowing contract termination in the public interest in case of unforeseen circumstances.
- For road PPPs, payment must not be based on the expected level of traffic as this may lead to efforts to

increase its volume, contrary to EU climate targets and sustainable development policy. The private sector partner must bear a significant share of the financial risk of operating the road.

- Contracts must require compliance with environmental standards and labour standards, including union recognition.

### Enforcement of contracts

- Public authorities proposing a PPP must show how they will ensure that they have adequate capacity and funds to enforce compliance with performance standards.
- If termination is to be taken seriously, the public partner needs to be aware of when it would be entitled to terminate the contract and must be prepared to use such powers. As part of its contract management procedures, the public sector should draw up and maintain contingency plans for contractor default, even when this is perceived to be unlikely.<sup>137</sup>
- Public authorities must carry out evaluations for all PPP projects, and these must be publicly available. This should happen twice: once when the initial investment has been completed and the service has begun to operate, and secondly, 4-6 years after operation has begun, in order to ensure that any problems can be minimised.

### The role of the IFIs

- The IFIs need to be more pro-active in ensuring that an affordability assessment and PSC calculation is carried out and that they rely on reasonable assumptions. As public institutions they should actively **ensure that the public sector obtains value for money**.
- The IFIs need to **ensure that the long-term cumulative impacts of PPPs and other public budget commitments are quantified** and analysed for their constraints on future public spending.
- The IFIs need to **ensure that public authorities release project documents** such as the PSC calculation and methodology, the draft and signed versions of the contract, and information about affordability. This may entail a review of the criteria for withholding information on the grounds of 'commercial confidentiality'.
- The IFIs must **ensure that the public authority adequately shows how it will monitor and enforce performance standards**. Where a public authority has low capacity to undertake such work effectively, the IFIs should not finance PPP projects.

- When an infrastructure project is being planned, the **IFIs should consider lending to the public authority** rather than the private partner in order to reduce the cost of financing, and so that the decision on whether to involve the private sector will not be made on the basis of off-balance-sheet accounting
- The IFIs should lend only to those projects **where other financing is not available** on reasonable commercial terms.
- The IFIs need to play a role in ensuring that **all project components have been included** in the project, in order to avoid cost increases later.
- During the preferred bidder stage, the IFIs need to **set clear limits on the cost increases** and specification changes that they are willing to accept, and to be ready to walk away from a project if the public is no longer getting good value for money.
- The IFIs need to **carry out a publicly available evaluation** – with the project named – for all PPP projects, and should consider doing two in order to allow the minimisation of problems that arise during the project. These could be timed as suggested above for the public authority's evaluations. Care should be taken to consult a range of stakeholders in order to ensure well-balanced analyses, and to include information which may not be particularly flattering.
- **Lending should be considered for Public-Public Partnership projects** for sectors such as water where management improvements are needed in municipal companies. These may involve well-run municipal companies being twinned with those in need of capacity building.
- The IFIs should **shift lending towards sustainable modes** of transport, energy and waste management.

# Annex 1: EBRD–financed PPP projects <sup>138</sup>

**Table I. EBRD financed PPP projects in the transportation sector 1993–2007**

Country	Project name	Year signed	PPP model	Sponsors	EBRD finance (EUR million)	Project value (EUR million)
Hungary	M1 – M15 Motorway	1993	BOT	Transroute International (France) CdD	66	350
Hungary	M5 Motorway	1995	BOT	Bouygues Travaux Publics (France) Bau Holding (Austria) Intertoll (South Africa)	61	311
Moldova	Port of Giurgiulesti Oil Terminal	1996			18	37
Latvia	Ventspils Port Container Terminal	1999		Noord Natie (Belgium) Ventplac (Latvia)	5	19
Georgia	Poti Port Refined Oil Products Terminal	2002		Tower Holdings (Luxembourg)	12	35
Hungary	M5 Motorway refinancing	2004	BOT	Bouygues Travaux Publics (France) Bau Holding (Austria) Intertoll (South Africa)	68	221
Hungary	M5 Phase II financing	2004	BOT	Bouygues Travaux Publics (France) Bau Holding (Austria) Intertoll (South Africa)	100	750
Hungary	M6 Motorway	2005	DBFO	Bilfinger Berger (Germany) Porr Infrastruktur (Austria) Swietelsky International (Austria)	32	411
Hungary	M6 motorway refinancing	2006	DBFO	Bilfinger Berger (Germany) Porr Infrastruktur (Austria) Swietelsky International (Austria)	32 (participation in Senior Floating Rate Notes)	431
Czech Republic	Redevelopment of 3 mainline stations (equity)	2004		Grandi Stazioni (Italy)	4	31
Albania	Tirana “Mother Teresa” Airport	2005	BOOT	Hochtief AirPort (Germany) Deutsche Investitions und Entwicklungsgesellschaft (Germany) Albanian-American Enterprise Fund (USA)	21	43
Georgia	Tbilisi International Airport	2006	BOT	Tepe (Turkey) Akfen (Turkey) Sera (Turkey) Urban (Turkey)	20.4	57.8
Armenia	Armenia International Airport - Passenger Terminal	2006		American International Airports (USA)	15	47.5

**Table II. EBRD financed PPP projects in the municipal and environmental infrastructure sector**

Country	Project name	Year	PPP mode	Sponsors	EBRD finance (EUR million)	Total project cost (EUR million)
Regional <sup>139</sup>	MPF Facility (current investments in Poland, Slovakia and Romania)	1996	Service Contracts/ Concessions	Véolia Energy (Dalkia) (France)	300	N/A
Hungary	Budapest Waste Water	1999	Concession	Véolia Environnement (France)/Berlinwasser Holding(Germany)	23	76
Slovenia	Maribor Waste Water Treatment Plant	2000	BOT	Suez Environnement (France) /RWE (Germany)	14	47
Croatia	Zagreb Waste Water Treatment Plant	2002	BOT	RWE Thames Water, WTE (Germany)	42	303
Czech Republic	Brno Waste Water Treatment Plant Upgrading	2002	Operating Contract	Suez Environnement (France)	28	83
Estonia	Tallinn Water	2002	Concession	United Utilities (Great Britain)	55	173
Romania	Apa Nova Water Treatment Plant	2002	Concession	Véolia Environnement (France)	55	197
Russia	St. Petersburg South-West Wastewater Treatment Plant	2002	BOT	Skanska (Sweden), NCC YIT Corporation (Sweden/Finland)	34	166
Regional <sup>140</sup>	AS Tallinna Vesi and Sofiyska Voda Acquisition	2003	Acquisition <sup>141</sup>	United Utilities (Great Britain)	17	47
Bulgaria	Sofiyska Voda	2004	Concession	United Utilities (Great Britain)	19	95
Regional <sup>142</sup>	Veolia Transport	2005	Service Contracts	Véolia Transport (France)	71	198
Regional <sup>143</sup>	Veolia Voda	2007	Service Contracts	Véolia Water (France)	105	275
Russian Federation	Taganrog District Heating	2007	Direct ownership	Centr Invest Bank (Russian Federation)	4	4
Lithuania Latvia Ukraine	E-Energija	2007	Service contracts / Concessions/ Lease	Mr Virginijus Strioga	12.6	29
Bulgaria	Sofia Water PPP	2008	Concession	United Utilities (Great Britain)	21	214

Russian Federation	Novogor Prikamiye	2008	Integrated Energy	Long term LeaseSystems (Russian Federation)	21	170
Russian Federation	Rovodokanal	2008	Service contracts /Long Term lease	RVK Group companies: Ventrelt, RVK-Invest, Barnaul Vodokanal, Omsk Vodokanal, Krasnodar Vodokanal, Tver Vodokanal, Orenburg Vodookanal, Tyumen Vodokanal and Kaluzhski Oblastnoi Vodokanal.	42	58

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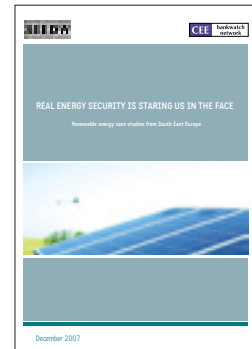


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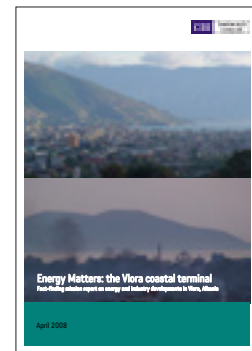
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- 140 With underlying investments in Bulgaria and Estonia.
- 141 Transaction consisted of acquisition of water and wastewater facilities, alongside United Utilities.
- 142 With investments in Poland, Slovenia, Czech Republic and Hungary as of October 2006.
- 143 With its existing market, namely Czech Republic, Slovakia, Hungary and Poland as of November 2007 and plans to expand its business to the Russian and Ukrainian markets.

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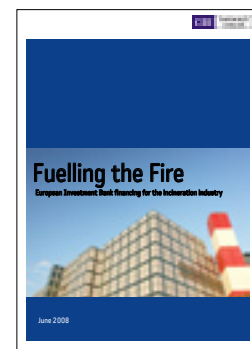
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